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Preface

Lawyers who represent clients in a wide range of transactions, from inventory and equipment financing to the sale of a business, are likely to be asked to help create or enforce security interests under the Uniform Commercial Code and related laws. This book will help those lawyers deal with the problems they are most likely to encounter.

This second edition of Secured Transactions in California Commercial Law Practice is an extensive reworking of the first edition published by CEB in 1986. It reflects substantial revisions of California's Commercial Code Division 9, adopted by the legislature effective July 1, 2001.

David Peyerwold, CEB attorney, was the project manager. Legal editing was performed by Robert Denham. Patricia Valentine handled production editing and copy editing. Legal research was provided by Kim Harris, Kamala Lyon, Alan Flatt, Shawn Ridgell, and Timothy Shannon. The index was written by Robert W. Burke and Jenny Jones. The cover was designed by Grier Thornburg. Composition was performed by CEB's Electronic Publishing staff.

December 2009 Update

CEB wishes to thank the author of this update: Ellen A. Friedman of Friedman Dumas & Springwater LLP, San Francisco.

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HILL BLACKETT, III ("BUZZ") received his B.A. in 1973 from Dartmouth College and his J.D. in 1977 from the University of California, Hastings College of the Law, San Francisco. He is of counsel at Friedman Dumas & Springwater LLP in San Francisco. His practice focuses on bankruptcy, workouts, reorganizations, and debtor-creditor relations. Mr. Blackett is a past co-chair of the UCC Committee of the Business Law Section of the State Bar of California (1997–1998) and has been a frequent author and speaker on commercial and bankruptcy law topics. He is the current President of the Board of Directors of GRID Alternatives, a California non-profit that installs solar electrical systems in low-income housing, and a member of the Board of Directors of the Ann Martin Center, a California non-profit that provides psychological and educational therapy and testing services. Mr. Blackett is co-author of chapter 5 (Remedies) and chapter 9 (Legal Opinions).

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Hill Blackett, III ("Buzz"), of counsel at Friedman Dumas & Springwater LLP, San Francisco, specializes in secured transactions and coauthored chapters 5 and 9. He also reviewed and provided advice on chapters 1-4 and 7.

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Randy Rogers, a partner at Winston & Strawn LLP, who specializes in bankruptcy and secured transactions, reviewed and provided advice on chapters 4, 6, and 8.

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Selected Developments

December 2009 Update

A judicial lien on registered copyrights must be perfected by recording the lien in the U.S. Copyright Office. *In re Franchise Pictures LLC* (Bankr CD Cal 2008) 389 BR 131. See §3.24.

The court in *In re Crystal Cascades Civil, LLC* (Bankr Nev 2008) 398 BR 23, held that tax lien notices that left out a nontrivial word of the debtor's name were ineffective against third parties. See §3.90.

Including a trade name on a financing statement can cause the filing to be ineffective. *In re Jim Ross Tires, Inc.* (Bankr SD Tex 2007) 379 BR 670. See §3.92.

AB 1549 (2009) (Stats 2009, ch 153, operative January 1, 2010) amended CCP §697.530 to eliminate the condition that a judgment lien could be created only if a security interest in the property could be perfected under the Commercial Code by filing a financing statement with the California Secretary of State. See §4.49.

A junior secured party that proceeds with a foreclosure sale after objection from the senior secured creditor may be liable for conversion. *JCB, Inc. v Union Planters Bank, NA* (8th Cir 2008) 539 F3d 862. See §5.71.

A debtor that transfers its property without regard to the automatic stay must observe the requirements of the Bankruptcy Code or risk having the transfer avoided pursuant to 11 USC §549. See *Burkart v Coleman (In re Tippett)* (9th Cir 2008) 542 F3d 68. See §6.8.

The Supreme Court has indicated a willingness to resolve the split in the circuits over the "actual" and "hypothetical" test for assumption of intellectual property contracts. See §6.48.

An investment bank was found to be an insider for preference purposes in *In re National Century Fin. Enters., Inc. Inv. Litig.* (SD Ohio 2009) 604 F Supp 2d 1128. See §6.83.

A recent bankruptcy court decision held that an opinion giver suffered a "disabling conflict" in continuing to represent its client when the opinion recipient later sought indemnification from the opinion giver. *In re SonicBlue, Inc.* (Bankr ND Cal, March 26, 2007, No. 03-51775) 2007 Bankr Lexis 1057. See §9.9.

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Cutoff Dates and CEB Citation

Cutoff Dates

We completed legal editing and analysis of authorities cited in this publication as of September 11, 2009, and monitored developments through October 21, 2009.

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Statutes Governing Secured Transactions

Ellen A. Friedman

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§1.1 I. INTRODUCTION

Most secured transactions in California involving personal property are governed by Division 9 of the California Commercial Code. Many liens and other security interests, however, are created under other state or federal statutes (*e.g.,* mechanics' liens, tax liens, judgment liens). Some security interests that are subject to the California Commercial Code are also subject to other laws that apply to particular aspects of the transaction (*e.g.,* documentation requirements and limits on creditors' remedies in consumer transactions, and federal recording requirements for liens on aircraft). This book deals primarily with California Commercial Code Division 9, but other statutory requirements are referred to when applicable. Chapter 1 provides a general overview of Commercial Code Division 9 and other applicable statutes. Chapter 2 examines the creation of a security agreement and provides forms. Chapter 3 reviews attachment and perfection of security interests under the Commercial Code. Chapter 4 describes priority among creditors. Chapter 5 describes remedies under Division 9. Chapter 6 examines how bankruptcy impacts the secured creditor. Chapter 7 deals with the special requirements for consumer transactions. Chapter 8 discusses agricultural financing.

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§1.2 II. UNIFORM COMMERCIAL CODE AND CALIFORNIA COMMERCIAL CODE

The California Commercial Code (Com C) is this state's version of the Uniform Commercial Code (UCC). Uniform Commercial Code section numbers are distinguished from those in the California Commercial Code by the inclusion of a hyphen (*e.g.,* UCC §9-306 versus Com C §9306). Division 9 of the California Commercial Code corresponds to Article 9 of the Uniform Commercial Code.

All states have adopted a version of Article 9. State codes, however, often contain local variations. Before relying on cases from other jurisdictions, the lawyer should compare the Commercial Code provision in question with the California version. California lawyers advising clients about transactions in another state should check the other state's version of the UCC. Because commercial law problems often are affected by non-UCC statutes peculiar to the jurisdiction, it usually is necessary to consult with local counsel. (For discussion of choice of law problems, see §§1.52-1.55.) In addition, Division 9 was substantially revised effective July 1, 2001. The rules under former Division 9 may apply in the limited circumstance of determining perfection and priority for transactions occurring before July 1, 2001. See §§3.116-3.117.

Although there are several instances in which Division 9 differs from Article 9, many of these differences are not substantive, but relate to how Division 9 interacts with other California statutes. The following provisions of California Commercial Code Division 9 are substantially different from Article 9: Com C §§9109(d), 9320, 9334(e)(2), 9604, 9626(b), and 9629.

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§1.3 III. COMMERCIAL CODE TERMINOLOGY

The Commercial Code relies heavily on statutory definitions of terms that may or may not be in accord with common usage. Some of the most important definitions with respect to secured transactions are those categorizing collateral. The category of collateral determines the applicability of numerous requirements and the legal consequences of the transaction. See §§1.4-1.12 for a discussion of categories of collateral. "Collateral" means the property subject to the security interest. Com C §9102(a)(12). Other important definitions are those describing the parties to the transaction. See §§1.13-1.14. The table in §1.15 lists alphabetically the terms that are defined for purposes of Division 9, and the sections in which the definitions appear.

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A. Categories of Collateral

§1.4 1. Accounts

"Account" means a right to payment of a monetary obligation, whether or not earned by performance, (1) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of; (2) for services rendered or to be rendered; (3) for a policy of insurance issued or to be issued; (4) for a secondary obligation incurred or to be incurred; (5) for energy provided or to be provided; (6) for the use or hire of a vessel under a charter or other contract; (7) arising out of the use of a credit card or information contained on or for use with the card; or (8) as winnings in a lottery or other game of chance operated or sponsored by a state, governmental unit of a state, or person licensed or authorized to operate the game by a state or governmental unit of a state. The term also includes healthcare receivables.

The term does not include (1) rights to payment evidenced by chattel paper or an instrument, (2) commercial tort claims, (3) deposit accounts, (4) investment property, (5) letters of credit or letter-of-credit rights, or (6) rights to payment for money or funds advanced or sold, other than rights arising out of the use of a credit or charge card or information contained on or for use with a card. Com C §9102(a)(2). The term "services" is not defined in the Commercial Code.

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§1.5 2. Chattel Paper

"Chattel paper" is a record or records that evidence both a monetary obligation and a security interest or lease in specific goods. Chattel paper may also relate to software or a license of software used in the specified goods. Com C §9102(a)(11). Chattel paper can be either "tangible chattel paper" that is evidenced by a record on a tangible medium such as a written lease, or by "electronic chattel paper" that is stored in an electronic medium. Com C §9102(a)(31), (a)(78); Official Comment 5b to UCC §9-102. The most common example is the security agreement or conditional sales contract in which the seller reserves a security interest in specific goods and the buyer undertakes to pay for them. A negotiable promissory note secured by a security agreement creating a security interest in specific goods is a chattel paper "package" governed by the rules for chattel paper rather than the rules for negotiable instruments. This is also true if the note contains a security agreement.

A lease of specific goods is chattel paper whether or not the lease itself was intended as security. Thus if a lessor leases goods and then uses the lease as collateral for his or her own debt, the lease is chattel paper for this purpose. Because chattel paper evidences a security interest in or lease of specific goods, this category does not include obligations secured by interests in real property or in types of property other than goods (*e.g.,* accounts).

A "charter or other contract for the use or hire of a vessel" is specifically excluded from the definition of chattel paper because it falls within the definition of accounts. Com C §9102(a)(2).

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§1.5A 3. Commercial Tort Claims

A "commercial tort claim" is a claim arising in tort with respect to which either (1) the claimant is an organization, or (2) the claimant is an individual and both of the following conditions are satisfied: (a) the claim arose in the course of claimant's business or profession and (b) the claim does not include damages arising out of personal injury to, or the death of, an individual. Com C §9102(a)(13). It is important to note that a commercial tort claim must relate to a specific existing tort claim. A secured creditor cannot take an interest in "all commercial tort claims of the debtor" as it can with most other categories of collateral. Official Comment 4 to UCC §9-204. See §2.15.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/1 Statutes Governing Secured Transactions/§1.6 4. Documents

§1.6 4. Documents

"Documents" are documents of title, *e.g.,* bills of lading and warehouse receipts, and some documents similar to warehouse receipts issued by nonwarehousemen. Com C §9102(a)(30). See Com C §7201(b) on warehouse receipts.

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§1.7 5. Fixtures

"Fixtures" are goods that become so related to particular real property that an interest in them arises under real property law. Com C §9102(a)(41). For discussion of fixtures, see §1.37.

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§1.8 6. General Intangibles

"General intangibles" is a residual category that includes any personal property "other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software." Com C §9102(a)(42). A "payment intangible" is a general intangible under which the account debtor's principal obligation is a monetary obligation. Com C §9102(a)(61). In *NetBank, FSB v Kipperman (In re Commercial Money Ctr., Inc.)* (BAP 9th Cir 2006) 350 BR 465, the Bankruptcy Appellate Panel held that payment streams stripped from underlying leases are payment intangibles and not chattel paper.

"Software" means a computer program and any supporting information provided in connection with a transaction relating to the computer program. Com C §9102(a)(75). The term "software" does not include computer programs included in the definition of goods discussed in §1.9. Com C §9102(a)(75).

Intellectual property is considered a general intangible. Official Comment 5d to UCC §9-102; *In re Cybernetic Servs., Inc.* (9th Cir 2001) 252 F3d 1039, 1045; *In re World Auxiliary Power* (9th Cir 2002) 303 F3d 1120.

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§1.9 7. Goods

"Goods" includes everything movable at the time the security interest attaches, including fixtures, growing crops, the unborn young of animals, standing timber to be cut and removed under a conveyance or contract for sale, and manufactured homes. The term also includes computer programs embedded in goods and any supporting information provided in connection with a transaction relating to the program if (1) the program is associated with the goods in such a manner that it customarily is considered part of the goods or (2) by becoming the owner of the goods, the person acquires a right to use the program. The term does not, however, include accounts, chattel paper, commercial tort claims, deposit accounts, documents, general intangibles, instruments, investment property, letter-of-credit rights, letters of credit, money, or oil, gas, or other minerals before extraction. Com C §9102(a)(44).

The general category of goods is divided into four subcategories:

- **Consumer goods**. Goods used or bought for use primarily for personal, family, or household purposes. Com C §9102(a)(23). Whether goods are consumer goods depends on the purpose for which the particular goods are purchased, not the ordinary use of goods of that type. See Official Comment 4 to UCC §9-102. See chap 7 for special requirements regarding consumer transactions.
- **Equipment.** Goods that do not fall within the definitions of inventory, farm products, or consumer goods. Com C §9102(a)(33).
- **Farm products.** Goods, other than standing timber, with respect to which the debtor is engaged in a farming operation, that are crops, livestock, supplies, and products. Com C §9102(a)(34).
- **Inventory.** Goods, other than farm products, that are (1) leased by a person as lessor; (2) held for sale or lease or to be furnished under a service contract; (3) furnished by a person under a contract of service; or (4) raw materials, materials used or consumed in a business, or work in process. Com C §9102(a)(48). A person's inventory is not classified as that person's equipment. Com C §9102(a)(33).

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§1.10 8. Instruments

"Instruments" are negotiable instruments or writings that evidence a right to the payment of a monetary obligation. An instrument is not itself a security agreement or lease, and is of a type that in the ordinary course of business is transferred by delivery with any necessary endorsement or assignment. Instruments do not include (1) investment property, (2) letters of credit, or (3) writings that evidence a right to payment arising out of the use of a credit or charge card or information contained on or for use with the cards. Com C §9102(a)(47).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/1 Statutes Governing Secured Transactions/§1.11 9. Investment Property

§1.11 9. Investment Property

"Investment property" is a security, security entitlement, securities account, commodity contract, or commodity account. Com C §9102(a)(49).

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§1.11A 10. Deposit Accounts

"Deposit accounts" are demand, time, savings, passbook, or similar accounts maintained with a bank. The term does not include investment property or instruments. Com C §9102(a)(29). A certificate of deposit will be treated as either a deposit account or an instrument, depending on whether the certificate of deposit is certificated or uncertificated. A certificated certificate of deposit is an instrument, and an uncertificated certificate of deposit is a deposit account. Official Comment 12 to UCC §9-102. The method of perfection for a certificate of deposit turns on whether it is an instrument (perfection by filing or control) or deposit account (perfection by control). See chap 3 for a discussion of perfection.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/1 Statutes Governing Secured Transactions/§1.12 11. Proceeds

§1.12 11. Proceeds

"Proceeds" are not a separate kind of property; they include (1) whatever is received on the sale, lease, license, exchange, collection, or other disposition of collateral; (2) whatever is collected on, or distributed on account of collateral; and (3) rights arising out of collateral. Com C §9102(a)(64).

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B. Parties to Secured Transaction

§1.13 1. Secured Party

The "secured party" is the creditor that holds the security interest. Com C §9102(a)(72). A "secured party" includes (1) a person in whose favor a security interest is created; (2) a person who holds an agricultural lien; (3) a consignor; and (4) a person to whom accounts, chattel paper, payment intangibles, or promissory notes have been sold. Com C §9102(a)(72)(A)-(D). If an agent, collateral agent, trustee, or other person represents the holder of the obligations, that agent, trustee, or person is the secured party rather than the holder of the obligation. Com C §9102(a)(72)(E). With respect to the sale of accounts, chattel paper, payment intangibles or promissory notes subject to Division 9, the secured party is the purchaser of the accounts, chattel paper, payment intangibles or promissory notes. Com C §9102(a)(72)(D).

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§1.14 2. Debtor, Obligor, and Secondary Obligor

A "debtor" is a person who has an interest or lien in the collateral other than a security interest or lien in the collateral. Com C §9102(a)(28). With respect to the sale of accounts, chattel paper, payment intangibles or promissory notes subject to Division 9, the debtor is the seller. Com C §9102(a)(28)(B). An "account debtor" is a person obligated on an account, chattel paper, or general intangible. Com C §9102(a)(3).

An "obligor" is a person who owes payment or performance on the obligation secured. Com C §9102(a)(59). A "secondary obligor" is an obligor whose obligation is secondary to that of another obligor. Com C §9102(a)(71).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/1 Statutes Governing Secured Transactions/§1.15 C. Table: Defined Terms With Commercial Code Sections

§1.15 C. Table: Defined Terms With Commercial Code Sections

The following table lists alphabetically many of the terms that are defined for purposes of Division 9, and the sections of the California Commercial Code in which the definitions appear. These definitions include those generally applicable to all divisions of the Commercial Code (see Com C §1201), those in Division 9 (see Com C §9102(a)), and those from other divisions that are incorporated by reference in Com C §9102(b).

Defined Term	*Com C §*
account	9102(a)(2)
account debtor	9102(a)(3)
action	1201(b)(1)
aggrieved party	1201(b)(2)
agreement	1201(b)(3)
attach	9203(a)
authenticate	9102(a)(7)
bank	1201(b)(4)
bearer	1201(b)(5)
bill of lading	1201(b)(6)
branch	1201(b)(7)
burden of establishing	1201(b)(8)
buyer in ordinary course of business	1201(b)(9)
certificated security	8102(a)(4)
chattel paper	9102(a)(11)
check	3104(f)
collateral	9102(a)(12)
conspicuous	1201(b)(10)
commercial tort claim	9102(a)(13)
commodity account	9102(a)(14)
commodity contract	9102(a)(15)
commodity customer	9102(a)(16)
commodity intermediary	9102(a)(17)
consignment	9102(a)(20)
consumer goods	9102(a)(23)
contract	1201(b)(12)
contract for sale	2106(1)
creditor	1201(b)(13)
debtor	9102(a)(28)
defendant	1201(b)(14)

delivery	1201(b)(15)
deposit account	9102(a)(29)
document	9102(a)(30)
document of title	1201(b)(16)
electronic chattel paper	9102(a)(31)
encumbrance	9102(a)(32)
equipment	9102(a)(33)
farm products	9102(a)(34)
fault	1201(b)(17)
fixture filing	9102(a)(40)
fixtures	9102(a)(41)
general intangibles	9102(a)(42)
"gives" notice	1202(d)
good faith	1201(b)(20)
goods	9102(a)(44)
holder	1201(b)(21)
holder in due course	3302
insolvency proceedings	1201(b)(22)
insolvent	1201(b)(23)
instrument	9102(a)(47)
inventory	9102(a)(48)
investment property	9102(a)(49)
know	1202(b)
knowledge	1202(b)
letter-of-credit right	9102(a)(51)
lien creditor	9102(a)(52)
money	1201(b)(24)
mortgage	9102(a)(55)
negotiable instrument	3104
new value	9102(a)(57)
note	3104
notice	1202(a)
obligor	9102(a)(59)
organization	1201(b)(25)
party	1201(b)(26)
payment intangible	9102(a)(61)
person	1201(b)(27)
proceeds	9102(a)(64)

promissory note	9102(a)(65)
purchase	1201(b)(29)
purchase money security interest	9103
purchaser	1201(b)(30)
pursuant to commitment	9102(a)(68)
receive notice	1202(e)
record	1201(b)(31); 9102(a)(69)
remedy	1201(b)(32)
representative	1201(b)(33)
right	1201(b)(34)
sale	2106(1)
secured party	9102(a)(72)
security agreement	9102(a)(73)
security interest	1201(b)(35)
send	9102(a)(74)
signed	1201(b)(37)
software	9102(a)(75)
supporting obligation	9102(a)(77)
surety	1201(b)(39)
tangible chattel paper	9102(a)(78)
term	1201(b)(40)
unauthorized signature	1201(b)(41)
uncertificated security	8102(a)(18)
warehouse receipt	1201(b)(42)
written; writing	1201(b)(43)

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§1.16 IV. SECURITY INTERESTS CREATED UNDER DIVISION 9

A "security interest" is an interest in personal property or fixtures that secures payment or performance of an obligation. The term also includes any interest of a consignor and a buyer of accounts, chattel paper, a payment intangible, or a promissory note in a transaction that is subject to Division 9. Com C §1201(b)(35). Division 9 of the Commercial Code applies to a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract. Com C §9109(a)(1). However, the analysis of how Division 9 applies to other transactions depends on the form of the particular transaction.

- The perfection and priority rules of Division 9 apply to transfers of accounts, chattel paper, payment intangibles and promissory notes, including both creation of security interests and sales—*i.e.,* even when ownership passes to the secured party. Com C §9109(a)(3). See §§1.17-1.20.
- Division 9 applies to leases of personal property only when they are intended as security. Otherwise, leases are governed by Division 10. See §§1.21-1.28.
- Division 9 applies to all consignments. Com C §9109(a)(4). See §1.29.
- Division 9 and Division 2 apply various rules to buyers, lessees, and licensees in the ordinary course of business. See §§1.30-1.31.

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A. Accounts, Chattel Paper, Notes, and Payment Intangibles

§1.17 1. General Rule of Coverage

Division 9 generally limits its coverage to transfers that are security interests. Division 9 coverage extends, however, to transfers of accounts, chattel paper, payment intangibles, and promissory notes whether such transfers are security interests or sales. See Com C §9109(a)(3). Limitations on coverage are discussed in §1.20.

For example, in a typical transaction a seller transfers a good to a buyer and in exchange receives the buyer's promise to pay the purchase price. The promise may be an account, a note, a payment intangible, or chattel paper. The seller, to raise cash, transfers this right to payment to a third party, normally a bank or finance company. This second transfer may be an outright sale or a transfer for security only. For purposes of Commercial Code coverage, it makes no difference; Division 9 applies in either case. Division 9 distinguishes between the two transfers for one purpose: rights on default. See §1.18.

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§1.18 a. Different Default Rights for Security Transfers and Outright Transfers

Assume that a transferor transferred chattel paper or an account to a transferee for $50 cash, and the transferee thereafter liquidates the collateral, *i.e.,* collects the account or chattel paper from the obligor. If the transferee collects $50 from the obligor, no issue concerning the nature of the transfer will arise. But if the transferee collects less than $50 from the obligor, does the transferee have a right to collect the deficiency from the transferor? Or, if the transferee collects more than $50 from the obligor, is the transferee required to pay over the surplus to the transferor?

The answer to these questions depends on the nature of the transfer. See Com C §9608(b). If it was an outright transfer, the transferee has no right to collect any deficiency from the transferor and no obligation to pay over any surplus to the transferor. If the transfer was a transfer for security, the transferee has the right to collect a deficiency, and the obligation to pay over the surplus. These rules apply unless the security agreement provides otherwise. See §1.19.

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§1.19 b. Distinguishing Security Transfers From Sales

The Commercial Code makes no attempt to indicate how to distinguish a security transfer from an outright sale. Generally, California case law provides that a sale is a transfer that carries with it the risk of loss and the opportunity to gain. See *Milana v Credit Discount Co*. (1945) 27 C2d 335, 163 P2d 869. Courts will examine whether the seller retains indicia of ownership or continues to bear significant risk regarding the accounts transferred. The degree of recourse back to the seller can be key in deciding whether or not the transaction was a sale. Courts also look at the pricing to determine whether it includes an interest component that makes it appear more like a loan than a sale, and whether the seller maintains control over the administration of the accounts. The intent of the parties is also an important factor. See *West Pico Furniture Co. v Pacific Fin. Loans* (1970) 2 C3d 594, 86 CR 793; *Milana v Credit Discount Co.* (1945) 27 C2d 335, 163 P2d 869; *Baruch Inv. Co. v Huntoon* (1967) 257 CA2d 485, 65 CR 131. The determination of whether a transaction is a true sale or financing is factually based and made on a case-by-case basis. No single factor is determinative.

Whether a transaction is a sale or a loan may be critical if the "purchaser" has also not perfected its security interest. Under Division 9, perfection may be automatic for the sale of certain types of collateral, including payment intangibles. If a payment intangible is collateral for a loan, however, perfection is not automatic; a financing statement must be filed for the secured party to be perfected. *NetBank, FSB v Kipperman (In re Commercial Money Ctr., Inc.)* (BAP 9th Cir 2006) 350 BR 465 (payment intangibles not automatically perfected when transaction is loan rather than sale). In a second appeal on a related issue, the lender tried to demonstrate perfection by possession of the lease documents, but was unable to do so. *FDIC v Kipperman (In re Commercial Money Ctr., Inc.)* (BAP 9th Cir 2008) 392 BR 814.

NOTE: Practitioners should either file a financing statement or take possession of the property being sold in connection with the sale of accounts, payment intangibles, chattel paper, or promissory note in order to ensure compliance with Division 9 and to protect the secured creditor if a transaction is deemed a loan rather than a sale. See chap 3 for a discussion of perfection, including choosing the correct method of perfection.

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§1.20 2. Limitations on Coverage of Division 9

The basic statutory rule that Division 9 applies "[t]o any sale of accounts, chattel paper, payment intangibles, or promissory notes" (Com C §9109(a)(3)) is subject to limitations. Division 9 specifically excludes several types of transfers of rights to payment, including the following:

- Sale of accounts, chattel paper, payment intangibles, or promissory notes that takes place "as part of a sale of the business out of which they arose" (Com C §9109(d)(4));
- Assignment of accounts, chattel paper, payment intangibles, or promissory notes for the purpose of collection only (Com C §9109(d)(5));
- Transfer of claim for wages, salary, or other compensation of an employee (Com C §9109(d)(3));
- Transfer of a right to payment under a contract to an assignee who is also obligated to perform under the contract (Com C §9109(d)(6)); and
- Transfer of a single account, payment intangible or promissory note to an assignee in satisfaction of a preexisting indebtedness (Com C §9109(d)(7)).

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B. Leases

§1.21 1. Leases as Security Interests Not Governed by Division 10

Division 10 applies to true leases and financing leases; leases intended as security are governed by Division 9. Com C §§10102, 10103(a)(10). Division 9 also applies to a lessee's security interest in leased goods under Com C §10508(e), when the lessee has rightfully rejected them or justifiably revoked acceptance of the goods. Com C §9110. Division 9, not Division 10, covers the transfer of a lease as a security interest. See §1.28.

Division 10 addresses (1) allocation of risk of loss; (2) warranties; (3) default, including the lessor's default; and (4) damages. These provisions of Division 10 are outside the scope of this book. See Com C §§10101-10600; see generally California UCC Sales and Leases, chap 19 (Cal CEB 2002).

Division 10 was intended to deal with true leases and finance leases, and it governs default and damages under those types of transactions. Security transactions disguised as leases are covered by Division 9.

Division 10 provides that for true leases and finance leases the total rent remaining on the lease must be discounted to present value in calculating the lessor's damages. Com C §10528.

Division 10 covers all transactions that create a lease. Com C §10102. A lease is defined in Com C §10103(a)(10) as

> a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, *or retention or creation of a security interest is not a lease*. [Emphasis added.]

Counsel attempting to structure a transaction as a personal property lease should make sure that the lease transaction does not fall within the Com C §1201(b)(35) definition of a security interest. See §§1.22-1.24. If the transaction is a security interest within the meaning of Com C §1201(36), counsel should perfect a security interest in the leased goods and make sure that the purported lease contains an acceleration clause and a clause defining the measure of the lessor's damages in the event of default.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/1 Statutes Governing Secured Transactions/§1.22 a. When Lease Is Considered a Security Interest

§1.22 a. When Lease Is Considered a Security Interest

Under Com C §1203, at least three conditions must be met for a transaction that is structured as a lease to be considered a security interest. First, the lessee must pay the lessor for the possession and use of the goods over the term of the lease. Second, the lessee does not have the right to terminate the lease. Those first two conditions are fixed and must always occur. The third condition must also occur, but may be any one or more of the following five alternatives:

- The original term of the lease is equal to or greater than the remaining economic life of the goods;
- The lessee is bound to renew the lease for the remaining economic life of the goods;
- The lessee is bound to become the owner of the goods;
- The lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration after complying with the lease agreement; or
- The lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration after complying with the lease agreement. See §1.24 on nominal additional consideration.

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§1.23 b. When Lease May Not Create Security Interest

A transaction does not create a security interest merely because it provides one or more of the following (Com C §1203(c)):

- The present value of the consideration for the right to possess and use the goods is substantially equal to or greater than the fair market value of the goods when the lease is entered into;
- The lessee assumes the risk of loss of the goods;
- The lessee agrees to pay taxes, insurance, filing, recording, registration fees, service costs, or maintenance costs;
- The lessee has an option to renew the lease or to become the owner of the goods;
- The lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the renewal term at the time the option is exercised; or
- The lessee has an option to become owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is exercised.

The court of appeal applied these rules to determine that a lease of a classic Ferrari roadster was not a security agreement governed by the Commercial Code in *Addison v Burnett* (1996) 41 CA4th 1288, 49 CR2d 132. In *Addison*, the guarantor of a lease brought an action against the lessee to recover payments made by the guarantor to the lessor after the lessee defaulted and the lessor repossessed and sold the car. The lessee defended the action by claiming that the lease was a disguised security agreement and that the lessor had not complied with the notice provisions of Division 9 before selling the car.

The lessee did meet the first two prongs of the test for a disguised security interest under Com C §1203: the lessee was obligated to pay for the use of the car through the term of the lease and did not have the power to terminate the lease. However, the lessee did not satisfy the remaining prong of the test, which requires a showing that the lessor retained no meaningful residual interest in the goods covered by the lease. There was no argument that the Ferrari retained some useful life beyond the three-year term of the lease in question; the lessee had no obligation either to re-lease the car for its remaining economic life or to buy the car from the lessor at the end of the lease term and the lessee did not have an option to buy the car at the end of the lease term—let alone an option to buy the car for nominal consideration. See §1.24 on nominal additional consideration.

The United States Bankruptcy Court for the Southern District of New York provided an in-depth analysis of the factors determining when a lease is a true lease or a disguised security agreement in *WorldCom, Inc. v General Elec. Global Asset Mgmt. (In re WorldCom)* (Bankr SD NY 2006) 339 BR 56 (applying California law). The court relied on *Addison, supra,* and described the "bright line test" set forth in Com C §1203. The court found that, for a court to determine whether an agreement is a true lease or a security agreement, a lease needs to be considered in a "contextual analysis" if the bright line test is not satisfied. *WorldCom, Inc.* 339 BR at 71.

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§1.24 c. Nominal Additional Consideration

Commercial Code §1203(d) provides guidance on the subject of what constitutes nominal additional consideration when the lessee renews the lease or purchases the property. Renewal or purchase for nominal additional consideration after completing the lease agreement are two of the variable elements that can cause an equipment lease to be construed as a security interest under Com C §1203(b). Counsel desiring to have a true lease should avoid having additional consideration that may be construed as nominal. See §1.22.

For a renewal, additional consideration is not nominal if, at the time the option to renew the lease is granted, the agreement states that the rent will be the fair market rent for the goods determined at the time the option is to be performed. For an option to purchase, additional consideration is not nominal if, at the time the option to purchase is granted, the agreement states that the price will be the fair market value of the goods determined at the time the option is to be performed. Com C §1203(d)(2).

Additional consideration is nominal if the lessee's reasonable predictable cost of performing under the lease agreement is greater than the consideration. Thus, if the lessee were obligated to pay for returning the goods to the lessor, and returning the goods to the lessor would cost the lessee more than renewing the lease or purchasing the goods, the additional consideration for the renewal or purchase would be considered nominal. Com C §1203(d)(1).

Although the amount of the additional consideration may be determined at the time the option is exercised, that additional consideration should exceed the lessee's cost of performing under the lease to avoid having the lease transaction classified as a security interest. If the lease transaction qualifies as a security interest, counsel should take steps to perfect that security interest.

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§1.25 d. Special Rule for Motor Vehicle Leases

In addition to the general rules discussed in §1.23, a lease of a motor vehicle that is not used for personal, family, or household purposes may still be a lease—as opposed to a disguised security interest—if the amount of the rental payments under the lease can be increased or decreased because of the amount realized by the lessor on sale or disposition of the motor vehicle. Com C §1203(c)(7).

Although this may be inconsistent with the general principles governing the distinction between leases and security interests, it does advance the general policy of the Commercial Code to "simplify, clarify, and modernize the law governing commercial transactions; [and] to permit the continued expansion of commercial practices through custom, usage and agreement of the parties" (Com C §1103(a)(1)-(2)), by providing simple rules to govern the popular practice of leasing motor vehicles.

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§1.26 2. Sale and Leaseback

In a typical sale-and-leaseback transaction, *A* buys property from a manufacturer or supplier and immediately sells it to *B*, who promptly leases it back to *A*. *A* retains possession of the item at all times and uses the property throughout its useful life and for the duration of the lease.

Such a lease may be subject to Division 9 as a lease intended as security. If it is not, the notice requirements of CC §3440.1(h) apply. At least 10 days before the date of the transfer, one of the parties must file a notice in the office of the county recorder in the county where the property is situated. CC §3440.1(h). There is also a publication requirement. CC §3440.1(h).

This two-step notice requirement is considerably more rigorous than any comparable procedure in the Commercial Code, as are the penalties for noncompliance. Any nonconforming transfer "is void as against the transferor's creditors (secured or unsecured) at the time of the transfer and those who become creditors while the transferor remains in possession." CC §3440(a). The protected class is not limited to lien creditors or secured creditors. CC §3430. See *Watson v Rodgers* (1879) 53 C 401.

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§1.27 3. Special Filing Requirements for Lease of Aircraft

The Federal Aviation Act of 1958 (49 USC §§40101-46507) provides for the recording of leases and security instruments in aircraft and aircraft equipment. 49 USC §44107. Division 9 does not apply.

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§1.28 4. Transfer of Lease; Transferor's Rights

Although a true lease is not initially covered by Division 9 (see §§1.21-1.22), it can become subject to Division 9 when it is transferred. Sales of or creation of security interests in chattel paper are covered by Division 9. Com C §9109(a)(3). See §1.17. The definition of chattel paper includes leases. Com C §9102(a)(11). Therefore a transferee of a lessor or lessee's interests under a true lease must, for example, conform to the perfection requirements of Com C §§9312-9313 in order to prevail over competing third parties. See chap 3 about perfection and chap 4 about competing priorities.

Technically, the security interest or sale described above is an interest in or sale of the lease itself and not the goods subject to the lease. Ordinarily, all the transferee receives is the right to the payments under the lease. As long as the lessee continues to pay the lessor, the transferee has no right to proceed against the goods, even if the lessor fails to remit those payments to the transferee. The transferee must either arrange to get payments directly or be willing to trust the lessor-transferor.

If the lessee stops paying, the transferee ordinarily stands in the shoes of the transferor and has the rights of the transferor, subject to defenses and claims that would be good against the transferor. See Com C §9404. Similarly, the transferee may have the benefit of any properly drafted and otherwise enforceable waiver-of-defenses clause.

A more worrisome problem for the transferee arises if the transferor-lessor operates a business that both sells and leases the same goods. Goods held for lease are inventory. Com C §9102(a)(48). If a wrongdoing transferor lessor violates the transfer agreement, and sells some of the goods held for lease to an unknowing customer, the customer may be a buyer in ordinary course of business within the meaning of Com C §1201(b)(9). If that is the case, the buyer probably enjoys the protection of Com C §9320, which allows buyers in ordinary course of business to take free of certain security interests. Presumably the transferee has a claim to the proceeds of the wrongful sale, but the goods themselves will be out of reach.

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§1.29 C. Consignments

If a person holds property for a third party for sale and meets the requirements outlined below, it is a consignment and is governed by Division 9. See Com C §9109(a)(4). The filing and priority provisions of Division 9 apply to "true" consignments. All of Division 9 applies to consignments for security. Official Comment 4 to UCC §9-109.

Commercial Code §9102(a)(20) defines consignment as a transaction, regardless of its form, in which a person, the consignor, delivers goods to a merchant, the consignee, for the purpose of sale. Com C §9102(a)(19). The merchant must (1) deal in goods of that kind under a name other than the name of the person making delivery, (2) not be an auctioneer, and (3) not generally be known by its creditors to be substantially engaged in selling the goods of others. Com C §9102(a)(20)(A). To meet the requirements of a consignment, the aggregate value of the goods must be $1000 or more at the time of each delivery and the goods must not be consumer goods immediately before delivery. Com C §9102(a)(20)(B)-(C). A final requirement is that the transaction does not create a security interest that secures an obligation. Com C §9102(a)(20)(D).

The key concept in a consignment is that the merchant does not obtain ownership to the goods delivered for sale; the person delivering the goods retains ownership of them. A "sale or return" under Com C §2326 is not a consignment because in a "sale or return" the merchant becomes the owner of the goods. The seller can obtain a security interest in the goods by following the requirements of Com C §9203.

Commercial Code §9319 provides that in determining the rights of creditors of, and purchasers for value of goods from, a consignee, the consignee is deemed to have rights and title to the goods identical to those the consignor had or had power to transfer (Com C §9319(a)), provided that a perfected security interest held by the consignor would have priority over the rights of a creditor not itself holding a prior perfected security interest (Com C §9319(b)). In *South Beverly Wilshire Jewelry & Loan v Superior Court* (2004) 121 CA4th 74, 16 CR3d 710, relying on CC §3543, the court held that a consignor did *not* have priority when he failed to perfect a security interest in certain gems and jewelry before delivering them to a consignee for inspection. Even though the consignor had specified that the jewelry should not be pledged, the consignee pawned it. Later, the consignee was convicted for embezzlement, but the consignee's creditors nonetheless had priority over the consignor as purchasers for value without notice and obtained good title to the jewelry. Filing a UCC-1 financing statement, however, will provide constructive notice to a lender that accepts the subject goods as collateral. *Irving Nelkin & Co. v South Beverly Hills Wilshire Jewelry & Loan* (2005) 129 CA4th 692, 28 CR3d 815 (UCC financial statement filed by plaintiff perfected security interest in consigned goods and provided basis for conversion claim). Commercial Code §9103(d) treats the consignor as if it held a purchase money security interest in the goods delivered to the consignee. See §3.32 for a discussion of purchase money security interests.

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§1.29A 1. Actions Consignor Should Take to Protect Its Interest in Consigned Goods

Because the consignor is treated as if it has a purchase money security interest, the consignor should take the same steps that a holder of a purchase money security interest takes in protecting its interest in collateral. To protect its interest in consigned goods, the consignor should file a financing statement before delivery of the goods. Com C §9324(b)(1), (c)(1). See *South Beverly Wilshire Jewelry & Loan v Superior Court* (2004) 121 CA4th 74, 16 CR3d 710, discussed in §1.29. The financing statement may use the terms "consignor" and "consignee" instead of "secured party" and "debtor." Com C §9505(a).

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§1.29B 2. Form: Suggested Language for Consignment Financing Statement

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

Notice is hereby given that _ _[*describe goods*]_ _, ("Consigned Goods") of Consignor, are being consigned to Consignee, and that Consigned Goods delivered from time to time are and shall be owned by Consignor and consigned to Consignee.

This financing statement is filed to give notice that the Consigned Goods are the sole property of Consignor, notwithstanding that such Consigned Goods may be in possession of Consignee. To the extent that any Consigned Goods are deemed owned by Consignee, Consignor is deemed to hold a purchase money security interest in such Consigned Goods.

Date: _ _ _ _ _ _

_ _[*NAME OF CONSIGNOR*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: This form consists of suggested language that may be used in a consignment financing statement.

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§1.29C 3. Notice to Creditors

To fully protect its interests, the consignor must send notification of its interests in the goods to the consignee's secured creditors before delivery of the goods. Com C §9324(b)(2).

The notification must state that the consignor has an interest in the goods and describe the goods by type or item. Com C §9324(b)(4). The notice must be received by the prior secured creditor up to five years before the consignee receives that consigned goods. Com C §9324(b)(3).

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§1.29D 4. Form: Notice to Secured Creditor

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Notice to Secured Party of Record

_ _[*date*]_ _

CERTIFIED MAIL RETURN RECEIPT REQUESTED

_ _[*name of secured party*]_ _
_ _[*address of secured party*]_ _

Re: Notice of Delivery of Consigned Goods

Ladies and Gentlemen:

This is to notify you that _ _[*name of consignor*]_ _ **("Consignor") has delivered or may from time to time in the future deliver goods to** _ _[*name of consignee*]_ _ **("Consignee"), with a place of business at** _ _[*address*]_ _ **on a consignment basis.**

The goods that are or may be consigned are more fully described as: _ _[*list type of collateral*]_ _**.**

This notice is being given to you pursuant to California Commercial Code §9324. If you have any question regarding this notice, please contact the undersigned.

Date: _ _ _ _ _ _

_ _[*NAME OF CONSIGNOR*]_ _**,**
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: The form above consists of suggested language for a consignor's notice to a secured party of record. It should be typed on consignor letterhead.

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§1.29E 5. Additional Considerations

The consignor should also require the consignee to keep the consigned goods separately from consignee's other goods, so there is no question as to which goods are consigned goods.

A consignor's interest in proceeds of consigned goods also extends to "identifiable cash proceeds." Com C §9324(b). Therefore, the consignor should also require the consignee to place the proceeds of any sale of consigned goods in a separate account so the proceeds are not commingled with proceeds of sales of other goods.

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§1.30 D. Buyers, Lessees, and Licensees in Ordinary Course of Business

A creditor with a security interest in inventory will lose to a competing buyer in the ordinary course of business. See Com C §9320(a). In *Valley Bank & Trust Co. v Holyoke Community Fed. Credit Union* (Colo Ct App 2005) 121 P3d 358, the court ruled that a credit union that financed purchases of automobiles for its members was a buyer in the ordinary course of business, and therefore prevailed over a bank with a security interest in the automobile dealer's inventory.

A similar and overlapping rule to Com C §9102(a) is contained in Com C §2403(2), which provides that "[a]ny entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in ordinary course of business." Commercial Code §2403(3) states:

> "Entrusting" includes any delivery and any acquiescence in retention of possession for the purpose of sale, obtaining offers to purchase, locating a buyer, or the like, regardless of any condition expressed between the parties to the delivery or acquiescence and regardless of whether the procurement of the entrusting or the possessor's disposition of the goods have been such as to be larcenous under the criminal law.

Thus, if goods are left for purposes of repair, the dealer in California cannot pass good title. The dealer may be able to do so in other states; UCC §2-403(3) does not include the purpose-of-sale limitation of Com C §2403(3). See Cal Comment 9 to Com C §2403. In *Mercedes-Benz Credit Corp. v Johnson* (2003) 110 CA4th 53, 1 CR3d 396, for example, the court held that a lessor did not entrust to a merchant an automobile that it leased to a dealer who then sold the automobile. Accordingly, the buyer did not acquire superior title to the lessor under Com C §10305(b).

The overlap between Com C §§9320(a) and 2403(2) is not complete. Limited protection was accorded the buyer in *Security Pac. Nat'l Bank v Goodman* (1972) 24 CA3d 131, 100 CR 763. For an interpretation of UCC §2-403 and UCC Article 9 with respect to after-acquired property, see *Stowers v Mahon (In re Samuels & Co.)* (5th Cir 1976) 526 F2d 1238 (creditor with perfected security interest in buyer's inventory and after-acquired property has priority over unpaid seller that attempts to reclaim goods sold to buyer; secured creditor has status of good faith purchaser for value and therefore takes free of seller's interest under Com C §2403).

Commercial Code §9321 protects lessees of goods and licensees of general intangibles acting in ordinary course of business the same way that Com C §9320 protects buyers in ordinary course. Basically, a lessee or licensee acting in ordinary course of business will take a leasehold or license free of a security interest created by the lessor. Com C §9321.

NOTE: Effective January 1, 2010, Com C §9321 will be repealed (unless a later enacted statute extends the sunset date) and licenses of general intangibles will no longer be covered.

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§1.31 V. SECURITY INTERESTS CREATED UNDER DIVISION 2 (SALES)

Commercial Code Division 2 (Sales) provides for the creation of security interests in certain situations, such as the seller's retention or reservation of title to goods shipped to the buyer (Com C §§2401, 2505), and the buyer's security interest in certain rejected goods (Com C §2711(3)). The seller also has rights of resale and stoppage (*e.g.,* Com C §§2703, 2705-2706) that are similar to a secured party's rights under Division 9. Financing agencies and others may also have rights such as these. See, *e.g.,* Com C §§2506, 2707. Commercial Code §9110 recognizes that Division 9 provisions governing the security agreement, filing, and default do not apply to these interests. Division 2 security interests exist by operation of law; thus no agreement is necessary. Com C §9110(1). They depend on the possession of the seller secured party; hence, no filing rules apply. Com C §9110(2). Rights on default for Division 2 security interests are governed by Division 2. Only security interests that arise solely under Division 2 are exempt from Division 9 requirements, however, and they are exempt only as long as the debtor does not have lawful possession of the goods. Com C §9110. See Official Comment 3 to UCC §9-110.

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§1.32 VI. MOBILEHOMES, MANUFACTURED HOUSING, AND COMMERCIAL COACHES

Security interests in mobilehomes, manufactured housing, and commercial coaches are subject to a special registration system maintained by the Department of Housing and Community Development, and are also subject to special requirements for sales, foreclosures, and levies under the Mobilehome Residency Law (Health & S C §§18000-18153), the Mobilehomes-Manufactured Housing Act of 1980 (CC §§798-799.9), and other provisions (CC §§3051, 3068; CCP §§700.080-700.090, 1161a, 1166a). Division 9 applies to mobilehomes, manufactured housing, and commercial coaches, but in the event of conflict the Health and Safety Code provisions control. Com C §9201(c).

Civil Code §798.40 prohibits the management of a mobilehome park from acquiring any lien or security interest in a mobilehome located in the park except by mutual agreement between the homeowner and the management or by process issued to enforce a judgment.

Installment contracts for the purchase of mobilehomes are subject to the protection of CC §2983.8, which is analogous to the antideficiency statute that applies to purchase money security interests in real property. See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 5 (4th ed Cal CEB 2009). *Bank of Sonoma County v Dorries* (1986) 185 CA3d 1291, 230 CR 459, held that the antideficiency provisions of CC §2983.8 require a creditor holding a conditional sales contract on a mobilehome to look to the security alone for recovery of the debt. The creditor cannot waive the security and sue for the balance due.

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§1.33 VII. REAL PROPERTY INTERESTS

Division 9 does not apply to the creation or transfer of an interest in or lien on real property, including a lease of the property or collection of rents (Com C §9109(d)(11)), except to the extent that provision is made for each of the following:

- Liens on real property in Com C §§9203 and 9308;
- Fixtures in Com C §9334 (see §1.37);
- Fixture filings in Com C §§9501, 9502, 9512, 9516, and 9519; and
- Security agreements covering personal *and* real property in Com C §9604.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/1 Statutes Governing Secured Transactions/§1.34 A. Personal Property Interests Distinguished

§1.34 A. Personal Property Interests Distinguished

In applying Com C §9109(d)(11), special problems exist in the intersection of real property and personal property law. See §§1.35-1.36.

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§1.35 1. Transfer of Note and Deed of Trust

One of the most difficult issues in the relationship of Division 9 to real property law arises when a lender takes a negotiable promissory note and deed of trust on real property, and then transfers that note and deed of trust as security for the lender's own indebtedness. Clearly the transfer of the note as security is covered by Division 9. Com C §9109(a)(1).

For example, if a debtor borrows money and executes a promissory note and grants the creditor a mortgage on real property, Division 9 does not apply to the creditor's interest under the real property mortgage. However, if the creditor sells the promissory note to a finance company or gives a security interest in the note to a finance company, Division 9 covers the creation of the security interest in the note and the finance company has an attached security interest in the mortgage lien. See Com C §§9203(g), Official Comment 7 to UCC §9-109; *Riebe v Budget Fin. Corp*. (1968) 264 CA2d 576, 583, 70 CR 654.

In addition, if the finance company perfects its security interest in the note, it will automatically also have a perfected security interest in the mortgage lien. Com C §§9203(g), 9308(e).

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§1.36 2. Assignment of Rents

The assignment of rents arising from real property may present a difficulty in the following situation. If a landlord assigns his or her right to receive rents from real property as security, the assignment of this interest is excluded from Division 9. Com C §9109(d)(11). If the landlord is supplying furniture as part of the lease, however, to the extent that any of the rents are allocable to the furniture, the assignment of the rents is a transfer of chattel paper covered by Division 9. Com C §9109(a)(3).

Lenders holding liens on hotels also may not be able to rely on the assignment-of-rents provisions in their real estate security documents and may have to perfect their interests in the revenues under Division 9 to the extent the revenues cover furniture or services.

In a case dealing with rents from a portfolio of 32 different commercial properties, the bankruptcy court in *In re GOCO Realty Fund I Corp.* (Bankr ND Cal 1993) 151 BR 241 held that the secured creditor still had to make some kind of a demand on the debtor to trigger its rights under the assignment-of-rents clauses in its deeds of trust. Accordingly, the court denied the secured creditor's motion to require the debtor's attorneys to return the retainers they received from the debtor before the commencement of the debtor's Chapter 11 case.

The U.S. District Court reached a similar conclusion in *U.S. v Redevelopment Agency* (ND Cal 1995) 926 F Supp 928, aff'd (9th Cir 1997) 111 F3d 139. Finding that the City of Oakland held an assignment of rents for security purposes, as opposed to an absolute assignment of rents, it held that the IRS had first claim on rents from the real estate in question because it had perfected its tax lien on the debtor's property before the City of Oakland obtained an order appointing a receiver for the property, which perfected its interest in the rents.

For further discussion of problems relating to the assignment of rents in bankruptcy, see §§6.70-6.71.

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§1.37 B. Security Interests in Fixtures

The Commercial Code governs the relative priorities of an encumbrancer of real property and the holder of a security interest in fixtures attached to that property. The Commercial Code defines fixtures as goods (other than ordinary building materials) that "become so related to particular real property that an interest in them arises under real property law." Com C §9102(a)(41). Special filing and priority rules apply to certain "readily removable" items. Com C §9334(e)(2). See §4.35.

The Commercial Code provides for a "fixture filing" in the office in which the real property records are filed (Com C §9501(a)(1)(B); see §3.97), in addition to the Commercial Code filing with the Secretary of State, as an alternative way to perfect the security interest. See chap 3 about perfection.

A security interest in fixtures has priority over a real property encumbrancer's interest (Com C §9334(e)(1)) if:

- The security interest is perfected;
- A fixture filing is made before the conflicting real property interest is recorded;
- The interest in fixtures has priority over any conflicting interest of the encumbrancer's predecessors in title; and
- The debtor has a record interest in, or possession of, the real property.

In addition, the holder of a purchase money security interest in fixtures also may obtain priority over encumbrancers of the real property (other than certain construction mortgagees) whose interests arose and were of record before the goods became fixtures. The requirements are similar to those noted above, except that the fixture filing need only be made within 20 days after the goods become fixtures. Com C §9334(d)(3). Even without a fixture filing, the security interest in fixtures may have priority (1) if the competing real property encumbrance is a lien obtained by later legal or equitable proceedings (Com C §9334(e)(3)); or (2) if the fixtures are owned by a debtor-tenant who has a right to remove them (Com C §9334(f)(2)). (For discussion of priorities in fixtures, see §§4.31-4.40.)

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VIII. MISCELLANEOUS EXCLUSIONS FROM DIVISION 9

§1.38 A. Setoff

Division 9 does not apply to any right of setoff or recoupment; however, Com C §9340 applies with respect to the effectiveness of rights of recoupment or offset against deposit accounts, and Com C §9404 applies with respect to defenses on claims of an account debtor. Com C §9109(d)(10).

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§1.39 B. Loans on Insurance Policies

A narrowly drawn exclusion from Division 9 coverage is provided for certain loans secured solely by an insurance policy, other than receivables under health insurance policies. If the loan is made by the company that issued the policy, the Commercial Code does not apply. If the loan is made by someone other than the insurance company that issued the policy, the Commercial Code applies. Com C §9109(d)(8). This California provision is narrower than the uniform provision, which excludes loans on insurance policies generally, other than receivables under health insurance policies. See Cal Comment 13 to Com C §9109.

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§1.40 C. Wage Assignments

Wage assignments are excluded from coverage by Division 9. Com C §9109(d)(3). The Federal Trade Commission has ruled that in connection with the extension of credit to consumers in or affecting commerce, the taking of an assignment of wages or other earnings by a lender or retail installment seller is an unfair act or practice under section 5 of the Federal Trade Commission Act (15 USC §45). This rule does not apply if (1) the assignment by its terms is revocable at the will of the debtor; (2) the assignment is a payroll deduction plan or preauthorized payment plan, commencing at the time of the transaction, in which the consumer authorizes a series of wage deductions as a method of making each payment; or (3) the assignment applies only to wages or other earnings already earned at the time of the assignment. See 16 CFR §444.2(a)(3). Wage assignments in California are covered by Lab C §300. See also CCP §487.020(c).

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§1.41 D. Judgments and Tort Claims

Division 9 does not apply to any transaction in "a right represented by a judgment other than a judgment taken on a right to payment that was collateral." Com C §9109(d)(9). Judgments are not commercial collateral and therefore not properly governed by a commercial statute. In a similar vein, Division 9 does not apply to "an assignment of a claim arising in tort, other than a commercial tort claim, but Sections 9315 and 9322 apply with respect to proceeds and priorities in proceeds." Com C §9109(d)(12). Commercial tort claims constitute a separate category of collateral. See Com C §9102(a)(13). It should be noted that once a claim arising in tort has been settled and reduced to a contractual obligation, the right to payment becomes intangible and ceases to be a claim arising in tort. See Official Comment 15 to UCC §9-109. See also *Fifteenth RMA Partners, L.P. v Pacific/West Communications Group, Inc. (In re Pacific/West Communications Group, Inc.*) (9th Cir 2002) 301 F3d 1150 (discussing history and nature of exclusion of assignment of claims arising in tort; case decided under former Division 9, but discusses current statute as well). Division 9 does apply to commercial tort claims and tort claims that constitute proceeds of other collateral. See Official Comment 15 to UCC §9-109. For a discussion of commercial tort claims, see §1.5A.

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§1.42 E. Deposit Account Assignments

Although Division 9 does apply to accounts themselves, Division 9 does not apply to "an assignment of a deposit account in a consumer transaction." Com C §9109(d)(13). See chap 7. Attachment of deposit accounts is governed by CCP §488.455. Division 9 also contains other protections for debtors against using deposit accounts as collateral. See Cal Comment 16 to Com C §9109. For discussion of deposit accounts, see §4.21.

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§1.43 IX. STATUTORY LIENS

Division 9 does not apply to statutory liens for services or materials, except as provided by Com C §9333, which gives most possessory liens of this type priority over perfected security interests. Com C §9109(d)(2). California has a host of these liens. See, *e.g.,* CC §§3045.1-3080.22 (miscellaneous liens), 3109-3154 (mechanics' liens). See also Food & A C §§55631-55653; *Saslow v Andrew (In re Loretto Winery, Ltd.)* (9th Cir 1990) 898 F2d 715, 720 (producer's lien prevails over bona fide purchaser of agricultural products when sales proceeds were not used to pay producer). Division 9 does apply to certain nonpossessory agricultural liens in farm products. Com C §§9102(a)(5), 9109(a)(2); see chap 8.

Other statutory liens do create security interests that are similar to conventional Division 9 security interests. In *Alliance Capital Mgmt. v County of Orange (In re County of Orange)* (Bankr CD Cal 1995) 189 BR 499, the court held that the statutory lien securing tax and revenue anticipation notes created a security interest in certain Orange County revenues that survived the Orange County bankruptcy filing.

A judgment creditor's service of an order to appear for a debtor's examination creates a lien on all of the debtor's nonexempt property for one year after the service. CCP §708.110(d). California law does not provide for perfecting this lien. Therefore, the judgment creditor need do nothing else to prevail over a trustee in a subsequent bankruptcy. See *Southern Cal. Bank v Zimmerman (In re Hilde)* (9th Cir 1997) 120 F3d 950. The trustee in that case argued (unsuccessfully) that it was necessary for the creditor to obtain orders for turnover or execution on the debtors' property, and that its failure to do so left the judgment creditor's lien unperfected and subject to avoidance by the judgment debtors' bankruptcy trustee.

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§1.44 X. STATUTES OF LIMITATIONS

Liens created under the Commercial Code are also subject to the general terms of California statutes of limitations, *e.g.,* the 4-year statute of limitations for written contracts under CCP §337. See *Kaichen's Metal Mart, Inc. v Ferro Cast Co.* (1995) 33 CA4th 8, 12, 39 CR2d 233, quoting Com C §1103(b): "Unless displaced by the particular provisions of this code, the principles of law and equity, including… [*any*] *validating or invalidating cause,* supplement its provisions." (Emphasis added.)

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§1.45 XI. FEDERAL LAW AND FEDERAL GOVERNMENT TRANSACTIONS

A body of "federal commercial law" may preempt, or at least impinge on, the law under the Commercial Code. Division 9 does not apply to the extent that a statute, regulation, or treaty of the United States preempts it. Com C §9109(c)(1). There is some preemption by:

- 46 USC §§31301-31343 (ship mortgages);
- The Copyright Act of 1976 (17 USC §301);
- The Interstate Commerce Act (49 USC §§11301, 14301 (railway rolling stock; motor vehicle liens));
- The Assignment of Claims Act of 1940 (31 USC §3727; 41 USC §15); and
- 49 USC §44107 (Federal Aviation Administration aircraft registry).

Similarly, Division 9 priority provisions are subordinate to federal priority rules such as the tax lien provision of the Internal Revenue Code (IRC §§6321-6323). In the absence of a federal statute setting priorities, state law determines the relative priority between competing federal and private liens. See *U.S. v Kimbell Foods, Inc*. (1979) 440 US 715, 59 L Ed 2d 711, 99 S Ct 1448.

For a detailed discussion of perfection of certain types of collateral under federal law, see chap 3.

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§1.46 XII. STATE LAW PARALLEL TO FEDERAL LAW

State law sometimes includes special rules affecting claims by or against the state, similar to rules imposed by federal statutes affecting claims by or against the federal government. See §1.45. Although the state is not bound to follow federal law in these matters, it is common for courts and legislatures to draw analogies between the state and federal statutes on particular issues.

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§1.47 A. Transfers by Governmental Entities

Division 9 does not apply to a transfer by a government or governmental entity. Com C §9109(d)(17).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/1 Statutes Governing Secured Transactions/§1.48 B. Assignment of Government Contract Rights

§1.48 B. Assignment of Government Contract Rights

Assignments of rights under state public construction contracts under the Improvement Act of 1911 (Str & H C §§5000-6794) are exempt from Division 9. Com C §9109(d)(14). Other types of assignment of government contract rights remain covered by Division 9.

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§1.49 XIII. SURETYSHIP

A surety is a person or entity that promises to pay the obligation of another. For example, in a common business arrangement, a lender extends credit to an incorporated business, takes a security interest in the corporation's assets, and also receives a guaranty from an individual who is a principal in the business. If the corporation fails to pay its debt, the principal pays and then claims to be subrogated to the lender's position as secured creditor and therefore to have that creditor's rights in the collateral. CC §2848. California law does not distinguish between sureties and guarantors; the terms have the same meaning wherever used in state statutes. CC §2787. The California Civil Code has an extensive body of law regarding suretyship. See CC §§2787-2856. The laws of suretyship are beyond the scope of this book. However, a guarantor or surety may also secure that guaranty obligation with collateral. The secured obligation is covered by Division 9.

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§1.50 A. Priority of Surety Against Secured Lender

Certain priority issues may arise with a surety that has not perfected a security interest. In a typical situation, a contractor undertakes to construct a building, financing the project by loans from a bank secured by assignment of the contractor's right to payment from the owners. The bank files a financing statement covering this assignment. The contractor also posts a performance bond issued by a bonding company; the bonding company does not file a financing statement. When the contractor is unable to complete the project, the bonding company finishes the work. Both the bank and the bonding company claim the right to be paid the balance due by the owners under the contract. The bank claims as the holder of a perfected security interest under the Commercial Code, while the bonding company claims under suretyship law as the surety that has fulfilled the obligations of the creditors through a doctrine called equitable subrogation.

The outcome is not certain. The Commercial Code expressly excludes sureties from the filing requirements of Division 9 (Com C §9109(d)(6)), but does not address the priority of an equitable subrogation claim. In some cases, the lender has prevailed (*U.S. v G. P. Fleetwood & Co*. (WD Pa 1958) 165 F Supp 723; *State Bank & Trust Co. v Ins. Co. of the West* (5th Cir 1997) 132 F3d 203), but other cases have favored the surety (*Kentucky Central Ins. Co. v Brown (In re Larbar Corp.)* (6th Cir 1999) 177 F3d 439; *National Shawmut Bank v New Amsterdam Cas. Co*. (1st Cir 1969) 411 F2d 843; *Canter v Schlager* (Mass 1971) 267 NE2d 492; *United Bonding Ins. Co. v Catalytic Constr. Co.* (9th Cir 1976) 533 F2d 469). In one instance, the Ninth Circuit seemed to make a decision for the lender based on the lender's not being aware that subcontractors had not been paid by the surety. *Reliance Ins. Co. v U.S. Bank* (9th Cir 1998) 143 F3d 502.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/1 Statutes Governing Secured Transactions/§1.51 B. Federal Government Construction Contracts

§1.51 B. Federal Government Construction Contracts

Disputes with sureties often arise over federal governmental construction contracts. Counsel should consult not only the Commercial Code, but also the Miller Act (40 USC §3131) and 40 USC §3134, which require the assignor to get performance and payment bonds, and the Assignment of Claims Act of 1940 (31 USC §3727; 41 USC §15), which provides the mechanism by which the assignor may make its assignment.

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§1.52 XIV. MULTISTATE TRANSACTIONS

Multistate conflict of laws problems involving Division 9 may arise in a variety of ways. The debtor, creditor, and collateral may be in different states, or the debtor may take the collateral to another state either at the inception of the security agreement or later.

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§1.53 A. Perfection of Security Interests

As a rule, the law governing perfection and priority of security interests in both tangible and intangible collateral is the law of the jurisdiction of the debtor's location. Com C §9301. The debtor's location is determined as follows: (1) a debtor who is an individual is located at the individual's principal residence; (2) a debtor that is an organization and has only one place of business is located at its place of business; (3) a debtor that is an organization and has more than one place of business is located at its chief executive office. Com C §9307(b). If the debtor is located in a jurisdiction that does not have a system permitting the filing and recording of nonpossessory security interests, the debtor is located in the District of Columbia. Com C §9307(c).

EXAMPLE: If a secured party wishes to take a security interest in the accounts of a corporation that has its chief executive office in France and that has several offices in the United States, the correct place to file depends on whether France has a public notice filing system for recordation of security interests. If it does, then the debtor is located in France under Com C §9307(b). If it does not, the correct place to file is the District of Columbia. Com C §9307(c).

A registered organization, such as a corporation, limited liability company, or limited partnership, that is organized under the laws of a state is located in that state. Com C §9307(e). For example, a secured party should file a financing statement with respect to a California corporation in California. A registered organization that is organized under the laws of the United States is located in the state designated by law or by the organization, if the law designates or authorizes the organization to designate a state of location, and otherwise in the District of Columbia. Com C §9307(f). The United States is located in the District of Columbia. Com C §9307(h).

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B. Issues Other Than Perfection

§1.54 1. Appropriate Relation Rule

For matters other than perfection, in the absence of the parties' agreement (see §1.55), the Commercial Code subsumes Division 9 under a general rule of territorial application. This rule provides that the Commercial Code "applies to transactions bearing an appropriate relation to this state." Com C §1301(b). The term "appropriate relation" is a term of art for conflicts scholars. Some explanation is offered by the official comments. The comments give, among others, one example of a situation in which a relation to the state where suit is brought is not sufficient to apply its law. This is the situation "where the parties have clearly contracted on the basis of some other law, as where the law of the place of contracting and the law of the place of contemplated performance are the same and are contrary to the law under the Code." Official Comment 2 to UCC §1-105.

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§1.55 2. Agreement of Parties

The parties may agree that their rights and duties, with respect to issues other than perfection, are to be governed either by the law of California or by that of another state or nation "when a transaction bears a reasonable relation to this state and also to another state or nation." Com C §1105(1). In the absence of such an agreement, the appropriate-relation test applies. See §1.54.

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2

The Security Agreement

Ellen A. Friedman

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§2.1 I. REQUIREMENTS FOR ENFORCEABILITY OF SECURITY INTEREST

A security interest is enforceable if (1) value has been given, (2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party, and (3) there is some evidence that the debtor intended to create a "security interest" in the collateral. Com C §9203(b). Perfection of a security interest, required for full assertion of rights against third parties, is discussed in chap 3.

With respect to most security interests, the debtor will evidence its intent by authenticating a security agreement that provides a description of the collateral. Com C §9203(b)(3)(A). See §§2.2-2.9. A "security agreement" is defined as "an agreement that creates or provides for a security interest." Com C §9102(a)(73). An "agreement" is defined as "the bargain of the parties in fact, as found in their language or inferred from other circumstances." Com C §1201(b)(3).

For particular types of collateral, evidence of the security agreement is provided in specific ways. For example, for a certificated security, enforceability may be evidenced by possession of the certificated security by the secured party under the debtor's security agreement. Com C §9203(b)(3)(C).

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II. FORMALITIES FOR SECURITY AGREEMENT CREATING NONPOSSESSORY SECURITY INTEREST

§2.2 A. Grant of Security Interest

The debtor must express its intent to grant the secured party an interest in the collateral. A security agreement should contain an explicit grant of a security interest. For short and long forms of granting language in a security agreement, see §2.24.

In *Expeditors Int'l, Inc. v Official Creditors Comm. of CFLC, Inc. (In re CFLC, Inc.)* (9th Cir 1999) 166 F3d 1012, the Ninth Circuit held that no security interest was created in favor of a freight forwarder when the freight forwarder repeatedly used a standard form containing the grant of a security interest in its dealings with the debtor, because the debtor never signed the forms and there was no discussion between the parties regarding the forwarder's interest in the debtor's goods. The court held that the freight forwarder had failed to prove the debtor's intent to create a security interest.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.3 1. General Rule--Explicit Granting Language Required

§2.3 1. General Rule—Explicit Granting Language Required

In general, courts require technical, explicit "granting" language in a document to make it a security agreement. The Ninth Circuit Court of Appeals in *DuBay v Williams* (9th Cir 1969) 417 F2d 1277, held that a certain document could not constitute a security agreement because it contained "no words of creation or grant." 417 F2d at 1285. See also *Needle v Lasco Indus*. (1970) 10 CA3d 1105, 89 CR 593; *American Card Co. v H.M.H. Co*. (RI 1963) 196 A2d 150. For a survey of decisions, see *Bank of America v Outboard Marine Corp. (In re Outboard Marine Corp.)* (Bankr ND Ill 2003) 300 BR 308, 321.

NOTE: Under current Division 9, financing statements are not authenticated and thus cannot serve as security agreements. See §2.5.

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§2.4 2. Explicit Granting Language Not Required

In certain cases, courts have looked at the circumstances and found the debtor's intent to grant a security interest without specific granting language. Practitioners should, however, always include granting language in the transaction documents. In *Nolden v Plant Reclamation (In re Amex-Protein Dev. Corp.)* (9th Cir 1974) 504 F2d 1056, the court held that explicit granting language was not required to create a security interest. At issue in that case was a promissory note containing a handwritten inscription (on an otherwise typewritten document) that read, "This note is secured by a Security Interest in subject personal property as per invoices." The court found that there was no doubt about the identity of the "invoices" in question and that the promissory note qualified as a security agreement because, by its terms, it "creates or provides for" a security interest. 504 F2d at 1056. The court rejected the holding in *American Card Co. v H.M.H. Co.* (RI 1963) 196 A2d 150, requiring explicit granting language, overruling the bankruptcy court on that issue.

A sales and marketing agreement was found to be a security agreement in *New West Fruit Corp. v Coastal Berry Corp.* (1991) 1 CA4th 92, 1 CR2d 664, even though the agreement did not identify the obligations that the security interest secured. In *New West,* the sales and marketing agreement provided that

> [i]n order to secure all of Grower's obligations under this agreement, Grower hereby gives to Shipper a security interest in all crops growing or to be grown on the above-described property in the crop year 1984-1985 and the proceeds thereof, and agrees to sign a financial statement and any other documents needed to perfect Shipper's security interest.

The grower did sign a financing statement, which the shipper filed as required under the California Commercial Code.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.5 B. Authentication

§2.5 B. Authentication

A security agreement must be "authenticated" by the debtor for it to be enforceable. Com C §9203(b)(3)(A). Authenticate means "(A) to sign; or (B) to execute or otherwise adopt a symbol, or encrypt or similarly process a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record." Com C §9102(a)(7). Obviously, authentication includes a manual signature.

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§2.6 C. Description of Collateral

The security agreement must contain "a description of the collateral." Com C §9203(b)(3)(A). Collateral must be particularly described as provided in Com C §9108. See §§2.7-2.8.

NOTE: Unlike the description of collateral in a security agreement, it is sufficient to identify collateral in a financing statement as "all assets" or "all personal property." Com C §9504(2). See §§3.76-3.96 for discussion of requirements of a financing statement.

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§2.7 1. Requirements for Sufficient Description

The following requirements apply to sufficiency of description of the collateral:

- A description of personal or real property is sufficient, whether or not it is specific, if it reasonably identifies what is described. Com C §9108(a).
- A description reasonably identifies collateral if the collateral is identified (1) by a specific listing, (2) by category, (3) as a type of collateral defined in the Commercial Code, (4) by quantity, (5) through a computational or allocational formula or procedure, or (6) by any other method if the collateral is objectively determinable. Com C §9108(b).
- A description of "all the debtor's assets" or "all the debtor's personal property" or similar phrases is not sufficient in a security agreement. Com C §9108(c).
- With respect to investment property, in a consumer transaction (see chap 7) the property must be described through a specific security entitlement, securities account, or commodity contract (*e.g.,* "all securities in account number 123 at Brokerage House Incorporated"). Com C §9108(d).
- A description by type is insufficient if it refers to a commercial tort claim or it is used in connection with a consumer transaction, consumer goods, a security entitlement, a securities account, or a commodity account. Com C §9108(e). For example, with respect to a commercial tort claim, the particular commercial tort claim must be described.
- In consumer transactions, descriptions of investment property must comply with CC §1799.103 and descriptions of consumer goods must comply with CC §1799.100. Com C §9108(f).

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§2.8 2. Effect of Limited Collateral Description

Although the Commercial Code gives a secured party wide latitude in describing collateral, the secured party must be careful not to limit collateral descriptions. Collateral descriptions should be carefully crafted.

The Ninth Circuit Court of Appeals took a relatively conservative view of the required description in deciding *Selby v England (In re California Pump & Mfg. Co.)* (9th Cir 1978) 588 F2d 717. In that case, the security interest purported to extend to property at a certain address in South San Francisco. In fact, the property was never located at that address, but at the debtor's plant in Fresno, and later in Hayward. The court held that the description was insufficient to fulfill the description requirements of former Com C §9110.

The court held in *Stoumbos v Kilimnik* (9th Cir 1993) 988 F2d 949, 955, that an agreement granting a security interest in property specified as "inventory … on hand at May 1, 1982," was strictly limited to the property on hand at that date.

In *Shelby County State Bank v Van Diest Supply Co.* (7th Cir 2002) 303 F3d 832, the court found the collateral description "all property, including but not limited to agricultural chemicals, fertilizers, and fertilizer materials sold to Debtor by Van Diest Supply Co." to be ambiguous and strictly construed the language against the secured creditor, deciding that only inventory sold by Van Diest Supply Co. was covered. *Shelby* is a case decided under Iowa law but is a cautionary tale to all secured creditors.

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§2.9 D. Using Several Documents

The secured transaction may be defined by several documents, which must be read together to find all the elements required for a valid security agreement. In a typical secured transaction, the creditor will prepare both a financing statement and a security agreement. There may be a separate loan or credit agreement, or the security agreement and loan agreement may be combined. Often, the experienced creditor will file the financing statement early in the negotiation of the secured transaction (before the security agreement has been executed) to assure the secured creditor's priority. See chaps 3 and 4.

Although the liens created under a single security agreement can secure a series of loans by the secured party under separate loan agreements, either the security agreement or the other loan agreements should explicitly state that the other loans are also secured under the one security agreement. See *Western Farm Credit Bank v Auza (In re Auza)* (BAP 9th Cir 1995) 181 BR 63 (dragnet clause did not apply to loans to other entities guaranteed by debtor). For discussion of dragnet clauses, see §2.17.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/ III. EVIDENCE OUTSIDE WRITTEN SECURITY AGREEMENT/§2.10 A. Course of Dealing and Usage of Trade

III. EVIDENCE OUTSIDE WRITTEN SECURITY AGREEMENT

§2.10 A. Course of Dealing and Usage of Trade

Under Com C §1303, the security agreement must be read in light of the "course of performance" and "course of dealing" between the parties and any provable "usage of trade."

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§2.11 B. Statute of Frauds and Parol Evidence Rule

Although Division 9 contains no explicit statute of frauds, Official Comment 3 to UCC §9-203 indicates that Com C §9203(b)(3) is tantamount to a statute of frauds.

Official Comment 3 to UCC §9-203 suggests that parol evidence should not create a valid and enforceable security interest in the absence of a possessory interest or an authenticated record.

The familiar parol evidence rule provides that, when an agreement has been integrated in a writing, the court may not admit evidence of prior or contemporaneous inconsistent terms that contradict the written agreement. See*, e.g., Selby v England (In re California Pump & Mfg. Co.)* (9th Cir 1978) 588 F2d 717. Although Division 2 contains an explicit parol evidence rule (favoring admitting parol evidence), it specifically applies only to Division 2 matters. Com C §§2102, 2202. General legal and equitable principles, however, supplement the Code's provisions unless displaced by them. Com C §1103(b).

A well-recognized exception to the parol evidence rule may apply to a secured transaction in which the parties intend a document that appears to be a bill of sale, absolute on its face, to be a security agreement. Official Comment 3 to UCC §9-203.

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IV. APPLICATION OF SECURITY AGREEMENT TO OTHER OBLIGATIONS AND COLLATERAL

§2.12 A. Floating Lien in After-Acquired Property, Future Advances, and Proceeds of Collateral

One of the most important concepts under Division 9 is the "floating lien." The floating lien is a combination of several concepts related to a secured creditor's rights in the debtor's property, including:

- **After-Acquired Property.** A floating lien allows a creditor to have a security interest in collateral acquired by the debtor after the security agreement is made (subject to various exceptions described in §§2.13-2.15). Com C §9204(a).
- **Future Advances.** A floating lien allows an agreement to secure future advances with present or after-acquired property. Com C §9204(c).

For the effect on priorities of any of these floating liens, see chap 4. For the interplay between the Bankruptcy Code and the floating lien, see chap 6.

Because of the great flexibility that the California Commercial Code allows with respect to the wide variety of floating liens, counsel representing the secured party should ensure that the client includes provisions in the security agreement to permit adequate policing of the collateral. See §2.29.

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B. Restrictions on Use of After-Acquired Property Clause

§2.13 1. Consumer Goods

One source of the floating lien, the after-acquired property clause, is subject to certain restrictions designed to protect a debtor whose obligation is secured by consumer goods. An after-acquired property clause does not apply to "[c]onsumer goods, other than an accession when given as additional security, unless the debtor acquires rights in them within 10 days after the secured party gives value." Com C §9204(b)(1). This is a vestige of the many "consumer protection" provisions in earlier drafts of the Commercial Code that did not become law.

"Consumer goods" are defined as goods used primarily for "personal, family, or household purposes." Com C §9102(a)(23). See chap 7.

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§2.14 2. Exception for Accessions

An after-acquired property clause in a security agreement covering consumer goods is effective when the collateral is accessions. See Com C §9204(b)(1). "Accessions" are goods that are physically united with other goods in such a manner that the identity of the original goods is not lost. Com C §9102(a)(1). Thus, for example, if a debtor acquires a power tool from a seller, signing a security agreement that gives the seller a security interest in after-acquired property, that interest may extend to an accessory installed in the power tool. This results if the secured party gives value (*e.g.*, the accessory or credit to purchase it) and the debtor acquires rights in the accessory within 10 days after value is given.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.15 3. Commercial Tort Claims

§2.15 3. Commercial Tort Claims

Commercial tort claims are also not subject to after-acquired property clauses. Com C §9204(b)(2). In order for a security interest to attach to a commercial tort claim, the claim must be in existence when the security agreement is authenticated. Secured parties should also keep in mind that the tort claim must be described with some specificity. A description only by type such as "all tort claims" is insufficient. Com C §9108(e)(1).

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§2.16 C. Security Interest in Proceeds

A security interest continues in any identifiable proceeds, including collections, received by the debtor. Com C §9315(a)(2). Identifiable proceeds may include commingled goods as provided in Com C §9336, or other collateral if the secured party identifies the proceeds by a method of tracing, including applicable equitable principles permitted by other state law. Com C §9315(b). See §§3.59, 4.18, 4.42. There has been a split of authority on whether the security interest is confined to identifiable proceeds in the hands of the debtor. California, however, does not limit the security interest in this manner. In *Producers Cotton Oil Co. v Amstar Corp.* (1988) 197 CA3d 638, 242 CR 914, Amstar bought a crop with borrowed funds and used a portion of the funds to pay a harvester. Although the funds were never in the debtor Amstar's hands, the court of appeal held that the security interest attached to the account created with the proceeds of the sale. However, practitioners should be aware that *Producers Cotton Oil Co. v Amstar Corp.* has been criticized. See §4.73.

For discussion of including a provision in the security agreement specifically granting a security interest in proceeds, see §2.24.

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§2.17 D. Dragnet Clauses

A dragnet clause is a clause that covers past, present, or future amounts owed to creditors. An example of a dragnet clause is set forth in §2.21. Official Comment 5 to UCC §9-204 provides that dragnet clauses are enforceable and rejects the holdings of courts that developed tests for when a dragnet clause is appropriate. Because the rejection of this case law is found only in the comment, however, these cases may still be applicable and are discussed in this section. But see *Pride Hyundai, Inc. v Chrysler Fin. Co., LLC* (1st Cir 2004) 369 F3d 603 (dragnet clause found enforceable under Massachusetts law in light of Official Comment 5 to UCC §9-204 and expanded definition of good faith in UCC §9-102(43) to include "the observance of reasonable commercial standards of fair dealing").

In *Union Bank v Wendland* (1976) 54 CA3d 393, 404, 126 CR 549, the court established a two-part test to determine when a dragnet clause covers additional debt. The two-part test is whether (1) the parties' intent to secure both loans under the same security agreement can be inferred from the connection between the loans—a "relationship of the loans" test, or (2) the second loan relied on the original security for the first loan—a "reliance on the security" test. In *Western Farm Credit Bank v Auza (In re Auza)* (BAP 9th Cir 1995) 181 BR 63, the Bankruptcy Appellate Panel for the Ninth Circuit adopted the two-part test set forth in *Union Bank* to determine that the dragnet clause in a personal loan did not cover guaranty obligations to a partnership. In *National Enters., Inc. v Woods* (2001) 94 CA4th 1217, 115 CR2d 37, however, the court criticized the *Union Bank* decision and the use of the two-part test. The court in *National Enterprises* held that the intent of the parties is critical in understanding whether a dragnet clause is valid.

PRACTICE NOTE: The *Auza* decision is a warning to counsel documenting loans to related parties or a series of loans to a single party. Secured parties should clearly state which obligations are secured by the liens created under the security agreement rather than relying on boilerplate dragnet clauses that leave room for future arguments. For an example of a specific dragnet clause, see §2.21.

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§2.18 V. EFFECT OF CONSUMER PROTECTION LAWS ON SECURITY INTEREST

The effect of a security agreement may be affected by a number of California consumer protection acts and laws, such as those governing usury, small loans, and retail installment sales. In case of a conflict with Division 9 of the California Commercial Code, these consumer protection acts and laws control. Com C §9201(b). For detailed discussion of consumer issues, see chap 7.

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VI. FORMS OF WRITTEN SECURITY AGREEMENTS

§2.19 A. Introduction

The general form of the written security agreement depends on the nature of the transaction (*e.g.,* possessory or nonpossessory security interest, commercial financing deal, or retail installment sale) and the nature of the collateral (*e.g*., goods, equipment, inventory, accounts receivable, or a combination of them—most often inventory and accounts).

This chapter contains a basic nonpossessory commercial security agreement in §§2.20-2.41, with specific clauses covering various kinds of collateral.

The chapter also contains a possessory security agreement in §§2.42-2.61. The agreement is designed for use with collateral that may be physically held by the secured party, such as a stock certificate. Much of the basic security agreement in §§2.20-2.41 is equally appropriate for this type of collateral. The typical pledge agreement, however, is shorter and simpler than a nonpossessory security agreement, because the secured party has physical possession of the collateral.

Finally, this chapter contains an intellectual property security agreement suitable for filing with the Copyright Office or the Patent and Trademark Office. See §§2.62-2.69. It is based on the same definitions found in the Security Agreement set forth in §2.21. As discussed in chap 3, the secured creditor may wish to file such an agreement to perfect security interests in certain types of intellectual property or to provide notice to bona fide purchasers for value that the security interest exists.

These agreements are guidelines only. Forms negotiated or prepared for a client must allow for differing circumstances. Counsel must also be aware of the potential need for other documentation, such as corporate resolutions authorizing the borrowing, guaranties, and subordination agreements.

It is important to keep in mind the conceptual distinction between the security agreement and the underlying obligation. Although two separate documents are not required, the security agreement is often accompanied by a loan document, such as a promissory note. In any event, the security agreement is meaningless unless it secures an identified obligation from the debtor to the secured party.

It is also important to note that in certain circumstances the debtor may be a guarantor of the principal debt to the lender. Special provision in the security agreement should be considered in those circumstances.

For a discussion of consumer financing instruments, see chap 7. For discussion of agricultural security agreements, see chap 8.

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B. Commercial Security Agreement for Nonpossessory Security Interest

§2.20 1. Form: Title and Preamble

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.20-2.41.

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2.20-1 Title and preamble of nonpossessory security agreement

SECURITY AGREEMENT

[*If desired, specify items subject to security agreement, e.g., accounts, inventory*]

The parties to this security agreement are:

SECURED PARTY

Name _____

Address of Chief Executive Office _____

_____

_____

DEBTOR

Name _____

Address of Chief Executive Office _____

_____

_____

Comment: If the document covers a security interest in accounts, inventory, equipment, or goods, the title of the agreement can reflect that fact for clarity's sake. Because the Commercial Code uses the terms "secured party" and "debtor," it is desirable to identify the parties by these words. Com C §9102(a)(28), (a)(72). See §§1.13-1.14. For the same reason, it is best to call the agreement a "security agreement." Com C §9102(a)(73). See §2.1.

As discussed in chapter 3 (Perfection) (see §3.78) in order to properly perfect a security interest by filing, the name of the debtor, if the debtor is a registered organization, must be the same on the financing statement as in the organizational documents. It is prudent for the secured party to review certified organizational documents at the time the security agreement is entered into in order to obtain the correct name for the financing statement and the security agreement. See §3.78.

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§2.21 2. Form: Common Definitions

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.20-2.41.

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2.21-1 Common definitions

1. Definitions

As used in this security agreement,

"Collateral" means all right, title, and interest of Debtor now owned or hereafter acquired in and to the property described in _ _[*Schedule __ (collectively and severally, the "Collateral"), which Schedule __ is incorporated here by this reference*]**_ _.**

"Indebtedness" means Debtor's obligations, obligations representing the purchase price of property other than accounts payable arising in connection with the purchase of inventory on terms customary in the trade, and obligations under leases that would be capitalized in accordance with generally accepted accounting principles.

"Lien" means any security interest, mortgage, pledge, lien, attachment, claim, charge, encumbrance, agreement retaining title, or lessor's interest covering the collateral.

"Obligations" means all existing and future indebtedness and liability of Debtor to Secured Party, including all obligations under that certain loan agreement dated _ _[*date*]**_ _, and attorney fees and costs incurred by Secured Party in enforcing this security agreement or collecting payment under it.**

Comment: The practitioner can choose to include a schedule of collateral or list the collateral in the body of the agreement. Both methods are illustrated in §2.24. It is critical to provide a collateral description. See §§2.6-2.8.

If the debtor is a guarantor, the lender may wish to reference the guaranty in the security agreement and add a reference to the obligations of the principal obligor in the definition of "obligations" secured by the agreement.

The clause defining "obligations" includes future indebtedness of the debtor under a specified loan agreement. This is one example of a dragnet clause. See §2.17.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.22 3. Form: Definitions Related to Type of Collateral

§2.22 3. Form: Definitions Related to Type of Collateral

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2.22-1 Definitions related to type of collateral

"Accounts" means all accounts, as that term is defined in section 9102(a)(2) of the California Commercial Code, now owned or hereafter acquired by Debtor, including (a) all accounts receivable, other receivables, book debts and other forms of obligations (other than forms of obligations evidenced by Chattel Paper, Documents or Instruments), whether arising out of Goods sold or services rendered by it or from any other transaction (including any such obligations that may be characterized as an account or contract right under the California Commercial Code); (b) all of Debtor's rights in, to, and under all purchase orders or receipts for Goods or services; (c) all of Debtor's rights to any Goods represented by any of the foregoing (including unpaid sellers' rights of rescission, replevin, reclamation, and stoppage in transit, and rights to returned, reclaimed, or repossessed Goods); (d) all money due or to become due Debtor under all purchase orders and contracts for the sale of Goods or the performance of services or both by Debtor or in connection with any other transaction (whether or not yet earned by performance by Debtor), including the right to receive the proceeds of those purchase orders and contracts; and (e) all collateral security and guaranties of any kind given by any other Debtor with respect to any of the foregoing.

"California Commercial Code" means the Uniform Commercial Code as may, from time to time, be enacted and in effect in the State of California.

"Chattel Paper" means any chattel paper, as such term is defined in section 9102(a)(11) of the California Commercial Code, now owned or hereafter acquired by any person, wherever located.

"Deposit Account" means any deposit account, as that term is defined in section 9102(a)(29) of the California Commercial Code, now owned or hereafter acquired by Debtor.

"Documents" means any documents, as that term is defined in section 9102(a)(30) of the California Commercial Code, now owned or hereafter acquired by Debtor, wherever located.

"Equipment" means all equipment, as that term is defined in section 9102(a)(33) of the California Commercial Code, now owned or hereafter acquired by Debtor, wherever located, including all of Debtor's materials handling equipment, manufacturing equipment, processing equipment, engineering equipment, conveyors, machine tools, data processing and computer equipment with software and peripheral equipment, office machinery, furniture, tools, attachments, accessories, _ _[*describe special types of equipment for the appropriate industry***]_ _ and other equipment of every kind and nature, trade fixtures and other fixtures, together with all additions and accessions, replacements, parts, substitutes for any of the foregoing, fuel, and all manuals, drawings, instructions, warranties, and rights with respect to the foregoing, and all products and proceeds of the foregoing and condemnation awards and insurance proceeds with respect thereto.**

"Fixtures" means all fixtures, as that term is defined in section 9102(a)(41) of the California Commercial Code, now owned or hereafter acquired by Debtor, wherever located.

"General Intangibles" means all general intangibles, as that term is defined in section 9102(a)(42) of the California Commercial Code, now owned or hereafter acquired by Debtor, including all right, title, and interest that Debtor may now or hereafter have in or under customer lists, licenses, copyrights, trademarks, patents, websites, domain names, and all applications therefor and reissues, extensions, or renewals thereof, rights in intellectual property, interests in partnerships, joint ventures, and other business associations, licenses, permits, trade secrets, proprietary or confidential information, inventions (whether or not patented or patentable), technical information, procedures, designs, knowledge, know-how, software, databases, data, skill,

expertise, experience, processes, models, drawings, materials and records, goodwill (including the goodwill associated with any trademark or trademark license), all rights and claims in or under insurance policies (including insurance for fire, damage, loss, and casualty, whether covering personal property, real property, tangible rights, or intangible rights, all liability, life, key man, and business interruption insurance, and all unearned premiums), uncertificated securities, certificated securities; choses in action, rights to receive tax refunds and other payments, rights to receive dividends, distributions, cash, instruments, and other property in respect of or exchange for pledged shares or other equity interests, rights of indemnification, all data maintained on all tapes, cards, computer runs, and other papers and documents in the possession or under the control of Debtor or any computer bureau or service company from time to time acting for Debtor.

"Goods" means any goods, as that term is defined in section 9102(a)(44) of the California Commercial Code, now owned or hereafter acquired by Debtor.

"Instruments" means any instrument, as that term is defined in section 9102(a)(47) of the California Commercial Code, now owned or hereafter acquired by Debtor, wherever located, including all certificated securities, all certificates of deposit, and all notes and other evidences of indebtedness other than instruments that constitute, or are a part of a group of writings that constitute, Chattel Paper.

"Inventory" means any inventory, as that term is defined in section 9102(a)(48) of the California Commercial Code, now owned or hereafter acquired by Debtor, wherever located, including inventory, merchandise, Goods, and other personal property that are held by or on behalf of Debtor for sale or lease or are furnished or are to be furnished under a contract of service, or that constitute raw materials, work in process, or materials used or consumed or to be used or consumed in Debtor's business or in the processing, production, packaging, promotion, delivery, or shipping of the same, including other supplies.

"Investment Property" means all investment property, as that term is defined in section 9102(a)(49) of the California Commercial Code, now owned or hereafter acquired by Debtor, wherever located, including (a) all securities, whether certificated or uncertificated, including stocks, bonds, interests in limited liability companies, partnership interests, treasuries, certificates of deposit, and mutual fund shares; (b) all securities entitlements of Debtor, including the rights of Debtor to any securities account and the financial assets held by a securities intermediary in the securities account and any free credit balance or other money owing by any securities intermediary with respect to such account; (c) all securities accounts of Debtor; (d) all commodity contracts held by Debtor; and (e) all commodity accounts held by Debtor.

Comment: These definitions track those in the California Commercial Code, but expand on them by including after-acquired property. See §§2.12-2.14. Under Com C §9108(b)(3), a description "reasonably identifies" collateral if it merely identifies the collateral as a type defined in the Commercial Code. Thus, the definitions given above for "accounts," "equipment," "general intangibles," "instruments," "inventory," and "investment property" could be shortened to simply state:

_ _[*Type of collateral—e.g., "accounts"*]_ _ **means all** _ _[*e.g., accounts*]_ _ **as that term is defined in section 9102(a)(2) of the California Commercial Code, now owned or hereafter acquired by Debtor.**

Although such a definition might not express the parties' intent with the desired degree of specificity, it would satisfy the Commercial Code's requirement for identifying the collateral subject to the security interest.

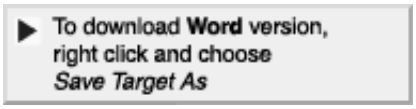
To the extent intellectual property is included in the collateral, it may be necessary or prudent to file with the Copyright Office or the Patent and Trademark Office. See §§3.19-3.29. A form of intellectual property security agreement may be found in §§2.62-2.69.

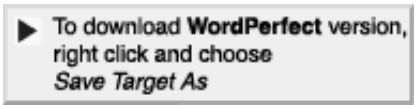
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§2.23 4. Form: UCC Definitions Incorporated by Reference

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2.23-1 UCC definitions incorporated by reference

Terms defined in the California Commercial Code not otherwise defined in this security agreement are used in this security agreement as defined in the California Commercial Code on the date of this agreement.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.24 5. Form: Grant of Security Interest

§2.24 5. Form: Grant of Security Interest

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2.24-1 Alternative: Grant of security interest (short form)

2. Debtor grants Secured Party a security interest in the Collateral to secure payment of the Obligations.

2.24-2 Alternative: Grant of security interest (long form)

2. To secure the prompt and complete payment, performance, and observance of all of the Obligations, Debtor hereby grants and assigns to Secured Party a lien on all of its right, title, and interest in, to, and under the following property, whether now owned or owing to, or hereafter acquired by or arising in favor of, Debtor, including under any trade names, styles, or derivations of Debtor, and whether owned by or consigned by or to, or leased from or to, Debtor, and regardless of where located (all of which being hereinafter collectively referred to as the "Collateral"):

a. All Accounts;

b. All Chattel Paper;

c. All Contracts;

d. All Equipment;

e. All General Intangibles;

f. All Goods;

g. All Instruments and letters of credit;

h. All Inventory;

i. All Investment Property;

j. All Deposit Accounts;

k. All money, cash, or cash equivalents; and

l. To the extent not otherwise included, all proceeds and products of the foregoing and all accessions to, substitutions and replacements for, and rents and profits of each of the foregoing.

Comment: Any language conveying the debtor's intention to grant a security interest in the described collateral to the secured party is sufficient. See §§2.2-2.4. In this agreement, the debtor's intention to include after-acquired property is stated in the definition of "collateral." See §2.22.

If form 2.24-2 is used, counsel to the secured party should choose which collateral is applicable from the list above. If definitions of collateral are omitted, the granting clause must be expanded to reasonably identify the collateral. Com C §9108. The language of the definitions in §2.22 may be adapted to the clause in this section.

If the secured party is only obtaining a security interest in specified equipment, the security agreement should be tailored accordingly. For example, for a single item of equipment the following description is appropriate:

_ _[*e.g., one Blazer-brand air compressor, serial #123456789*]_ _ **together with any improvements, replacements, accessions, and additions to it.**

Proceeds of the collateral are automatically included, subject to the provisions of Com C §9315(c). See §2.16. A definition in the agreement is necessary only to reach proceeds acquired with cash proceeds. Nevertheless, some attorneys include a provision covering a class of proceeds. A provision regarding proceeds acquired by the debtor with cash proceeds is essential for the financing statement. See Com C §9315(d)(1)(C). For discussion of financing statements, see chap 3.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.25 6. Form: Debtor's Covenants

§2.25 6. Form: Debtor's Covenants

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2.25-1 Debtor's covenants

3. Debtor promises:

a. To pay the Obligations to Secured Party when they are due.

b. To pay all expenses, including attorney fees, incurred by Secured Party in the perfection, preservation, realization, enforcement, and exercise of Secured Party's rights under this agreement.

c. To indemnify Secured Party against loss of any kind, including reasonable attorney fees, caused to Secured Party by reason of its interest in the Collateral.

d. To conduct Debtor's business efficiently and without voluntary interruption.

e. To preserve all rights, privileges, and franchises held by Debtor's business.

f. To keep Debtor's business property in good repair.

g. To pay all taxes when due.

h. To give Secured Party notice of any litigation that may have a material adverse effect on the Debtor's business.

i. Not to change the name or place of Debtor's business, or to use a fictitious business name, without first notifying Secured Party in writing.

j. Not to sell, lease, transfer, or otherwise dispose of the Collateral

[*Add, if collateral includes accounts*]

except, before the occurrence of a default, for cash proceeds of accounts collected in the ordinary course of business.

[*Add, if collateral includes inventory*]

except, before the occurrence of a default, for sales of inventory in the ordinary course of business.

k. Not to permit liens on the Collateral, except existing liens, current tax liens, and purchase money liens.

l. To maintain fire and extended coverage insurance on the Collateral in the amounts and under policies acceptable to Secured Party, naming Secured Party under a lender's loss-payable clause, and to provide Secured Party with the original policies and certificates at Secured Party's request.

m. Not to use the Collateral for any unlawful purpose or in any way that would void any effective insurance.

n. To permit Secured Party, its representatives, and its agents to inspect the Collateral at any time, and to make copies of records pertaining to it, at reasonable times at Secured Party's request.

o. To perform all acts necessary to maintain, preserve, and protect the Collateral.

p. Not to move the Collateral from the following locations without first obtaining Secured Party's agreement in writing: _ _[*describe locations*]**_ _.**

q. To notify Secured Party promptly in writing of any default, potential default, or any development that might have a material adverse effect on the Collateral.

r. To execute and deliver to Secured Party all financing statements and other documents that Secured Party requests, in order to maintain a first perfected security interest in the Collateral.

s. To furnish Secured Party the reports relating to the Collateral at Secured Party's request.

[*Add, if collateral includes accounts, chattel paper, promissory notes, or payment intangibles*]

t. Not to make or agree to make any reduction in the original amount owing on an obligation, or to accept less than the original amount in satisfaction of an obligation, except before default or potential default, when Debtor may do so in ordinary course of business and in accordance with its present policies.

[*Add, if collateral includes accounts, chattel paper, promissory notes, payment intangibles, or inventory*]

u. To deliver to Secured Party (1) duplicate invoices for each account, bearing the language of assignment as Secured Party specifies; (2) the originals of all Instruments and Documents constituting Collateral, endorsed and assigned as Secured Party requests; and (3) proceeds (except cash proceeds collected in ordinary course of business, unless Debtor is in default).

Comment: The range and diversity of the debtor's promises depend on the type of collateral, the actions necessary to protect the secured party's rights in the collateral, and the relative bargaining power of the parties.

Under some circumstances, the debtor's failure to pay a tax when due as required by subparagraph b may trigger a claim against the collateral superior to the claim of the secured creditor. The secured party's practical remedy may be to pay taxes on the debtor's behalf and charge the amount as part of the debtor's obligation. See §5.53.

Subparagraph i requires the debtor to notify the secured party in writing if the debtor changes the name or location of its business. Note in this regard that a security interest perfected in accordance with the law of the jurisdiction where the debtor is located (Com C §§9301(1), 9305(c)) remains perfected until the expiration of four months after a change of the debtor's location to another jurisdiction (unless some other event has already caused the interest to lose its perfected status). Com C §9316(a)(2).

The exceptions for accounts and inventory in subparagraph j may be combined if the collateral includes both. A clause permitting transfer by sale in the ordinary course of business is appropriate for accounts and inventory. If it is used for inventory, it merely restates the effect of Com C §9320, which allows a buyer in ordinary course of business to take inventory free of a security interest. The parties cannot vary this provision by agreement to limit the protection of a buyer in ordinary course of business. Com C §9320.

When the collateral includes equipment and inventory, it may be useful to add a sentence like subparagraph p providing that the debtor will not remove the collateral. For mobile goods (*e.g.,* carrying cases that go on trucks or vessels), it may be necessary to spell out the terms and conditions of permissible movement.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.26 7. Form: Collection of Proceeds

§2.26 7. Form: Collection of Proceeds

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2.26-1 Alternative: Debtor to collect proceeds

4. Debtor promises:

a. To receive and use reasonable diligence in collecting the proceeds, and to deliver the proceeds required to be delivered by this agreement promptly to Secured Party.

b. Not to commingle the proceeds with other property or proceeds.

c. To keep complete and accurate records of the proceeds, in accordance with generally accepted accounting principles.

d. To provide any service and perform any other acts necessary to keep the proceeds free and clear of defenses, rights of setoff, and counterclaims.

2.26-2 Alternative: Secured party to collect proceeds

4. Debtor promises to pay all expenses incurred by Secured Party in connection with the collection of the proceeds, including expenses of and incidental to accounting, correspondence, collection effort, reporting to account or contract debtors, filing, recording, and record keeping.

Comment: These forms are suitable for use when the security interest includes accounts, inventory, chattel paper, and the like, as proceeds.

Most inventory and accounts financing arrangements permit the debtor to collect proceeds and turn them over to the secured party, as provided in form 2.26-1. The secured party must maintain adequate business controls to ensure that the proceeds are not dispersed. Promises alone are not enough. The secured party must set up a control system that provides the required legal protection without stifling the debtor's business practices.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.27 8. Form: Secured Party's Possession of Proceeds

§2.27 8. Form: Secured Party's Possession of Proceeds

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2.27-1 Secured party's possession of proceeds

5. From time to time, Secured Party may notify obligors to make payments on receivables (but not on accounts arising in the ordinary course of business unless a default or potential default exists) at the place and in the manner specified by Secured Party.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.28 9. Form: Power of Attorney

§2.28 9. Form: Power of Attorney

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2.28-1 Power of attorney

6. Debtor hereby appoints Secured Party as Debtor's attorney in fact, with the following powers:

a. To perform any of Debtor's obligations under the agreement in Debtor's name or otherwise.

b. To give notice of Debtor's right to payment, to enforce that right, and to make extension agreements with respect to it.

c. To release persons liable on rights to payment, to compromise disputes with those persons, and to surrender security, all as Secured Party determines in its sole discretion when acting in good faith based on information known to it when it acts.

d. To prepare and file financing statements, continuation statements, statements of assignment, termination statements, and the like, as necessary to perfect, protect, preserve, or release Secured Party's interest in the collateral.

e. To endorse Debtor's name on instruments, documents, or other forms of payment or security that come into Secured Party's possession.

f. To take cash in payment of obligations.

g. To verify information concerning rights to payment by inquiry in its own name or in a fictitious name.

h. To prepare, execute, and deliver insurance forms; to adjust insurance claims; to receive payment under insurance claims; and to apply such payment to reduce Debtor's obligation.

This power of attorney is coupled with an interest and may not be revoked or cancelled by Debtor without Secured Party's written consent.

Comment: The power of attorney may be indispensable if the secured creditor is doing the actual collection of rights to payment as a matter of course. It may also be useful if the debtor is hostile or is unavailable to carry out ordinary obligations with respect to the collateral. The debtor's signature should be acknowledged so that the power of attorney will be recognized by the Secretary of State, stock transfer agents, and others.

In many instances, however, the debtor will resist providing the power of attorney to the secured party unless an event of default has occurred. The power of attorney section can include the following language at the end of the introductory clause: "upon the occurrence of a default or event of default."

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.29 10. Form: Debtor's Warranties and Representations

§2.29 10. Form: Debtor's Warranties and Representations

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.20-2.41.

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2.29-1 Debtor's warranties and representations

7. Debtor covenants, warrants, and represents as follows:

a. Debtor is a _ _[*e.g., corporation/limited liability company/partnership*]**_ _, duly organized, validly existing, and in good standing under the laws of the _ _**[*name jurisdiction of organization*]**_ _, and has all necessary authority to conduct its business wherever it is conducted.**

b. Debtor has been authorized to execute and deliver this security agreement. The security agreement is a valid and binding obligation of Debtor. The agreement creates a perfected, first-priority security interest enforceable against the Collateral in which Debtor now has rights, and will create a perfected, first-priority security interest enforceable against the Collateral in which Debtor later acquires rights, when Debtor acquires those rights.

c. Neither the execution and delivery of this security agreement, nor the taking of any action in compliance with it, will (1) violate or breach any law, regulation, rule, order, or judicial action binding on Debtor, any agreement to which Debtor is a party, Debtor's articles of incorporation or bylaws; or (2) result in the creation of a lien against the Collateral except that created by this security agreement.

d. No default or potential default exists.

e. A schedule attached to and made a part of this security agreement states, without exceptions:

(1) Debtor's correct name as listed in its current organizational documents and the location of Debtor's chief executive office.

(2) Debtor's mailing address.

(3) The location of Inventory Collateral.

(4) The location of records relating to receivables.

(5) All the names under which Debtor has conducted its business.

(6) All liens and adverse claims to which the Collateral is subject.

(7) All financing statements except those naming Secured Party in which Debtor is the debtor.

(8) Any of the Collateral that consists of Fixtures, including the location, legal description, and name of the owner of the real property to which it is affixed.

f. Debtor will notify Secured Party in writing ___ days before any change occurs in any of the above.

g. Debtor owns and has possession of all tangible Collateral, subject only to those liens and adverse claims identified in the schedule referred to in paragraph 7(e).

Comment: Warranties are the debtor's representations of essential facts and are conditions of the agreement. If the

facts are other than the debtor warrants, the secured party may be excused from its obligation to perform and may be able to accelerate all outstanding loans and exercise remedies against the collateral. The secured party also may have a cause of action based on fraud. See §2.33 for remedies upon default and chap 5 for a discussion of how a secured party may exercise remedies.

There is no requirement that the agreement contain any warranties at all. Because most security agreements are drafted by lenders, however, they tend to contain long lists of warranties that effectively shift the risks and costs of the agreement to the debtor.

Subparagraph a should be included for entities such as corporations, limited liability companies, and limited partnerships. This information will be critical in determining where to file a financing statement in most instances. See §3.78. It is also prudent to review the debtor's organizational documents to determine the debtor's correct name and jurisdiction of organization.

It is important for the secured party to have adequate notice of changes related to the debtor's warranties and representations. The typical time period for a secured party to receive notice is 30 days, as provided in subparagraph f.

If the debtor is an individual, a representation should be included as follows:

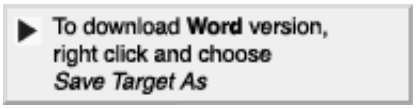
> **Debtor has provided Secured Party with his or her correct legal name as listed on his or her birth certificate, driver's license, tax returns, and other official documents.**

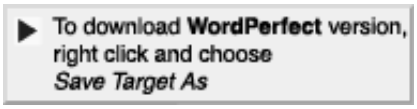
See §3.88 for a discussion of issues that arise in connection with obtaining the correct legal name for an individual.

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§2.30 11. Form: Special Provision for Fixtures

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2.30-1 Special provision for fixtures

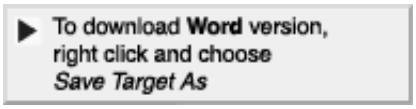
8. If any of the Collateral consists of Fixtures, the Collateral subject to this security agreement includes those Fixtures. Debtor has provided Secured Party all information needed to make the fixture filings required to give Secured Party's security interest in that Fixture Collateral priority over all third parties with an interest in the real property to which the Fixtures are attached.

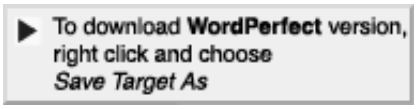
Comment: Special provisions govern the filing of financing statements covering fixtures as collateral. See §§3.97-3.101.

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§2.31 12. Form: Termination of Agreement

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2.31-1 Termination of agreement

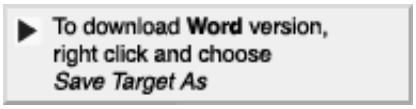
9. This security agreement will continue in effect even though from time to time there may be no outstanding obligations or commitments to Secured Party under this agreement or any related agreements. The agreement will terminate when (a) Debtor completes performance of all Obligations to Secured Party, including without limitation the repayment of all indebtedness by Debtor to Secured Party; (b) Secured Party has no commitment that could give rise to an Obligation; and (c) Debtor has notified Secured Party in writing of the termination.

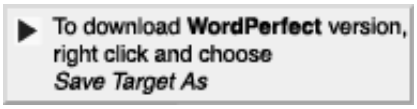
Comment: If the security agreement covers obligations under other agreements, such as a note or loan agreement, those agreements should be referred to in this clause. If the security agreement covers a shifting obligation in which the debt may drop to zero from time to time, the secured party may lose continuing perfection of the secured interest securing later advances, unless a proper financing statement has been filed. See chap 3.

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§2.32 13. Form: Default

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2.32-1 Default

10. Debtor will be in default under this agreement if:

a. Debtor fails to pay any Obligations, or any portion thereof, to Secured Party when due, at stated maturity, on accelerated maturity, or otherwise.

b. Debtor fails to make any remittances required by this agreement.

c. Debtor commits any breach of this agreement, or any present or future rider or supplement to this agreement, or any other agreement between Debtor and Secured Party evidencing the obligation or securing it.

d. Any warranty, representation, or statement, made by or on behalf of Debtor in or with respect to the agreement, is false.

e. The Collateral is lost, stolen, or damaged.

f. There is a seizure or attachment of, or a levy on, the Collateral.

g. Debtor ceases operations, is dissolved, terminates its existence, does or fails to do anything that allows obligations to become due before their stated maturity, or becomes insolvent or unable to meet its debts as they mature.

h. Secured Party for any reason deems itself insecure.

i. Debtor (1) applies for or consents to the appointment of a receiver, trustee, liquidator, or custodian of itself or of a substantial part of its property; (2) is unable, or admits in writing its inability, to pay its debts generally as they mature; (3) makes a general assignment for the benefit of its creditors or any of them; (4) is dissolved or liquidated in full or in part; (5) commences a voluntary case or other proceeding seeking liquidation, reorganization, or other relief with respect to itself or its debts under any bankruptcy, insolvency, or other similar law now or hereafter in effect, or consents to any relief or to the appointment of or taking possession of its property by any official in an involuntary case or other proceeding commenced against it; or (6) takes any action for the purpose of effecting any of the foregoing.

j. Proceedings for the appointment of a receiver, trustee, liquidator, or custodian of the Debtor or of all or a substantial part of its property, or an involuntary case or other proceedings seeking liquidation, reorganization, or other relief with respect to the Debtor or its debts under any bankruptcy, insolvency, or other similar law now or hereafter in effect are commenced and an order for relief is entered or such a proceeding is not dismissed or discharged within 60 days of commencement.

Comment: The Commercial Code does not define "default." The range and diversity of events of default depend partly on the ingenuity of the drafter, who normally is the secured party.

If the security agreement covers obligations under other agreements, such as a note or loan agreement, there should be an event of default for defaults under those agreements. If the note or loan agreement contain a complete listing of the events of default, only a reference to defaults under the note or loan agreement is necessary.

Security agreements often contain a clause making bankruptcy an event of default. See subparagraphs i and j above. These clauses are largely unenforceable under the Bankruptcy Code. 11 USC §§365(e), 541(c). See chap 6.

Although the agreement may provide that a default occurs when the secured party deems itself insecure, as provided in subparagraph h, the secured party is subject to a duty to act in good faith. Com C §1309; *Brown v Avemco Inv. Corp*. (9th Cir 1979) 603 F2d 1367. See §5.4.

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§2.33 14. Form: Remedies

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2.33-1 Remedies

11. When an event of default occurs:

a. Secured Party may exercise all rights and remedies available to a secured creditor after default, including but not limited to the rights and remedies of secured creditors under the California Commercial Code.

b. Secured Party's notice of the time and place of public sale of the Collateral, or the time on or after which a private sale or other disposition of the Collateral will be made, is reasonable if sent to Debtor in the manner for giving notice at least 10 days before the public or private sale.

c. Debtor must:

(1) Assemble the Collateral and make it and all records relating to it available to Secured Party as Secured Party directs.

(2) Allow Secured Party, its representatives, and its agents to enter the premises where all or any part of the Collateral, the records, or both may be, and remove any or all of it.

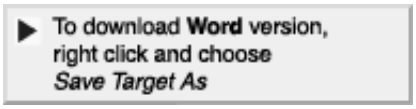
Comment: The specification of rights on default is purposely brief, because the California Commercial Code establishes specific rights and remedies. See Com C §§9207, 9601-9629. The debtor cannot waive a number of important rights under the Code. See Com C §9602. See also chap 5. Counsel may wish to spell out in detail what will constitute a "commercially reasonable" disposition of the collateral. See §5.42.

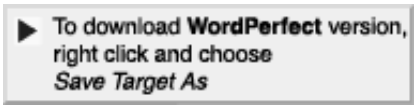
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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.34 15. Form: Attorney Fees and Costs

§2.34 15. Form: Attorney Fees and Costs

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2.34-1 Attorney fees and costs

12. Debtor will pay all costs and expenses of the Secured Party enforcing its rights under this agreement, including reasonable attorney fees.

Comment: The effect of this clause is made reciprocal by statute. CC §1717. See *Berge v International Harvester Co*. (1983) 142 CA3d 152, 164, 190 CR 815. If the creditor includes the clause and then loses a lawsuit based on the agreement, it must pay the debtor's attorney fees and costs.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.35 16. Form: Waiver by Secured Party

§2.35 16. Form: Waiver by Secured Party

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2.35-1 Waiver by secured party

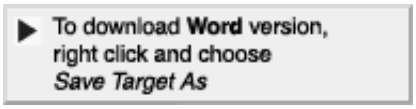
13. No waiver by Secured Party of any breach or default will be a waiver of any breach or default occurring later. A waiver will be valid only if it is in writing and signed by Secured Party.

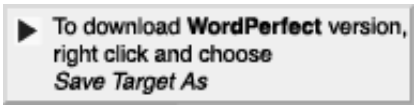
Comment: In negotiating with a debtor, the secured party may waive the debtor's breach in an effort to "work things out." The absence of a clause limiting the effect of the waiver to the specific breach waived may allow the debtor to claim that future performance of the breached term was also waived.

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§2.36 17. Form: Survival of Representations and Warranties

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2.36-1 Survival of representations and warranties

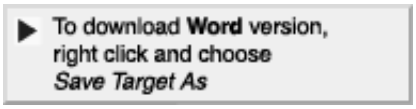
14. Debtor's representations and warranties made in this security agreement will survive its execution, delivery, and termination.

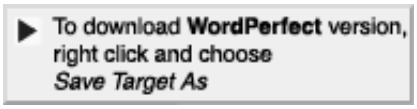
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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.37 18. Form: Assignment

§2.37 18. Form: Assignment

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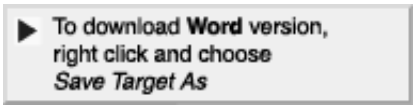
2.37-1 Assignment

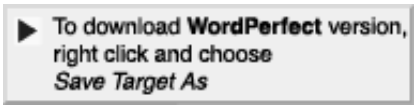
15. This security agreement will bind and benefit the successors and assignees of the parties, but Debtor may not assign its rights under the agreement without Secured Party's prior written consent.

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§2.38 19. Form: Governing Law

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.20-2.41.





2.38-1 Governing law

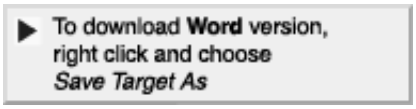
16. This security agreement will be governed by the law of California.

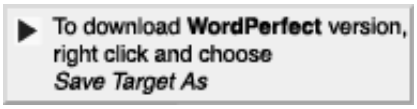
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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.39 20. Form: Entire Agreement

§2.39 20. Form: Entire Agreement

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2.39-1 Entire agreement

17. This security agreement is the entire agreement and supersedes any prior agreement or understandings between Secured Party and Debtor relating to the Collateral.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.40 21. Form: Notices

§2.40 21. Form: Notices

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2.40-1 Notices

18. Notices under this security agreement are considered to be served (a) three days after they are deposited in the United States mail, with prepaid first-class postage, addressed as follows; or (b) on receipt if served by facsimile:

DEBTOR	**SECURED PARTY**
_____	_____
_____	_____
_____	_____
Attention: _____	**Attention: _____**
Facsimile: _____	**Facsimile: _____**

Either party may change its address for service of notice, by notice to the other.

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§2.41 22. Form: Signatures

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2.41-1 Signatures

Date: _ _ _ _ _ _

_ _[*NAME OF DEBTOR*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _

_ _[*NAME OF SECURED PARTY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: This form assumes that both the debtor and secured party are entities. The secured party is not required to sign the security agreement. If the security agreement includes a power of attorney (see §2.28), the debtor's signature should be acknowledged so that the power of attorney will be recognized by the Secretary of State, stock transfer agents, and others.

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C. Security Agreement for Possessory Security Interest (Pledge Agreement for "Paper" Personal Property, Including Chattel Paper)

§2.42 1. Form: Title and Preamble

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.42-2.61.

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2.42-1 Title and preamble for pledge agreement

PLEDGE AGREEMENT

The parties to this pledge agreement are:

SECURED PARTY

Name _____

Address of Chief Executive Office _____

DEBTOR

Name _____

Address of Chief Executive Office _____

Comment: For discussion of pledge agreements, see §2.19. For discussion of perfection of possessory security interests, see chap 3.

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§2.43 2. Form: Definitions

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.42-2.61.

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2.43-1 Definitions for pledge agreement

1. Definitions

As used in this pledge agreement,

a. "Collateral" means all documents, instruments, investment property, and other property in Secured Party's possession in which Debtor now or later acquires a right, all distributions with respect to and all proceeds of that property, including without limitation the pledged instruments listed on Exhibit A-1 and the pledged stock listed on Exhibit A-2.

b. "Indebtedness" means Debtor's obligations, obligations representing the purchase price of property other than accounts payable arising in connection with the purchase of inventory on terms customary in the trade, and obligations under leases that would be capitalized in accordance with generally accepted accounting principles.

c. "Lien" means any security interest, mortgage, pledge, lien, attachment, claim, charge, encumbrance, or agreement retaining title covering the collateral.

d. "Obligations" means existing and future indebtedness and liability of Debtor to Secured Party, including obligations under _ _[*list applicable agreement*]_ _ and attorney fees incurred by Secured Party in enforcing this pledge agreement or collecting payment under it.

e. "Potential default" means an event or omission that would be a default under this pledge agreement, except for the passage of time or the giving of notice.

f. "Stock distributions" means all substitutions and exchanges for and all distributions with respect to stock and rights related to stock that is collateral, including but not limited to dividends, splits, adjustments, reclassifications, options, and warrants.

Comment: The secured party should ask the debtor to list any pledged promissory notes and pledged stock. With respect to pledged stock, the certificate number and the name of the corporation should be listed on a schedule. If the collateral includes stock, the secured party customarily asks for stock powers executed in blank.

The pledge agreement presumes that the creditor takes physical possession of the collateral before or at the same time as funds are advanced.

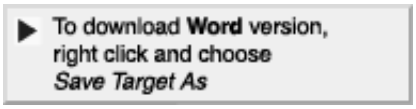
See §2.17 for discussion of possible problems with dragnet clauses such as the one in subparagraph d.

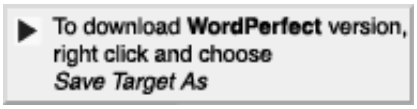
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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.44 3. Form: UCC Definitions Incorporated by Reference

§2.44 3. Form: UCC Definitions Incorporated by Reference

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.42-2.61.





2.44-1 UCC definitions incorporated by reference

g. Terms defined in the California Commercial Code not otherwise defined in this pledge agreement are used in this pledge agreement as defined in the California Commercial Code on the date of this agreement.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.45 4. Form: Grant of Security Interest

§2.45 4. Form: Grant of Security Interest

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2.45-1 Grant of security interest (short form)

2. Debtor grants Secured Party a security interest in the Collateral to secure payment of the Obligations.

Comment: See §2.24.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.46 5. Form: Debtor's Covenants

§2.46 5. Form: Debtor's Covenants

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2.46-1 Debtor's covenants

3. Debtor promises:

a. To pay the Obligations to Secured Party when they are due.

b. To pay all expenses, including attorney fees, incurred by Secured Party in the perfection, preservation, realization, enforcement, and exercise of its rights under this agreement.

c. To indemnify the Secured Party against loss of any kind, including reasonable attorney fees, caused to Secured Party by reason of its interest in the Collateral.

d. To conduct Debtor's business efficiently and without voluntary interruption.

e. To preserve all rights, privileges, and franchises held by Debtor's business.

f. To promptly deliver to Secured Party any Collateral in which the Debtor acquires an interest after the date of this pledge agreement.

g. To pay all taxes when due.

h. To give Secured Party notice of any litigation that may have a material adverse effect on the Debtor's business.

i. Not to change the name or place of business, or to use a fictitious business name, without first notifying Secured Party in writing.

j. Not to sell, lease, transfer, or otherwise dispose of the Collateral.

k. Not to permit liens on the Collateral, except existing liens and current tax liens.

l. To perform all acts necessary to maintain, preserve, and protect the Collateral.

m. To notify Secured Party promptly in writing of any default, potential default, or any development that might have a material adverse effect on the Collateral.

n. To execute and deliver to Secured Party all financing statements and other documents that Secured Party requests, in order to maintain a first perfected security interest in the Collateral.

o. To furnish Secured Party the reports relating to the Collateral at Secured Party's request.

[*Add, if collateral includes stock*]

p. To deliver promptly to Secured Party all certificates received in a split or distribution of, or issuance of stock dividends on, the Collateral.

Comment: The range and diversity of the debtor's promises depend on the type of collateral, the actions necessary to protect the secured party's rights in the collateral, and the relative bargaining power of the parties.

Subparagraph f requires the debtor to provide the secured party with additional instruments, stock certificates, or other collateral in which the debtor acquires an interest after the date of the pledge agreement. This is because this pledge agreement provides that the collateral will be held by the secured party. The secured party should also file a financing statement to ensure perfection of after-acquired instruments and stock certificates. See chap 3 for discussion of perfection of a security interest in this type of collateral.

Under some circumstances, the debtor's failure to pay a tax when due as provided in subparagraph g may trigger a claim against the collateral superior to the claim of the secured creditor. The secured party's practical remedy may be to pay taxes on the debtor's behalf and charge the amount as part of the debtor's obligation.

Subparagraph i requires the debtor to notify the secured party in writing if the debtor changes the name or location of its business. Note in this regard that a security interest perfected in accordance with the law of the jurisdiction where the debtor is located (Com C §§9301(1), 9305(c)) remains perfected until the expiration of four months after a change of the debtor's location to another jurisdiction (unless some other event has already caused the interest to lose its perfected status). Com C §9316(2).

When stock is the pledged collateral (see subparagraph p), "proceeds" include "whatever is collected on, or distributed on account of [the stock]." Com C §9102(a)(64)(B).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.47 6. Form: Secured Party's Possession of Proceeds

§2.47 6. Form: Secured Party's Possession of Proceeds

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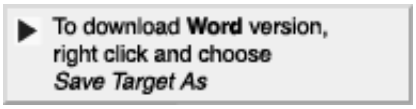
2.47-1 Secured party's possession of collateral

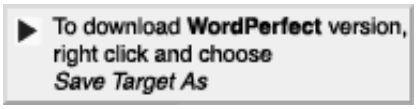
5. From time to time, Secured Party may notify obligor or issuer to make payments and distributions with respect to any or all of the Collateral directly to Secured Party.

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§2.48 7. Form: Power of Attorney

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.42-2.61.





2.48-1 Power of attorney

6. Debtor hereby appoints _ _[*name*]_ _, or any other person whom Secured Party may designate, as Debtor's attorney in fact, with the following powers:

a. To perform any of Debtor's obligations under the agreement in Debtor's name or otherwise.

b. To give notice of Debtor's right to payment, to enforce that right, and to make extension agreements with respect to it.

c. To release persons liable on rights to payment, to compromise disputes with those persons, and to surrender security, all as Secured Party determines in its sole discretion when acting in good faith based on information known to it when it acts.

d. To prepare and file financing statements, continuation statements, statements of assignment, termination statements, and the like, as necessary to perfect, protect, preserve, or release Secured Party's interest in the Collateral.

e. To endorse Debtor's name on instruments, documents, or other forms of payment or security that come into Secured Party's possession.

f. To take cash in payment of Obligations.

g. To verify information concerning rights to payment by inquiry in its own name or in a fictitious name.

h. To prepare, execute, and deliver insurance forms; to adjust insurance claims; to receive payment under insurance claims; and to apply such payment to reduce Debtor's Obligation.

This power of attorney is coupled with an interest and may not be revoked or cancelled by Debtor without Secured Party's written consent.

Comment: See §2.28.

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§2.49 8. Form: Debtor's Warranties and Representations

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.42-2.61.

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2.49-1 Debtor's warranties and representations

7. Debtor covenants, warrants, and represents as follows:

a. Debtor is a _ _[*e.g., corporation/limited liability company/partnership*]**_ _, duly organized, validly existing, and in good standing under the laws of the _ _**[*name of jurisdiction of organization*]**_ _, and has all necessary authority to conduct its business wherever it is conducted.**

b. Debtor has been authorized to execute and deliver this pledge agreement. The pledge agreement is a valid and binding obligation of Debtor. The agreement creates a security interest enforceable against the Collateral in which Debtor now has rights, and will create a security interest enforceable against the Collateral in which Debtor later acquires rights, when Debtor acquires those rights.

c. Neither the execution and delivery of this pledge agreement, nor the taking of any action in compliance with it, will (1) violate or breach any law, regulation, rule, order, or judicial action binding on Debtor, any agreement to which Debtor is a party, or Debtor's articles of incorporation or bylaws; or (2) result in the creation of a lien against the collateral except that created by this pledge agreement.

d. No default or potential default exists.

e. A schedule attached to and made a part of this pledge agreement states, without exceptions:

(1) Debtor's correct name as listed in its current organizational documents and the location of Debtor's chief executive office.

(2) Debtor's mailing address.

(3) All the names under which Debtor has conducted its business.

(4) All liens and adverse claims to which the collateral is subject.

(5) All financing statements except those naming Secured Party in which Debtor is the debtor.

[*Add, if collateral includes, e.g., stock, options, warrants*]

(6) All issuers of stock, options, warrants, or other rights that are collateral of which Debtor is an officer or director.

(7) All issuers of stock, options, warrants, or other rights that are collateral in which Debtor owns or controls more than 10 percent of the stock.

f. Debtor owns and has possession of the Collateral, subject only to those liens and adverse claims identified in the schedule referred to in paragraph 7(e).

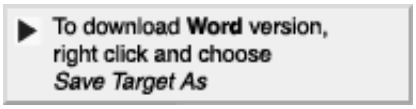
Comment: See §2.29.

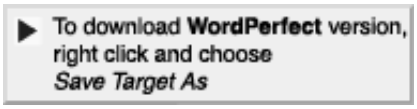
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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.50 9. Form: Secured Party's Duties

§2.50 9. Form: Secured Party's Duties

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.42-2.61.





2.50-1 Secured party's duties

8. Secured Party has no duty or liability for the Collateral except to exercise reasonable care while it is in Secured Party's possession.

[*Add, if collateral includes, e.g., stock, options, warrants*]

Secured Party need not ascertain, act, or notify Debtor, with respect to tenders, calls, conversions, or other matters relating to the Collateral.

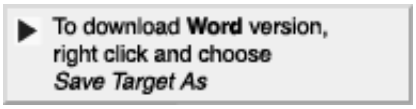
Comment: See §§3.60-3.62 for discussion of the rights and duties of a secured party in possession.

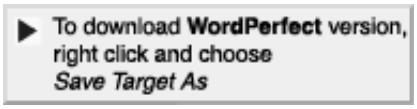
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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.51 10. Form: Termination

§2.51 10. Form: Termination

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2.51-1 Termination

9. This pledge agreement will continue in effect even though from time to time there may be no outstanding Obligations or commitments to Secured Party under this agreement or any related agreement. The agreement will terminate when (a) Debtor completes performance of all Obligations to Secured Party, including without limitation the repayment of all indebtedness by Debtor to Secured Party; (b) Secured Party has no commitment that could give rise to an Obligation; and (c) Debtor has notified Secured Party in writing of the termination.

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§2.52 11. Form: Default

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.42-2.61.

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2.52-1 Default

10. Debtor will be in default under this agreement if:

a. Debtor fails to pay any installment when due, or its entire indebtedness to Secured Party when due, at stated maturity, on accelerated maturity, or otherwise.

b. Debtor fails to make any remittances required by this agreement.

c. Debtor commits any breach of this agreement, or any present or future rider or supplement to this agreement, or any other agreement between Debtor and Secured Party evidencing the obligation or securing it.

d. Any warranty, representation, or statement, made by or on behalf of Debtor in or with respect to the agreement, is false.

e. The Collateral is lost, stolen, or damaged.

f. There is a seizure or attachment of, or a levy on, the Collateral.

g. Debtor ceases operations, is dissolved, terminates its existence, does or fails to do anything that allows Obligations to become due before their stated maturity, or becomes insolvent or unable to meet its debts as they mature.

h. Secured Party for any reason deems itself insecure.

i. Debtor (1) applies for or consents to the appointment of a receiver, trustee, liquidator, or custodian of itself or of a substantial part of its property; (2) is unable, or admits in writing its inability, to pay its debts generally as they mature; (3) makes a general assignment for the benefit of its creditors or any of them; (4) is dissolved or liquidated in full or in part; (5) commences a voluntary case or other proceeding seeking liquidation, reorganization, or other relief with respect to itself or its debts under any bankruptcy, insolvency, or other similar law now or hereafter in effect, or consents to any relief or to the appointment of or taking possession of its property by any official in an involuntary case or other proceeding commenced against it; or (6) takes any action for the purpose of effecting any of the foregoing.

j. Proceedings for the appointment of a receiver, trustee, liquidator, or custodian of the Debtor or of all or a substantial part of its property, or an involuntary case or other proceedings seeking liquidation, reorganization, or other relief with respect to the Debtor or its debts under any bankruptcy, insolvency, or other similar law now or hereafter in effect are commenced and an order for relief is entered or such a proceeding is not dismissed or discharged within 60 days of commencement.

Comment: See §2.32.

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§2.53 12. Form: Remedies

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2.53-1 Remedies

11. When an event of default occurs:

a. Secured Party may:

(1) Exercise all rights and remedies available to a secured creditor after default, including but not limited to the rights and remedies of secured creditors under the California Commercial Code.

(2) Perform any of Debtor's obligations under this agreement for Debtor's account. Any money expended or obligations incurred in doing so, including reasonable attorney fees and interest at the highest rate permitted by law, will be charged to Debtor and added to the Obligations secured by this agreement.

[*Add, if collateral includes stock*]

(3) At its option and without notice to Debtor, transfer and register the Collateral or any part of it in Secured Party's name or the name of its nominees; collect and enforce payment with respect to the Collateral; exercise all rights, options, and privileges with respect to the Collateral, and deliver it in that connection to any appropriate person or agency; and vote the Collateral as Debtor's proxy, that proxy to be irrevocable until this pledge agreement is terminated. Until such default, Debtor's right to vote the Collateral will not be impaired by this agreement.

(4) Conduct a "commercially reasonable" private sale or other disposition of the Collateral although a higher price might have been obtained for it at a public sale under the Securities Act of 1933, as amended, or in compliance with any other applicable laws or regulations.

[*Continue*]

b. Secured Party's notice of the time and place of public sale of the Collateral, or the time on or after which a private sale or other disposition of the Collateral will be made, is reasonable if sent to Debtor in the manner for giving notice at least 10 days before the public or private sale.

c. Debtor must:

(1) Assemble all records relating to the Collateral and make them available to Secured Party as Secured Party directs.

(2) Execute all documents and instruments on Secured Party's request that Secured Party considers necessary or advisable to exercise its rights under this pledge agreement.

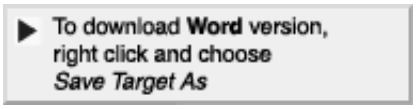
Comment: See §2.33. This clause omits reference to assembling the collateral and making it available to secured party, because secured party already has the collateral in its possession.

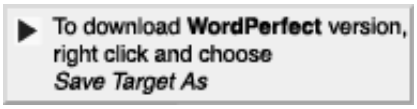
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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.54 13. Form: Attorney Fees and Costs

§2.54 13. Form: Attorney Fees and Costs

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.42-2.61.





2.54-1 Attorney fees and costs

12. Debtor will pay all costs and expenses of collection, including reasonable attorney fees.

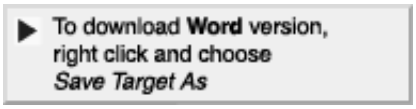
Comment: See §2.34.

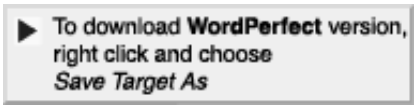
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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.55 14. Form: Waiver by Secured Party

§2.55 14. Form: Waiver by Secured Party

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2.55-1 Waiver by secured party

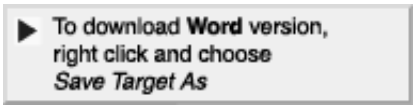
13. No waiver by Secured Party of any breach or default will be a waiver of any breach or default occurring later. A waiver will be valid only if it is in writing and signed by Secured Party.

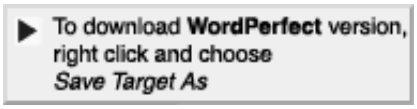
Comment: See §2.35.

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§2.56 15. Form: Survival of Representations and Warranties

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2.56-1 Survival of representations and warranties

14. Debtor's representations and warranties made in this security agreement will survive its execution, delivery, and termination.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.57 16. Form: Assignment

§2.57 16. Form: Assignment

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2.57-1 Assignment

15. This pledge agreement will bind and benefit the successors and assignees of the parties, but Debtor may not assign its rights under the agreement without Secured Party's prior written consent.

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§2.58 17. Form: Governing Law

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2.58-1 Governing law

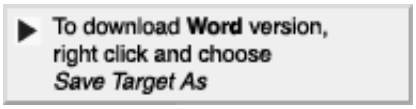
16. This pledge agreement will be governed by the law of California.

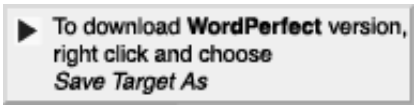
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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.59 18. Form: Entire Agreement

§2.59 18. Form: Entire Agreement

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.42-2.61.





2.59-1 Entire agreement

17. This pledge agreement is the entire agreement, and supersedes any prior agreement or understandings, between Secured Party and Debtor relating to the Collateral.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.60 19. Form: Notices

§2.60 19. Form: Notices

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2.60-1 Notices

18. Notices under this pledge agreement are considered to be served (a) three days after they are deposited in the United States mail, with prepaid first-class postage, addressed as follows; or (b) upon receipt if served by facsimile:

DEBTOR	**SECURED PARTY**
_____	_____
_____	_____
_____	_____
Attention: _____	**Attention:** _____
Facsimile: _____	**Facsimile:** _____

Either party may change its address for service of notice, by notice to the other.

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§2.61 20. Form: Signatures

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2.61-1 Signatures

Date: _ _ _ _ _ _

_ _[*NAME OF DEBTOR*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _

_ _[*NAME OF SECURED PARTY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: See §2.41. If the pledge agreement includes a power of attorney (see §2.48), the debtor's signature should be acknowledged so that the power of attorney will be recognized by the Secretary of State, stock transfer agents, and others.

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§2.62 D. Intellectual Property Security Agreement

As discussed in chap 3, secured creditors should be aware that certain precautions should be taken to perfect security interests in intellectual property or to provide notice to bona fide purchasers of the secured party's interest in the intellectual property collateral. Therefore, the secured creditor may wish to file an intellectual property security agreement with the Copyright Office or the Patent and Trademark Office. Set forth below is a form agreement. It is based on the same definitions found in the Security Agreement set forth in §2.21.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.63 1. Form: Title and Preamble

§2.63 1. Form: Title and Preamble

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PATENT, TRADEMARK, AND COPYRIGHT SECURITY AGREEMENT

This Patent, Trademark, and Copyright Security Agreement (as the same may be amended, restated, supplemented or otherwise modified from time to time, the "Agreement"), dated as of _____, is made by _____, a _____ corporation ("Debtor"), in favor of _____, a _____ corporation ("Secured Party").

A. Pursuant to that certain _ _[*describe loan agreement or note*]_ _ executed this date by and among Debtor and Secured Party (including all annexes, exhibits, and schedules thereto, and as the same may be amended, restated, supplemented, or otherwise modified from time to time, the "Loan Agreement"), Secured Party has agreed to extend certain financial accommodations to or for the direct or indirect benefit of Debtor.

B. Pursuant to the Loan Agreement and related agreements, Debtor is required to execute and deliver to Secured Party, for the benefit of Secured Party, this Patent, Trademark, and Copyright Security Agreement.

C. NOW, THEREFORE, in consideration of the premises and mutual covenants herein contained and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Debtor and Secured Party hereby agree as follows:

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.64 2. Form: Definitions

§2.64 2. Form: Definitions

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1. Unless otherwise defined herein, capitalized terms or matters of construction defined or established in the Loan Agreement shall be applied in this Agreement as defined or established in the Loan Agreement. All other undefined terms contained in this Agreement, unless the context indicates otherwise, shall have the meanings provided for by the California Commercial Code to the extent the same are used or defined there.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.65 3. Form: Grant of Security Interest in Intellectual Property Collateral

§2.65 3. Form: Grant of Security Interest in Intellectual Property Collateral

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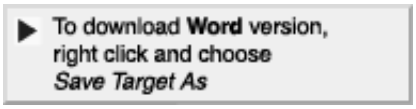
2. Debtor hereby grants to Secured Party a continuing first-priority security interest on all of Debtor's right, title, and interest in, to and under the property described in Schedule I, whether presently existing or hereafter created or acquired (collectively, the "Intellectual Property Collateral"):

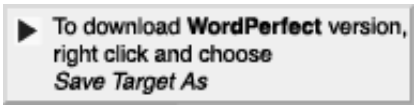
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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.66 4. Form: Incorporation of Loan Agreement Security Provision

§2.66 4. Form: Incorporation of Loan Agreement Security Provision

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.63-2.69.





3. The security interest granted pursuant to this Agreement is granted in conjunction with the liens granted to Secured Party, for the benefit of Secured Party, pursuant to the Loan Agreement. Debtor hereby acknowledges and affirms that the rights and remedies of Secured Party with respect to the liens granted under this Agreement are more fully set forth in the Loan Agreement, the terms and provisions of which are incorporated by reference herein as if fully set forth herein.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.67 5. Form: Signatures

§2.67 5. Form: Signatures

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IN WITNESS WHEREOF, the parties have executed this Patent, Trademark, and Copyright Security Agreement as of the date first set forth above.

Date: _ _ _ _ _ _

_ _[*NAME OF DEBTOR*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _

_ _[*NAME OF SECURED PARTY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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6. Intellectual Property Collateral

§2.68 a. Form: Schedule I to Patent, Trademark, and Copyright Security Agreement

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.63-2.69.

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All right, title and interest of ____ ("Debtor") now owned or hereafter acquired in and to the following:

(1) All patentable inventions, patent rights, shop rights, letters of patent of the United States or any other country, all right, title, and interest in the foregoing, and all registrations and recordings of the foregoing, including all patent registrations and recordings in the Patent and Trademark Office or in any similar office or agency of the United States, any state, or any foreign country or political subdivision of such a country, relating to the software described in Schedule II (collectively, the "Patents");

(2) All copyrights, including all original works of authorship fixed in any tangible medium of expression; all right, title, and interest in the foregoing, and all registrations and recordings of the foregoing, including all applications, registrations, and recordings in the Copyright Office or in any similar office or agency of the United States, any state, or any foreign country or political subdivision of such a country, relating to the software described in Schedule II (collectively, the "Copyrights");

(3) All trademarks, trade names, trade styles, and service marks, and all prints and labels on which said trademarks, trade names, trade styles, and service marks have appeared or appear, and all designs and general intangibles of like nature, now existing or hereafter adopted or acquired; all right, title, and interest in the foregoing, all registrations and recordings of the foregoing, including all applications, registrations, and recordings in the Patent and Trademark Office or in any similar office or agency of the United States, any state, or any foreign country or political subdivision of such a country, relating to the software described in Schedule II, including any and all goodwill associated with it (collectively, the "Trademarks");

(4) All rights of Debtor under any written agreement with respect to the use of any Patents, Copyrights, Trademarks, trade secrets, or proprietary or confidential information, including rights of a licensee or licensor with respect thereto;

(5) All goodwill, trade secrets, proprietary or confidential information, technical information, procedures, formulas, quality control standards, operating and training manuals, and customer lists with respect to any Patents, Copyrights, and Trademarks; and

(6) All products and proceeds of the foregoing.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/2 The Security Agreement/§2.69 b. Form: Schedule II to Patent, Trademark, and Copyright Security Agreement

§2.69 b. Form: Schedule II to Patent, Trademark, and Copyright Security Agreement

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§2.63-2.69.

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Part A (Patents, Including Patent Applications)

Docket No.	Country	Filing Date	Application No.	Patent No.	Title

Part B (Copyrights, Including Copyright Applications)

Country	Description	Application No.	Registration No.	Application or Registration Date

Part C (Trademarks, Including Trademark Applications)

Country	Description	Serial or Application No.	Application Date

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3

Perfection

Ellen A. Friedman

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§3.1 I. ATTACHMENT AND PERFECTION

Attachment and perfection of security interests are two central concepts in Division 9. Attachment relates to a creditor's rights against the debtor. Perfection deals with the creditor's rights with respect to third parties. The requirements for attachment are discussed in §§3.2-3.5. The requirements for perfection are discussed in §3.6 and throughout this chapter.

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§3.2 A. Attachment of Security Interest

For a security interest to attach to the collateral, it must be enforceable against the debtor. Com C §9203(a).

A security interest is enforceable if (1) value has been given; (2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured third party; and (3) there is evidence that the debtor intended to pledge the collateral through one of a variety of methods, but generally through execution of a security agreement. Com C §9203(b). See §§3.3-3.5.

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§3.3 1. Value Given

In determining whether "[v]alue has been given" under Com C §9203(b)(1), it is necessary to look at the definition of "value" in Com C §1204, which provides:

> [A] person gives "value" for rights if the person acquires them:
> (1) in return for a binding commitment to extend credit or for the extension of immediately available credit, whether or not drawn upon and whether or not a chargeback is provided for in the event of difficulties in collection;
> (2) as security for, or in total or partial satisfaction of, a preexisting claim;
> (3) by accepting delivery pursuant to a preexisting contract for purchase;
> (4) in return for any consideration sufficient to support a simple contract.

The definition of "value" applicable here is not applicable to Divisions 3, 4, and 5 and is broader than the definition used to determine whether the holder of a negotiable instrument takes it "for value" under Division 3 (Commercial Paper) or with respect to collecting banks under Division 4. The definition of value in Com C §1204, used for purposes of Division 9, provides that an executory promise may constitute value; Division 3 and Division 4 do not so provide. See Com C §§3303, 4210-4211.

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§3.4 2. Debtor's Rights in Collateral

The second requisite for attachment is that the debtor have rights in the collateral or the power to transfer rights in the collateral. Com C §9203(b)(2).

The statute does not define the phrase "rights in the collateral." The determination of whether the debtor has rights in collateral is made by "other laws," not the Uniform Commercial Code. Official Comment 3 to UCC §9-408. It is not necessary that the debtor own or hold title to the collateral; however, mere possession is not sufficient.

If a debtor has limited rights in collateral short of full ownership, a debtor may be able to grant a security interest in those rights, but it is important to remember that the security interest only attaches to whatever rights the debtor has, not to anything broader. Official Comment 6 to UCC §9-203.

In *Foothill Capital Corp. v Clare's Food Market, Inc. (In re Coupon Clearing Serv., Inc.)* (9th Cir 1997) 113 F3d 1091, 1103, the Chapter 7 debtor was a coupon clearinghouse that collected coupons from supermarkets and obtained reimbursement on their behalf from the manufacturers who offered the coupons. For every coupon redeemed, the supermarkets received the coupon's face value plus a handling fee of eight cents. For handling the reimbursement transaction, the clearinghouse received a fee, which it deducted from the redemption proceeds. This bankruptcy case involved a fight over those proceeds between the supermarkets and the clearinghouse's secured lender. The court considered whether the debtor clearinghouse had sufficient rights in the proceeds for the lender's security interest to attach, thereby defeating the retailers' claim. The Ninth Circuit held that although the debtor did not own the coupon proceeds, it had no contractual obligation to segregate them from its own funds, and could use the proceeds as its general operating funds. This indicated that the debtor had rights greater than mere possession in the proceeds; thus, the lender's security interest attached and the lender prevailed.

Other cases have examined whether a security interest can attach if the seller retains title to the goods sold to a debtor. The debtor may have rights in the collateral and not have title to the collateral. See *Usiner Industeel v Leeco Steel Prods., Inc.* (ND Ill 2002) 209 F Supp 2d 880 (secured party's security interest attached to collateral although seller retained title to goods. But see *Arcadia Fin., Ltd. v Southwest-Tex Leasing Co.* (Tex App 2002) 78 SW3d 619 (seller's retention of title to car inventory prevented secured party's security interest in debtor's inventory from attaching).

A question may arise as to whether a security interest attaches in certain intellectual property because of anti-assignment issues under intellectual property licenses. Under applicable patent and copyright law, nonexclusive patent licenses and copyright licenses are personal and can be assigned only with the consent of the licensor. *Perlman v Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)* (9th Cir 1999) 165 F3d 747; *Everex Sys., Inc. v Cadtrak Corp. (In re CFLC, Inc.)* (9th Cir 1996) 89 F3d 673; *In re Golden Books Family Entertainment, Inc.* (Bankr D Del 2001) 269 BR 300; *In re Patient Educ. Media, Inc.* (Bankr SD NY 1997) 210 BR 237, 242. The Ninth Circuit has held that an exclusive copyright license may not be assigned without consent. *Gardner v Nike, Inc.* (9th Cir 2002) 279 F3d 774. See §§6.46-6.50 for a detailed discussion of these cases and related issues arising in the bankruptcy context. Commercial Code §9408, however, allows a licensee to grant a security interest in a license notwithstanding license agreement terms to the contrary. See also *Superbrace, Inc. v Tidwell* (2004) 124 CA4th 388, 401, 21 CR3d 404 (state law governs assignment of patent licenses). See §4.88 for a discussion of Com C §9408.

Special regulations governing the sale of Native American properties may supersede the Uniform Commercial Code. In *Hoopa Valley Tribe v Hong Kong & Shanghai Banking Corp. (In re Blue Lake Forest Prods.)* (9th Cir 1994) 30 F3d 1138, the court held that the debtor did not obtain rights in timber purchased from the Hoopa Valley Tribe until it paid for the timber, despite general law to the contrary, because the sale was controlled by special regulations governing sales of timber from Native American lands. Accordingly, the tribe's rights were held superior to those of the bank claiming a security interest in the debtor's inventory and the proceeds of the inventory under a security agreement.

"Remedies" and "rights" are defined in Com C §1201(b)(32) and (b)(34), respectively. "Security interest" is defined in Com C §1201(b)(35).

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§3.5 3. Evidence of Intent to Pledge Collateral

There are several methods by which a debtor can evidence its intent to pledge collateral. Generally, the debtor can evidence such an intent by authentication of a security agreement that contains a description of the collateral. Com C §9203(b)(3)(A). See §2.5 regarding authentication and §§2.6-2.8 about describing the collateral.

If the collateral is a certificated security, an alternative permits delivery to the secured party pursuant to a security agreement. Com C §9203(b)(3)(C). See Com C §8301.

If the collateral is not a certificated security, then the secured party may obtain an enforceable security interest by taking possession of tangible collateral under a security agreement as required under Com C §9313. Com C §9203(b)(3)(B). For a discussion of delivery of an uncertificated security, see §3.54.

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§3.6 B. Perfection of Security Interest

A central function of Division 9 of the Commercial Code is to establish rules of priority to determine conflicts between competing claimants to the same collateral.

Perfection of a security interest in collateral is the means by which a creditor may seek to have superior rights to other creditors. Because more than one creditor may "perfect" its interest in the same collateral, Division 9 also sets forth rules of priority among creditors. Chapter 4 considers priority among creditors. This chapter examines the rules and methods of perfection under Division 9. In addition, if a security interest is not perfected, special rules in bankruptcy may cause the secured creditor to lose its secured position. For discussion of avoidance of security interests in bankruptcy, see chap 6.

The basic rules governing perfection are set forth in Com C §9308. In general, a security interest is perfected when (1) it attaches (see §§3.2-3.5) and (2) any necessary steps for perfection set forth in Com C §§9310-9316 are taken. Com C §9308(a). In certain cases, perfection is automatic on attachment. See §§3.7-3.12. The different methods of perfection under Division 9 are discussed in §§3.13-3.59. Problems with perfection by possession and control are discussed in §§3.60-3.63. Perfection of security interests in certain types of collateral by statutes other than the Commercial Code is discussed in §§3.64-3.75. How to perfect by filing, the most common method under Division 9, is discussed in §§3.76-3.115. Transition rules apply to certain cases in which perfection was governed by former Division 9. See §3.116.

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§3.7 II. AUTOMATIC PERFECTION

In some situations, perfection is achieved automatically on attachment. Com C §§9308-9309. Under Com C §9308, a creditor can take the steps required to perfect a security interest before attachment of the interest. In such cases, perfection occurs on attachment. Section 9309 provides a list of 14 instances in which perfection occurs on attachment. Certain of those instances are described in §§3.8-3.12.

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§3.8 A. Consumer Goods

Special rules apply to "consumer goods," defined in Com C §9102(a)(23) as goods "used or bought for use primarily for personal, family or household purposes." This definition is similar (but not identical) to the coverage definitions of major consumer protection statutes. See chap 7.

Perfection of a purchase money security interest in consumer goods is automatic. The creditor (or seller-creditor) need not take possession of the consumer goods, and need not file (except for goods for which a fixture filing is necessary, or for vehicles or boats subject to registration requirements; see §§3.64-3.74). Com C §§9309(1), 9311, 9334. The practical consequence of this exception is that competing claimants—general creditors, subsequent secured creditors, and buyers—are subject to the security interest, even though there is no way they can learn of its existence.

For detailed discussion of transactions in consumer goods, see chap 7.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.9 B. Security Interests Arising Under Division 2 (Sales) and Division 10 (Leases)

§3.9 B. Security Interests Arising Under Division 2 (Sales) and Division 10 (Leases)

Security interests arising under Com C §2401 (seller's reservation of title to goods shipped or delivered to buyer), Com C §2505 (seller's shipment under reservation), Com C §2711(3) (buyer's security interest in rejected goods), or Com C §10508 (lessee's remedies on default by lessor) are governed by Division 9. Com C §9110. Until the debtor obtains possession of the goods, however:

- The security interest is enforceable, even if it has not attached;
- Filing is not required to perfect the security interest;
- The rights of the secured party after default are governed by Division 2 (sales) or Division 10 (leases), as applicable; and
- The security interest has priority over a conflicting security interest created by the debtor.

For discussion of leases as security interests under Division 9, see §§1.21-1.30. For discussion of security interests created under Division 2, see §1.31.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.10 C. Interests in Estates

§3.10 C. Interests in Estates

A security interest created by assignment of the beneficial interest in a decedent's estate is perfected on attachment. Com C §9309(13).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.11 D. Security Interest of Collecting Bank

§3.11 D. Security Interest of Collecting Bank

The filing provisions of Division 9 do not apply to a security interest of a collecting bank arising under Com C §4210. Com C §9309(7). A bank has a security interest in an item and accompanying documents or the proceeds of either when the bank (though it has not become the owner of the item) has benefited the depositor by either advancing money or giving credit, available for withdrawal as of right, on the security of the item. Com C §4210.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.12 E. Assignment for Benefit of Creditors

§3.12 E. Assignment for Benefit of Creditors

No filing or possession is necessary with respect to an assignment for the benefit of creditors or subsequent transfers by the assignee. Com C §9309(12).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.12A F. Sale of Payment Intangible or Promissory Note

§3.12A F. Sale of Payment Intangible or Promissory Note

A sale of a payment intangible or promissory note is perfected automatically. Com C §9309(3)-(4).

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§3.13 III. METHODS OF PERFECTION

The Commercial Code prescribes different methods of perfection, depending on the kind of collateral and the nature of the transaction. The creditor may perfect by filing a financing statement, by taking possession, or by taking "control" of the collateral. In limited circumstances, perfection will occur automatically. Requirements for different types of collateral are discussed in §§3.14-3.59.

Here are some major principles:

- **Accounts and general intangibles.** A security interest in accounts or general intangibles (except for sale payment intangibles) may be perfected only by filing. Com C §9310. See §3.14.
- **Goods.** A security interest in goods may be perfected by either filing or possession. Com C §§9312-9313. There are limited protections with neither filing nor possession. See §3.30.
- **Negotiable documents, instruments, investment property, and chattel paper.** A security interest in negotiable documents, instruments, investment property, or chattel paper may be perfected either by filing or by possession, although investment property may also be perfected by control. Com C §§9312-9313, 9324. But the secured creditor who depends only on filing will lose important advantages that would be available if he or she took possession. See §§3.38, 3.40, 3.48. There are limited protections with neither filing nor possession. See §3.39.
- **Deposit accounts, electronic chattel paper, electronic documents of title, investment property, or letter-of-credit rights.** A security interest in deposit accounts, electronic chattel paper, electronic documents of title, investment property, or letter-of-credit rights may be perfected by control. Com C §§9310, 9314. Com C §§9310(b)(8) and 9314(a) refer to electronic documents of title that may be perfected by control under Com C §9314. See §§3.40, 3.44, 3.44A, 3.46, 3.48.
- **Automatic perfection**. In some instances perfection is automatic, without either filing or possession; *i.e.,* the creditor may perfect by doing nothing at all. Com C §9309. An important example is the purchase money security interest in consumer goods, but there are several others as well. See §§3.7-3.12, 3.32.
- **Compliance with other statutes.** In some situations (*e.g.,* perfection of security interests in registered copyrights, most motor vehicles), compliance with a statute other than the Commercial Code is required. See §§3.23, 3.64-3.75.

In a great variety of transactions, the secured creditor may perfect the security interest either by filing or by taking possession of the collateral. This is true in many transactions in which the collateral is goods. It is also true to a lesser extent for negotiable documents and chattel paper, and even for instruments under limited circumstances. The rules are straightforward and, for the most part, workable, but it is not possible to say categorically which method is preferable. The decision of which method of perfection a secured creditor should use depends on the circumstances of each transaction.

For certain types of collateral, the secured creditor's priority with respect to other creditors is determined by how the secured party perfected its interest in the collateral. See chap 4.

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A. Accounts

§3.14 1. Requirement of Filing to Perfect Security Interest in Accounts

Perfection of a security interest in accounts can be accomplished only by filing a financing statement. See §§3.76-3.79. Because of the nature of accounts, there is no "thing" to associate with the property right, only abstract rights or enforceable legal relationships.

This rule is never directly stated in the Commercial Code. Rather, Com C §9310 states that a financing statement must be filed to perfect all security interests except those specifically mentioned, and there is no exception for accounts.

For discussion of the problems in characterizing some revenues as rents or accounts and the critical difference it makes in a bankruptcy context, see §6.70.

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§3.15 2. Limitations on Protection by Filing With Respect to Accounts

The creditor taking a transfer of accounts faces three problems against which the filing system offers no protection. See §§3.16-3.18.

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§3.16 a. Levy on Account

One problem for the creditor is the risk that there has been a levy on the account under CCP §488.470. That levy is effected not by filing but by notice to the account debtor, and is effective through service of the notice. See CCP §488.500. In the ordinary accounts-receivable financing transaction, there are great numbers of accounts, and it is not feasible to check with all account debtors to see whether there has been prior notice by a levying creditor. Ordinarily, the secured party at the very least requires warranties from the debtor that there are no levies. The creditor may also spot-check account debtors to see whether there has been any "general" service of notice.

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§3.17 b. Excluded Transfers

A second problem for the creditor is that the Commercial Code does not apply to certain extraordinary transfers of accounts. Com C §9109(d). If the transferee is to get any protection, that protection must come from sources other than the Commercial Code. Transfers excluded from the coverage of Division 9 include:

- A transfer of a single account to an assignee in whole or partial satisfaction of a preexisting indebtedness. Com C §9109(d)(7).
- An assignment of a right to payment under a contract to an assignee that is also obligated to perform under the contract. Com C §9109(d)(6).
- A sale of accounts as part of the sale of the business out of which they arose. Com C §9109(d)(4).
- An assignment of accounts for the purpose of collection only. Com C §9109(d)(5).

Although the collection agent by definition does not claim "ownership" of the account, the agent may assert a right to take a percentage collection fee from the money collected before turning it over to the account creditor or the secured creditor. The secured creditor may want to police the transfer of funds to a collection agent in order to monitor the collection fees. The secured creditor should obtain a representation in its security agreement covering each of the above-listed transactions.

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§3.18 c. Statute of Limitations on Underlying Obligation

A possible third limitation on the protection given by filing a financing statement with respect to accounts was revealed in *Kaichen's Metal Mart, Inc. v Ferro Cast Co.* (1995) 33 CA4th 8, 39 CR2d 233. The statute of limitations on the underlying obligation may run and allow a junior lienholder to set aside a senior lien securing the obligation. In this case the debtor borrowed money and gave a security interest. A subsequent judgment lien creditor was initially prevented from enforcing its lien because the debtor had insufficient assets to satisfy the senior lienholder and the judgment creditor. Subsequently, more than four years after the debtor defaulted on its debt to the senior lienholder, the judgment lien creditor moved to set aside the senior security interest because the four-year limitation period of CCP §337 had made the senior debt unenforceable even though the original security interest had been extended by a continuation statement. The court held that because the debtor and senior creditor agreed to extend the statute of limitations *before* it expired, the senior lien continued unabated. The court declined to follow an out-of-state case holding that the statute of limitations cannot defeat a personal property security transaction. If the debtor and the senior lienholder had not agreed to extend the statute of limitations before it ran, it is likely that the judgment lien creditor would have been able to levy on the debtor's assets.

PRACTICE TIP: If the security agreement secures a debt, counsel should be careful to make sure that the debt remains enforceable.

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B. General Intangibles

§3.19 1. General Rule of Perfection by Filing

In most instances, an interest in general intangibles may be perfected by filing a financing statement. Com C §9310. However, because general intangibles encompass a wide variety of collateral, including intellectual property, a secured creditor should be aware that certain additional steps may be required to perfect a security interest in intellectual property or to provide notice to bona fide purchasers of intellectual property. For discussion of filing requirements for patents, trademarks, copyrights, mask works, and trade secrets, see §§3.20-3.27.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.20 2. Intellectual Property

§3.20 2. Intellectual Property

There are several types of property that are considered intellectual property, including patents, trademarks, copyrights, mask works, and trade secrets. All types of intellectual property qualify as "general intangibles" under the Commercial Code. See Com C §9102(a)(42). Official Comment 5d to UCC §9-102. Normally the appropriate method for perfecting a security interest in general intangibles is to file Form UCC-1. See Com C §9310.

Division 9 will not govern to the extent that a federal statute, regulation, or treaty preempts it. Com C §9109(c)(1). Generally, courts have concluded that patents and trademarks may be perfected by filing a Form UCC-1, although filings should also be made at the federal level to protect a secured party against a bona fide purchaser. See §§3.21-3.22. With respect to copyrights, recent opinions have held that only a federal recording in the Copyright Office perfects a security interest in registered copyrights. See §3.23. The UCC, however, governs perfection and priority of security interests in unregistered copyrights. *Aerocon Eng'g, Inc. v Silicon Valley Bank (In re World Auxiliary Power Co.)* (9th Cir 2002) 303 F3d 1120, 1128. See §§3.24-3.25. Federal filings should also be considered for mask works and certain trade secrets. See §§3.26-3.27.

NOTE: It is important to remember that intellectual property may be embodied in tangible form. Copyrightable material, such as source code, may be contained in tangible goods. The tangible goods may be inventory. Therefore, if a secured party wants to be secured in all of the collateral, the secured party should also obtain and perfect a security interest in additional collateral such as inventory. See §3.30.

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§3.21 a. Patents

Patents are created by a federal grant under the Patent Act of 1952 (35 USC §§1-376). Because the Patent Act provides for a system for recording assignments and grants of patents that permits the recording of security interests, several courts have reviewed whether the Patent Act preempts Division 9. See 35 USC §261 (recording of patents); 37 CFR §§3.11(a), 3.28, 3.31 (documents that may be recorded and requirements for the cover sheet permitting the filing of a security interest).

In general, courts have found that a security interest in a patent need not be recorded in the Patent and Trademark Office to be perfected, although a bona fide purchaser for value who has recorded will defeat a secured creditor who has not filed notice with the Patent Office. *In re Transportation Design & Technol., Inc.* (Bankr SD Cal 1985) 48 BR 635. In *Moldo v Matsco, Inc. (In re Cybernetic Servs., Inc.)* (9th Cir 2001) 252 F3d 1039, the Ninth Circuit concluded that, to perfect a security interest in a patent, a UCC filing rather than a filing with the Patent and Trademark Office was necessary. The court concluded that while filing a security agreement was permissible under the Patent Act regulations, the Patent Act did not contemplate the registration of security interests or the implementation of a recording system as contemplated under Article 9. The concept of a patent "assignment" involves a transfer of title.

In a case under the Maryland Commercial Code, a court sustained the secured creditor's lien on a patent application and confirmed the distinction made in *Transportation Design* between the relative rights of secured creditors claiming a lien on patents and the rights of a bona fide purchaser for value. *Chesapeake Fiber Packaging Corp. v Sebro Packaging Corp.* (D Md 1992) 143 BR 360, aff'd (4th Cir 1993) 8 F3d 817.

PRACTICE TIP: Because of the beneficial effect of defeating a bona fide purchaser for value, the cautious practitioner will record the secured party's interest with the Patent and Trademark Office by filing a security agreement such as the one found in §§2.62-2.69 with cover sheet Form PTO-1595 (see §3.28).

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§3.22 b. Trademarks

Trademarks are common law rights that may be registered at the federal or the state level. The Trademark Act of 1946 (Lanham Act) (15 USC §§1051-1141n) governs trademarks at the federal level.

As with patents, courts have also found that federal trademark law does not preempt the filing requirements of the California Commercial Code. *Joseph v 1200 Valencia, Inc. (In re 199Z, Inc.)* (Bankr CD Cal 1992) 137 BR 778. The court in that case distinguished cases decided under the United States Copyright Act of 1976 on the grounds that the Copyright Act expressly provides for filing a "mortgage" or a "hypothecation" of a copyright, but the Lanham Act provides for filing of assignments of trademarks only. The definition of "assignment" in the Lanham Act does not include assignments for security purposes and, accordingly, the perfection of an assignment for security purposes was controlled by the California Commercial Code.

Although the Lanham Act does not specifically contemplate the filing of security interests, the Patent and Trademark Office will record a security agreement covering a trademark. The correct cover sheet to use is Form PTO-1594. See §3.29.

PRACTICE TIP: As with patents, it is prudent to file security interests in trademarks at the federal level in order to defeat a bona fide purchaser for value. See §3.21.

It is important to note that because trademarks may involve copyrightable material, certain practitioners will continue to file with the Copyright Office to fully protect the client's interests. See §3.23.

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§3.23 c. Copyrights

Copyrights are governed by federal law under the Copyright Act of 1976 (17 USC §§101-1332). Copyrights need not be registered with the United States Copyright Office to obtain copyright protection. 17 USC §408(a).

Unlike the Lanham Act and the Patent Act, the Copyright Act specifically refers to, and some courts have held that it applies to, security interests in copyrights. 17 USC §§101, 201(d)(1), 205(a). In *National Peregrine, Inc. v Capital Fed. Sav. & Loan Ass'n (In re Peregrine Entertainment, Ltd.)* (CD Cal 1990) 116 BR 194, the United States District Court for the Central District of California held that the national copyright registration system preempts state statutes governing the perfection of security interests in copyrights. The court extended its holding to the copyright receivables because, under 17 USC §106, "a copyright entitles the holder to receive all income derived from the display of the creative work." 116 BR at 199.

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§3.24 (1) Registered and Unregistered Copyrights

The Copyright Act and related rules permit the filing of a security agreement only with respect to registered copyrights. If the copyright is not registered, no filing can be made. The Ninth Circuit in *Aerocon Eng'g, Inc. v Silicon Valley Bank (In re World Auxiliary Power Co.)* (9th Cir 2002) 303 F3d 1120 held that with respect to unregistered copyrights, the Uniform Commercial Code is not preempted. The *Aerocon* court adopted the holdings of *National Peregrine, Inc. v Capital Fed. Sav. & Loan Ass'n (In re Peregrine Entertainment*, *Ltd.)* (CD Cal 1990) 116 BR 194 (see §3.23), but distinguished and limited them to registered copyrights. The Ninth Circuit specifically rejected the opinions of two lower courts, *Zenith Prods., Ltd. v AEG Acquisition Corp. (In re AEG Acquisition Corp.)* (BAP 9th Cir 1993) 161 BR 50, and *In re Avalon Software, Inc.* (Bankr D Ariz 1997) 209 BR 517, which had extended *Peregrine*'s holding to unregistered copyrights. 303 F3d at 1125.

A judicial lien on registered copyrights must be perfected by recording the lien in the U.S. Copyright Office. *Morgan Creek Prods., Inc. v Franchise Pictures LLC (In re Franchise Pictures LLC)* (Bankr CD Cal 2008) 389 BR 131, 141.

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§3.25 (2) Proceeds of Copyrighted Material

In addition to holding that the proper place to perfect a security interest in copyrights is in the Copyright Office (see §3.23), the court in *National Peregrine, Inc. v Capital Fed. Sav. & Loan Ass'n (In re Peregrine Entertainment, Ltd.)* (CD Cal 1990) 116 BR 194 held that a lender cannot obtain a security interest in any type of proceeds of copyrighted materials, including accounts or royalties, unless the secured creditor has perfected against the copyright itself by making a federal filing. Most commentators consider this aspect of *Peregrine* wrongly decided. The court in *Aerocon Eng'g, Inc. v Silicon Valley Bank (In re World Auxiliary Power Co.)* (9th Cir 2002) 303 F3d 1120 did not address the proceeds issue. The Ninth Circuit, however, previously distinguished *Peregrine* in *Broadcast Music, Inc. v Hirsch* (9th Cir 1997) 104 F3d 1163, holding that proceeds of copyrighted material may take the form of other types of collateral, such as accounts, and may be perfected in accordance with the Uniform Commercial Code. It is still prudent, however, to obtain a security interest in the copyrighted or copyrightable material itself if the lender wishes to obtain a security interest in proceeds of such material.

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§3.26 d. Mask Works

The Semiconductor Chip Protection Act of 1984 (17 USC §§901-914) permits the registration of mask works. A "mask work" is a series of related images, however fixed or encoded, having or representing the predetermined, three-dimensional pattern of metallic, insulating, or semiconductor material present or removed from the layers of a semiconductor chip product and in which series the relation of the images to one another is that each image has the pattern of the surface of one form of the semiconductor chip product. 17 USC §901(a)(2). Although the Act does not specifically provide for the recording of security interests in mask works, regulations under the Act provide that the Copyright Office will serve as the registry for mask works. 17 USC §903; 37 CFR §211.2. Therefore, although there are no reported cases on mask works, a prudent practitioner will file with the Copyright Office to perfect a security interest in registered mask works. The Ninth Circuit did not address the issue of mask works when it determined that perfection by filing under the Uniform Commercial Code was appropriate for unregistered copyrights in *Aerocon Eng'g, Inc. v Silicon Valley Bank (In re World Auxiliary Power Co.)* (9th Cir 2002) 303 F3d 1120. See §3.24. However, the same rule that applies to copyrights should apply to mask works.

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§3.27 e. Trade Secrets

Trade secrets exist under common law. A state UCC filing is required to perfect a security interest in trade secrets. It is important to note, however, that trade secrets may be made up of other intellectual property, including copyrightable material, so other filings may be necessary to perfect the secured party's interest. See §3.23. Also, in order to preserve its secret nature, a trade secret should never actually be described in a filing. For further discussion of security interests in trade secrets, see Trade Secrets Practice in California, chap 9 (2d ed Cal CEB 1996).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/ f. Forms/§3.28 (1) Form: Patent Recordation Form Cover Sheet (Form PTO-1595)

f. Forms

§3.28 (1) Form: Patent Recordation Form Cover Sheet (Form PTO-1595)



Form **PTO-1595** (Rev. 03-09)
OMB No. 0651-0027 (exp. 03/31/2009)

U.S. DEPARTMENT OF COMMERCE
United States Patent and Trademark Office

RECORDATION FORM COVER SHEET
PATENTS ONLY

To the Director of the U.S. Patent and Trademark Office: Please record the attached documents or the new address(es) below.

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Additional name(s) of conveying party(ies) attached? ☐ Yes ☐ No

2. Name and address of receiving party(ies)

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3. Nature of conveyance/Execution Date(s):

Execution Date(s) _____

☐ Assignment ☐ Merger
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4. Application or patent number(s):

☐ This document is being filed together with a new application.

A. Patent Application No.(s)

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Guidelines for Completing Patents Cover Sheets (PTO-1595)

Cover Sheet information must be submitted with each document to be recorded. If the document to be recorded concerns both patents and trademarks separate patent and trademark cover sheets, including any attached pages for continuing information, must accompany the document. All pages of the cover sheet should be numbered consecutively, for example, if both a patent and trademark cover sheet is used, and information is continued on one additional page for both patents and trademarks, the pages of the cover sheet would be numbered from 1 to 4.

Item 1. Name of Conveying Party(ies).

Enter the full name of the party(ies) conveying the interest. If there is insufficient space, enter a check mark in the "Yes" box to indicate that additional information is attached. The name of the additional conveying party(ies) should be placed on an attached page clearly identified as a continuation of the information Item 1. Enter a check mark in the "No" box, if no information is contained on an attached page. If the document to be recorded is a joint research agreement, enter the name(s) of the party(ies) other than the owner of the patent or patent application as the conveying party(ies).

Item 2. Name and Address of Receiving Party(ies).

Enter the name and full address of the first party receiving the interest. If there is more than one party receiving the interest, enter a check mark in the "Yes" box to indicate that additional information is attached. Enter a check mark in the "No" box, if no information is contained on an attached page. If the document to be recorded is a joint research agreement, enter the name(s) of the patent or patent application owner(s) as the receiving party.

Item 3. Nature of Conveyance/Execution Date(s).

Enter the execution date(s) of the document. It is preferable to use the name of the month, or an abbreviation of that name, in order that confusion over dates is minimized. Place a check mark in the appropriate box describing the nature of the conveying document. If the "Other" box is checked, specify the nature of the conveyance.

Item 4. Application Number(s) or Patent Number(s).

Indicate the application number(s), and/or patent number(s) against which the document is to be recorded. National application numbers must include both the series code and a six-digit number (e.g., 07/123,456), and international application numbers must be complete (e.g., PCT/US91/12345).

Enter a check mark in the appropriate box: "Yes" or "No " if additional numbers appear on attached pages. Be sure to identify numbers included on attached pages as the continuation of Item 4. Also enter a check mark if this Assignment is being filed with a new application.

Item 5. Name and Address of Party to whom correspondence concerning the document should be mailed. Enter the name and full address of the party to whom correspondence is to be mailed.

Item 6. Total Applications and Patents involved.

Enter the total number of applications and patents identified for recordation. Be sure to include all applications and patents identified on the cover sheet and on additional pages.

Block 7. Total Fee Enclosed.

Enter the total fee enclosed or authorized to be charged. A fee is required for each application and patent against which the document is recorded.

Item 8. Payment Information.

Enter the deposit account number and authorized user name to authorize charges.

Item 9. Signature.

Enter the name of the person submitting the document. The submitter must sign and date the cover sheet. Enter the total number of pages including the cover sheet, attachments, and document.

This collection of information is required by 35 USC 261 and 262 and 15 USC 1057 and 1060. The information is used by the public to submit (and by the USPTO to process) patent and trademark assignment requests. After the USPTO records the information, the records for patent and trademarks, assignments, and other associated documents can be inspected by the public. To view documents recorded under secrecy orders or documents recorded due to the interest of the federal government, a written authorization must be submitted. This collection is estimated to take 30 minutes to complete, including gathering, preparing, and submitting the form to the USPTO. Any comments on the amount of time you require to complete this form and/or suggestions for reducing this burden, should be sent to the Manager of the Assignment Division, USPTO, P.O. Box 1450, Alexandria, VA 22313-1450. DO NOT SEND FEES OR COMPLETED FORMS TO THIS ADDRESS. SEND TO: Mail Stop Assignment Recordation Services, Director of the USPTO, P.O. Box 1450, Alexandria, VA 22313-1450.

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Privacy Act Statement for Patent Assignment Recordation Form Cover Sheet

The Privacy Act of 1974 (P.L. 93-579) requires that you be given certain information in connection with the above request for information. This collection of information is authorized by 35 U.S.C. 1, 2, 261 and E.O. 9424. This information will primarily be used by the USPTO for the recordation of assignments related to patents and patent applications. Submission of this information is voluntary but is required in order for the USPTO to record the requested assignment. If you do not provide the information required on the cover sheet, the assignment will not be recorded, and all documents will be returned to you.

After the information is recorded, the records and associated documents can be inspected by the public and are not confidential, except for documents that are sealed under secrecy orders or related to unpublished patent applications. Assignment records relating to unpublished patent applications are maintained in confidence in accordance with 35 U.S.C. 122. Records open to the public are searched by users for the purpose of determining ownership for other property rights with respect to patents and trademarks.

Routine uses of the information you provide may also include disclosure to appropriate Federal, state, local, or foreign agencies in support of their enforcement duties and statutory or regulatory missions, including investigating potential violations of law or contract and awarding contracts or other benefits; to a court, magistrate, or administrative tribunal in the course of presenting evidence; to members of Congress responding to requests for assistance from their constituents; to the Office of Management and Budget in connection with the review of private relief legislation; to the Department of Justice in connection with a Freedom of Information Act request; to a contractor in the performance of their duties; to the Office of Personnel Management for personnel studies; and to the General Services Administration (GSA) as part of their records management responsibilities under the authority of 44 U.S.C. 2904 and 2906. Such disclosure to GSA shall not be used to make determinations about individuals.

Comment: Form PTO-1595 is available on the United States Patent and Trademark Office website at http://www.uspto.gov/web/forms.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.29 (2) Form: Trademark Recordation Form Cover Sheet (Form PTO-1594

§3.29 (2) Form: Trademark Recordation Form Cover Sheet (Form PTO-1594



Form **PTO-1594** (Rev. 01-09)
OMB Collection 0651-0027 (exp. 02/28/2009)

U.S. DEPARTMENT OF COMMERCE
United States Patent and Trademark Office

RECORDATION FORM COVER SHEET
TRADEMARKS ONLY

To the Director of the U. S. Patent and Trademark Office: Please record the attached documents or the new address(es) below.

1. Name of conveying party(ies):

☐ Individual(s) ☐ Association
☐ General Partnership ☐ Limited Partnership
☐ Corporation- State:_____
☐ Other_____

Citizenship (see guidelines)_____

Additional names of conveying parties attached? ☐ Yes ☐ No

2. Name and address of receiving party(ies)

Additional names, addresses, or citizenship attached? ☐ Yes ☐ No

Name:_____
Internal Address:_____
Street Address:_____
City:_____
State:_____
Country:_____ Zip:_____

☐ Association Citizenship _____
☐ General Partnership Citizenship _____
☐ Limited Partnership Citizenship _____
☐ Corporation Citizenship_____
☐ Other_____ Citizenship _____

If assignee is not domiciled in the United States, a domestic representative designation is attached: ☐ Yes ☐ No
(Designations must be a separate document from assignment)

3. Nature of conveyance)/Execution Date(s) :

Execution Date(s)_____

☐ Assignment ☐ Merger
☐ Security Agreement ☐ Change of Name
☐ Other_____

4. Application number(s) or registration number(s) and identification or description of the Trademark.

A. Trademark Application No.(s)

B. Trademark Registration No.(s)

Additional sheet(s) attached? ☐ Yes ☐ No

C. Identification or Description of Trademark(s) (and Filing Date if Application or Registration Number is unknown):

5. Name & address of party to whom correspondence concerning document should be mailed:

Name:_____
Internal Address:_____
Street Address:_____
City:_____
State:_____ Zip:_____
Phone Number:_____
Fax Number:_____
Email Address:_____

6. Total number of applications and registrations involved:

7. Total fee (37 CFR 2.6(b)(6) & 3.41) $_____

☐ Authorized to be charged to deposit account
☐ Enclosed

8. Payment Information:

Deposit Account Number _____
Authorized User Name _____

9. Signature:

_____ _____
Signature Date

_____
Name of Person Signing

Total number of pages including cover sheet, attachments, and document:

Documents to be recorded (including cover sheet) should be faxed to (571) 273-0140, or mailed to:
Mail Stop Assignment Recordation Services, Director of the USPTO, P.O. Box 1450, Alexandria, VA 22313-1450

Print

Guidelines for Completing Trademarks Cover Sheets (PTO-1594)

Cover Sheet information must be submitted with each document to be recorded. If the document to be recorded concerns both patents and trademarks, separate patent and trademark cover sheets, including any attached pages for continuing information, must accompany the document. All pages of the cover sheet should be numbered consecutively for example, if both a patent and trademark cover sheet is used, and information is continued on one additional page for both patents and trademarks, the pages of the cover sheet would be numbered from 1 to 4.

Item 1. Name of Conveying Party(ies).
Enter the full name of the party(ies) conveying the interest. If there is more than one conveying party, enter a check mark in the "Yes" box to indicate that additional information is attached. The name of the second and any subsequent conveying party(ies) should be placed on an attached page clearly identified as a continuation of the information in Item 1. Enter a check mark in the "No" box, if no information is contained on an attached page.

Item 2. Name and Address of Receiving Party(ies).
Enter the name and full address of the first party receiving the interest. If there is more than one party receiving the interest, enter a check mark in the "Yes" box to indicate that additional information is attached. If the receiving party is an individual, check the "other" box, place the word "individual" in the following line, and enter the citizenship of the receiving individual. If the receiving party is a legal entity, designate the legal entity of the receiving party by checking the appropriate box. If the receiving party has more than one citizenship, then the citizenship of **each** partner should be specified on an additional sheet, and "See additional sheet" should be written on the line for citizenship. A corporation must set forth the state, if applicable, or country of incorporation. An association must set forth the state, if applicable, or country under which they are organized. If the receiving party is not domiciled in the United States, a designation of domestic representative is encouraged. Place a check mark in the appropriate box to indicate whether or not a designation of domestic representative is attached. Enter a check mark in the "No" box if no information is contained on an attached page.

Item 3. Nature of Conveyance/Execution Date(s).
Enter the execution date(s) of the document. It is preferable to use the name of the month, or an abbreviation of that name, to minimize confusion over dates. In addition, place a check mark in the appropriate box describing the nature of the conveying document. If the "Other" box is checked, specify the nature of the conveyance. The "Other" box should be checked if the conveying/receiving party is correcting a previously filed document.

Item 4. Application Number(s) or Registration Number(s).
Indicate the application number(s) including series code and serial number, and/or registration number(s) against which the document is to be recorded. The identification of the trademark should be provided for all properties to avoid recordation against the wrong property. A filing date should be provided only when the application or registration number is unknown. Enter a check mark in the appropriate box: "Yes" or "No" if additional numbers appear on attached pages. Be sure to identify numbers included on attached pages as the continuation of Item 4.

Item 5. Name and Address of Party to whom correspondence concerning document should be mailed.
Enter the name and full address of the party to whom correspondence is to be mailed.

Item 6. Total Applications and Trademarks Involved.
Enter the total number of applications and trademarks identified for recordation. Be sure to include all applications and registrations identified on the cover sheet and on additional pages.

Block 7. Total Fee Enclosed.
Enter the total fee enclosed or authorized to be charged. A fee is required for each application and registration against which the document is recorded.

Item 8. Payment Information.
Enter the deposit account number and authorized user name to authorize charges.

Item 9. Signature.
Enter the name of the person submitting the document. The submitter must sign and date the cover sheet. Enter the total number of pages including the cover sheet, attachments, and document.

This collection of information is required by 35 USC 261 and 262 and 15 USC 1057 and 1060. The information is used by the public to submit (and by the USPTO to process) patent and trademark assignment requests. After the USPTO records the information, the records for patent and trademarks, assignments, and other associated documents can be inspected by the public. To view documents recorded under secrecy orders or documents recorded due to the interest of the federal government, a written authorization must be submitted. This collection is estimated to take 30 minutes to complete, including gathering, preparing, and submitting the form to the USPTO. Any comments on the amount of time you require to complete this form and/or suggestions for reducing this burden, should be sent to the Manager of the Assignment Division, Crystal Gateway 4, Room 310, 1213 Jefferson Davis Highway, Arlington, VA 22202. DO NOT SEND FEES OR COMPLETED FORMS TO THIS ADDRESS. SEND TO: Mail Stop Assignment Recordation Services, Director of the USPTO, P.O. Box 1450, Alexandria, VA 22313-1450.

Comment: Form PTO-1594 is available on the United States Patent and Trademark Office website at

http://www.uspto.gov/web/forms.

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§3.30 C. Goods

Goods is a broad category of collateral that includes equipment and inventory. See §1.9 for discussion of goods. The creditor may perfect a security interest in goods either by taking possession (Com C §9313) or by filing (Com C §9310). For discussion of the advantages and disadvantages of filing, see §3.31.

A special type of security interest, known as a purchase money security interest, is available for goods and related software. Com C §9103. See §3.32.

A security interest in goods in the possession of a third party is perfected by issuance of documents or authentication of an acknowledgment by the third party. See §§3.33-3.36. In certain instances, a security interest in goods may be perfected on a temporary basis without possession or filing. See §3.37.

For discussion of perfection when the collateral is a motor vehicle or a boat, see §§3.65-3.74.

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§3.31 1. Perfection of Security Interest by Filing

Filing is usually easier and cheaper than taking possession. It avoids burdening the creditor with the responsibilities of caring for the collateral, and it gives the creditor the benefit of "first to file" and "continuous perfection" provisions of Com C §§9316 and 9322. If the collateral is inventory, the goods remain available in the debtor's hands for sale or other appropriate disposition. However, perfection by filing requires that the creditor trust the debtor to deal honestly with the collateral and with the creditor. A buyer in ordinary course of business (defined in Com C §1201(b)(9)) will prevail over a secured creditor who depends on filing alone.

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§3.32 2. Automatic Perfection of Purchase Money Security Interest

Purchase money security interests in consumer goods are perfected when they attach. Com C §9309(1). See §3.8. A purchase money security interest arises if a third party provides the funds for a debtor to purchase goods or if the third party sells the debtor the goods and the debtor pays the third party for the goods over a period of time. Com C §9103. A purchase money security interest arises in software if it arises in connection with a purchase money security interest in goods in an integrated transaction, and the software is being acquired for the principal purpose of using the goods. Com C §9103(c). A purchase money security interest is accorded first priority if certain specific requirements are met. See chap 4. There are also special rules relating to a consumer goods transaction. See chap 7.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.33 3. Goods in Possession of Third Party

§3.33 3. Goods in Possession of Third Party

Division 9 distinguishes between goods in the possession of a bailee who has issued a document of title covering the goods and goods in the possession of a third party who has not issued a document. Commercial Code §9312(c) (see §3.34) or §9312(d) (see §3.35) applies to a bailee that has issued a document of title and Com C §9313(c) applies to a third party that has not issued a document of title (see §3.36). Commercial Code §9312(f) provides for temporary perfection of goods in the possession of a bailee that has not issued a negotiable document of title. See §3.37.

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§3.34 a. Goods Under Negotiable Documents

While goods are in the possession of a bailee that has issued a negotiable document covering the goods, the secured creditor may obtain a security interest by perfecting a security interest in the document. Com C §9312(c)(1). See §3.38 for a discussion of obtaining a security interest in a negotiable document. A security interest perfected in the document will have priority over any security interest that becomes perfected in the goods by another method during that time. Com C §9312(c)(2).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.35 b. Goods Under Nonnegotiable Documents

§3.35 b. Goods Under Nonnegotiable Documents

A nonnegotiable document is, at least for purposes of perfection, a mere receipt. To the extent goods are in the possession of a bailee that has issued a nonnegotiable document covering the goods, a security interest in the goods may be perfected by any of the following methods: (1) issuance of a document in the name of the secured party, (2) the bailee's receipt of notification of the secured party, or (3) filing as to the goods. Com C §9312(d).

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§3.36 c. Goods Not Covered by Documents

A security interest in goods that are in possession of a third party that has not issued a document are perfected when the third party authenticates a record acknowledging that it holds possession of the collateral for the secured party's benefit. Com C §9313(c). Notice to the third party is not sufficient to perfect under Com C §9313(c). Official Comment 4 to UCC §9-313.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.37 d. Temporary Perfection for Goods in Possession of Bailee That Has Not Issued Negotiable Document

§3.37 d. Temporary Perfection for Goods in Possession of Bailee That Has Not Issued Negotiable Document

A perfected security interest in goods in possession of a bailee, other than a bailee that has issued a negotiable document for the goods, remains perfected for 20 days without filing if the secured creditor makes available to the debtor the goods for the purpose of ultimate sale or exchange or loading, unloading, storing, shipping, transshipping, manufacturing, processing, or otherwise in a manner preliminary to their sale or exchange. Com C §9312(f).

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D. Negotiable Documents and Instruments

§3.38 1. Perfection by Possession or Filing

A security interest in negotiable documents or instruments may be perfected either by possession or by filing. Com C §§9312(a), 9313(a). However, a purchaser often will have priority over a secured creditor who has perfected by filing rather than possession. Com C §9330(d). See §4.24. In *Omega Envt'l Inc. v Valley Bank* (9th Cir 2000) 219 F3d 984, the court held that a certificate of deposit was an instrument despite transfer restrictions; therefore, possession of it perfected the creditor's security interest. Under Bus & P C §10233.2, if the debtor is a real estate broker who arranges a loan or sells an interest in a promissory note, the security interest may be perfected even though the debtor retains possession of the note to service it on behalf of the secured creditor. *Neilson v Chang (In re First T.D. & Inv., Inc.)* (9th Cir 2001) 253 F3d 520.

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§3.39 2. Temporary Perfection for Negotiable Documents and Instruments

A security interest in negotiable documents or instruments may be perfected without filing or taking possession or control for a period of 20 days from the time it attaches to the extent that it arises from new value given under an authenticated security agreement. Com C §9312(e).

As with goods held by a bailee (see §3.37), a perfected security interest in negotiable documents remains perfected without filing if the secured creditor makes the goods represented in the documents available for ultimate sale or exchange or in a manner preliminary to their sale or exchange. Com C §9312(f).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.40 E. Chattel Paper and Electronic Chattel Paper

§3.40 E. Chattel Paper and Electronic Chattel Paper

"Chattel paper" is defined as "a record or records that evidence both a monetary obligation and a security interest in specific goods, a security interest in specific goods and software used in the goods, a security interest in specific goods, and license of software used in the goods, a lease of specific goods, or a lease of specific goods and license of software used in the goods." Com C §9102(a)(11). The category thus straddles the line between abstract collateral (a writing or writings) and tangible collateral (the goods). Electronic chattel paper is chattel paper consisting of information stored in an electronic medium. Com C §9102(a)(31).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.41 1. Perfection of Security Interest in Tangible Chattel Paper by Possession or Filing

§3.41 1. Perfection of Security Interest in Tangible Chattel Paper by Possession or Filing

A security interest in chattel paper (other than electronic chattel paper) may be perfected either by possession or by filing. Com C §§9312(a), 9313(a).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.42 2. Perfection of Security Interest in Electronic Chattel Paper by Filing or Control

§3.42 2. Perfection of Security Interest in Electronic Chattel Paper by Filing or Control

A security interest in electronic chattel paper may be perfected by filing or obtaining control. Com C §9314. Commercial Code §9105 provides the criteria for obtaining control over electronic chattel paper. In order to have control, the records comprising the chattel paper must be created, stored, and assigned such that:

- A single authoritative copy of the record or records exist that is unique and identifiable.
- The authoritative copy identifies the secured party as the assignee of the record or records.
- The authoritative copy is communicated to and maintained by the secured party or a designated custodian.
- Copies or revisions of the authoritative copy that add or change an identified assignee can only be made with the participation of the secured party.
- Copies of the authoritative copy and copies of copies must be readily identifiable as not being the authoritative copy.
- Revisions of the authoritative copy must be readily identifiable as authorized or unauthorized revisions.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.43 F. Money

§3.43 F. Money

A security interest in money may only be perfected by the secured party taking possession. Com C §9312(b)(3).

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G. Deposit Accounts

§3.44 1. Perfection by Control

A security interest in a deposit account may only be perfected by control. Com C §9312(b)(1). Commercial Code §9104(a) provides three methods by which a secured party can obtain control over a deposit account:

- (1) A secured party has control of a deposit account if the secured party is the bank where the deposit account is maintained;
- (2) The debtor, the secured party, and the bank have entered into an agreement that the bank will comply with instructions originated by the secured party directing disposition of the funds in the account without further consent by the debtor; or
- (3) The secured party becomes the bank's customer with respect to the deposit account.

If one of the three preceding conditions is met, a secured party will still have control over the deposit account, even if the debtor retains the right to direct the disposition of funds. Com C §9104(b). However, perfection continues only for so long as the secured party maintains control. Com C §9314(b). For a form of agreement to obtain control over a deposit account, see §3.45.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.44A 2. Key Elements of Control Account Agreement

§3.44A 2. Key Elements of Control Account Agreement

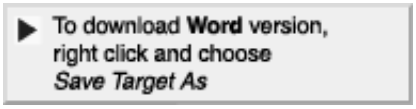
An account control agreement is a three-party agreement between debtor, secured party, and depository bank. The following elements are required in a control agreement:

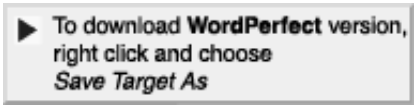
- The depository bank must agree in an authenticated record to follow the instructions of the secured creditor regardless of the debtor's instructions and without further consent by the debtor (Com C §9104(a)(2)); and
- There can be no withdrawals by the debtor after the secured party has notified the depository bank of a default (see Com C §9314(b)).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.45 3. Form: Control Agreement for Deposit Account

§3.45 3. Form: Control Agreement for Deposit Account





DEPOSIT ACCOUNT CONTROL AGREEMENT

THIS DEPOSIT ACCOUNT CONTROL AGREEMENT ("Agreement") is made and entered into as of this __ day of _____, 20__, by and among _____, a _____ ("Bank"), _____, a _____ ("Company"), and _____ ("Secured Creditor").

A. Pursuant to that certain Credit Agreement dated _ _[*date*]_ _ between Company and Secured Creditor, as amended, supplemented or otherwise modified from time to time (the "Credit Agreement"), Secured Creditor has agreed to make loans and extend other financial accommodations to Company.

B. Company has established Account No. _____ with Bank (the "Deposit Account").

C. The parties hereto desire to enter into this Agreement in order to set forth their relative rights and duties with respect to the Deposit Account and all funds on deposit therein from time to time.

NOW, THEREFORE, in consideration of the premises and the mutual covenants and agreements hereafter set forth, the parties agree as follows:

1. Security Interest; Agency. Company has granted to Secured Creditor a present and continuing security interest in (a) the Deposit Account, (b) all contract rights, claims, and privileges with respect to the Deposit Account, and (c) all cash, checks, money orders, and other items of value of Company now or hereafter paid, deposited, credited, held (whether for collection, provisionally or otherwise), or otherwise in the possession or under the control of, or in transit to, Bank or any agent, bailee, or custodian (collectively, "Receipts"), and all proceeds of the foregoing.

2. Control of Deposit Account. The Deposit Account shall be under the sole dominion and control of Secured Creditor and Bank will comply with Secured Creditor's instructions directing disposition of the funds in the Deposit Account without further consent by Debtor. The Deposit Account shall be maintained by Bank in the name of "_ _[*name of Company*]_ _." However, unless and until notice to the contrary is provided by Secured Creditor to Bank, Company shall have the right from time to time to write checks against amounts from the Deposit Account. Before Bank's receipt of any such notice from Secured Creditor, Bank shall be entitled to honor Company's instructions and directions with respect to any transfer or withdrawal of funds from the Deposit Account.

3. Statements and Other Information. Upon Secured Creditor's request, Bank shall provide Secured Creditor with copies of the regular monthly bank statements provided to Company and such other information relating to the Deposit Account as shall reasonably be requested by Secured Creditor. Bank shall also deliver a copy of all notices and statements required to be sent to Company pursuant to any agreement governing or related to the Deposit Account to Secured Creditor at such times as provided therein.

4. Fees. Company agrees to pay on demand all usual and customary service charges, transfer fees, and account maintenance fees (collectively, "Fees") of Bank in connection with the Deposit Account. In the event Company fails to make a timely payment to Bank of any Fees, Bank may thereafter exercise its right of setoff against the Deposit Account for such amounts. Secured Creditor shall not have any responsibility or liability for the payment of any Fees.

5. Setoff. Bank hereby agrees that Bank will not exercise or claim any right of setoff or security interest or banker's lien against the Deposit Account or any Receipts on deposit therein, and Bank hereby further waives until such date any such right or lien that it may have against any Receipts deposited in the Deposit Account, except to the extent expressly set forth in paragraph 4 above.

Comment: Certain banks may be unwilling to waive the rights referred to in Section 5. Permitting the bank to have those rights will give the bank priority over the secured creditor with respect to those rights. The bank may be willing to limit its rights in Section 5 to claims for fees and reimbursement of expenses related to the deposit account.

6. Exculpation of Bank; Indemnification by Company. Company and Secured Creditor agree that Bank shall have no liability to either of them for any loss or damage that either or both may claim to have suffered or incurred, either directly or indirectly, by reason of this Agreement or any transaction or service contemplated by its provisions, unless occasioned by the gross negligence or willful misconduct of Bank. In no event shall Bank be liable for losses or delays resulting from computer malfunction, interruption of communication facilities, labor difficulties, or other causes beyond Bank's reasonable control or for indirect, special, or consequential damages. Company agrees to indemnify Bank and hold it harmless from and against any and all claims, other than those ultimately determined to be founded on gross negligence or willful misconduct of Bank, and from and against any damages, penalties, judgments, liabilities, losses, or expenses (including reasonable attorney fees and disbursements) incurred as a result of the assertion of any claim, by any person or entity, arising out of, or otherwise related to, any transaction conducted or service provided by Bank through the use of any account at Bank pursuant to the procedures provided for or contemplated by this Agreement.

7. Termination. This Agreement may be terminated by Company only upon delivery to Bank of a written notification jointly executed by Company and Secured Creditor. This Agreement may be terminated by Secured Creditor at any time, with or without cause, upon its delivery of written notice to Company and Bank. This Agreement may be terminated by Bank at any time on not less than 30 days' prior written notice delivered to Company and Secured Creditor. Upon delivery or receipt of such notice of termination to or by Bank, Bank will immediately transmit to such account as Secured Creditor may direct all funds, if any, then on deposit in, or otherwise to the credit of, the Deposit Account.

8. Irrevocable Agreements. Company acknowledges that the agreements made by it and the authorizations granted by it in paragraphs 1 and 2 are irrevocable and that the authorizations granted in paragraphs 2 and 3 are powers coupled with an interest.

9. Notices. All notices, requests, or other communications given to Company, Secured Creditor, or Bank shall be given in writing (including by facsimile) at the address specified on the signature page.

10. Miscellaneous.

a. This Agreement may be amended only by a written instrument executed by Secured Creditor, Bank, and Company acting by their respective duly authorized representatives.

b. This Agreement shall be binding on and shall inure to the benefit of the parties and their respective successors and assigns, but neither Company nor Bank shall be entitled to assign or delegate any of its rights or duties under this Agreement without first obtaining the express prior written consent of Secured Creditor.

c. This Agreement may be executed in any number of several counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

d. THIS AGREEMENT SHALL BE GOVERNED BY THE LAWS OF THE STATE OF CALIFORNIA.

IN WITNESS WHEREOF, each of the parties has executed and delivered this Deposit Account Agreement as of the day and year first above set forth.

Date: _ _ _ _ _ _

Bank: _ _[*NAME OF BANK*]**_ _,**
a _ _[*specify entity, e.g., California commercial bank*]**_ _**

By: __[*Signature*]**__**
Name: _ _[*Typed name*]**_ _**
Its: _ _[*Title*]**_ _**

Address: _____
_____
Attention: _____

Telephone: (___) ___-_____
Facsimile: (___) ___-_____

Date: _ _ _ _ _ _

Company: _ _[*NAME OF COMPANY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Address: _____
_____
Attention: _____
Telephone: (___) ___-_____
Facsimile: (___) ___-_____

Date: _ _ _ _ _ _

Secured Creditor: _ _[*NAME OF SECURED CREDITOR*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Address: _____
_____
Attention: _____
Telephone: (___) ___-_____
Facsimile: (___) ___-_____

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§3.46 H. Letter-of-Credit Rights

A letter-of-credit right is a right to payment or performance under a letter of credit. Com C §9102(a)(51). A letter-of-credit right that supports the payment or performance of an account, chattel paper, document, general intangible, instrument, or investment property is a "supporting obligation" under Com C §9102(a)(77). A security interest in a supporting obligation for collateral is automatically perfected if the security interest in the collateral is perfected. Com C §9308(d). However, with respect to a letter-of-credit right that is not a supporting obligation, a security interest can only be perfected by control under Com C §9314. Com C §9312(b)(2). A secured party has control over a letter-of-credit right to the extent of any right to payment or performance by the issuer or any nominated person if the issuer or nominated person has consented to an assignment of proceeds of the letter of credit under Com C §5114(c). Com C §9107.

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§3.47 I. Insurance Policy

A security interest in an insurance policy or unearned premiums may be perfected only by giving written notice of the security interest or claim to the insurer. Com C §9312(b)(4). This rule does not apply to health "care" insurance receivables, in which a security interest is perfected by filing. Cal Comment 6.5 to Com C §9312. Practitioners should be aware that Com C §9312(b)(4) is a nonuniform provision.

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§3.48 J. Investment Property

A security interest in investment property may be perfected using three different methods: filing, possession (if the investment property is a certificated security), or control. Com C §§9312(a), 9313(a), 9314(a).

The type of the investment property and the way the investment property is held will dictate how to perfect the interest in the investment property. An interest in investment property may always be perfected by filing a financing statement. Com C §9312(a). However, secured creditors who have taken control will have priority over a secured creditor who has perfected by filing. Com C §9328(1). See §4.22.

For discussion of perfection by possession of a certificated security, see §§3.49-3.51. For discussion of perfection by control of investment property, see §§3.52-3.56.

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§3.49 1. Perfection by Possession of Certificated Securities

A security interest in certificated securities may be perfected by possession. Com C §9313(a). The secured party must take delivery of the certificated security as provided in Com C §8301. Under Com C §8301(a), there are three ways for a secured creditor to take delivery of a certificated security:

- The secured creditor may take possession of the security certificate. Com C §8301(a)(1).
- A third party, other than a securities intermediary, may take possession of the security certificate on behalf of the secured party if the third party acknowledges that the security certificate is being held on behalf of the secured creditor. Com C §8301(a)(2).
- A securities intermediary, acting on behalf of the secured party, perfects a security interest if the security certificate (1) is in registered form and (2) is either registered in the name of the secured party, payable to the order of the secured party, or specifically endorsed to the secured party by an effective endorsement. Com C §8301(a)(3).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.50 a. Possession of Certificated Securities in Registered Form and Bearer Form

§3.50 a. Possession of Certificated Securities in Registered Form and Bearer Form

A security interest in a certificated security in registered form is perfected by delivery under Com C §8301 and remains perfected until the debtor obtains possession. Com C §9313(e). With respect to a bearer-form certificated security, if the certificated security is delivered to the purchaser, the security interest is perfected. Com C §8106(a).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.51 b. Third Party Possession of Certificated Securities

§3.51 b. Third Party Possession of Certificated Securities

Issues arise when a third party holds collateral in escrow as security for a creditor. Official Comment 3 to UCC §9-313 provides that, if collateral is in possession of the secured party's agent for purposes of possessing on behalf of secured party, and if the agent is not also the agent of debtor, the secured party has taken actual possession without need to rely on third party acknowledgment.

NOTE: Escrow agreements must be carefully drafted to ensure that the debtor does not have rights to undercut the secured creditor's control.

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§3.52 2. Perfection by Control of Investment Property

Compliance with Com C §8106 determines whether a person has control of a certificated security, uncertificated security, or security entitlement. Com C §9106(a). A secured party that is the commodity intermediary with which the commodity contract is carried has control of a commodity contract. Com C §9106(b). A secured party having control of all security entitlements or commodity contracts in a securities account or commodity account has control over the account. Com C §9106(c).

A secured interest in investment property remains perfected by control until the secured party ceases to have control and the debtor receives possession of the investment property. With respect to a certificated security, for control to end, the debtor needs to obtain possession of the security. With respect to an uncertificated security, the issuer needs to register the debtor as registered owner. Finally, in connection with a security entitlement, the debtor must become the entitlement holder. Com C §9314(c)(2)(C).

For discussion of requirements for control of certificated securities, uncertificated securities, security entitlements, and commodity contracts, see §§3.53-3.56A. For a form of control agreement over an account containing financial assets, see §3.57.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.53 a. Certificated Securities

§3.53 a. Certificated Securities

With respect to a certificated security in registered form, the secured party has control if the certificate is delivered to the secured party and either (1) the certificate is endorsed to the secured party or (2) the certificate is registered in the name of the secured party. Com C §8106(b).

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§3.54 b. Uncertificated Securities

Control of an uncertificated security occurs if the uncertificated security is "delivered" to the secured party, or the issuer agrees that it will comply with instructions originated by the secured party without further consent by the registered owner. Com C §8106(c). An uncertificated security is "delivered" to a secured party when (1) the issuer registers the purchaser as the registered owner on original issue or registration of transfer or (2) another person, other than a securities intermediary, either becomes the registered owner of the uncertificated security on behalf of the purchaser or having previously become the registered owner, acknowledges that it holds the uncertificated security for the secured party. Com C §8301(b).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.55 c. Security Entitlements

§3.55 c. Security Entitlements

The rule for control of a security entitlement is also governed by Com C §8106. Com C §9106(a). A secured creditor obtains control of a security entitlement if (1) the purchaser becomes the entitlement holder, (2) the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder, or (3) another person has control of the security entitlement on behalf of the purchaser or, having previously acquired control of the security entitlement, acknowledges that it has control on behalf of the purchaser. Com C §8106(d).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.56 d. Commodity Contracts

§3.56 d. Commodity Contracts

For a secured party to obtain control of a commodity contract if the secured party is not a commodity intermediary, the commodity customer, secured party, and commodity intermediary must agree that the commodity intermediary will apply any value distributed on account of the commodity contract as directed by the secured party without further consent by the commodity customer. Com C §9106(b)(2).

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§3.56A e. Key Elements of Control Agreement for Investment Accounts

An investment account control agreement must be signed by the securities intermediary and does not need to be signed by the secured party and the debtor. See Com C §§8106(d)(2), 9106(a). However, it is prudent for all three parties to sign it.

The following provisions are required in a investment account control agreement for the secured party's interest to be properly perfected:

- The securities intermediary must agree to follow the instructions of the secured party, regardless of any further instructions of the debtor (see Com C §8106(d)(2); Official Comment 4 to UCC §9-106); and
- There can be no trades or releases of funds allowed after the secured creditor provides notice of exclusive control (see Com C §9314(c)).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.57 f. Form: Control Agreement for Investment Account

§3.57 f. Form: Control Agreement for Investment Account

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INVESTMENT ACCOUNT CONTROL AGREEMENT

_____, 20__

_ _[*Name of Creditor*]_ _ ("Creditor") and _ _[*Name of Debtor*]_ _ ("Debtor") and _ _[*Name of Broker*]_ _ ("Broker") hereby agree as follows:

PREAMBLE

A. Broker and Debtor have entered into a customer agreement, as from time to time amended, modified, supplemented, or restated (the "Customer Agreement"), pursuant to which Broker has established its securities account number(s) _____ in the name of Debtor (collectively, the "Account").

B. Debtor and Creditor have entered into a Security Agreement dated as of _____, 20__, as from time to time amended, modified, supplemented, or restated (the "Security Agreement"), in which Debtor has granted creditor a security interest in the Account.

C. Creditor, Debtor, and Broker are entering into this Agreement to provide for the control of the Account and to perfect the security interest of Creditor in the Account as more fully described in the Security Agreement.

TERMS

1. The Account. Broker hereby represents and warrants to Creditor and Debtor that (a) the Account has been established in the name of Debtor as recited above; (b) the Customer Agreement, the security entitlements arising out of the financial assets carried in the Account, and any free credit balances are valid and legally binding obligations of Broker; and (c) except for the claims and interest of Creditor and of Debtor in the Account, Broker does not know of any claim to or interest in the Account or in any financial asset carried therein.

2. Control; No Withdrawals After Receipt of Notice of Exclusive Control. Broker will hold the Account and all financial assets as the security agent for Creditor. Broker will comply with all orders, instructions, and directions of Creditor with respect to the control, preservation, maintenance, sale, transfer, disposition, liquidation, or release of the Account or the financial assets maintained in the Account, or any portion of the Account and all financial assets ("Orders"), without further consent by Debtor. Further, Broker has no obligation to, and will not, investigate the reason for any action taken by Creditor, the amount of any obligations of Debtor to Creditor, the validity of any of Creditor's claims against, or agreements with, Debtor, the existence of any defaults under such agreements or any other matter. Debtor hereby irrevocably waives any rights Customer may have either under the Account Agreement or otherwise to the extent such rights are inconsistent with the provisions of this Agreement, and hereby irrevocably authorizes Broker to comply with all instructions and Orders and Notices of Exclusive Control that are delivered by Creditor to Broker. After Broker receives a Notice of Exclusive Control (as such term is defined in Section 4 below), notwithstanding the provisions of Section 4 below, (i) Broker shall not accept or comply with any entitlement order from Debtor withdrawing any financial assets from the Account, deliver any such financial assets to Debtor, or pay any free credit balance or other amount owing from Broker to Debtor with respect to the Account without the specific prior written consent of Creditor, and (ii) Broker shall comply with entitlement orders originated by Creditor concerning the Account without further consent by Debtor.

3. Fees. Broker hereby waives and releases all liens, encumbrances, claims, and rights of setoff it may have against the Account of any financial asset carried in the Account or any credit balance in the Account and

agrees that, except for payment of its customary fees and commission pursuant to the Customer Agreement, it will not assert any such lien, encumbrance, claim, or right against the Account or any financial assets carried in the Account or any credit balance in the Account. Broker will not agree with any third party that Broker will comply with entitlement orders concerning the Account originated by such third party without the prior written consent of Creditor and Debtor.

4. Trades. Except as otherwise provided in Sections 2 and 3 above, Broker shall make trades of financial assets held in the Account at the instruction of Debtor, or its authorized representatives, and comply with entitlement orders concerning the Account from Debtor, or its authorized representatives, until such time as Creditor delivers a written notice to Broker that states that Creditor is thereby exercising exclusive control over the Account. Such notice may be referred to herein as the "Notice of Exclusive Control." After Broker receives a Notice of Exclusive Control, it will immediately cease complying with instructions or entitlement orders concerning the Account originated by Debtor or its representatives.

5. Statements, Confirmations, and Notices of Adverse Claims. Broker will send copies of all statements, confirmations, and other correspondence concerning the Account simultaneously to each of Debtor and Creditor at the address set forth in the heading of this Agreement. If Broker acquires knowledge that any person asserts any lien, encumbrance, or adverse claim against the Account or in any financial asset carried therein, Broker will promptly notify Creditor and Debtor thereof.

6. Responsibility of Broker. Except for permitting a withdrawal or payment in violation of Section 2 above or advancing margin or other credit to Debtor in violation of Section 3 above, Broker shall have no responsibility or liability to Creditor for making trades of financial assets held in the Account at the instruction of Debtor, or its authorized representatives, that are received by Broker before Broker receives a Notice of Exclusive Control. Broker shall have no responsibility or liability to Debtor for complying with a Notice of Exclusive Control or complying with entitlement orders concerning the Account originated by Creditor.

7. Termination. This Agreement shall remain in full force and effect until Broker receives written notice of its termination by Creditor.

8. This Agreement. This Agreement, the schedules and exhibits hereto, and the agreements and instruments required to be executed and delivered hereunder set forth the entire agreement of the parties with respect to the subject matter hereof and supersede and discharge all prior agreements (written or oral) and negotiations and all contemporaneous oral agreements concerning such subject matter and negotiations. There are no oral conditions precedent to the effectiveness of this Agreement.

9. Amendments. No amendments, modification, or termination of this Agreement or waiver of any right hereunder shall be binding on any party hereto unless it is in writing and is signed by the party to be charged.

10. Notices. Any notice, request, or other communication required or permitted to be given under this Agreement shall be in writing and deemed to have been properly given when delivered in person, or when sent by telecopy or other electronic means and electronic confirmation of error-free receipt is received, or two days after being sent by certified or registered United States mail, return receipt requested, postage prepaid, addressed to the party at the address set forth on the signature page of this Agreement. Any party may change its address for notices in the manner set forth above.

11. Counterparts. This Agreement may be executed in any number of counterparts, all of which shall constitute one and the same instrument, and any party hereto may execute this Agreement by signing and delivering one or more counterparts.

12. THIS AGREEMENT SHALL BE GOVERNED BY THE LAWS OF THE STATE OF CALIFORNIA.

Date: _ _ _ _ _ _

Creditor: _ _[*NAME OF CREDITOR*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Address: _____

_____
Attention: _____
Telephone: (___) ___-_____
Facsimile: (___) ___-_____

Date: _ _ _ _ _ _

Debtor: _ _[*NAME OF DEBTOR*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Address: _____
_____
Attention: _____
Telephone: (___) ___-_____
Facsimile: (___) ___-_____

Date: _ _ _ _ _ _

Broker: _ _[*NAME OF BROKER*]_ _,
a _ _[*specify entity, e.g., licensed investment company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Address: _____
_____
Attention: _____
Telephone: (___) ___-_____
Facsimile: (___) ___-_____

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§3.58 K. Partnership Interest

In *Raiton v G & R Prop. (In re Raiton)* (Bankr 9th Cir 1992) 139 BR 931, the Ninth Circuit Bankruptcy Appellate Panel held that a creditor received and perfected a lien on the debtor's interest in a California partnership by obtaining a charging order from a California state court and serving a copy of that charging order on the partnership through its general partner. This case validated a method of creating and perfecting an involuntary lien on interests in California partnerships in addition to the conventional method of granting a lien under a written security agreement and perfecting that lien under the various means provided in former Divisions 8 and 9 of the Commercial Code. See §5.16A for a discussion of charging orders.

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§3.59 L. Proceeds

In general, a security interest attaches to any identifiable proceeds of collateral. Com C §9315(a)(2). Proceeds that are commingled with other property are identifiable proceeds as follows (Com C §9315(b)):

- If the proceeds are goods, to the extent provided in Com C §9336. See §4.42.
- If the proceeds are not goods, to the extent that the secured party identifies the proceeds by a method of tracing.

A security interest in proceeds is a perfected security interest if the security interest in the original collateral was perfected. Com C §9315(c). See §1.12 for discussion of the definition of proceeds.

NOTE: A perfected security interest in proceeds becomes unperfected on the 21st day after the security interest attaches to the proceeds unless the following conditions are satisfied: (1) the proceeds are identifiable cash proceeds, (2) the security interest in the proceeds is perfected when the security interest attaches to the proceeds or within 20 days thereafter, or (3) the following three conditions are met: (a) a filed financing statement covers the original collateral, (b) the proceeds are collateral in which a security interest may be perfected by filing in the office in which the financing statement has been filed, and (c) the proceeds are not acquired with cash proceeds. Com C §9315(d). A security interest that remains perfected under (3) becomes unperfected when the filed financing statement lapses or is terminated. Com C §9315(e).

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IV. PROBLEMS WITH PERFECTION BY POSSESSION OR CONTROL

§3.60 A. Rights and Duties of a Secured Party in Possession or Control of Collateral

Commercial Code §9207 codifies and amplifies the common law rights and duties of the secured party in possession of collateral. In general, "a secured party shall use reasonable care in the custody and preservation of collateral in the secured party's possession." Com C §9207(a). See Official Comment 2 to UCC §9-207. The duty to use reasonable care cannot be nullified by agreement, but "[t]he parties, by agreement, may determine the standards by which the performance of those obligations is to be measured if those standards are not manifestly unreasonable." Com C §1302(b).

If the collateral is an instrument or chattel paper, reasonable care "includes taking necessary steps to preserve rights against prior parties unless otherwise agreed." Com C §9207(a). For example, a secured party who is the holder of a negotiable promissory note must make presentment and give notice of dishonor at the proper time to charge secondary parties on the instrument. Com C §§3501-3505. The prudent secured party should have an instrument endorsed in a manner that would make the secured party a holder (Com C §1201(b)(21)) in order to meet the requirements of Division 3.

If the secured party is a buyer of accounts, chattel paper, payment intangibles, or promissory notes or is a consignor, a secured party is not charged with the duty to use reasonable care in the custody of the collateral as set forth in Com C §9207(a), unless the secured party has a right to charge back uncollected collateral or otherwise has recourse against the debtor or a secondary obligor based on nonpayment or other default of an obligor on the collateral. Com C §9207(d).

The provisions of Com C §9207 apply both when the secured party is in possession of the collateral before default and when the secured party takes possession after default. See Official Comment 4 to UCC §9-207. Specific provisions of Com C §9207(b) are discussed in §3.61. Specific provisions of Com C §9207(c) that apply when the secured party is in either possession or control are discussed in §3.62.

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§3.61 1. Rules That Apply Only to Secured Party in Possession

Section 9207(b) prescribes several rules that apply if the secured party is in possession of the collateral:

- Reasonable expenses incurred in keeping the collateral are added to the debt secured by that collateral. This includes the cost of insurance and taxes paid on the property. Com C §9207(b)(1).
- The risk of loss is imposed on the debtor "to the extent of any deficiency in any effective insurance coverage." Com C §9207(b)(2).
- The secured party must keep the collateral identifiable, but may commingle fungible collateral. Com C §9207(b)(3). See Com C §1201(b)(16).
- A secured party may use or operate the collateral (1) pursuant to a court order, (2) when necessary to preserve the collateral or its value, or (3) as agreed by the debtor (except in the case of consumer goods). Com C §9207(b)(4). (Section 9207(b)(4) does not prohibit the use of consumer goods altogether; it merely requires that either (1) or (2) be satisfied.)

NOTE: A secured party's ability to use or operate collateral can be for a substantial period. In *Crosby v Reed (In re Crosby)* (BAP 9th Cir 1994) 176 BR 189, 192, aff'd (9th Cir 1996) 85 F3d 634 (unpublished opinion), a secured creditor with a lien on a restaurant was permitted to make improvements to the restaurant, to apply for a new liquor license for the restaurant, and to operate the restaurant over an eight-month period following repossession of the restaurant, without implicitly electing to retain the collateral in satisfaction of its debt under former Com C §9505(2). The time period between the repossession and the foreclosure sale was reasonable, and the steps to improve the restaurant and keep it in operation preserved and increased the value of the collateral.

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§3.62 2. Rules That Apply to Secured Party in Either Possession or Control

If a secured party has perfected by possession or control, the secured party may hold proceeds, other than money, as additional security. Com C §9207(c)(1). Money or funds received from the collateral are applied to reduce the secured obligation. Com C §9207(c)(2). The secured party may create a security interest in the collateral. Com C §9207(c)(3). This rule applies even if the debtor's right to redeem the collateral may be impaired. See Official Comment 5 to UCC §9-207.

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§3.63 B. Liability of Pledgees Under Securities Laws

An important problem for secured creditors taking stock in pledge is potential liability under the federal securities laws. Extensive discussion of the securities laws is beyond the scope of this book, but the attorney for the creditor should be aware of the possibility of such liability.

The U.S. Supreme Court has held that the pledge of stock to a bank as collateral for a loan is an "offer or sale" of a security for the purpose of the fraud and deceit provisions of the Securities Act of 1933 §17(a) (15 USC §77q(a)). *Rubin v U.S.* (1981) 449 US 424, 66 L Ed 2d 633, 101 S Ct 698. In *Mallis v Federal Deposit Ins. Corp.* (2d Cir 1977) 568 F2d 824, the court held that the release of pledged securities by the pledgee on payment of the debt can subject the pledgee to possible liability under §10(b) of the Securities Exchange Act of 1934 (15 USC §78j(b)). In this case, the pledgor sold the securities and used the sale proceeds to satisfy the loan. The buyer at this sale borrowed the purchase price from another lender and pledged the shares to the new lender following the closing of the purchase. The second lender asserted that the original lender had made material misrepresentations at the closing, thus incurring liability under SEC Rule 10b-5 (17 CFR §240.10b-5). The Court of Appeals for the Second Circuit held that the pledgee who released the shares became a "seller" for purposes of the federal securities laws.

Equally cautionary is *Bosse v Crowell Collier & Macmillan* (9th Cir 1977) 565 F2d 602, in which the court held that a foreclosure sale of securities by a pledgee in which the pledgee is the purchaser constitutes a sale by the pledgor, permitting the pledgor to maintain an action against the pledgee. The pledgor argued that the pledgee harbored the secret intent to gain control of the corporation whose stock was being pledged, and that this constituted a "manipulative or deceptive device." The court held that this allegation was "barely sufficient" to survive a motion to dismiss.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.64 V. PERFECTION UNDER STATUTES OTHER THAN THE COMMERCIAL CODE

§3.64 V. PERFECTION UNDER STATUTES OTHER THAN THE COMMERCIAL CODE

Security interests in certain types of collateral are not perfected under the Commercial Code. These types of collateral generally include vehicles, boats, and aircraft. See §§3.65-3.75. Security interests in registered copyrights are perfected by filing under the Copyright Act, rather than the Commercial Code. See §§3.20-3.27.

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§3.65 A. Motor Vehicles and Boats

Commercial Code filing is not effective to perfect a security interest in collateral that is subject to a certificate of ownership under the Vehicle Code. Com C §9311(b). This includes automobiles that are no longer inventory and many (though not all) other motor vehicles, as well as certain boats. The same rule applies to vehicles subject to a certificate of title from another jurisdiction. Com C §9311(a)(3).

The Code envisions the situation in which the security interest is noted on the certificate itself. In California it is customary for the secured creditor (called the "legal owner"; see Veh C §370) to retain the certificate of ownership ("pink slip"), while the debtor gets a certificate of registration. This system is meant to ensure that subsequent prospective buyers or encumbrancers will know about the secured creditor's claim. The secured creditor must note the security interest on the certificate of title, but the vehicle must be titled in the debtor's name. Possession of the pink slip will not be enough to perfect the security interest. *JPL & Co., Inc. v Global Envt'l Servs. Group, LLC* (*In re Global Envt'l Servs. Group, LLC)* (Bankr D Haw, Mar. 16, 2006, No. 05-90148) 2006 WL 980582 (decided under California law).

The Vehicle Code registration system is generally the exclusive means of perfecting a security interest in California motor vehicles, but the effect of perfection and the creation, attachment, priority, and validity of security interests are governed by the Commercial Code. Veh C §§6300-6303. See *Quartz of S. Cal., Inc. v Mullen Bros., Inc.* (2007) 151 CA4th 901, 61 CR3d 54. Practically speaking, compliance with the Vehicle Code provision becomes a substitute for the filing of Form UCC-1.

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§3.66 1. Vehicles in Inventory

If a vehicle in inventory is not yet subject to the Vehicle Code provisions, it is treated like any other inventory and Commercial Code provisions apply. Com C §9311(d); Veh C §5907. If the vehicle has been registered and the secured party has possession of the certificate of ownership (if one has been issued), transfer of registration to show the secured party's interest is not necessary; the validity and perfection of the security interest are governed exclusively by the Commercial Code. Veh C §5907. A secured party will need to determine whether motor vehicles are held as equipment or inventory. *Van Curen v Bank of the West* (*In re Hat)* (Bankr ED Cal, Sept. 4, 2007, No. 04-32497-B-11) 2007 Bankr Lexis 3055, 2007 WL 2580688 (trailers used by debtor for transporting grapes were equipment; proper method of perfection was under Vehicle Code).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.67 2. Trucks and Buses

§3.67 2. Trucks and Buses

Security interests in trucks weighing more than 10,000 pounds and buses with a seating capacity of at least ten individuals are governed by federal law, mostly set forth in 49 USC §14301. Section 14301(b) in turn refers perfection of security interests to the law of the state issuing the certificate of title on the truck or bus. Thus, if a truck or bus is registered in California, the security interest should be shown on the California certificate.

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§3.68 B. Mobilehomes, Commercial Coaches, Truck Campers, Floating Homes, and Manufactured Housing

Registration of mobilehomes, commercial coaches, manufactured housing, floating homes, and some slide-in truck campers is governed by Health & S C §§18000-18153. (For detailed coverage and exemptions, see Health & S C §§18075-18076.) Security interests (other than security interests in inventory) are registered with the Department of Housing and Community Development, which issues certificates of title and registration cards, similar to those covering motor vehicles. Health & S C §18090.5. The department maintains a permanent title record showing the "legal owner" and, if there are other secured parties, the "junior lienholders." Health & S C §§18080.7, 18090.5.

A security interest in these types of collateral is perfected when it has attached and the department has received the required documentation and fees. Health & S C §18080.7(a)-(b). A special procedure is also provided for submitting an electronic facsimile statement of lien. Health & S C §18080.7(b).

The Commercial Code governs security interests in these types of collateral except to the extent the Health and Safety Code provides otherwise. Health & S C §18080.7(h). If there is a conflict, the Health and Safety Code controls. Com C §§9201, 9311.

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§3.69 1. Certificate of Origin by Manufacturer

When the manufacturer releases a new mobilehome, manufactured home, or commercial coach, or a new truck camper that is to be registered, the manufacturer prepares a certificate of origin. The original is forwarded to the purchase money creditor, if any (except in case of a truck camper), and otherwise to the purchaser. Health & S C §§18093-18093.5.

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§3.70 2. Right to Payment for Inventory Creditor of Manufactured Homes and Mobilehomes

When the dealer sells a new manufactured home or mobilehome, the "inventory creditor" has the right to be paid off out of escrow unless it agrees otherwise. Health & S C §18035(b). An inventory creditor is one named on the manufacturer's certificate of origin, or one who puts the original certificate of origin in escrow and claims a purchase money security interest. Health & S C §18035(b)(2)(B).

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§3.71 3. Antideficiency Protection for Mobilehomes

Installment contracts for the purchase of mobilehomes are subject to the protection of CC §2983.8, which is analogous to the antideficiency statute that applies to purchase money security interests in real property. *Bank of Sonoma County v Dorries* (1986) 185 CA3d 1291, 230 CR 459, held that the antideficiency provisions of CC §2983.8 that apply to mobilehomes require a creditor holding a conditional sales contract on a mobilehome to look to the security alone for the recovery of the debt. The creditor cannot waive the security and sue for the balance due.

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§3.72 C. Agricultural Implements

Vehicle Code §36100 exempts from registration "[i]mplements of husbandry which are only incidentally operated or moved over a highway," and those listed in Veh C §36005 or §36015. Implements of husbandry are vehicles used exclusively in the conduct of agricultural operations, not including vehicles designed primarily for the transportation of persons or property on a highway. Veh C §36000. Hence, a pickup truck used in farming operations must be registered, while a tractor need not be registered even though it might be incidentally operated on a highway. See Veh C §§36015, 36100.

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D. Vessels

§3.73 1. Undocumented Vessels

Vehicle Code provisions similar to those governing motor vehicles apply to undocumented vessels numbered under Veh C §9850. See generally Veh C §§9919-9922. An "undocumented vessel" is defined as "any vessel which is not required to have and does not have a valid marine document issued by the Bureau of Customs of the United States or any federal agency successor thereto." Veh C §9840(g).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.74 2. Documented Vessels

§3.74 2. Documented Vessels

Mortgages of vessels documented under the laws of the United States (46 USC §§12101-12152) must be filed with the Secretary of Transportation under 46 USC §31321. A mortgage that includes the whole of the vessel and is filed in substantial compliance with 46 USC §31321 is a "preferred" mortgage that takes priority over all claims except preferred maritime liens under 46 USC §31326. 46 USC §§31322(a), 31326(b)(1).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.75 E. Aircraft

§3.75 E. Aircraft

Filing of security interests in aircraft is governed by 49 USC §44107, under which the Federal Aviation Administration maintains a system of registry. For requirements and procedure, see 14 CFR pts 47 (Aircraft Registration), 49 (Recording of Aircraft Titles and Security Documents).

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VI. HOW TO PERFECT BY COMMERCIAL CODE FILING

§3.76 A. Procedure for Filing Financing Statement

To perfect a security interest by filing, a financing statement (see §3.77) must be filed with the Secretary of State or other appropriate officer (see §3.78). Com C §9310(a). Filing requirements and considerations are discussed in §§3.77-3.82. Forms are provided in §§3.83-3.84B.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.77 1. What to File

§3.77 1. What to File

Commercial Code §9502 sets forth the information required to be contained in a financing statement. See §§3.86-3.96. A secured party should use the national UCC Financing Statement (Form UCC-1), a copy of which is reprinted in §3.84. California accepts only this version of the form. All other forms will be rejected. See Com C §9521.

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§3.78 2. Where to File

The local law of the jurisdiction in which the debtor is located governs. Com C §9301(1). Therefore, in order to determine where to file, it is important to determine the location of the debtor. Commercial Code §9307 provides rules for determining the location of a debtor. An individual debtor is located at the individual's principal residence. Com C §9307(b)(1). If a debtor is a registered organization, for filing purposes it is located in the state in which it is organized. Com C §9307(e).

If the debtor is a corporation or limited liability company organized under the laws of California, the secured party should file a financing statement in the California Secretary of State's office for collateral other than (1) fixtures and (2) as-extracted collateral or timber to be cut. Com C §9501(a). A financing statement for these types of collateral should be filed in the office designated for the filing and recording of a record of a mortgage on the related real property. Com C §9501(a)(1). All financing statements perfecting a security interest in collateral, including fixtures, of a transmitting utility should be filed in the Secretary of State's office. Com C §9501(b).

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§3.79 3. When to File

For most purposes, perfection by filing is effective only from the time of filing forward. In competition with other secured creditors, however, filing will establish priority even if some of the other steps necessary for the security interest to attach (see §§3.2-3.5) do not occur until later. For this reason it is advantageous for the creditor to file a financing statement as soon as a security agreement is contemplated. Often the creditor will present a financing statement (Form UCC-1) (see §3.84) and a request for information (Form UCC-11) (see §3.85) to the Secretary of State simultaneously, instructing the Secretary of State to file the Form UCC-1 and process the Form UCC-11 when the Secretary of State can show the Form UCC-1 on record. (See §3.83 for form letter.)

In this way, the creditor will be able to tell what competing financing statements are on file up to the moment of the creditor's filing. There are several services that will file financing statements and obtain official search reports for secured parties. In addition, it is possible to obtain an unofficial search from various online service providers.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.79A 4. Secretary of State's Online Service

§3.79A 4. Secretary of State's Online Service

The California Secretary of State's office has an online service for both filing financing statements and searching and retrieving existing filings. The service is called UCC Connect and can be accessed online at http://www.sos.ca.gov/business/ucc. Files are available in PDF format.

NOTE: The Secretary of State's office has redacted Social Security numbers from all UCC records filed prior to December 31, 2007. Social Security numbers provided on records filed on paper after January 1, 2008, are also being redacted. Revised UCC1 and UCC3 forms with blacked-out Social Security number boxes are now required. For more information and for revised forms, see http://www.sos.ca.gov/business/ucc.

UCC Connect can be used by both subscribers and nonsubscribers. However, subscribers have more streamlined access for log-in and, in addition, can request bulk orders and make XML transactions. A subscriber may establish an account with the Secretary of State's office. The account may be prefunded, or the subscriber may keep a credit card number on file. For assistance in setting up an account, the attorney should call (916) 651-9885.

Nonsubscribers can make inquiries on the web, place orders, and submit filings by using a credit card. Nonsubscribers can also retrieve filings and print them, but cannot place bulk orders or make XML transactions.

The following are fees for transactions on UCC Connect as of September 2009. Practitioners should check the website for fee updates. See http://www.sos.ca.gov/business/ucc/forms.htm.

WEB INQUIRIES	**FEE**
Debtor Name—Standard Search Logic (Fee waived if certificate requested at time of inquiry)	$5.00
Wild Card (Debtor Name)	No Charge
Filing Number	$5.00
Secured Party	$5.00
View Image (per document)	$1.00
WEB FILING	**FEE**
National Financing Statement (UCC-1) & Addendum	$5.00
National Financing Statement Amendment (UCC-3) & Addendum	$5.00
Master Amendment of Assignment	$5.00 per Record
WEB ORDERS	**FEE**
Debtor Search Certificate	$5.00
Copy of first page of any document on file	$1.00
Copy of each additional attachment page	$0.50
Certified Copy	$5.00
BULK ORDERS	**FEE**
Annual Daily Subscription − Data	$2,700.00
Annual Daily Subscription − Image	$3,700.00

Annual Daily Subscription − Data + Image	$4,300.00
ONE TIME OR AS NEEDED	**FEE**
Master Unload − Data	$100.00
Master Unload − Image	$800.00
Master Unload − Data + Image	$900.00
XML	**FEE**
Financing Statements (UCC-1)	$5.00
Financing Statement Amendment (UCC-3)	$5.00
Debtor Name—Standard Search Logic	N/A

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§3.80 5. What Constitutes Filing

Except for reasons set forth in Com C §9516(b), "communication of a record to a filing office and tender of the filing fee or acceptance of the record by the filing officer constitutes filing." Com C §9516(a).

The reasons that a financing statement can be rejected include failure to provide the correct filing fee, failure to communicate the filing in a medium accepted by the filing office, and failure to include the name of the debtor. Com C §9516(b). If a filing office refuses to accept a financing statement for a reason other than the reasons set forth in Com C §9516(b), then the financing statement is effective, except against a purchaser for value in reasonable reliance on the absence of the record from the files. Com C §9516(d).

The secured party does not bear the risk that the financing statement will not be properly filed or indexed after it is presented to the office of the Secretary of State or a county recorder (with the appropriate filing fee) and accepted by the filing officer. Com C §§9516(a), 9517. See *Bartolan, Inc. v Columbian Peanut Co.* (MD Ga 1989) 727 F Supp 1444, interpreting analogous provisions of the Georgia Commercial Code.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.81 6. Authorization Needed for Filing

§3.81 6. Authorization Needed for Filing

Neither the signature of the debtor nor of the secured creditor is required for the filing of a financing statement. Com C §9502. However, a financing statement is effective only to the extent that it was filed by a person authorized by Com C §9509. Com C §9510. See Official Comment 3 to UCC §9-502. Commercial Code §9509 authorizes a person to file a financing statement only if the debtor authorizes the filing in an authenticated record. Com C §9509(a)(1). By signing a security agreement, the debtor authorizes the secured party to file a financing statement covering the collateral described in the security agreement and identifiable proceeds. Com C §9509(b).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.82 7. Filing Fees for Mail or Counter Submissions

§3.82 7. Filing Fees for Mail or Counter Submissions

The filing fee for an original financing statement, an amendment, or a continuation statement is $10 for a form that is two pages or fewer or $20 for a filing statement that is more than two pages. Com C §9525. Current fees may be ascertained by calling the California Secretary of State's voice-mail system at (916) 653-3516 or visiting the website at http://www.sos.ca.gov/business/ucc/forms.htm. See §3.79A.

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8. Forms

§3.83 a. Form: Cover Letter to Secretary of State [Deleted]

This section has been deleted as obsolete.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.84 b. Form: Financing Statement (Form UCC-1)

§3.84 b. Form: Financing Statement (Form UCC-1)



[redacted]

UCC FINANCING STATEMENT

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]

B. SEND ACKNOWLEDGEMENT TO: (Name and Address)

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1. DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (1a or 1b) – do not abbreviate or combine names

1a. ORGANIZATION'S NAME

OR

1b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX
1c. MAILING ADDRESS	CITY	STATE / POSTAL CODE	COUNTRY

[redacted] | ADD'L INFO RE ORGANIZATION DEBTOR | 1e. TYPE OF ORGANIZATION | 1f. JURISDICTION OF ORGANIZATION | 1g. ORGANIZATIONAL ID#, if any ☐ NONE

2. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (2a or 2b) – do not abbreviate or combine names

2a. ORGANIZATION'S NAME

OR

2b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX
2c. MAILING ADDRESS	CITY	STATE / POSTAL CODE	COUNTRY

[redacted] | ADD'L INFO RE ORGANIZATION DEBTOR | 2e. TYPE OF ORGANIZATION | 2f. JURISDICTION OF ORGANIZATION | 2g. ORGANIZATIONAL ID#, if any ☐ NONE

3. SECURED PARTY'S NAME (or NAME of TOTAL ASSIGNEE of ASSIGNOR S/P) – insert only one secured party name (3a or 3b)

3a. ORGANIZATION'S NAME

OR

3b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX
3c. MAILING ADDRESS	CITY	STATE / POSTAL CODE	COUNTRY

4. This FINANCING STATEMENT covers the following collateral:

5. ALTERNATIVE DESIGNATION [if applicable]: ☐ LESSEE/LESSOR ☐ CONSIGNEE/CONSIGNOR ☐ BAILEE/BAILOR ☐ SELLER/BUYER ☐ AG. LIEN ☐ NON-UCC FILING

6. ☐ This FINANCING STATEMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS. Attach Addendum [if applicable]

7. Check to REQUEST SEARCH REPORT(S) on Debtor(s) [ADDITIONAL FEE] [optional] ☐ All Debtors ☐ Debtor 1 ☐ Debtor 2

8. OPTIONAL FILER REFERENCE DATA

Print

Instructions for National UCC Financing Statement (Form UCC1)

Please type or laser-print this form. Be sure it is completely legible. Read all Instructions, especially Instruction 1; correct Debtor name is crucial. Follow Instructions completely.

Fill in form very carefully; mistakes may have important legal consequences. If you have questions, consult your attorney. The filing office cannot give legal advice.

Do not insert anything in the open space in the upper portion of this form; it is reserved for filing office use.

When properly completed, send Filing Office Copy, with required fee, to filing office. If you want an acknowledgment, complete item B and, if filing in a filing office that returns an acknowledgment copy furnished by filer, you may also send Acknowledgment Copy; otherwise detach. If you want to make a search request, complete item 7 (after reading Instruction 7 below) and send Search Report Copy, otherwise detach. Always detach Debtor and Secured Party Copies.

If you need to use attachments, use 8-1/2 X 11 inch sheets and put at the top of each sheet the name of the first Debtor, formatted exactly as it appears in item 1 of this form; you are encouraged to use Addendum (Form UCC1Ad).

A. To assist filing offices that might wish to communicate with filer, filer may provide information in item A. This item is optional.

B. Complete item B if you want an acknowledgment sent to you. If filing in a filing office that returns an acknowledgment copy furnished by filer, present simultaneously with this form a carbon or other copy of this form for use as an acknowledgment copy.

1. **Debtor name**: Enter only one Debtor name in item 1, an organization's name (1a) or an individual's name (1b). Enter Debtor's exact full legal name. Don't abbreviate.

1a. Organization Debtor. "Organization" means an entity having a legal identity separate from its owner. A partnership is an organization; a sole proprietorship is not an organization, even if it does business under a trade name. If Debtor is a partnership, enter exact full legal name of partnership; you need not enter names of partners as additional Debtors. If Debtor is a registered organization (e.g., corporation, limited partnership, limited liability company), it is advisable to examine Debtor's current filed charter documents to determine Debtor's correct name, organization type, and jurisdiction of organization.

1b. Individual Debtor. "Individual" means a natural person; this includes a sole proprietorship, whether or not operating under a trade name. Don't use prefixes (Mr., Mrs., Ms.). Use suffix box only for titles of lineage (Jr., Sr., III) and not for other suffixes or titles (e.g., M.D.). Use married woman's personal name (Mary Smith, not Mrs. John Smith). Enter individual Debtor's family name (surname) in Last Name box, first given name in First Name box, and all additional given names in Middle Name box.

For both organization and individual Debtors: Don't use Debtor's trade name, DBA, AKA, FKA, Division name, etc. in place of or combined with Debtor's legal name; you may add such other names as additional Debtors if you wish (but this is neither required nor recommended).

1c. An address is always required for the Debtor named in 1a or 1b.

1d. **This field has been removed pursuant to California Uniform Commercial Code, Section 9526.5.**

1e,f,g."Additional information re organization Debtor" is always required. Type of organization and jurisdiction of organization as well as Debtor's exact legal name can be determined from Debtor's current filed charter document. Organizational ID #, if any, is assigned by the agency where the charter document was filed; this is different from tax ID #; this should be entered preceded by the 2-character U.S. Postal identification of state of organization if one of the United States (e.g., CA12345, for a California corporation whose organizational ID # is 12345); if agency does not assign organizational ID #, check box in item 1g indicating "none."

Note: If Debtor is a trust or a trustee acting with respect to property held in trust, enter Debtor's name in item 1 and attach Addendum (Form UCC1Ad) and check appropriate box in item 17. If Debtor is a decedent's estate, enter name of deceased individual in item 1b and attach Addendum (Form UCC1Ad) and check appropriate box in item 17.If Debtor is a transmitting utility or this Financing Statement is filed in connection with a Manufactured-Home Transaction or a Public-Finance Transaction as defined in applicable Commercial Code, attach Addendum (Form UCC1Ad) and check appropriate box in item 18.

2. If an additional Debtor is included, complete item 2, determined and formatted per Instruction 1. To include further additional Debtors, or one or more additional Secured Parties, attach either Addendum (Form UCC1Ad) or other additional page(s), using correct name format. Follow Instruction 1 for determining and formatting additional names.

3. Enter information for Secured Party or Total Assignee, determined and formatted per Instruction 1. If there is more than one Secured Party, see Instruction 2. If there has been a total assignment of the Secured Party's interest prior to filing this form, you may either (1) enter Assignor S/P's name and address in item 3 and file an Amendment (Form UCC3) [see item 5 of that form]; or (2) enter Total Assignee's name and address in item 3 and, if you wish, also attaching Addendum (Form UCC1Ad) giving Assignor S/P's name and address in item 12.

4. Use item 4 to indicate the collateral covered by this Financing Statement. If space in item 4 is insufficient, put the entire collateral description or continuation of the collateral description on either Addendum (Form UCC1Ad) or other attached additional page(s).

5. If filer desires (at filer's option) to use titles of lessee and lessor, or consignee and consignor, or seller and buyer (in the case of accounts or chattel paper), or bailee and bailor instead of Debtor and Secured Party, check the appropriate box in item 5. If this is an agricultural lien (as defined in applicable Commercial Code) filing or is otherwise not a UCC security interest filing (e.g., a tax lien, judgment lien, etc.), check the appropriate box in item 5, complete items 1-7 as applicable and attach any other items required under other law.

6. If this Financing Statement is filed as a fixture filing or if the collateral consists of timber to be cut or as-extracted collateral, complete items 1-5, check the box in item 6, and complete the required information (items 13, 14 and/or 15) on Addendum (Form UCC1Ad).

7. This item is optional. Check appropriate box in item 7 to request Search Report(s) on all or some of the Debtors named in this Financing Statement. The Report will list all Financing Statements on file against the designated Debtor on the date of the Report, including this Financing Statement. There is an additional fee for each Report. If you have checked a box in item 7, file Search Report Copy together with Filing Officer Copy (and Acknowledgment Copy). Note: Not all states do searches and not all states will honor a search request made via this form; some states require a separate request form.

8. This item is optional and is for filer's use only. For filer's convenience of reference, filer may enter in item 8 any identifying information (e.g., Secured Party's loan number, law firm file number, Debtor's name or other identification, state in which form is being filed, etc.) that filer may find useful.

Comment: This form is specified in Com C §9521(a). A copy of this form may be obtained from the California

Secretary of State's website at http://www.sos.ca.gov/business/ucc/financing-statement.htm. Additional debtors or secured creditors may be listed by using the Financing Statement Addendum (Form UCC1Ad). See §3.84A. The addendum can also be used to list descriptions of collateral if there is insufficient space on the UCC-1 form. See §3.79A regarding Social Security numbers on this form.

There is also a form, Financing Statement Additional Party (Form UCC1AP), that may be used to accommodate multiple debtors or secured creditors. See §3.84B.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.84A c Form: Financing Statement Addendum (Form UCC1Ad)

§3.84A c Form: Financing Statement Addendum (Form UCC1Ad)



UCC FINANCING STATEMENT ADDENDUM

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

9. NAME OF FIRST DEBTOR (1a or 1b) ON RELATED FINANCING STATEMENT

9a. ORGANIZATION NAME

OR

9b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME, SUFFIX

10. MISCELLANEOUS:

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

11. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME – insert only one name (11a or 11b) – do not abbreviate or combine names

11a. ORGANIZATION'S NAME

OR

11b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

11c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

ADD'L INFO RE ORGANIZATION DEBTOR	11e. TYPE OF ORGANIZATION	11f. JURISDICTION OF ORGANIZATION	11g. ORGANIZATIONAL ID#, if any ☐ NONE

12. ☐ ADDITIONAL SECURED PARTY'S or ☐ ASSIGNOR S/P's NAME – insert only one name (12a or 12b)

12a. ORGANIZATION'S NAME

OR

12b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

12c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

13. This FINANCING STATEMENT covers ☐ timber to be cut or ☐ as-extracted collateral, or is filed as a ☐ fixture filing.

14. Description of real estate:

15. Name and address of a RECORD OWNER of above-described real estate (if Debtor does not have a record interest):

16. Additional collateral description:

17. Check only if applicable and check only one box.

Debtor is a ☐ Trust or ☐ Trustee acting with respect to property held in trust or ☐ Decedent's Estate

18. Check only if applicable and check only one box.

☐ Debtor is a TRANSMITTING UTILITY

☐ Filed in connection with a Manufactured-Home Transaction – effective 30 years

☐ Filed in connection with a Public-Finance Transaction – effective 30 years

Print

Instructions for National UCC Financing Statement Addendum (Form UCC1Ad)

9. Insert name of first Debtor shown on Financing Statement to which this Addendum is related, exactly as shown in item 1 of Financing Statement.

10. Miscellaneous: Under certain circumstances, additional information not provided on Financing Statement may be required. Also, some states have non-uniform requirements. Use this space to provide such additional information or to comply with such requirements; otherwise, leave blank.

11. If this Addendum adds an additional Debtor, complete item 11 in accordance with Instruction 1 on Financing Statement. To add more than one additional Debtor, either use an additional Addendum form for each additional Debtor or replicate for each additional Debtor the formatting of Financing Statement item 1 on an 8-1/2 X 11 inch sheet (showing at the top of the sheet the name of the first Debtor shown on the Financing Statement), and in either case give complete information for each additional Debtor in accordance with Instruction 1 on Financing Statement. All additional Debtor information, especially the name, must be presented in proper format exactly identical to the format of item 1 of Financing Statement.

12. If this Addendum adds an additional Secured Party, complete item 12 in accordance with Instruction 3 on Financing Statement. In the case of a total assignment of the Secured Party's interest before the filing of this Financing Statement, if filer has given the name and address of the Total Assignee in item 3 of the Financing Statement, filer may give the Assignor S/P's name and address in item 12.

13-15. If collateral is timber to be cut or as-extracted collateral, or if this Financing Statement is filed as a fixture filing, check appropriate box in item 13; provide description of real estate in item 14; and, if Debtor is not a record owner of the described real estate, also provide, in item 15, the name and address of a record owner. Also provide collateral description in item 4 of Financing Statement. Also check box 6 on Financing Statement. Description of real estate must be sufficient under the applicable law of the jurisdiction where the real estate is located.

16. Use this space to provide continued description of collateral, if you cannot complete description in item 4 of Financing Statement.

17. If Debtor is a trust or a trustee acting with respect to property held in trust or is a decedent's estate, check the appropriate box.

18. If Debtor is a transmitting utility or if the Financing Statement relates to a Manufactured-Home Transaction or a Public-Finance Transaction as defined in the applicable Commercial Code, check the appropriate box.

Comment: Either this form or the form in §3.84B can be used as an attachment to continue a listing of debtors or

secured creditors in an original filing on the Form UCC-1. The form may be used only in conjunction with Form UCC-1 or Form UCC-3. See §3.84. This form is specified in Com C §9521(a). Copies of this form may be obtained from the California Secretary of State's website at http://www.sos.ca.gov/business/ucc/ra_9_ucc-1.pdf.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.84B d. Form: Financing Statement Additional Party (Form UCC1AP)

§3.84B d. Form: Financing Statement Additional Party (Form UCC1AP)



UCC FINANCING STATEMENT ADDITIONAL PARTY

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

19. NAME OF FIRST DEBTOR (1a or 1b) ON RELATED FINANCING STATEMENT

19a. ORGANIZATION NAME

OR

19b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME, SUFFIX

20. MISCELLANEOUS:

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

21. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME – insert only one name (21a or 21b) – do not abbreviate or combine names

21a. ORGANIZATION'S NAME

OR

21b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

21c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

ADD'L INFO RE ORGANIZATION DEBTOR	21e. TYPE OF ORGANIZATION	21f. JURISDICTION OF ORGANIZATION	21g. ORGANIZATIONAL ID#, if any
			☐ NONE

22. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME – insert only one name (22a or 22b) – do not abbreviate or combine names

22a. ORGANIZATION'S NAME

OR

22b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

22c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

ADD'L INFO RE ORGANIZATION DEBTOR	22e. TYPE OF ORGANIZATION	22f. JURISDICTION OF ORGANIZATION	22g. ORGANIZATIONAL ID#, if any
			☐ NONE

23. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME – insert only one name (23a or 23b) – do not abbreviate or combine names

23a. ORGANIZATION'S NAME

OR

23b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

23c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

ADD'L INFO RE ORGANIZATION DEBTOR	23e. TYPE OF ORGANIZATION	23f. JURISDICTION OF ORGANIZATION	23g. ORGANIZATIONAL ID#, if any
			☐ NONE

24. ADDITIONAL SECURED PARTY'S NAME (or Name of TOTAL ASSIGNEE) – insert only one name (24a or 24b)

24a. ORGANIZATION'S NAME

OR

24b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

24c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

25. ADDITIONAL SECURED PARTY'S NAME (or Name of TOTAL ASSIGNEE) – insert only one name (25a or 25b)

25a. ORGANIZATION'S NAME

OR

25b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

25c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

Print

Instructions for UCC Financing Statement Additional Party (Form UCC1AP)

Use this form to continue adding additional Debtor or Secured Party names as needed when filing a UCC Financing Statement (Form UCC1).

19. Insert name of first Debtor shown on Financing Statement to which this Additional Party relates, exactly as shown in item 1 of Financing Statement.

20. Miscellaneous: Under certain circumstances, additional information not provided on Financing Statement may be required. Also, some states have non-uniform requirements. Use this space to provide such additional information or to comply with such requirements; otherwise, leave blank.

21-23. If this Additional Party adds additional Debtors, complete items 21, 22, and 23 in accordance with Instruction 1 of Financing Statement and give complete information for each additional Debtor. Be sure to complete either the organization's name or individual's name items.

24-25. If this Additional Party adds additional Secured Parties, complete items 24 and 25 in accordance with Instruction 3 of Financing Statement and give complete information for each additional Secured Party.

Comment: Either this form or the form in §3.84A may be used as an attachment to continue a listing of debtors or

secured creditors in an original filing on the Form UCC-1. This form is specified in Com C §9521(a) and may be used only in conjunction with Form UCC-1 or Form UCC-3. See §3.84. This form is available from the California Secretary of State's website at http://www.sos.ca.gov/business/ucc/ucc1_ap.pdf.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.85 e. Form: Information Request (Form UCC-11)

§3.85 e. Form: Information Request (Form UCC-11)



INFORMATION REQUEST

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT	FILING OFFICE ACCT #

B. RETURN TO: (Name and Address)

[ ]

[ ]

THIS SPACE FOR FILING OFFICER USE ONLY

1. DEBTOR NAME to which this request relates – insert only one debtor name (1a or 1b) – do not abbreviate or combine names

1a. ORGANIZATION NAME			
1b. INDIVIDUAL LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

2. INFORMATION OPTIONS RELATING TO UCC FILINGS AND OTHER NOTICES FILED IN FILING OFFICE THAT INCLUDE AS A DEBTOR THE NAME IDENTIFIED IN ITEM 1

☐ For 2a and 2b, **mark this box** to request a Search that is **COMPLETE** to include **lapsed and unlapsed** filings. UNLESS MARKED, SEARCH MAY BE INCOMPLETE.

2a. ☐ SEARCH RESPONSE with copies of ALL records found. ☐ Please CERTIFY all copies **(additional $5.00 fee per record)**.

2b. ☐ **SEARCH RESPONSE only.**

2c. ☐ **COPIES ONLY. Please complete the information below, as appropriate. For UCC3 records, include the type of UCC3 and corresponding filing date.**

File Number	# of copies	# of Certified copies (add'l fee applies)	File Date (use for UCC3 only)	Filing Type – Financing Statement, Cont., Term., Assign., Amend.

3. CALIFORNIA SECRETARY OF STATE'S OFFICE OFFERS THESE ADDITIONAL SEARCHING OPTIONS - (Please see instructions):

3a. ☐ SEARCH TO REFLECT – Please run the search after the filing document accompanying this request has been filed.

3b. ☐ SEARCH LIMITED TO THE FOLLOWING ADDRESS: _____

3c. ☐ SEARCH LIMITED FROM THIS DATE: _____

4. DELIVERY INSTRUCTIONS

4a. ☐ Pick Up (Only if request was originally delivered to our Public Counter)

4b. ☐ Other: _____

Specify desired method; Completed **prepaid** airbill and packaging must accompany this request, if applicable.

Print

INSTRUCTIONS FOR INFORMATION REQUEST (FORM UCC 11)

Please type or laser-print this form. Be sure it is completely legible. Read all instructions. Follow instructions completely. Fill in form very carefully; mistakes may have important legal consequences. If you have questions, consult your attorney. The filing office cannot give legal advice.

Do not insert anything in the open space in the upper portion of this form; it is reserved for filing office use. When properly completed, send form together with a separate, clearly marked SEARCH copy, with required fee, to the filing office.

A. To assist filing office communication with requestor, the information in item A may be provided. This item is optional.
B. Enter name and mailing address of requestor in item B. This item is REQUIRED.

1. Debtor Name to which this request relates: Enter only one debtor name in item 1, EITHER an organization's name (1a) or an individual's name (1b). The name entered is the name used to produce a search report. It is recommended that the search be requested against the EXACT LEGAL DEBTOR NAME. The filing office will conduct the search under the name given in either Item 1a or 1b.

   ****The information for 1a and 1b is offered as a guide for completing this form using the EXACT LEGAL DEBTOR NAME. There may be records on file in which the Exact Legal Debtor Name was not used. You may wish to submit a separate UCC11 for each possible name variation.**

1a. Organization Debtor: "Organization" means an entity having a legal identity separate from its owner. A partnership is an entity; a sole proprietorship is not an organization, even if it does business under a trade name. If a debtor is a partnership, enter exact full legal name of the partnership. If debtor is a registered organization (e.g., corporation, limited partnership, limited liability company), it is advisable to examine Debtor's current filed charter documents to determine Debtor's correct name.

   For both Organization and Individual Debtors: Do not use Debtor's trade name, DBA, AKA, FKA, DIVISION name, etc. in place of or combined with Debtor's legal name (i.e., DO NOT use "Simpson Motor Inc. DBA Cornelia Car City.) Search results in response to such a search request may not reveal financing statements on file that correctly use the legal name of the debtor.

1b. Individual Debtor: "Individual" means a natural person, this includes a sole proprietorship, whether or not operating under a trade name. Do not use prefixes (Mr., Mrs., and Ms.). Use suffix box only for title of lineage (Jr., Sr., III) and not for other suffixes or title (e.g., MD, CPA). Use married woman's personal name (Mary Smith, not Mrs. John Smith). Enter individual debtor's family name (surname) in Last Name box, first given name in First Name box, and all additional given names in Middle Name box.

   Information Options: For 2a and 2b, mark this box to receive a search response that is complete and includes lapsed and unlapsed filings. Unless marked, the search may be incomplete.

   To request a SEARCH, choose either:

   2a -This option results in a complete search at ANY ADDRESS and includes copies of all the filings reflected on the search response. Searches include unlapsed and lapsed filings. Mark the certify box to receive certified copies. Please enclose a $5.00 fee for each copy certified.
   2b - This options will result in a search response with no copies.
   3a - The search report will not be produced until the accompanying document and all other documents received on that day have been filed and can be certified.
   3b - Limits the debtor search to a specific street address. Please indicate a complete address. This filing office does not offer searches by CITY.
   3c - Limits the debtor search to a specific date range. Please indicate the starting date to be searched.

   To request COPIES, choose:

   2c - Complete the grid for each specific record to be copied. The **UCC1 file number** must be referenced. There is a limit of 10 file numbers per UCC11. Complete the grid as instructed on the form.

4. Requests will be returned by mail to the party indicated in Item B, unless otherwise requested.

Please enclose the appropriate fees. If the exact amount is not known, you may enclose either a blank check payable to the Secretary of State or a check with the notation "Not to exceed $___" (usually $35.00 is sufficient). Once the exact fees have been determined, the filing officer will complete the check for the correct amount. A detailed billing sheet will be returned with the requested information.

Search fee	$10.00
Copy fee	$1.00 for each face page of record + $ .50 for each attachment page
Certified copies	$5.00 additional fee for each record that is certified

---

Comment: A copy of this form may be obtained from the California Secretary of State's website at

http://www.sos.ca.gov/business/ucc/form.htm.

Comment: See §3.82 for filing fees. Entities may establish a prepaid account with the Secretary of State's office for Commercial Code filings. For further information, write to California Secretary of State, P.O. Box 942385, Sacramento, CA 94235-0001, Attention: Uniform Commercial Code, or call (916) 653-3516.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.86 B. Contents of Financing Statement

§3.86 B. Contents of Financing Statement

The formal required contents of a financing statement are set forth in Com C §9502. See §§3.87-3.96. A financing statement is conceptually different from the underlying security agreement between the debtor and the creditor (see chap 2). The financing statement serves only as a notice to third parties and generally discloses less about the underlying transaction than does the security agreement. Commercial Code §9506(a) provides that a financing statement, substantially meeting the requirements of Chapter 5 of Division 9, will be effective despite minor errors or omissions unless the errors or omissions make the financing statement seriously misleading.

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§3.87 1. Debtor's Name

The financing statement must include the name of the debtor. Com C §9502(a)(1). A financing statement that fails to provide the name of the debtor as set forth in §9502(a)(1) is seriously misleading. Com C §9506(b). Filings are indexed by the California Secretary of State's office using a standard search logic. If the search logic does not pick up the name in a search, then the filing will be seriously misleading. See Com C §9506(b)-(c). Different states have employed different search logics that may or may not pick up even slight deviations from a name. It is important, therefore, that the creditor know the precise form and spelling of the debtor's name and that the financing statement (as well as the security agreement) bear that name. See *Corona Fruits & Veggies, Inc. v Frozsun Foods, Inc.* (2006) 143 CA4th 319, 48 CR3d 868, discussed in §3.88. See also *Host Am. v Coastline Fin., Inc.* (D Utah, July 6, 2006, No. 2:06-CV-5) 2006 US Dist Lexis 35727 (financing statement that did not contain periods in debtor's name was seriously misleading because State of Utah search logic did not find it).

More than one debtor may be listed on a financing statement. Com C §9503(e). For discussion of specific information requirements, see §§3.88-3.92. Corporate, limited partnership, and limited liability company names can be searched online to determine if an entity is registered in the State of California and to obtain preliminary information needed to order corporate documents at the California Secretary of State's website (http://kepler.sos.ca.gov).

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§3.88 a. Individuals

If the debtor is an individual, a secured creditor should use the debtor's full legal name. In *Corona Fruits & Veggies, Inc. v Frozsun Foods, Inc.* (2006) 143 CA4th 319, 48 CR3d 868, the court held that a creditor failed to perfect a security interest because its financing statement listed the debtor's last name erroneously. Failure to use the debtor's correct name was "seriously misleading" (see Com C §9506(b)), because a subsequent creditor was unable to discover the previous financing statement and therefore had no notice of the prior lien.

In *Clark v Deere & Co. (In re KinderKnecht)* (BAP 10th Cir 2004) 308 BR 71, the court held that the use of the nickname "Terry" instead of the debtor's legal name, "Terence," was insufficient under Kansas law. Therefore, the secured party was not properly perfected, and the bankruptcy trustee was able to avoid the secured creditor's security interest. The creditor may wish to check the debtor's driver's license, credit cards, tax return, birth certificate, or other identification. Customarily, the loan will not be made without a credit check; the creditor can cross-check information from his or her own inquiry with information from the credit search. See also *Parks v Berry* (*In re Berry)* (Bankr D Kan, Dec. 1, 2006, No. 05-14423) 2006 WL 2795507; *Genoa Nat'l Bank v Southwest Implement, Inc*. *(In re Borden)* (Bankr D Neb 2006) 353 BR 886. The secured party may need to file a financing statement under more than one name if it is not clear from the documents reviewed what is the correct name for the individual. Certain states have amended Uniform Commercial Code §9-503, including Texas (Tex Bus & Com C §9.503), Virginia (Va C Ann §8.9A-503(a)), and Tennessee (Tenn C Ann §47-9-503(b)) to indicate the appropriate identification to determine the correct name of an individual. California has not adopted any amendments.

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§3.89 b. Partnerships

If the debtor is a partnership, the Commercial Code requires filing in the name of the partnership (not in the names of the partners), unless the partnership does not have a name, in which case the names of the partners should be listed. Com C §9503(a)(4).

Commercial Code §9503(a)(1) provides that, with respect to "registered organizations," the name on the financing statement must be the same as the name on the public records of the debtor's jurisdiction of organization. Because a limited partnership is a "registered organization" under Com C §9503(a)(1) (see Corp C §15621), it must file a certificate of limited partnership with the Secretary of State's office. The name used in the certificate of limited partnership must be the name included in the limited partnership organizational documents. Com C §9503(a)(1).

To obtain a copy of a limited partnership certificate by mail, send a completed Business Entities Records Order Form (available at http://sos.ca.gov/business/pdf/be_ircform.pdf) to Secretary of State, Certification and Records, P.O. Box 944260, Sacramento, CA 94244-2600. Fees for copies of formation documents are $1 for the first page and 50 cents for each additional page; $5 for certification. Certification of status is $5. Govt C §12183(a). An unofficial business entity search is available at http://kepler.sos.ca.gov/list.html. Special handling (counter service) is available at 1500 11th Street, 3rd Floor, Sacramento, CA 95814) for $10.

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§3.90 c. Corporations

If the debtor is a corporation, the Commercial Code requires filing under the corporate name as set forth in its organizational documents. Com C §9503(a)(1). A prudent practitioner will review the articles of incorporation to insure that the financing statement lists the debtor's name correctly. The creditor will want to make sure that the debtor has abided by the appropriate corporate formalities.

NOTE: The Sixth Circuit held in *U.S. v Crestmark Bank* (*In re Spearing Tool & Mfg. Co.)* (6th Cir 2005) 412 F3d 653, that the Internal Revenue Service would not be held to the same exacting standard for filing a federal tax lien, and therefore a federal tax lien filed against a similar but not precisely correct name was senior to a lien filed by a creditor against the correct name. But see *In re Crystal Cascades Civil, LLC* (Bankr D Nev 2008) 398 BR 23, aff'd sub nom *U.S. v Buenting (In re Crystal Cascades Civil, LLC)* (BAP 9th Cir 2009) 104 AFTR2d 5162 (tax lien notices that left out nontrivial word of debtor's name ineffective against third parties because reasonable search of property would not have revealed lien).

The fee for copies of formation or other documents filed with the California Secretary of State is $1 for copies of the first page and 50 cents for each additional page, and $5 for certification. The fee for a certificate of corporate status is $5. Mail a completed Business Entities Records Order Form (available at http://www.sos.ca.gov/business/pdf/be_ircform.pdf with a self-addressed envelope to Secretary of State, P.O. Box 944260, Sacramento, CA 94244-2600.

Unofficial business entity searches are available online at http://kepler.sos.ca.gov.

PRACTICE TIP: Filing and information requests submitted by mail to the Secretary of State are generally processed within 10 to 20 business days. However, processing times vary greatly depending on the type of request submitted and the time of year it is received. The Secretary of State maintains a list of mail processing times on its website at http://www.sos.ca.gov/business/be/mail-processing-times.htm. If an expeditious response is required, a practitioner may wish to consider using a private research company.

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§3.91 d. Limited Liability Companies

If the debtor is a limited liability company, the Commercial Code requires filing under the corporate name as set forth in its organizational documents. Com C §9503(a)(1). A prudent practitioner will review the articles of organization to insure that the financing statement lists the debtor's name correctly. The creditor will want to make sure that the debtor has abided by the appropriate formalities.

The fees for certification of limited liability company status are $1 for copies of the first page and 50 cents for each additional page, $5 for certification (Govt C §12183(a)), and $10 for special handling (counter service) (Govt C §12182(a); 2 Cal Code Regs §21903(b)). Mail a completed Business Entities Records Order Form (available at http://www.sos.ca.gov/business/pdf/be_ircform.pdf) to Secretary of State, Certification and Records, PO Box 944260, Sacramento, CA 94244-2600. Telephone confirmation of status is not available without a prepaid account. The fee for telephonic confirmation of status is $4 per name. Information regarding limited liability companies can also be accessed via the website at http://www.sos.ca.gov/business/llc/llc.htm.

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§3.92 e. Trade Names

It is not necessary to include trade names of the debtor on the financing statement. Com C §9503(b). A trade name alone will be insufficient to provide the name of the debtor. Com C §9503(c). In fact, including a trade name can cause the filing to be ineffective. *In re Jim Ross Tires, Inc.* (Bankr SD Tex 2007) 379 BR 670 (financing statement which included both debtor's correct name as indicated by Secretary of State and debtor's "dba" name, which had expired, did not properly state debtor's name).

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§3.93 2. Creditor's Name

The financing statement must include the name of the secured party or its representative. Com C §9502(a)(2); *Trust Corp. of Montana v Patterson (In re Copper King Inn, Inc.)* (9th Cir 1990) 918 F2d 1404. In *Copper King Inn,* however, the court interpreted a provision of Montana law analogous to Com C §9502(a)(2) and held that a creditor, the trustee for a retirement account, had failed to perfect its security interest in certain goods because its name did not appear on the filed Form UCC-1. The name appearing on the Form UCC-1 was that of the trust account's trustor, who had also made loans to the debtor in his individual capacity. Absent a finding that the trustor was acting as the creditor's agent, the creditor's security interest was subject to avoidance in the debtor's subsequent bankruptcy proceeding. Commercial Code §9503(d) provides that "[f]ailure to indicate the representative capacity of a secured party or representative of a secured party does not affect the sufficiency of a financing statement." See also Official Comment 3 to UCC §9-503. For example, a financing statement listing a collateral agent and not the lender is sufficient. The creditor's address is not required under Com C §9502; however, Com C §9516(b)(4) provides that the filing office may reject the financing statement if the mailing address is not included.

Courts have found that if an incorrect name of the secured party does not materially lead another creditor astray, the error or omission in the name may not be fatal. In *Hergert v Bank of the West (In re Hergert)* (Bankr D Idaho 2002) 275 BR 58, distinguishing *Copper King Inn,* the court determined that changes in a secured party's name did not render the financing statement ineffective. Because searches are not conducted under the secured party's name, and no filing is needed to continue the perfected status of a security interest after it is assigned, an error in the secured party's name will not be seriously misleading; although, in an appropriate case, an incorrect secured party's name may give rise to an estoppel in favor of a holder of a conflicting claim under UCC §1-103. Official Comment 2 to UCC §9-506. To avoid this issue, secured creditors should update financing statements if the secured creditor's name changes.

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§3.94 3. Description of Collateral

The financing statement must "indicate the collateral covered by the financing statement." Com C §9502(a)(3). This is more liberal than the standard for the security agreement itself (see chap 2), which must contain "a description of the collateral." Com C §§9108, 9203(b)(3)(A). A mere reference to a security agreement in which the collateral is described, however, does not meet the requirements for a financing statement. *Rameker v Farmers State Bank (In re Lynch)* (Bankr WD Wis 2004) 313 BR 798. See §2.4 for a discussion of the collateral description in the security agreement.

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§3.95 a. General Requirements for Sufficient Indication of Collateral

Section 9504 describes what is a sufficient indication of collateral. The financing statement can describe the collateral under §9108 or state that the financing statement covers all assets or all personal property. Com C §9504. See §2.7 for descriptions under Com C §9108. Under the prior versions of Division 9, there were numerous cases regarding sufficiency of description. It is hoped that the statement "all assets or personal property" will solve this problem.

If a secured creditor's collateral is limited to specified equipment, it is critical to accurately describe the collateral. In *Deere Credit, Inc. v Pickle Logging, Inc. (In re Pickle Logging, Inc.)* (Bankr MD Ga 2002) 286 BR 181, the secured creditor used an incorrect serial number in the filing. The court found that the secured creditor was unperfected.

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§3.96 b. Special Requirements for Fixtures and As-Extracted Collateral or Timber to Be Cut

In addition to the general requirement for the description of the collateral in the financing statement (see §3.94), there are special requirements when the financing statement covers fixtures and as-extracted collateral or timber to be cut. The secured party must indicate that the financing statement covers this type of collateral, indicate that it is to be filed in the real property records, and provide a description of the real property to which the collateral is related sufficient to give constructive notice of a mortgage in California if the description were contained in a record of the mortgage of real property. If the debtor does not have an interest in the real property, the name of the record owner must be included. Com C §9502(b). See §3.97 regarding fixtures.

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§3.97 C. Additional Fixture Filing

If goods are or will become fixtures, a separate "fixture filing," in addition to the ordinary filing that perfects the security interest, is necessary if the secured party wants priority over an interest arising under real estate law. Com C §§9334(c), 9501(a)(1)(B). A fixture filing must be recorded in the office where a mortgage on the real property would be recorded. Com C §9501(a)(1)(B). Practically speaking, in many cases this will mean that the secured creditor will have to file twice: once with the Secretary of State (to perfect other collateral, if that is the proper mode of perfection) and once with the county recorder. See §§3.98-3.101.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.98 1. Requirements for Fixture Filing

§3.98 1. Requirements for Fixture Filing

A fixture filing must meet the following requirements (Com C §9502(b)):

- Cover the goods that are or will become fixtures,
- State that it is to be filed in the real property records,
- Contain a description of the real property, and
- Show the name of a record owner of the real property if the debtor does not have an interest of record.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.99 2. Mortgage Effective as Fixture Filing

§3.99 2. Mortgage Effective as Fixture Filing

A mortgage is effective as a financing statement filed as a fixture filing from the date of recording if it meets all the following requirements (Com C §9502(c)):

- The goods are described in the mortgage by item or type,
- The goods are or are to become fixtures related to the real property described in the mortgage,
- The mortgage complies with all the requirements for a financing statement (other than a recital that it is to be filed in the real property records), and
- The mortgage is duly recorded.

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§3.100 3. Waiver of Landlord's or Mortgagee's Interest in Fixtures

A security interest in fixtures, whether or not perfected, has priority over the conflicting interest of a real property owner or encumbrancer if the owner or encumbrancer has consented in writing to the security interest or has disclaimed an interest in the goods (Com C §9334(f)(1)) or if the debtor has the right to remove the goods (Com C §9334(f)(2)). Without such an agreement, a real property encumbrance will have priority. Com C §9334(e). If there is any question whether the secured party's interest obtains priority over the landlord's or mortgagee's interest as a result of a fixture filing, it is recommended that the secured party obtain a waiver agreement such as the one set forth in §3.101.

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§3.101 4. Form: Landlord's or Mortgagee's Waiver

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

3.101-1 Landlord's or mortgagee's waiver

WAIVER AGREEMENT

This agreement is made on _ _ _ _ _ _, 20_ _, between _ _[*name*]_ _, "Secured Party," and _ _[*name*]_ _, _ _[*"Landlord/Mortgagee"*]_ _.

1. _ _[*Landlord/Mortgagee*]_ _ agrees that _ _[*name of debtor*]_ _ and Secured Party, or either of them, may remove the following described goods:

[*Insert description of goods*]

from the following described premises:

[*Insert legal description of real property*]

located in the City of _ _ _ _ _ _, county of _ _ _ _ _ _, California.

2. _ _[*Landlord/Mortgagee*]_ _ agrees that the goods described above will remain personal property even though they may be affixed to or placed on the premises.

3. _ _[*Landlord/Mortgagee*]_ _ waives and disclaims any right, title, claim, or interest in the goods arising from their being attached to or resting on the premises and grants _ _[*name of debtor*]_ _ and Secured Party, or either of them, permission to remove the goods from the premises at any reasonable time. Secured Party will not be liable for the condition of the premises after it has removed the goods as long as reasonable care is used in removing them.

IN WITNESS WHEREOF, the parties to this waiver agreement have executed it on the day and year written above.

Date: _ _ _ _ _ _ _ _[*NAME OF SECURED PARTY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _ _ _[*NAME OF LANDLORD/ MORTGAGEE*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: This agreement would not be sufficient if it were an agreement subordinating one real property interest to another, because it does not conform to the statutory requirements for such agreements, set forth in CC §§2953.1-2953.5. Clauses such as paragraph 2 frequently are included in order to sidestep the real property rules.

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§3.102 D. Protective Filing by Lessors, Consignors, Bailors, and Licensors

A true lease, license, bailment, or consignment arrangement does not establish a security interest. However, in certain cases, these types of arrangements may prove to be secured transactions. See §§1.21-1.30 for a discussion of difficulties in characterizing certain types of transactions.

Commercial Code §9505(a) provides that consignors, lessors, licensees, bailors of goods, or the buyers of payment intangible or promissory notes may all file protective filings indicating their interest in the property that will be included the collateral description.

Terms such as "consignors," "consignee," "lessor," "lessee," "bailor," "bailee," "licensor," "licensee," "owner," "registered owner," "buyer," and "seller" may be substituted for "secured party" and "debtor" in such a financing statement, as appropriate. Com C §9505(a).

Commercial Code §9505(b) provides that a consignor, a lessor, or a licensor may file a financing statement, but its filing "is not of itself a factor in determining whether the collateral secures an obligation." If it is determined that a security interest exists, the protective filing of the financing statement will be effective to perfect a security interest in the collateral. Com C §9505(b).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.103 E. Duration and Effectiveness of Financing Statement

§3.103 E. Duration and Effectiveness of Financing Statement

A financing statement generally is effective for a period of five years after the date of filing. Com C §9515(a). The Commercial Code provides the following exceptions to this rule:

- A real property mortgage effective as a fixture filing remains effective as a fixture filing until the mortgage is released or satisfied of record, or its effectiveness otherwise terminates as to the real property. Com C §9515(g).
- If the debtor is a transmitting utility and the financing statement so states, the financing statement is effective until a termination statement is filed. Com C §9515(f).
- If a financing statement relates to a public finance transaction or a manufactured home transaction, the financing statement is effective for 30 years. Com C §9515(b).

When the period of effectiveness of a financing statement expires, the financing statement lapses unless a continuation statement has been filed. See §3.107. The lapse of a financing statement is not tolled if the debtor enters into a bankruptcy proceeding, and a secured creditor must file a continuation statement (which will not violate the automatic stay). See 11 USC §362(b)(3); Official Comment 4 to UCC §9-515. For discussion of the effect of lapse of a financing statement, see §3.105.

NOTE: Although financing statements are generally effective for five years following filing, the liens created under the Commercial Code are also subject to the general terms of California statutes of limitation. *Kaichen's Metal Mart, Inc. v Ferro Cast Co.* (1995) 33 CA4th 8, 39 CR2d 233.

If information changes after the filing of a financing statement, in general, the financing statement is still effective. Com C §9507(b). However, if the debtor changes its name, an amendment may be required to be filed, as discussed in §3.104.

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§3.104 1. Limited Effectiveness After Debtor's Name Change

If the debtor changes its name so that the original financing statement no longer comports with listing the debtor's name as required by Com C §9503(a), the financing statement becomes seriously misleading. Com C §§9506-9507. However, if an official search of the filing office's records would reveal the filing, it is not seriously misleading. Com C §9506(c). If the financing statement becomes seriously misleading, a secured creditor should file an amendment setting forth the correct name of the debtor. See §3.112. The new filing will not affect the time at which the original financing statement will lapse. Com C §9512(b).

If an amendment is not filed, the financing statement will still be effective as to collateral that was perfected prior to the name change and with respect to collateral acquired within 4 months after the name change. However, the financing statement is not effective to perfect a security interest in collateral acquired by the debtor more than 4 months after the change. Com C §9507(c).

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§3.105 2. Loss of Perfection on Lapse of Financing Statement

If the financing statement lapses, it ceases to be effective and any security interest that was perfected becomes unperfected. The security interest is deemed never to have been perfected as against a "purchaser of the collateral for value." Com C §9515(c).

If two secured creditors have been perfected by filing against the same collateral and the senior secured creditor lets its financing statement lapse, the junior secured creditor will have priority, because the first creditor is deemed never to have been perfected. Official Comment 3 to UCC §9-515. By contrast, if a secured creditor perfected by filing and lets that filing lapse, the secured creditor would still be senior to a creditor who acquired a judicial lien during the time the financial statement was effective because under Com C §9515(c), a lien creditor is not a purchaser for value. Official Comment 3 to UCC §9-515.

Even if a security interest becomes unperfected because the financing statement describing the security interest lapses, the security interest is still valid and enforceable as between the debtor and the secured party, and between other creditors or purchasers such as creditors or buyers who takes an interest in the collateral with knowledge of the unperfected security interest. *Turbinator, Inc. v Superior Court* (1995) 33 CA4th 443, 39 CR2d 342.

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§3.106 F. Change of Financing Statement

Once the original financing statement is on file, certain issues arise that will require the filing of an amendment. In addition, termination or continuation statements and releases or assignments may need to be filed. See §§3.107-3.113. Most of these changes will be filed on a Form UCC-3. See §3.114.

For a discussion of the filing fee and for the Secretary of State's website address and telephone number, from which current fees may be ascertained, see §§3.79A and 3.82.

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§3.107 1. Continuation Statement

A filing may be continued for an additional five years by filing a continuation statement within the six months before the original five-year period expires. Com C §9515(d). The effectiveness of the financing statement continues for five years beginning with the day the financing statement would have become ineffective. Com C §9515(e).

The five-year period for filing the continuation statement includes the day on which the preceding filing expires (or the next business day if the final day falls on a Saturday, Sunday, or holiday). Thus, if a financing statement is filed on January 22, 2002, it is effective until the end of the day on January 22, 2007, and a continuation statement filed anytime during the day of January 22, 2007, is timely. *SCT (U.S.A.), Inc. v Mitsui Mfrs. Bank* (1984) 155 CA3d 1059, 202 CR 547.

Continuation statements may be filed for successive five-year periods. Com C §9515(e). The continuation statement (ordinarily on official Form UCC-3; see §3.114) should identify the original financing statement by date and file number, and state that the original statement is continued. Com C §9521(a). See §3.82 for a discussion of filing fees and for the Secretary of State's website address and telephone number, from which current fees may be ascertained.

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§3.108 2. Partial Release of Collateral

Short of terminating the interest altogether (see §3.109), the secured party may file a release of part or all of the collateral covered by a filed financing statement. See Com C §9512. If all the collateral is to be released, it ordinarily is preferable to file a termination statement. Care should be taken, however, not to file a termination statement if less than all the collateral is to be released. See *Koehring Co. v Nolden (In re Pacific Trencher & Equip., Inc.)* (9th Cir 1984) 735 F2d 362 (secured party who erroneously checked "termination" box instead of "release" box on Form UCC-2 was denied reformation to reflect his true intent even though no one had been misled).

A release needs to be authorized by the secured party of record. Com C §9509(d). If there is more than one secured party of record, the secured party of record's actions do not affect the filing of the other. Com C §§9509(e), 9510(b); Official Comment 3 to UCC §9-510.

A release needs to contain a description of the collateral being released and the file number of the original financing statement. Com C §9521. See §3.77 for filing fees.

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§3.109 3. Termination of Perfected Security Interest

The creditor may terminate its status of record by filing a termination statement and the debtor may demand such a statement in appropriate circumstances. Com C §9513. See §§3.110-3.111.

A secured creditor may terminate its lien by conduct as well as by filing a written termination statement with the Secretary of State. In *Spear v CEMA Distrib. (In re Rainbow Music, Inc.)* (Bankr ND Cal 1993) 154 BR 559, the debtor sold its music stores and tendered checks to suppliers that held liens on the inventory and fixtures at the stores, on the condition that the suppliers release their liens on the debtor's inventory. Although the secured creditor did not sign the release form enclosed with the check, it did cash the check. The court held that it released its lien when it cashed the check, and that the release provisions of former Com C §9405 (now Com C §9513) were permissive, not mandatory, to release a lien.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.110 a. Filing Termination Statement

§3.110 a. Filing Termination Statement

A secured creditor may file a statement terminating the creditor's claim to secured status. Com C §9513(a). The secured creditor may file such a statement at any time. A termination statement (ordinarily on official Form UCC-3) may identify the financing statement solely by file number. The date and names of the parties to the original financing statement are not required. Com C §§9512(a)(1), 9521(b).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.111 b. Duty to File or Deliver Termination Statement to Debtor

§3.111 b. Duty to File or Deliver Termination Statement to Debtor

The secured party must file a termination statement or send a termination statement to the debtor on demand from the debtor if there is no secured obligation outstanding and no commitment to make any new advances. If the secured party fails to do so within 20 days after an authenticated demand from the debtor, the secured party may be subject to liability for any loss of the debtor. Com C §§9513(c), 9625(b). The loss could include loss from not being able to obtain alternative financing. Com C §9625(b). In addition, the debtor may recover $500 for failure to file a termination statement. Com C §9625(e)(4). A secured creditor is not required to file or send a termination statement unless requested by a debtor, except in the case of consumer goods.

In the case of consumer goods, a secured creditor must file a termination statement within one month after no obligation is outstanding and there is no continuing obligation to make advances. Com C §9513(a)-(b). A secured creditor is required to file a termination statement under these circumstances because many consumers will not understand the importance of requesting a secured creditor to clear the public record. See Official Comment 2 to UCC §9-513.

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§3.112 4. Amendment of Financing Statement

A secured party may file an amendment to a financing statement to add or delete collateral, or add or delete debtors and secured parties. Com C §9512(a). An amendment also may otherwise amend the information provided in the financing statement, such as the name of the debtor. Com C §9512(a). See §3.104.

An amendment does not extend the life of the original financing statement. Com C 9512(b). If an amendment adds collateral, it is effective with respect to the additional collateral only from the date it is filed. Com C §9512(c).

All amendments must identify the file number and initial financing statement to which the amendment relates. Com C §9512(a)(1). To the extent that the filing relates to as-extracted collateral or timber to be cut, or the filing is a fixture filing, the amendment must contain the information required in Com C §9502(b). Com C §9512(a)(2). See §3.96 for a description of the requirements of Com C §9502(b).

If the amendment adds collateral or a debtor, the filing of the amendment must be authorized by the debtor in an authenticated record. Com C §9509(a). See §2.5 for a discussion of how the debtor can authenticate a record.

Under other circumstances, an amendment may be filed if the secured party of record authorizes the filing. Com C §9509(d)(1). If there is more than one secured party of record for a financing statement, each secured party may authorize the filing of an amendment under Com C §9509(e).

If a secured party has not filed a termination statement, the debtor may authorize the filing of an amendment that will act as a termination statement. The financing statement must indicate that the debtor authorized the financing statement to be filed. Com C §9509(d)(2).

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§3.113 5. Statement of Assignment by Secured Creditor

If a secured party assigns or transfers a security interest in any collateral as to which a financing statement has been filed, then a statement of that assignment may also be filed. Com C §9514(b).

Filing a statement of assignment is not necessary to perfect or continue perfection of the security interest against creditors or transferees. Com C §9310(c). A secured party that has assigned its interest may, however, wish to have the fact noted so that inquiries will be addressed not to it but to the assignee. An amendment indicating the name of the party to whom the financing statement is being assigned is appropriate. The name of the debtor, the assignor, the date of the original filing, and the file number should be included in the amendment. Com C §9514(b). Once a secured party has assigned its rights of record, then the assignee may file continuation statements, termination statements, or statements of release.

If a secured creditor holding a security interest under a security agreement containing a future advance clause assigns its rights to another creditor, the assignee-creditor can make future advances to the debtor with the same priority the initial creditor would have enjoyed, even if the assignment were made after other creditors perfected their own security interests against the debtor. *Grassmueck v Champion Credit Corp. (In re Robert B. Lee Enters.)* (9th Cir 1992) 980 F2d 606. This holding relies in part on the fact that the assignment was properly recorded with the Oregon Secretary of State, making the assignee the secured party of record at the time of the additional advances. Accordingly, an assignee should record its assignment as soon as possible to preserve its rights to make additional advances if permitted under the initial security agreement.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.114 6. Form: Financing Statement Amendment (Form UCC-3)

§3.114 6. Form: Financing Statement Amendment (Form UCC-3)



[redacted]

UCC FINANCING STATEMENT AMENDMENT

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]

B. SEND ACKNOWLEDGEMENT TO: (Name and Address)

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1a. INITIAL FINANCING STATEMENT FILE #

1b. ☐ This FINANCING STATEMENT AMENDMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS.

2. ☐ TERMINATION: Effectiveness of the Financing Statement identified above is terminated with respect to security interest(s) of the Secured Party authorizing this Termination Statement.

3. ☐ CONTINUATION: Effectiveness of the Financing Statement identified above with respect to security interest(s) of the Secured Party authorizing this Continuation Statement is continued for the additional period provided by applicable law.

4. ☐ ASSIGNMENT (full or partial): Give name of assignee in item 7a or 7b and address of assignee in item 7c; and also give name of assignor in item 9.

5. AMENDMENT (PARTY INFORMATION): This Amendment affects ☐ Debtor or ☐ Secured Party of record. Check only one of these two boxes.

Also check one of the following three boxes and provide appropriate information in items 6 and/or 7.

☐ CHANGE name and/or address: Give current record name in item 6a or 6b; also give new name (if name change) in item 7a or 7b and/or new address (if address change) in item 7c. ☐ DELETE name: Give record name to be deleted in item 6a or 6b. ☐ ADD name: Complete item 7a or 7b, and also item 7c; also complete items 7d-7g (if applicable).

6. CURRENT RECORD INFORMATION:

6a. ORGANIZATION'S NAME

OR

6b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

7. CHANGED (NEW) OR ADDED INFORMATION:

7a. ORGANIZATION'S NAME

OR

7b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

7c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

[redacted] | ADD'L INFO RE ORGANIZATION DEBTOR | 7e. TYPE OF ORGANIZATION | 7f. JURISDICTION OF ORGANIZATION | 7g. ORGANIZATIONAL ID#, if any ☐ NONE

8. AMENDMENT (COLLATERAL CHANGE): check only one box.

Describe collateral ☐ deleted or ☐ added, or give entire ☐ restated collateral description, or describe collateral ☐ assigned.

9. NAME OF SECURED PARTY OF RECORD AUTHORIZING THIS AMENDMENT (name of assignor, if this is an Assignment). If this is an Amendment authorized by a Debtor which adds collateral or adds the authorizing Debtor, or if this is a Termination authorized by a Debtor, check here ☐ and enter name of DEBTOR authorizing this Amendment.

9a. ORGANIZATION'S NAME

OR

9b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

10. OPTIONAL FILER REFERENCE DATA

Print

UCC FINANCING STATEMENT AMENDMENT ADDENDUM

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

11. INITIAL FINANCING STATEMENT FILE # (same as item 1a on Amendment form)

12. NAME OF PARTY AUTHORIZING THIS AMENDMENT (same as item 9 on Amendment form)

12a. ORGANIZATION'S NAME

OR

12b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME,SUFFIX

13. Use this space for additional information

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

Print

Instructions for National UCC Financing Statement AMENDMENT (Form UCC3)

Please type or laser-print this form. Be sure it is completely legible. Read all Instructions, especially Instruction 1a; correct file number of initial financing statement is crucial. Follow Instructions completely.

Fill in form very carefully; mistakes may have important legal consequences. If you have questions, consult your attorney. The filing office cannot give legal advice.

Do not insert anything in the open space in the upper portion of this form; it is reserved for filing office use.

When properly completed, send Filing Office Copy, with required fee, to filing office. If you want an acknowledgment, complete item B and, if filing in a filing office that returns an acknowledgment copy furnished by filer, you may also send Acknowledgment Copy; otherwise detach. Always detach Debtor and Secured Party Copies.

If you need to use attachments, use 8-1/2 X 11 inch sheets and put at the top of each sheet: "AMENDMENT" and the file number of the initial financing statement to which this Amendment relates; you are encouraged to use Amendment Addendum (Form UCC3Ad).

Always complete items 1a and 9.

A. To assist filing offices that might wish to communicate with filer, filer may provide information in item A. This item is optional.

B. Complete item B if you want an acknowledgment sent to you. If filing in a filing office that returns an acknowledgment copy furnished by filer, present simultaneously with this form a carbon or other copy of this form for use as an acknowledgment copy.

1a. **File number:** Enter file number of initial financing statement to which this Amendment relates. Enter only one file number. In some states, the file number is not unique; in those states, also enter in item 1a, after the file number, the date that the initial financing statement was filed.

1b. Only if this Amendment is to be filed or recorded in the real estate records, check box 1b and also, in item 13 of Amendment Addendum, enter Debtor's name, in proper format exactly identical to the format of item 1 of financing statement, and name of record owner if Debtor does not have a record interest.

Note: Show purpose of this Amendment by checking box 2, 3, 4, 5 (in item 5 you must check two boxes) or 8; also complete items 6, 7 and/or 8 as appropriate. Filer may use this Amendment form to simultaneously accomplish both data changes (items 4, 5, and/or 8) and a Continuation (item 3), although in some states filer may have to pay a separate fee for each purpose.

2. To terminate the effectiveness of the identified financing statement with respect to security interest(s) of authorizing Secured Party, check box 2. See Instruction 9 below.

3. To continue the effectiveness of the identified financing statement with respect to security interest(s) of authorizing Secured Party, check box 3. See Instruction 9 below.

4. To assign (i) all of assignor's interest under the identified financing statement, or (ii) a partial interest in the security interest covered by the identified financing statement, or (iii) assignor's full interest in some (but not all) of the collateral covered by the identified financing statement: Check box in item 4 and enter name of assignee in item 7a if assignee is an organization, or in item 7b, formatted as indicated, if assignee is an individual. Complete 7a or 7b, but not both. Also enter assignee's address in item 7c. Also enter name of assignor in item 9. If partial Assignment affects only some (but not all) of the collateral covered by the identified financing statement, filer may check appropriate box in item 8 and indicate affected collateral in item 8.

5,6,7. To change the name and/or address of a party: Check box in item 5 to indicate whether this Amendment amends information relating to a Debtor or a Secured Party; also check box in item 5 to indicate that this is a name and/or address change; also enter name of affected party (current record name, in case of name change) in items 6a or 6b as appropriate; and also give new name (7a or 7b) and/or new address (7c) in item 7.

5,6. To delete a party: Check box in item 5 to indicate whether deleting a Debtor or a Secured Party; also check box in item 5 to indicate that this is a deletion of a party; and also enter name (6a or 6b) of deleted party in item 6.

5,7. To add a party: Check box in item 5 to indicate whether adding a Debtor or Secured Party; also check box in item 5 to indicate that this is an addition of a party; also enter all required information in item 7: name (7a or 7b) and address (7c); also, additional organization Debtor information (7e-g), if added Debtor is an organization. Note: The preferred method for filing against a new Debtor (an individual or organization not previously of record as a Debtor under this file number) is to file a new Financing Statement (UCC1) and not an Amendment (UCC3). **(Field 7d has been removed pursuant to California Uniform Commercial Code, Section 9526.5.)**

8. Collateral change. To change the collateral covered by the identified financing statement, describe the change in item 8. This may be accomplished either by describing the collateral to be added or deleted, or by setting forth in full the collateral description as it is to be effective after the filing of this Amendment, indicating clearly the method chosen (check the appropriate box). If the space in item 8 is insufficient, use item 13 of Amendment Addendum (Form UCC3Ad). A partial release of collateral is a deletion. If, due to a full release of all collateral, filer no longer claims a security interest under the identified financing statement, check box 2 (Termination) and not box 8 (Collateral Change). If a partial assignment consists of the assignment of some (but not all) of the collateral covered by the identified financing statement, filer may indicate the assigned collateral in item 8, check the appropriate box in item 8, and also comply with instruction 4 above.

9. Always enter name of party of record authorizing this Amendment; in most cases, this will be a Secured Party of record. If more than one authorizing Secured Party, give additional name(s), properly formatted, in item 13 of Amendment Addendum (Form UCC3Ad). If the indicated financing statement refers to the parties as lessee and lessor, or consignee and consignor, or seller and buyer, instead of Debtor and Secured Party, references in this Amendment shall be deemed likewise so to refer to the parties. If this is an assignment, enter assignor's name. If this is an Amendment authorized by a Debtor that adds collateral or adds a Debtor, or if this is a Termination authorized by a Debtor, check the box in item 9 and enter the name, properly formatted, of the Debtor authorizing this Amendment, and, if this Amendment or Termination is to be filed or recorded in the real estate records, also enter, in item 13 of Amendment Addendum, name of Secured Party of record.

10. This item is optional and is for filer's use only. For filer's convenience of reference, filer may enter in item 10 any identifying information (e.g., Secured Party's loan number, law firm file number, Debtor's name or other identification, state in which form is being filed, etc.) that filer may find useful.

Print

Instructions for National UCC Financing Statement AMENDMENT Addendum (Form UCC3Ad)

11. Enter information exactly as given in item 1a on Amendment form.

12. Enter information exactly as given in item 9 on Amendment form.

13. If space on Amendment form is insufficient or you must provide additional information, enter additional information in item 13.

Comment: This form is specified in Com C §9521(b). A copy of this form may be obtained from the California

Secretary of State's website at http://www.sos.ca.gov/business/ucc/ra_9_ucc-3.pdf. Additional debtors or secured creditors may be listed on the California UCC Addendum as an attachment to Form UCC-1. See §3.84A.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.115 G. Correction Statement by Debtor

§3.115 G. Correction Statement by Debtor

A person may file a correction statement if the person believes that a record indexed under the person's name is inaccurate or was wrongfully filed. Com C §9518(a). The correction statement must properly identify the filing by using the filing number and the date it was filed. The person must also indicate the reason why the financing statement was inaccurate and the method by which it should be corrected. Com C §9518(b).

This approach is intended to assist debtors who may find inaccuracies in financing statements and who would not otherwise be able to fix the public record without resorting to litigation. Official Comment 2 to UCC §9-518.

The effectiveness of the original financing statement is unaffected by a correction statement. Com C §9518(c).

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§3.116 VII. TRANSITION RULES

Division 9 made several changes to methods of perfection under former Division 9. Division 9 applies to all security interests, even if the lien was created before Division 9 became effective on July 1, 2001. Com C §9702(a). Chapter 7 of Division 9 created special transition rules with respect to security interests created before July 1, 2001. See generally Sigman & Smith, *Revised U.C.C. Article 9's Transition Rules: Insuring a Soft Landing, Parts I & II*, 55 Bus Law 1065, 1763 (May/Aug. 2000).

If a security interest was perfected before July 1, 2001, and remained perfected under Division 9 after July 1, 2001, no action was required by the secured party, and the secured interest remained valid. Com C §§9702(b), 9703(a).

If a security interest was perfected by filing a financing statement before July 1, 2001, and the statement was filed in the correct jurisdiction under former Division 9 but not under current Division 9, the interest remained perfected until the earlier of the lapse date of the statement or July 1, 2006. See §3.117.

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§3.116A A. Issues With Certain States [Deleted]

This section has been deleted as obsolete.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/3 Perfection/§3.116B B. Interpretation of Commercial Code §9705(c)

§3.116B B. Interpretation of Commercial Code §9705(c)

Commercial Code §9705(c) sets forth the timing requirements for when a new in-lieu financing statement must be filed. Section §9705(c) provides:

> This division does not render ineffective an effective financing statement that, before July 1, 2001, is filed and satisfies the applicable requirements for perfection under the law of the jurisdiction governing perfection as provided in former Section 9103. However, except as otherwise provided in subdivisions (d) and (e) and in Section 9706, the financing statement ceases to be effective at the earlier of either of the following:
> (1) The time the financing statement would have ceased to be effective under the law of the jurisdiction in which it is filed.
> (2) June 30, 2006.

NOTE: Section 9705(c) refers to "an effective financing statement that was filed before July 1, 2001," not to those that were effective under former Article 9 but would not be under revised Article 9. Because the transition rules were designed to achieve an orderly transition under the revisions, §9705(c) should apply only to filings that were effective under former Article 9 but would not be effective under revised Article 9. The plain language of the statute, however, suggests that it applies to all filings. Certain states have attempted to address the issue through special legislation. The California Legislature has not taken a position, and no cases have yet been decided on this issue. It remains to be seen how courts will interpret Com C §9705(c) in cases in which a secured creditor did not file an in-lieu financing statement for filings that were effective under former Article 9.

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§3.117 C. "In-Lieu" Financing Statements

Because of the significant changes in the rules that determine where financing statements are to be filed and where registered organizations are deemed to be located (see §3.78), a transitional filing rule permitted financing statements that had been filed in the correct filing office to perfect a security interest under former Division 9, to remain effective to maintain that perfection and priority if a new financing statement were filed in the correct jurisdiction under current Division 9 (if different) before the earlier of the lapse date of the financing statement or July 1, 2006. Com C §§9703, 9705(c), 9706.

To maintain the existing perfection and priority, the new financing statement had to (1) identify the original financing statement by listing its place of filing, filing date (and the date of any continuation statements), and filing number, (2) confirm that the original financing statement remained effective, and (3) satisfy the requirements of Com C §§9501-9528 for financing statements. Com C §9706(c). This type of new financing statement, which effectively exported the perfection and priority represented by the original filing into the new, correct jurisdiction, is commonly referred to as an "in-lieu" financing statement or filing because of language in Official Comment 2 to UCC §9-706. The period in which it was possible to file an in-lieu financing statement has now ended. However, these requirements are currently being used to determine whether in-lieu statements were filed correctly. See *Duesterhaus Fertilizer, Inc. v Capital Crossing Bank (In re Duesterhaus Fertilizer, Inc.)* (Bankr D Ill 2006) 347 BR 646 (collateral description not included in in-lieu financing statement made in-lieu financing statement ineffective).

An in-lieu financing statement is effective for 5 years. Com C §9706(b). An in-lieu financing statement acts as a continuation statement. Com C §9705(d). See §3.107.

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4

Priorities

Ellen A. Friedman

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§4.1 I. SUMMARY OF PRIORITY RULES

Commercial Code Division 9 establishes the rules for priorities among competing third parties, including secured creditors, unsecured creditors, lien creditors, buyers, licensees, and lessees. Commercial Code §§9317 and 9322 set forth the general rules for priority among creditors and other third parties:

- Conflicting perfected security interests rank according to priority in time of filing or perfection. Com C §9322(a)(1). See §§4.4-4.7.
- A perfected security interest takes priority over an unperfected security interest. Com C §9322(a)(2). See §4.8.
- If both interests are unperfected, the first to attach or become effective will have priority. Com C §9322(a)(3). See §4.9.
- A lien creditor has priority over an unperfected secured creditor. Com C §9317(a)(2). See §§4.43-4.62.

Special rules apply to different types of collateral. In general, if a security interest may be perfected by both filing and control, the secured party perfecting by control will have priority. See §§4.20-4.26.

This chapter examines priority in connection with (1) unperfected security interests; (2) perfected secured creditors; (3) proceeds and fixtures; (4) lien creditors; (5) buyers, licensees, and lessees; and (6) rights of third parties in general. This chapter also discusses intercreditor agreements in which creditors agree on priority among themselves. Finally, this chapter discusses UCC insurance policies. See §§4.74-4.81.

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§4.2 II. UNPERFECTED SECURITY INTERESTS

A perfected security interest takes priority over an unperfected security interest. Com C §9322(a)(2). See chap 3 about perfection of security interests. In addition, a lien creditor will take prior to an unperfected secured creditor. Com C §9317(a)(2). See §4.43 for a discussion of lien creditors and priorities. In a bankruptcy setting, an unperfected security interest will be defeated by a trustee or debtor in possession. See chap 6 for discussion of how bankruptcy affects secured claims. In a number of situations, however, an unperfected security interest will prevail over a competing claim.

First, an unperfected security interest is binding on the debtor and will prevail over the claim of a mere general creditor not holding a judicial lien. See chap 3. The unperfected secured creditor may perfect the interest or exercise his or her remedies on default, and the general creditor will have no basis for attack.

Second, an unperfected security interest will prevail over another unperfected security interest that attaches later. Com C §9322(a)(3).

Third, in a few situations (see Com C §9317(b)-(d)) a subsequent transferee with knowledge of the prior security interest is bound by it, even though the security interest is unperfected. See §§4.63-4.72 for a discussion of buyers, lessees, and licensees in the ordinary course.

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III. PERFECTED SECURITY INTERESTS

§4.3 A. General Priority Rule

The priority rules governing conflicts between two creditors, each of whom has a valid security interest, can be stated in terms of a general rule and its exceptions. The general rule is that the first creditor to either file or perfect wins. Com C §9322(a)(1). However, special rules apply to different types of collateral because of the different methods by which a secured party can perfect its interest. For instance, a secured party who perfects by obtaining control will have priority over a secured party who filed against the same collateral. See §§4.20-4.26. In addition, exceptions to the general first-to-file rule include those for purchase money interests (see §§4.10-4.19) and some proceeds (see §§4.27-4.30).

This chapter first examines priority issues in connection with filing a financing statement, and then reviews priority among various methods of perfection by type of collateral.

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§4.4 1. First to File

The first aspect of the general priority rule, which resolves most conflicts between security interests, is that the first creditor to file a financing statement (before another creditor perfects by some other means) wins. Com C §9322(a)(1). Note that the first creditor to file is not necessarily the first to perfect. A secured creditor may file a financing statement before the security interest attaches. Com C §9502(d). See §3.2 on attachment.

The first filing will apply to subsequent security agreements, even if they were not contemplated at the time of the original filing. Official Comment 4 to UCC §9-322. Priority achieved by filing extends to after-acquired property that fits within the financing statement's description, whenever it is acquired. Official Comment 5 to UCC §9-322. The priority established by filing also determines the priority in proceeds of the collateral (subject to limitations; see §§4.27-4.30). Com C §§9317(a)(1), 9322(b)(1); Official Comments 6-8 to UCC §9-322. The priority achieved by filing will also apply to future advances. Com C §9323(a). Priority achieved by filing is not unlimited, however. See §§4.10-4.19.

The great practical significance of the first-to-file rule is its convenience for the ordinary commercial lender making a loan and taking a nonpossessory security interest. The lender checks to see whether there is a prior filing. If the lender finds none, it files its own financing statement of record at the same time its search of the records terminates. Thus, the lender is assured that it has established a priority. Although its priority is not perfect or impregnable, it is strong and the competing risks are largely predictable and definable.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.5 a. Examples of Priority by Filing

§4.5 a. Examples of Priority by Filing

In many situations, filing alone controls priority. It makes no difference that the debtor did not acquire the collateral until later, that the debtor did not receive the loan until later, that the security agreement came later, or that the senior loan and security agreement came after the junior loan and security agreement and also after the junior creditor had filed his or her financing statement. The following are examples of the first-to-file rule.

EXAMPLE 1: Creditor *A* takes a security interest in specific collateral owned and held by the debtor, Creditor *A* and the debtor execute a security agreement, and Creditor *A* advances funds to the debtor. Before Creditor *A* files its financing statement, however, Creditor *B* files a financing statement covering the same collateral. Creditor *A* then files its financing statement, perfecting its security interest. Creditor *B* and the debtor later execute a security agreement, and Creditor *B* advances funds to the debtor. Creditor *B* would win.

EXAMPLE 2: On January 1, Creditor *A* files a financing statement designating as collateral the "equipment, including forklift trucks," of the debtor. At this point the debtor does not own any forklift trucks, and Creditor *A* and the debtor have not entered into a security agreement. On January 10, the debtor buys a forklift truck for cash. On January 15, the debtor signs a security agreement with Creditor *B,* giving Creditor *B* a security interest in the forklift truck that the debtor now owns, as security for a $10,000 loan. On the same day, Creditor *B* files a financing statement designating as collateral the particular forklift truck in which it has taken a security interest. On January 20, the debtor signs a security agreement with Creditor *A*, giving *A* a security interest in the same forklift truck, as security for another $10,000 loan. Creditor *A*'s claim to the truck would have priority over Creditor *B's* claim.

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§4.6 b. Advances by Assignee of Secured Creditor

In *Grassmueck v Champion Credit Corp. (In re Robert B. Lee Enters.)* (9th Cir 1992) 980 F2d 606, the court held that advances by the assignee of a secured creditor, whose initial security agreement provided for future advances, were protected under the first-to-file rule, as the secured party of record, even though the assignment and the additional advances were made after other secured creditors filed their financing statements against the debtor. This holding relies in part on the fact that the assignment was properly recorded with the Oregon Secretary of State, which made the assignee the secured party of record at the time of the additional advances. Accordingly, an assignee should record its assignment as soon as possible to preserve its rights to make additional advances if permitted under the initial security agreement.

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§4.7 c. Financing Statement Without Security Interest

It is an obvious but sometimes overlooked fact that a secured creditor can have priority only if it has a security interest. Thus if the secured creditor does not yet have a security interest, but has a financing statement on file, the debtor and a competing creditor may, by appropriate action, be able to defeat its claim of priority.

If at any time there is "no obligation secured by the collateral covered by the financing statement and no commitment to make an advance, incur an obligation, or otherwise give value," the debtor has a right to demand that the secured party deliver a termination statement. Com C §9513(a)(1), (c)(2). For a more detailed discussion of termination of security interests, see §§3.109-3.111.

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§4.8 2. First to Perfect

The second aspect of the general priority rule is that a creditor that perfects before another creditor files or perfects wins. Com C §9322(a)(1). Note that this rule is subordinate to the first-to-file rule. If one party files before another party has filed or perfected, that party prevails. If a party that was first to perfect files while it is perfected, it will retain priority even if it later becomes unperfected. The rule dates priority from the time of first perfection, provided that "there is no period thereafter when there is neither filing nor perfection." Com C §9322(a)(1).

EXAMPLE 1: Secured Party *A* lends money to a debtor and takes possession of the goods as collateral under a security agreement. Secured Party *B* later lends money and takes a security interest in the same goods by written agreement, filing a financing statement designating the appropriate property as security. Secured Party *A* would prevail. Secured Party *B* was the first to file, but Secured Party *A* was the first to perfect, and Secured Party *A*'s perfection preceded Secured Party *B's* filing.

EXAMPLE 2: Secured Party *A* sells goods to the debtor on credit and delivers them under a security agreement, relying on the temporary 20-day automatic perfection available under Com C §9312(f). Within the 20-day period of Secured Party *A*'s temporary perfection, Secured Party *B* makes a loan to the debtor and takes possession of the same goods as collateral for that loan under a security agreement. If a priority conflict arises between Secured Party *A* and Secured Party *B* during the original 20-day period, Secured Party *A* prevails. Each party had perfected, and Secured Party *A* had perfected first. Note that if Secured Party *A* takes no further action, its priority will end when its period of temporary perfection expires. If, however, Secured Party *A* files a financing statement during the 20-day period, it will retain its original priority.

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§4.9 3. First to Attach

The third aspect of the general priority rule is that, as long as neither security interest is perfected, "the first to attach has priority." Com C §9322(a)(3). This issue rarely arises. At least one creditor ordinarily will be able to perfect before the issue is litigated, except in bankruptcy, and a trustee in bankruptcy will prevail over both unperfected interests. See Official Comment 11 to UCC §9-322; see also chap 6.

NOTE: The first-to-attach rule theoretically could create a tie between secured creditors. Suppose that Secured Party *A* makes a loan and takes a security interest in equipment that the debtor expects to acquire the following week. The next day Secured Party *B* makes a loan to the same debtor and takes a security interest with the same description. Neither secured party files a financing statement, and the debtor acquires the equipment. Neither secured party's security interest would "attach" until the acquisition of the equipment, because that is when "the debtor has rights in the collateral." Com C §9203(b)(2). Thus, the two interests are simultaneous.

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B. Priority of Purchase Money Security Interests

§4.10 1. Goods Other Than Inventory or Livestock

Purchase money security interests can be obtained in goods and related software. Com C §9103(b)(3). In general, a purchase money security interest in goods other than inventory or livestock takes priority over conflicting interests in the same goods if it is perfected when the debtor receives possession of the collateral or within 20 days thereafter. Com C §§9317(e), 9324(a). For rules relating to particular security interests, see §§4.11-4.13. For rules relating to inventory collateral, see §§4.14-4.19. For rules relating to livestock, see §8.13.

For discussion of creation of purchase money security interests, see §3.32.

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§4.11 a. Interests in Software

A purchase money security interest in software only arises if the debtor acquires its interest in the software for the principal purpose of using the software in goods that are subject to a purchase money security interest. Com C §9103(c). Therefore, a purchase money security interest in software will have the same priority as the purchase money security interest in the goods in which the software was acquired for use. Com C §9324(f).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.12 b. Multiple Interests

§4.12 b. Multiple Interests

If there are multiple purchase money security interests governing the same collateral under Com C §9324(a), a security interest securing the price of the collateral will take priority over a security interest for value given; otherwise, the general priority rule of Com C §9322(a) governs. Com C §9324(g).

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§4.13 c. Identifiable Proceeds of Collateral

The purchase money priority granted by Com C §9324(a) also extends to identifiable proceeds of the collateral. If the collateral is inventory, the proceeds must be received on or before delivery of the inventory to a buyer. In order for the security interest in proceeds to be perfected, the security interest in the original collateral must be perfected. Official Comment 8 to UCC §9-324. For discussion of proceeds of inventory collateral, see §§4.17-4.19.

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§4.14 2. Special Rules for Inventory Collateral

To obtain priority over an otherwise prior floating lien in inventory collateral, a purchase money secured creditor must satisfy certain criteria under Com C §9324(b):

- The purchase money security interest must be perfected when the debtor receives possession of the inventory. Com C §9324(b)(1). There is no grace period such as the 20-day grace period for filing allowed for noninventory collateral (see §4.10).
- The purchase money secured creditor must send an authenticated notification to the holder of the conflicting security interest. Com C §9324(b)(2). The following standards govern the notification:
- The holder of the prior conflicting interest must receive the notification within five years before the debtor receives possession of the inventory. Com C §9324(b)(3).
- The notification must state that the person giving it has or expects to acquire a purchase money security interest in the inventory of the debtor, describing the inventory by item or type. Com C §9324(b)(4).

The notification need be given only if the holder of the conflicting security interest has filed a financing statement before the date of the purchase money secured creditor's filing, or before the beginning of the 20-day temporary perfection period under Com C §9312(f) if the creditor relies on temporary perfection. Com C §9324(c). For discussion of temporary perfection, see §3.37.

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§4.15 a. Consignments of Inventory

For the purposes of Division 9, the interest of a "consignor" is a purchase money security interest. Therefore, Com C §9324(b) applies to consignments. Com C §9103(d); Official Comment 6 to UCC §9-103; Official Comment 7 to UCC §9-324. For a discussion of consignment, see §§1.29-1.29E.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.16 b. Terminology Used by Consignor

§4.16 b. Terminology Used by Consignor

If a consignor does not use the term "security interest" in its notice required under Com C §9324(b)(4) but describes the goods as consigned, the requirements of Com C §9324(b)(4) will still be met. By the same token, the use of the term "security interest" in a notice will not give rise to an inference that it is not a true consignment. This is because Com C §9103(d) provides that consignments are purchase money security interests. Official Comment 7 to UCC §9-324.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.17 c. Proceeds of Inventory Collateral

§4.17 c. Proceeds of Inventory Collateral

The rule for proceeds of inventory collateral is more limited than the rule for proceeds of noninventory collateral (see §4.13). For inventory collateral, the purchase money security interest applies only to "identifiable cash proceeds … received on or before the delivery of the inventory to a buyer." Com C §9324(b). The consequences of these limitations on proceeds of inventory collateral are discussed in §§4.18-4.19.

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§4.18 (1) Limitation to Identifiable Cash Proceeds

The limitation to identifiable cash proceeds under Com C §9324(b) means that the purchase money security interest in inventory collateral does not extend to accounts and chattel paper. However, the purchase money priority in inventory does carry over to proceeds consisting of chattel paper and its proceeds (and also to instruments) to the extent provided in Com C §9330. Official Comment 8 to UCC §9-324. See §§4.24-4.25.

EXAMPLE: Secured Party *A* perfects a security interest in the accounts of the debtor, and Secured Party *B* later obtains a purchase money security interest in the debtor's inventory. On the debtor selling its inventory and generating accounts, Secured Party *A* will have priority in the accounts. See Official Comment 9 to UCC §9-324.

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§4.19 (2) Proceeds Must Be Received on or Before Delivery

Proceeds must be received "on or before the delivery of the inventory" to a buyer from the debtor for a perfected purchase money security interest in inventory to apply to identifiable cash proceeds of that inventory. Com C §9324(b). In *In re Sunrise R.V., Inc.* (Bankr ED Cal 1989) 107 BR 277, the bankruptcy court ordered the debtor to immediately place all proceeds from the sale of inventory subject to a purchase money security interest into a segregated cash collateral account. When the debtor failed to immediately segregate the proceeds, a secured creditor that had previously perfected its security interest in the debtor's inventory claimed a prior interest in the proceeds against the purchase money lender because of the lender's failure to satisfy the similar receipt requirement of former Com C §9312(3). Although it was unclear whether the proceeds ultimately deposited in the cash collateral account were actually received "on or before the delivery of the inventory," the bankruptcy court refused to allow the secured creditor to improve its position relative to the purchase money lender, due to the debtor's noncompliance with a specific court order.

PRACTICE TIP: Although the purchase money lender prevailed, the holding in *Sunrise* demonstrates the limitations of a purchase money priority. It is often advisable to enter into an intercreditor agreement with the other secured creditor so that these rights and interests are clearly delineated. See §4.74.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.20 C. Special Rules for Specified Types of Collateral

§4.20 C. Special Rules for Specified Types of Collateral

Because there are various ways to perfect against certain types of collateral other than by filing, the first-to-file rule will not cover all situations. The rules regarding most of these situations are discussed in §§4.21-4.26.

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§4.21 1. Deposit Accounts

A secured creditor that has perfected a security interest in a deposit account by control has a superior interest to that of a creditor who has perfected a security interest in the funds as proceeds of other collateral, such as accounts receivable or inventory. Com C §9327(1). With respect to competing secured creditors with control over a deposit account, priority is set by time of obtaining control unless the bank with which the deposit account is maintained is one of the secured creditors. Com C §9327(2). A security interest held by the bank has priority over a conflicting security interest held by another secured party, unless the secured party becomes the bank's customer with respect to the deposit account. Com C §9327(3). If the other secured party becomes the bank's customer with respect to the deposit account under Com C §9104(a)(3), the secured party will take priority over the bank. Com C §9327(4). For discussion of perfection by control of deposit accounts, see §§3.44-3.45.

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§4.22 2. Investment Property

A secured party that perfects a security interest in investment property by control has priority over a secured party that does not obtain control. Com C §9328(1). With respect to certificated and uncertificated securities, the secured creditor that obtains control first has priority among secured creditors who have control. Com C §9328(2)(A). The first-to-obtain control rule also applies with respect to security entitlements held in securities accounts, or a commodity contract carried with a commodity intermediary; however, the event determining priority depends on the method of obtaining control. Com C §9328(2)(B)-(E). A security interest held by a securities intermediary in a security entitlement or a securities account maintained with the securities intermediary has priority over a conflicting security interest held by another secured party. Com C §9328(3). Similarly, a security interest held by a commodity intermediary in a commodity contract or a commodity account maintained with the commodity intermediary has priority over a conflicting security interest held by another secured party. Com C §9328(4). With respect to certificated securities in registered form, perfection by taking delivery has priority over perfection by filing. Com C §9328(5). For discussion of perfection by control of investment property, see §§3.52-3.57.

NOTE: Although control is the best method to ensure priority, a lender may not wish to go to the expense of obtaining control or may not be relying upon investment property as its primary collateral. In those cases, the lender may choose to perfect by filing with the knowledge that the lender may not have or retain a priority position in that investment property.

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§4.23 3. Letter-of-Credit Rights

A secured creditor with control of letter-of-credit rights under Com C §9107 will have priority over a secured creditor that does not have control. Com C §9329(1). Priority of competing security interests among secured parties who have control will be decided by time of obtaining control under Com C §9314. Com C §9329(2). For discussion of perfection by control of letter-of-credit rights, see §3.46.

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§4.24 4. Chattel Paper

A purchaser of chattel paper has priority over a security interest in the chattel paper that is claimed "merely as proceeds of inventory subject to a security interest" if (1) in good faith and in the ordinary course of the purchaser's business, the purchaser gives new value and takes possession of the chattel paper or obtains control of the chattel paper under Com C §9105; and (2) the chattel paper does not indicate that it has been assigned to an identified assignee other than the purchaser. Com C §9330(a).

EXAMPLE: Secured Party *A* holds a perfected security interest in the debtor's inventory and the proceeds of that inventory, having perfected by filing a financing statement with the Secretary of State. The debtor sells an item of inventory to a buyer in the ordinary course of business, taking in exchange a conditional sale contract (chattel paper). The debtor then transfers that chattel paper to Secured Party *B,* who gives new value and takes possession of the conditional sale contract in the ordinary course of business. In this case, Secured Party *B* would prevail over Secured Party *A*, even though Secured Party *B* knows that the specific chattel paper is subject to Secured Party *A*'s security interest. Secured Party *A* could easily have defeated Secured Party *B* by taking possession of the chattel paper.

A purchaser also has priority over a security interest in chattel paper that is claimed other than merely as proceeds of inventory if, in addition, the purchaser acts without knowledge that the purchase violates the rights of the secured party. Com C §9330(b). A holder of a purchase money security interest is deemed to give "new value" for chattel paper constituting proceeds of the inventory. Com C §9330(e).

New value generally includes (1) money; (2) money's worth in property, services, or new credit; or (3) release by a transferee of an interest in property previously transferred to the transferee. The term does not include an obligation substituted for another obligation. Com C §9102(a)(57).

If a possessory security interest in tangible chattel paper or a perfected-by-control security interest in electronic chattel paper does not qualify for priority under Com C §9330, then the security interest will be subject to the general rules for priority set forth in Com C §9322. See §§4.3-4.9. For discussion of perfection by possession or control of chattel paper, see §§3.40-3.42.

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§4.25 5. Instruments

A purchaser of an instrument has priority over a security interest in the instrument perfected by a method other than possession (such as filing) if the purchaser gives "value" and takes possession of the instrument in good faith and without knowledge that the purchase violates the rights of the secured party. Com C §9330(d). Unlike a purchaser of chattel paper (see §4.24), the purchaser need not give "new value" or purchase the instrument in the ordinary course of its business. Official Comment 7 to UCC §9-330. However, Com C §9330(d) does not limit the rights of a holder in due course under Division 3. Com C §9331(a). Furthermore, filing a financing statement under Com C §9312(a) does not constitute notice that would preclude a subsequent purchaser from becoming a holder in due course under Com C §3306. Com C §9331(c). See Official Comment 2 to UCC §9-312. To the extent that Com C §9330(d) conflicts with Com C §3306, Com C §9330(d) generally governs. See Official Comment 7 to UCC §9-330.

For discussion of perfection of security interests in instruments by possession or filing, see §§3.38-3.39.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.26 6. Negotiable Documents

§4.26 6. Negotiable Documents

The priority rules of Com C §9324 do not limit the rights of a holder in due course of a negotiable document, a holder to which negotiable document of title has been duly negotiated, or a protected purchaser of a security. Com C §9331(a).

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IV. SPECIAL PRIORITY PROBLEMS

A. Proceeds of Collateral

§4.27 1. Proceeds of Collateral Perfected by Filing

With respect to security interests in collateral that may be perfected by filing, such as accounts and general intangibles, a secured party's interest in proceeds is perfected at the time of filing or perfection of the security interest in the collateral. Com C §9322(b)(1). This means that the general priority rules of Com C §9322(a) also govern security interests in proceeds. See §§4.3-4.9.

EXAMPLE: Secured Party *A* enters into a security agreement with the debtor and files a financing statement covering inventory on October 1. Secured Party *B* enters into a security agreement with the debtor and files a financing statement in accounts on November 1. On the debtor's sale of inventory on November 15, Secured Party *A* will have priority in the account generated by that sale of inventory because Secured Party *A* was the first to file.

Special rules for priority of security interests in proceeds of collateral not perfected by filing are discussed in §§4.28-4.30. Another limitation on the general priority rules applies if the proceeds take the form of chattel paper or instruments. Com C §9330. See §§4.24-4.25. In bankruptcy, further limitations apply to proceeds received after the bankruptcy petition is filed. 11 USC §552(b). See chap 6.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.28 2. Proceeds of Collateral Not Perfected by Filing

§4.28 2. Proceeds of Collateral Not Perfected by Filing

With respect to security interests in collateral perfected by possession and control, such as deposit accounts, investment property, and letter-of-credit rights, if the secured party has perfected in a way to obtain a super priority, such as obtaining control over investment property, the priority in the original collateral continues in the proceeds under the following conditions (Com C §9322(c)(2)):

- The security interest in proceeds is perfected;
- The proceeds are cash proceeds or proceeds "of the same type" as the original collateral (§4.29); or
- In the case of proceeds of proceeds, all intervening proceeds are cash proceeds, proceeds of the same type as the collateral, or an account relating to the collateral.

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§4.29 a. Continued Priority for Cash Proceeds or Same Type of Collateral

The official comments regarding the general rule of continued priority in proceeds under Com C §9322(c)(2) state that "type" of collateral should be construed broadly so that a "security" and "security entitlement" are the same "type" of collateral because they are both investment property. Official Comment 8 to UCC §9-322.

EXAMPLE: Secured Party *A* perfects a security interest in investment property by filing and Secured Party *B* later perfects by control and by filing. If the debtor receives stock dividends that are proceeds of the investment property, Secured Party *B* will have a senior interest in the stock dividend proceeds because the stock dividends are the same type as the investment property collateral. The same result would be obtained if the debtor had received a dividend check, because the check is cash proceeds.

This example could have a different result if Secured Party *B* had not perfected by both filing and control. Without perfection by filing, Secured Party *B* would have a perfected security interest in the new stock dividend until the 20-day temporary perfection period expires but then would be unperfected. Therefore, Secured Party *A* would thereafter have the superior interest unless Secured Party *B* perfects its security interest before expiration of the 20-day period. See Com C §§9315(d), 9322(c)(2)(A).

If, instead of receiving stock dividends or receiving a dividend check, the debtor received an instrument that is not cash proceeds, still another result would obtain. Because an instrument is not the same type of collateral as cash proceeds, Secured Party *A*, which had perfected by filing prior to Secured Party *B*, would have priority. See Official Comment 8 to UCC §9-322 for other examples of priority in proceeds of non-filing collateral. Special rules apply to proceeds of chattel paper, deposit accounts, negotiable documents, instruments, investment property, or letter-of-credit rights. See §4.30.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.30 b. Priority for Proceeds of Chattel Paper, Deposit Accounts, Negotiable Documents, Instruments, Investment Property, and Letter-of-Credit Rights

§4.30 b. Priority for Proceeds of Chattel Paper, Deposit Accounts, Negotiable Documents, Instruments, Investment Property, and Letter-of-Credit Rights

If security interests in proceeds of chattel paper, deposit accounts, negotiable documents, instruments, investment property, or letter-of-credit rights are perfected by a method other than filing, then conflicting perfected security interests in proceeds of the collateral rank according to the time of filing. Com C §9322(d).

Commercial Code §9322(d) applies only if the proceeds of the collateral are not cash proceeds, chattel paper, negotiable documents, instruments, or letter-of-credit rights. Com C §9322(e).

EXAMPLE: Secured Party *A* obtains a security interest in a deposit account by obtaining control on January 15. Secured Party *B* files against inventory on January 16, and Secured Party *A* perfects on inventory on February 1. If the debtor uses the funds in the deposit account to purchase inventory, Secured Party *B* will have priority because it filed against the inventory first.

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§4.31 B. Fixtures

Commercial Code §9334 establishes a number of rules that govern priority conflicts in fixtures, covering both situations in which the competing claimant is the holder of a lien on the underlying real property and situations in which the competing claimant is the owner of the underlying real property. In a typical example of the latter conflict, the debtor is a lessee of the real property and the competing claimant is the lessor. In most cases, a secured creditor can obtain priority over subsequent real estate interests by making a fixture filing. See §4.32. A perfected secured creditor has priority over subsequent judicial liens even without a fixture filing. See §4.39. In some cases, a secured creditor can obtain priority over owners and prior encumbrancers. See §§4.33, 4.35-4.38. In other cases, owners and encumbrancers have priority. See §§4.34, 4.40.

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§4.32 1. First-To-File Rule

The most important priority rule is essentially a "first-to-file" provision in Com C §9334(e)(1). Under this rule, a security interest in fixtures has priority over a conflicting interest in the fixtures of an encumbrancer or owner of real property if all of the following conditions are satisfied:

- The debtor has an interest of record in the real property or is in possession of the real property;
- The security interest is perfected by a fixture filing before the interest of the encumbrancer or owner is of record; and
- The security interest has priority over any conflicting interest of a predecessor in title of the encumbrancer or owner.

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2. Purchase Money Priority

§4.33 a. Priority of Purchase Money Security Interest Over Prior Encumbrances

A secured creditor with a purchase money security interest in fixtures can obtain priority that will allow it to prevail even over prior encumbrancers. Com C §9334(d). This is conceptually similar to the purchase money priority under Com C §9324. See §§4.10-4.19. The concept may be more important in connection with real property because the lender claiming a security interest in personal property other than fixtures may or may not have to contend with an earlier lender, while the lender claiming a purchase money security interest in fixtures nearly always has to contend with an earlier real property lender. However, the purchase money creditor usually cannot obtain priority over a construction mortgage. See §4.34.

Under Com C §9334(d), the creditor obtains priority when all of the following conditions are met:

- The security interest is a purchase money security interest (see §§3.7-3.12, 3.32);
- The debtor has a record interest in the real property or possession of the real property;
- The conflicting real property interest arose before the goods became fixtures; and
- The security interest is perfected by a fixture filing (see §§3.97-3.101) within 20 days after the goods become fixtures.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.34 b. Priority of Construction Mortgage Over Purchase Money Security Interest

§4.34 b. Priority of Construction Mortgage Over Purchase Money Security Interest

In most cases, a previously recorded construction mortgage will be senior to a purchase money security interest in fixtures under Com C §9334(d). See Official Comment 11 to UCC §9-334. Except as provided in Com C §9334(e)-(f) (see §§4.35-4.38), a security interest in fixtures will not be effective against a prior construction mortgage if the goods become fixtures after the mortgage is recorded but before construction is completed. Com C §9334(h). Under Com C §9334(h), a mortgage is a construction mortgage to the extent that it secures an obligation incurred for the construction of an improvement on land, including the acquisition cost of the land, if a recorded document so indicates.

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3. Priority Over Owners and Prior Encumbrances

§4.35 a. Readily Removable Items

Even if the personal property secured party does not make a fixture filing, it may nevertheless prevail over the otherwise prior holder of a real property interest with respect to certain kinds of fixtures. This protection is available when the fixtures are readily removable factory or office machines, equipment that is not primarily used or leased for use in the operation of the real property, or replacements of domestic appliances that are consumer goods. Com C §9334(e)(2). If the security interest is perfected by any means (normally filing with the Secretary of State) before the goods become fixtures, then the personal property creditor prevails.

PRACTICE TIP: The "readily removable" rule of Com C §9334(e)(2) is an exception to the first-to-file rule (see §4.32); however, the secured party must file before the goods become fixtures.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.36 b. Manufactured Homes

§4.36 b. Manufactured Homes

Even if there is no fixture filing, a security interest in a manufactured home created in a manufactured home transaction and perfected by compliance with the certificate of title statute referenced in Com C §9311(a)(2) has priority over an encumbrancer or real property owner. Com C §9334(e)(4). See Official Comment 10 to UCC §9-334.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.37 c. Priority by Agreement

§4.37 c. Priority by Agreement

Even in the absence of filing or perfection, a security interest in fixtures has priority over the interest of an owner or encumbrancer who consents to the security interest or disclaims an interest in the goods or fixtures. Com C §9334(f)(1).

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§4.38 d. Tenant's Priority

A security interest in fixtures has priority over the interest of a real property owner or mortgagee if the debtor has a right, as against the owner or mortgagee, to remove the fixtures. Com C §9334(f)(2). No fixture filing or perfection is required. The right to remove the fixtures continues for a reasonable time beyond the debtor's own right to remove them. Com C §9334(g). Thus, when the secured creditor learns that the debtor has defaulted on its real property lease, the secured creditor still may be able to remove the fixtures for a reasonable period of time.

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§4.39 4. Priority Over Subsequent Judicial Liens

Even if there is no fixture filing, a perfected security interest in fixtures has priority over a lien on the real property obtained by legal or equitable proceedings after the security interest is perfected. Com C §9334(e)(3). For example, consider the case of a purchase money creditor that files with the Secretary of State but does not file a fixture filing in the real property records and the collateral does not qualify as "readily removable" under Com C §9334(e)(2). See §§4.33, 4.35. The personal property creditor would be subordinate to prior and subsequent encumbrances on the real property (see §4.40), but nonetheless would prevail over subsequent judicial lienholders.

NOTE: Commercial Code §9334(e)(3) is intended to insulate the personal property lender against a bankruptcy trustee. See Official Comment 9 to UCC §9-334. The Bankruptcy Code, however, gives the trustee the power to avoid any interest in real property that is voidable by a bona fide purchaser under state law. 11 USC §544(a)(3). An encumbrancer is a bona fide purchaser. Because the fixture interest would be void against a real property encumbrancer, the secured party cannot rely on Com C §9334(e) to defeat the interests of a bankruptcy trustee.

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§4.40 5. Residual Rule

Nothing in the Commercial Code provision on fixtures is meant to prevent the creation of an encumbrance on fixtures "under real property law." Com C §9334(b). Thus, a mortgage or deed of trust may cover fixtures. If there is no fixture filing and no other specific rule applies, the residual rule is that a security interest in fixtures is subordinate to the interest of an encumbrancer or owner of the related real property other than the debtor. Com C §9334(c). See Official Comment 5 to UCC §9-334.

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C. Goods That Become Associated With Other Goods

§4.41 1. Accessions

When goods become accessions by being installed in or affixed to other goods, conflicts may arise between a creditor that had a security interest in the item as a whole before the accession was installed and a creditor with a security interest in the accession. A security interest may be created in an accession and continues in goods that become accessions. Com C §9335(a). A perfected security interest remains perfected when goods become accessions. Com C §9335(b). With one exception concerning goods covered by a certificate of title (Com C §9335(d)), which creditor will prevail is determined by the usual rules of priority for security interests in goods. Com C §9335(c). See Official Comment 6 to UCC §9-335.

EXAMPLE: Secured Party *A* claims a security interest in an engine for a road grader and Secured Party *B* claims a security interest in the road grader as a whole. Therefore, if Secured Party *B* perfected its interest in the road grader and all accessions before Secured Party *A* obtained its interest in the road grader engine, Secured Party *B* would prevail under Com C §9322. If, however, Secured Party *A* obtained a purchase money security interest, Secured Party *A* would prevail under Com C §9324.

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§4.42 2. Commingled or Processed Goods

Goods in which a creditor has perfected a security interest may become part of a product or mass, *e.g.,* through commingling or processing. This situation should be distinguished from that of accessions (see §4.41), in which the goods still retain their separate character even though affixed to other goods.

When goods subject to a perfected security interest become part of a product or mass, the secured creditor retains its security interest in the product or mass and the security interest remains perfected. Com C §9336(c)-(d).

If one secured creditor is unperfected, the secured creditor that is perfected will take priority. Com C §9336(f)(1). If conflicting perfected security interests attach to the product or mass, they rank with equal priority but share according to the ratio that the cost of the goods to which each interest originally attached bears to the cost of the total product or mass. Com C §9336(f)(2).

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V. LIEN CREDITORS

A. Liens Under Commercial Code

§4.43 1. Definition of Lien Creditor

A "lien creditor" is (1) a creditor that has acquired a lien by attachment, levy, or similar means; (2) an assignee for the benefit of creditors; (3) a trustee in bankruptcy; or (4) a receiver. Com C §9102(a)(52)(A). A lien creditor does not include a creditor that has acquired only an attachment or judgment lien by filing a notice with the Secretary of State. Com C §9102(a)(52)(B). See §§4.48-4.54.

NOTE: Section 9102(a)(52)(B) is a nonuniform provision.

Except for this general provision, the Commercial Code leaves the determination of who is a lien creditor to other law. The typical lien creditor is one who acquires a lien by levy of a writ of execution on a money judgment.

The definition includes an assignee for the benefit of creditors, a receiver, and a bankruptcy trustee. An assignee for the benefit of creditors can be thought of as acting on behalf of all creditors, somewhat in the manner of a bankruptcy trustee. See, *e.g.,* CCP §1800 (assignee's power to recover preferences). The receiver can be thought of either as a type of ordinary lien creditor or as a type of assignee, as the circumstances may dictate. For a discussion of bankruptcy trustees, see chap 6.

The definition of "lien creditor" excludes general creditors and secured creditors (whose position is governed by rules set forth in Com C §9322). See §§4.1-4.9.

NOTE: The term "lien creditor" is more limited than the general definition of "creditor" in Com C §1201(13), which includes "a general creditor, a secured creditor, a lien creditor and any representative of creditors, including…an executor or administrator of an insolvent debtor's or assignor's estate." Difficulties may arise from this difference. See *Estate of Hinds* (1970) 10 CA3d 1021, 89 CR 341, in which the court held that the administrator of an insolvent decedent's estate was not a lien creditor for purposes of former Com C §9301(3) (current Com C §9317). The court noted that former Com C §1201(b)(12) specifically included an executor or administrator of an estate as a creditor, while former Com C §9301(3) did not.

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§4.44 2. Priority With Respect to Lien Creditor

If a third party becomes a lien creditor before the security interest is perfected or a financing statement covering the collateral is filed and a security agreement has been entered into, the third party's interest in the collateral has priority. If the third party becomes a lien creditor after the security interest is perfected or after a financing statement has been filed, then the security interest has priority. Com C §9317(a)(2).

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§4.45 a. Priority in Advances After Lien Creditor Acquires Lien

A creditor with a perfected security interest securing future as well as present indebtedness may advance additional funds to the debtor after a lien creditor acquires its lien. The prior secured creditor will prevail over the intervening lien creditor for advances made (1) within 45 days after the lien attaches, or (2) until the secured creditor acquires knowledge of the lien, whichever occurs later. The secured creditor also will prevail with respect to advances made pursuant to a commitment entered into without knowledge of the lien. Com C §9323(b). Knowledge of the lien means actual knowledge. Com C §1202(b). See Official Comment 4 to UCC §9-323. Secured creditor priority does not apply to purchasers of accounts, chattel paper, payment intangibles, or promissory notes or a consignor. Com C §9323(c).

Greater protection is afforded to a secured creditor as against a lien creditor under a judgment lien by requiring the judgment creditor to serve the secured creditor with a copy of the notice of judgment lien before the judgment creditor can assert its priority over the secured creditor as to future advances. See §4.53.

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§4.46 b. Priority of Possessory Liens

"Possessory liens" are common law and statutory liens that are effective if the lienor possesses goods with respect to which the lienor provided services or furnished materials in the ordinary course of business. Com C §9333(a). A possessory lien has priority over security interest in the goods unless the lien is created by a statute that expressly provides otherwise. Com C §9333(b).

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§4.47 c. Enforcement of Lien by Third Party Claims

If a levy is made on the collateral under a writ of attachment, execution, possession, or sale, a secured creditor that holds a claim superior to that of the levying creditor may file a third party claim to force the release of the collateral or payment of the secured indebtedness. CCP §720.210. The claim must be filed before the officer sells the property or delivers the property or proceeds of collection to the creditor. CCP §720.220.

The secured creditor's failure to file a third party claim, without more, does not affect his or her interest in the property. CCP §720.250(b). If, however, the levying creditor has served on the secured creditor a demand that the secured party file a third party claim (see CCP §§720.510-720.540), failure to file a claim within 30 days results in a waiver of the secured party's priority, and the property may be applied to satisfaction of the levying creditor's claim, free of the security interest. CCP §720.550(a).

Detailed procedural requirements and provisions for hearings on claims are provided in CCP §§720.210-720.800.

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B. Liens Obtained by Filing With Secretary of State

§4.48 1. Judgment Liens

In the ordinary situation, a judgment creditor achieves a lien by levy and thus qualifies for the priority afforded a "lien creditor" by the Commercial Code (see §4.43). A judgment creditor may also obtain a "judgment lien," however, by filing with the Secretary of State. See generally CCP §§697.510-697.670. Technically, the creditor with such a judgment lien is not a lien creditor under the Commercial Code. Com C §9102(a)(52)(B). See §4.43. Nonetheless, the creditor with a judgment lien gets a priority very similar to that afforded a lien creditor. See §§4.49-4.51.

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§4.49 a. Scope of Judgment Lien

The judgment lien attaches to specified types of "business" property, but not "consumer" property. The limited list of property subject to a judgment lien comprises accounts receivable, when the judgment debtor is located in California, and tangible chattel paper (see Com C §9102(a)(78)), equipment, farm products, inventory, and negotiable documents of title, all of which must be "located in this state." CCP §697.530(a). Types of personal property not listed in CCP §697.530 are not subject to judgment liens. See *Waltrip v Kimberlin* (2008) 164 CA4th 517, 79 CR3d 460 (commercial tort claim not included in list of property subject to judgment liens).

NOTE: AB 1549 (2009) (Stats 2009, ch 153, operative January 1, 2010) amended CCP §697.530 to eliminate the condition that a judgment lien could be created only if a security interest in the property could be perfected under the Commercial Code by filing a financing statement with the California Secretary of State. Former CCP §697.530(a). That requirement prevented a judgment creditor from obtaining a judgment lien against a foreign corporation, such as a Delaware corporation. See *Morgan Creek Prods., Inc. v Franchise Pictures LLC* (*In re Franchise Pictures LLC)* (Bankr CD Cal 2008) 389 BR 131; *Aura Sys., Inc. v Barovich (In re Aura Sys.)* (Bankr CD Cal 2006) 347 BR 720, aff'd (9th Cir 2008) 286 Fed Appx 446. AB 1549 also amended CCP §697.590 to give priority to a judgment lien perfected by the filing of a financing statement in another state over a judgment lien on the same property filed in California. See CCP §697.590(h).

Effective January 1, 2010, judgment creditors may obtain judgment liens against the assets of a judgment debtor organization that is incorporated or registered in another state but has assets "located in this state." See CCP §697.530(a), (g).

PRACTICE TIP: Filed judgment liens are shown on the combined information certificate that the Secretary of State issues in response to a request for a record search, unless the request for the search is specifically limited.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.50 b. Extinction of Judgment Lien

§4.50 b. Extinction of Judgment Lien

Under CCP §§697.530(e) and 697.610, the lien is extinguished if the property subject to it:

- Becomes a fixture;
- Is transferred to a buyer in the ordinary course of business;
- Is a negotiable document of title and transferred to a holder to whom it has been duly negotiated under Com C §7501;
- Is chattel paper and is transferred to a purchaser who gives new value and takes possession of it in the ordinary course of business;
- Is sold by a senior secured party under Division 9; or
- Is transferred to a lessee in the ordinary course of business.

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§4.51 c. Priority of Judgment Lien

As a general rule, priority between a judgment lien and a competing security interest is determined by the times of filing or perfection. The judgment lien ranks from the time of filing; the security interest ranks from the time of filing or perfection, whichever occurs first. CCP §697.590(b).

The date of filing or perfection as to the property is also the date of filing or perfection as to proceeds. CCP §697.590(c).

Judgment liens continue for 5 years from the date of filing unless earlier satisfied, terminated, or released. CCP §697.510(b). They do not relate back to earlier judgment liens for priority purposes. CCP §697.510(c). However, pending legislation would permit the continuation of judgment liens for 5-year periods. AB 121 (2009).

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§4.52 (1) Purchase Money Priority Over Judgment Lien

A purchase money security interest (see §§3.32, 4.10-4.19) has priority over a judgment lien if the security interest is perfected within 20 days after the debtor receives possession of the property. CCP §697.590(d). To avoid a problem when the purchase money security interest has priority over the judgment lien, any other security interest that has priority over the purchase money security interest also has priority over the judgment lien. CCP §697.590(e).

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§4.53 (2) Priority in Advances After Judgment Lien Filed

As described in §4.45 with respect to lien creditors, if a secured party with a prior security interest makes further advances after the judgment lien is filed, the secured party has priority with respect to those advances only to the extent that those advances are made (CCP §697.590(f)):

- Within 45 days after the judgment lien attaches;
- Without knowledge of the judgment lien; or
- Pursuant to a commitment made without knowledge of the judgment lien.

For this purpose, "knowledge" means actual knowledge. Com C §1202(b). In addition, a creditor is considered not to have knowledge unless he or she has been served (personally or by mail) with a copy of notice of the judgment lien. CCP §697.590(f). This additional protection against the priority of lien creditors is not afforded to secured creditors under the Commercial Code. See §4.45.

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§4.54 2. Attachment Liens

In certain limited cases, a general unsecured creditor may achieve a lien by prejudgment attachment. See CCP §§481.010-493.060. In many such cases, the prescribed method of attachment is by filing with the Secretary of State. See CCP §§488.375, 488.405. Although such creditors are not in the class of lien creditors under the Com C §9102(a)(52)(B) definition (see §4.43), they receive the same protection as a creditor with a judgment lien on personal property (see §§4.49-4.51). CCP §488.500(c).

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C. Tax Liens

§4.55 1. Federal Tax Liens

The general principles that apply to priority contests between federal tax liens and the interests of secured creditors are discussed in §§4.56-4.61. Detailed discussion of tax liens and enforcement procedures is beyond the scope of this chapter.

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§4.56 a. How to Locate Tax Lien

Counsel for the secured creditor must know where to look to discover whether there is a competing tax lien. If the debtor is a corporation or partnership whose principal executive office is in California, a tax lien on its personal property is filed in the office of the Secretary of State. CCP §2101(c)(1).

If the debtor is not a corporation or partnership with its principal executive office in this state, a tax lien on its personal property is filed with the county recorder of the county where the debtor resides at the time of filing. CCP §2101(c)(4); IRC §6323(f). Such a lien, therefore, will not be reflected in a Secretary of State's certificate.

Federal tax liens against a trust or the estate of a decedent must be filed in the office of the Secretary of State. CCP §2101(c)(2), (3).

PRACTICE TIP: Filed tax liens affecting such debtors will be shown on the combined information certificate that the Secretary of State issues in response to a request for a record search, unless the request for the search is specifically limited. See Com C §9528.

If the county recorder is the filing officer, a certificate of tax liens on file, showing the date and time of filing, may be obtained from the county recorder for a fee for each name searched. CCP §2103(d). Copies of the notices of federal lien, or other notices or certificates affecting the lien, may be obtained for a fee to be determined by the county board of supervisors. CCP §2103(d); Govt C §27366.

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§4.57 b. Priority of Tax Lien

The date on which a federal tax lien was filed is the most important factor in determining priorities between federal tax lien holders and secured creditors. As a general rule, a federal tax lien that is filed before a security interest is perfected has priority over the security interest, and a perfected security interest has priority over a later-filed tax lien. IRC §6323(a). This rule is subject, however, to exceptions and qualifications.

Under IRC §6323(h), a security interest "exists" only:

- When the property is in existence;
- When the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation; and
- To the extent that the holder has parted with money or money's worth.

This definition does not coincide completely with Commercial Code concepts, *e.g.,* "rights in collateral" (Com C §9203(b)) versus "property … in existence," and "value has been given" (Com C §9203(b)) versus "has parted with money or money's worth." The Internal Revenue Code definition says nothing about a "floating lien." In some circumstances, however, the secured creditor has priority for advances made even after the tax lien is filed and for collateral not owned by the debtor when the tax lien was filed. IRC §6323(c)-(d). Section 6323(b) also provides specific exceptions for certain security interests in securities, possessory liens on tangible personal property, mechanics' liens, and attorneys' liens, among other exceptions. The principal exceptions to the general priority of the tax lien are discussed in §§4.58-4.61.

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c. Exceptions to Priority of Tax Lien

§4.58 (1) Commercial Transaction Financing Agreements

To qualify for this priority, the financing agreement must have been made in the ordinary course of the lender's trade or business (see IRC §6323(c)(2)(A)) and must have been entered into before the tax lien was filed. IRC §6323(c)(1)(A). In addition, the security interest must be one that would be protected under local law against an unsecured creditor's judgment lien that arose at the time the tax lien was filed. IRC §6323(c)(1)(B).

This exemption from the general priority given to tax liens grants priority to security interests in inventory, accounts receivable, paper of a kind that ordinarily arises in commercial transactions, and real estate mortgages acquired in the ordinary course of the debtor's trade or business. IRC §6323(c)(2)(C). The protection extends to purchasers of such accounts receivable, paper, or mortgages (but not inventory) as well as to lenders. IRC §6323(c)(2)(A)(ii), (c)(2)(D). It applies only (1) to loans and purchases made before the 46th day after the tax lien filing and before the lender or purchaser had actual notice or knowledge (defined in IRC §6323(i)(1)) of the filing (IRC §6323(c)(2)(A)), and (2) to property acquired by the debtor before the 46th day after filing (IRC §6323(c)(2)(B)).

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§4.59 (2) Obligatory Disbursement Agreements

To qualify for this priority, the lender must be required by its agreement with the debtor to make the postfiling disbursements on the occurrence of an event beyond its control. IRC §6323(c)(4)(A); Reg §301.6323(c)-3(b). Priority extends only to security interests in property that the debtor owned at the time the tax lien was filed, or that it acquired later as a result of the disbursements. IRC §6323(c)(4)(B). The financing agreement must have been entered into in the ordinary course of the lender's business (IRC §6323(c)(4)(A)) and before the tax lien was filed (IRC §6323(c)(1)(A)); the security interest must be one that would be protected under local law against an unsecured creditor's judgment lien that arose at the time the tax lien was filed (IRC §6323(c)(1)(B)). This exception does not limit the period after filing in which disbursements may be made or in which property may be acquired as the result of disbursements.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.60 (3) Real Property Construction or Improvement Financing Agreement

§4.60 (3) Real Property Construction or Improvement Financing Agreement

This exception gives priority to postfiling disbursements made under an agreement to finance construction or improvement of real property or the raising or harvesting of a farm crop or livestock. IRC §6323(c)(3)(A). The priority applies to the real property subject to construction or improvement, proceeds of the construction or improvement contract, and the farm crop or livestock. IRC §6323(c)(1)(B). This exception does not limit the period after filing in which the disbursements may be made.

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§4.61 (4) Disbursements Within 45 Days After Filing

A separate exception gives priority to disbursements made before the 46th day after the tax lien is filed and before the lender has actual notice or knowledge (defined in IRC §6323(i)(1)) of the filing. IRC §6323(d). The disbursements must be made under a written agreement covering the property and entered into before the tax lien was filed. IRC §6323(d)(1). The priority is limited to interests in property owned by the debtor at the time the tax lien is filed (IRC §6323(d)(1)) and protected against judgment creditors on that date (IRC §6323(d)(2)). There is no requirement that the person making the disbursements be a professional lender.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.62 2. California Tax Liens

§4.62 2. California Tax Liens

A California state tax lien on the debtor's personal property may arise as a result of liability for any of several state taxes. See Govt C §7162. The taxing agency may file a notice of state tax lien with the Secretary of State. Govt C §§7171, 7220-7229.

PRACTICE TIP: Filed tax liens affecting such debtors will be shown on the combined information certificate that the Secretary of State issues in response to a request for a record search, unless the request for the search is specifically limited. See Com C §9528.

The state tax lien on personal property is junior to a security interest that is perfected before the notice is filed. Govt C §7170(c)(1)-(2). The state tax lien is also junior to the rights of holders of various interests that arise after the notice of tax lien is filed. Govt C §7170(c)(4). These interests include the following:

- A holder of a purchase money security interest (Govt C §7170(c)(4)(E));
- A holder of a security interest in a deposit account (Govt C §7170(c)(4)(G));
- A holder of any right or interest under certain certificate of title laws of other jurisdictions (Govt C §7170(c)(4)(J));
- A purchaser of chattel paper who gives new value and takes possession in the ordinary course of business (Govt C §7170(c)(4)(D));
- A purchaser of an instrument who gives new value and takes possession in good faith (Govt C §7170(c)(4)(D));
- A holder of a security interest in an insurance policy or claim who acquires it without actual knowledge of the tax lien (Govt C §7170(c)(4)(I));
- Holders of various negotiable instruments (Govt C §7170(c)(4)(A)) and negotiable documents of title (Govt C §7170(c)(4)(B));
- Protected purchasers of securities (Govt C §7170(c)(4)(C));
- A purchaser of an instrument who has priority under Com C §9330(d) (Govt C §7170(c)(4)(K))
- A purchaser of investment property (Govt C §7170(c)(4)(L));
- A transferee of money not in collusion with the debtor (Govt C §7170(c)(4)(M));
- Collecting banks (Govt C §7170(c)(4)(F));
- A holder of any right or interest in letters of credit, advices of credit, or money (Govt C §7170(c)(4)(H)); and
- A holder of a security interest in the beneficial interest in a trust or estate (Govt C §7170(c)(4)(G)).

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VI. BUYERS, LESSEES, AND LICENSEES

§4.63 A. Buyers

Goods held for sale by a merchant often are subject to a security interest in favor of the lender who finances the merchant's inventory. When the goods are sold to a customer in the ordinary course of business, the buyer prevails over the holder of the original security interest in inventory. See §§4.64-4.67.

PRACTICE TIP: The inventory lender who anticipates that the goods will be sold may also have a security interest in the proceeds (see §§4.17-4.19) and often will be the assignee of the new conditional sale contract arising from the sale. In many cases, the inventory lender may set up collection mechanisms to ensure that it is paid immediately after disposition of the inventory to a customer. The inventory security interest itself, however, is cut off.

Special provisions protect (1) some financers who buy chattel paper or instruments in the ordinary course of their business (Com C §9330), (2) holders in due course of negotiable instruments, (3) holders to whom negotiable documents of title have been negotiated, and (4) protected purchasers of securities (Com C §9331) against the claims of secured parties who have perfected their interests in such property by filing.

Buyers not in the ordinary course of business are generally protected against unperfected security interests. See §§4.68-4.69. Buyers also may be protected if the disposition of collateral was authorized by the secured party. See §4.70. Special rules apply to the purchase of aircraft. See §4.71.

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§4.64 1. Buyer in Ordinary Course of Business

Commercial Code §9320(a) provides that a buyer in ordinary course of business takes free of a security interest created by the seller, even though the security interest is perfected and even though the buyer knows of its existence. Under Com C §1201(9), such a buyer is a person who, in good faith and without knowledge that the sale to him or her is in violation of the ownership rights or security interest of a third party in the goods, buys in ordinary course from a person in the business of selling goods of that kind, but does not include a pawnbroker.

This definition does not require that the buyer purchase at retail. A wholesale purchase or purchase from a manufacturer will do. There is no requirement that the buyer purchase as a consumer for personal, family, or household purposes. The buyer may be a merchant or even another person in the business of selling goods of the same kind. "Buying may be for cash, or by exchange of other property or on secured or unsecured credit, and includes receiving goods or documents of title under a preexisting contract for sale." Com C §1201(9). However, courts have found that the buyers that receive goods in satisfaction of a debt are not buyers in the ordinary course of business. See *U.S. v Handy & Harman* (9th Cir 1984) 750 F2d 777; *GMAC Bus. Credit LLC v Ford Motor Co. (In re H.S.A., II, Inc.)* (Bank ED Mich 2002) 271 BR 534 (both cases decided under former Com C §9307). Specific requirements of this definition are discussed in §§4.65-4.67.

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§4.65 a. Purchase Made in Ordinary Course

The purchase must be made "in the ordinary course." A person buys in the ordinary course if the sale comports with the usual or customary practices in the kind of business in which the seller is engaged or with the seller's own usual or customary practices. Com C §1201(9).

A buyer may have a duty to inquire about the seller's business to be able to rely on the protection of Com C §9320(a). In *American Nat'l Bank v Cloud* (1988) 201 CA3d 766, 247 CR 325, a bank had a perfected security interest in the debtor's raisin crop. The debtor entered into an agreement to sell his estimated 400 tons of raisins to a packing company. The debtor's sons also entered into an agreement to sell raisins to the packer, even though the sons were not growing any raisins. The sons received payment for raisins grown by the father subject to the bank's security interest, and the bank sued the packer for conversion. The court held that the packer was not protected as a buyer in ordinary course of business under former Com C §9307(1) because the packing company failed to prove that the sons were "persons in the business of selling goods of that kind." The trial court had expressly found that the packing company was negligent in failing to inquire as to the source of the raisins because the sons were new growers/sellers to the packer.

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§4.66 b. Buyer Without Knowledge of Security Interest

The buyer's knowledge of the prior security interest presents a nagging definitional problem, although it seems to be more serious in theory than in practice. In order to be a buyer in ordinary course of business under Com C §1201(9), a buyer must act "in good faith, without knowledge that the sale violates the rights of another person in the goods." Commercial Code §9320(a), however, states that a buyer in ordinary course of business takes free of the security interest "even if the security interest is perfected and the buyer knows of its existence." Reading Com C §§1201(9) and 9320 together, a buyer takes free of the security interest if the buyer merely knows that a security interest covers the goods but takes subject to the security interest if the buyer knows, in addition, that the sale violates a term in an agreement with the secured party. Official Comment 3 to UCC §9-320.

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§4.67 c. Security Interest Created by Seller

A buyer in the ordinary course of business will take free only of those security interests "created by his seller." Com C §9320(a).

In *In re Sunrise R.V., Inc.* (Bankr ED Cal 1989) 105 BR 587, a buyer purchased a recreational vehicle and granted the dealer a security interest that was properly perfected. Thereafter, the buyer traded in the recreational vehicle to a different dealer, who sold it to a second buyer. The bankruptcy court held that the second buyer, despite having paid the full price to the second dealer, took the vehicle subject to the first dealer's security interest.

In *Gordon v Hamm* (1998) 63 CA4th 1324, 74 CR2d 631, the original owner of a motor coach delivered the motor coach to a dealer as a trade-in. The motor coach was subject to a lien. The subsequent purchaser of the motor coach was found to have purchased it subject to the lien because a perfected security interest in collateral survives the collateral's disposition unless the secured party authorizes the transfer free and clear of its lien. See §4.70.

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2. Buyer Not in Ordinary Course of Business

§4.68 a. Perfected Security Interests

A buyer who does not qualify as a buyer in the ordinary course of business does not take free of an existing perfected security interest (*e.g.,* a security interest in a merchant's inventory), but may nevertheless be protected to the extent that the security interest secures advances that are made to the seller after the goods are sold to the buyer. See Com C §9323(d).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.69 b. Unperfected Security Interests

§4.69 b. Unperfected Security Interests

A competing buyer outside ordinary course of business will prevail against an unperfected security interest when (Com C §9317(b), (d)):

- The buyer gives value without knowledge of the security interest; and
- If the collateral is goods, instruments, documents, chattel paper, or security certificates, the buyer receives delivery of the collateral before he or she obtains knowledge of the security interest.

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§4.70 3. Disposition Authorized by Secured Party

One other provision of the Commercial Code might be used to protect buyers against preexisting security interests. Commercial Code §9315(a)(1) generally provides that a security interest continues in collateral notwithstanding disposition, unless the disposition was authorized by the secured party. A secured party's right to proceeds under this section or under the express terms of an agreement does not in itself constitute an authorization of disposition. Official Comment 2 to UCC §9-315.

In *J.I. Case Credit Corp. v Crites* (10th Cir 1988) 851 F2d 309, decided under the Oklahoma Commercial Code, the court held that a secured creditor had not implicitly authorized a sale of a tractor by signing an extension agreement with the debtor after the debtor sold the tractor to a third party.

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§4.71 4. Buyer of Aircraft

With respect to the purchase of aircraft, there is an inherent conflict between FAA recording statutes and state law lien priority statutes. This conflict was recognized by the U.S. Supreme Court in *Philko Aviation, Inc. v Shacket* (1983) 462 US 406, 76 L Ed 2d 678, 103 S Ct 2476, in which the Court held that a buyer's unrecorded interest lost out to a subsequent buyer's recorded interest. "Although state law determines priorities, all interests must be federally recorded before they can obtain whatever priority to which they are entitled under state law." 462 US at 413, 76 L Ed 2d at 684.

This interplay of state and federal laws arose again in the case of *Software Customer, Inc. v Bullet Jet Charter, Inc. (In re Bullet Jet Charter, Inc.)* (Bankr ND Ill 1995) 177 BR 593, 605, in which the debtor in possession tried to avoid a pre-petition sale of an aircraft. In distinguishing *Philko Aviation,* the bankruptcy court held that the FAA recording statute did not apply because the avoiding powers of 11 USC §544(a)(1) on which the debtor relied gave it only the rights of a putative judicial lienholder, which were not equivalent to those of an innocent purchaser for value. Accordingly, the bankruptcy court held that the actual buyer of the aircraft was entitled to specific performance of the purchase agreement, that it had fully performed pre-petition, and that the debtor could not avoid the buyer's interest in the aircraft under the strong-arm powers of 11 USC §544(a)(1). For discussion of strong-arm powers, see chap 6.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.72 B. Lessee of Goods and Licensees of General Intangibles in Ordinary Course of Business

§4.72 B. Lessee of Goods and Licensees of General Intangibles in Ordinary Course of Business

Rules similar to rules for buyers in ordinary course of business apply to lessees of goods and licensees of general intangibles under Com C §9321. A lessee in ordinary course of business takes its leasehold interest free of a security interest in the goods created by the lessor, even if the security interest is perfected and the lessee knows of its existence. Com C §9321(c). The rule works in the same way as Com C §9320(a). Official Comment 3 to UCC §9-321. See §§4.64-4.67.

The definition of a "licensee in ordinary course of business" is similar to that of a buyer in ordinary course. Com C §9321(a). In addition, a licensee in ordinary course of business takes its rights under a nonexclusive licensee free of a security interest in the general intangible created by the licensor, even if the security interest is perfected and the licensee knows of its existence. Com C §9321(b).

NOTE: The provisions relating to licensees will remain in effect only until January 1, 2010, unless a later enacted statute extends that date. The section with respect to lessees will remain operative. See Com C §9321(d).

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§4.73 VII. RESTITUTION

Although the Commercial Code is intended to protect a secured creditor's collateral from other creditors' claims, one California decision permitted restitution from a secured creditor under exceptional, limited circumstances based on "the principles of law and equity" as provided in Com C §1103(b).

In *Producers Cotton Oil Co. v Amstar Corp.* (1988) 197 CA3d 638, 242 CR 914, the court held the buyer of a crop was entitled to recover the cost of harvesting the crop from a creditor with a security interest in the proceeds of sale because the harvesting directly benefited the secured creditor. This decision, however, has been much criticized and is contrary to the overall tenor of Division 9.

In *Knox v Phoenix Leasing, Inc.* (1994) 29 CA4th 1357, 35 CR2d 141, the court refused to apply this limited exception to the Commercial Code rules to require restitution by the secured creditor of a winery to the supplier of wine barrels for barrels delivered to the winery but not paid for. The court noted that the delivery of barrels was not necessary to preserve the collateral—in comparison to the harvesting of a crop in the fields or the feeding of livestock in the pen. The court also noted that the supplier could have protected its purchase money security interest in the barrels by filing a financing statement before it shipped the barrels to the winery. 29 CA4th at 1368 n10. See also *Weststeyn Dairy 2 v Eades Commodities Co.* (ED Cal 2003) 280 F Supp 2d 1044 (no constructive trust in amounts prepaid by dairy farms for cattle feed).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.74 VIII. SUBORDINATION

§4.74 VIII. SUBORDINATION

The Commercial Code and the Code of Civil Procedure provide specified rules for priorities among creditors. However, it is possible for secured creditors to agree on their relative priorities pursuant to a subordination or intercreditor agreement.

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§4.75 A. Need for Subordination Agreement

A subordination or intercreditor agreement is often required if a secured creditor determines that another creditor has or will have superior rights in certain collateral. In some circumstances, the creditor with the existing superior interest may be willing to subordinate its rights to the rights of the other creditor.

EXAMPLE: Secured Party *A* enters into a security agreement on January 15 under which the debtor grants Secured Party *A* a security interest in all inventory. Secured Party *A* files a financing statement on January 15. At that time, no other parties had filed against the personal property of the debtor. On June 15, the debtor negotiates a receivables financing agreement with Secured Party *B*, under which Secured Party *B* will receive a security interest in all of the debtor's accounts. If Secured Party *B* were to file a financing statement, Secured Party *B*'s interest would be junior to that of Secured Party *A*'s interest in the accounts, because Secured Party *A* filed first, and the accounts will most probably be proceeds of the inventory. See §4.27. Therefore, Secured Party *B* may not want to provide the receivables financing unless Secured Party *B* and Secured Party *A* reach an agreement that Secured Party *B* will have a senior interest in the accounts.

For a form of subordination agreement, see §§4.76-4.76I.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.75A B. Types of Subordination

§4.75A B. Types of Subordination

There are two types of subordination, and within these two types there are levels or degrees of subordination. The two major categories of subordination are lien subordination and debt subordination.

Lien subordination occurs when two secured creditors have a security interest in the same collateral, and one of the creditors agrees that it will not receive payment from that collateral until the other secured creditor is paid in full.

Debt subordination is when two creditors agree that one will be paid before the other. Debt subordination is broader and generally more helpful to senior creditors because it applies to all payments regardless of their source, while lien subordination applies only to distributions of collateral and payments of proceeds of collateral.

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§4.75B C. Levels of Subordination

There are many levels of subordination, and it is important for creditors to be explicit in any intercreditor agreement as to the nature and extent of the subordination. Sometimes the junior creditor is an insider of the debtor. In those situations, the subordination is generally very deep. In other circumstances, the junior creditor may be an existing creditor who is willing to give up some of its rights in order to insure that the borrower obtains new financing. In addition, there are lenders that specialize in subordinated credit. These lenders are often called "mezzanine lenders" because their debt is layered between the senior creditor and even more subordinated debt. Finally, if the subordination is a lien subordination, the creditors may each have an interest in a portion of the collateral but also have interests in different, additional collateral, so that one creditor may be subordinated with respect to one type of collateral and not on another.

A junior creditor may subordinate its debt, but depending on the level of subordination, may cap the subordinated amount to the amount of the senior creditor's commitment or debt under a specified credit facility. In a deep subordination, however, the senior creditor usually requires the debt subordination to be with respect to any or all obligations until the senior creditor is paid in full.

In both debt and lien subordinations, the defined scope of the senior debt is important. Senior creditors generally want broad definitions of the senior debt to ensure that their senior debt is fully paid first. Senior creditors should specifically include interest and fees accruing after commencement of the debtor's bankruptcy case as part of the senior debt. The scope of the subordination should be carefully outlined. In *Musicland Holding Corp. v Wachovia Bank, N.A. (In re Musicland Holding Corp.)* (SD NY 2008) 386 BR 428, aff'd sub nom *Buena Vista Home Entertainment, Inc. v Wachovia Bank, N.A. (In re Musicland Holding Corp.)* (2d Cir 2009) 318 Fed Appx 36, the senior creditor was permitted to incorporate a term loan into a revolving credit agreement and thereby increase the amount of the loan to which junior creditors were subordinated. In the intercreditor agreement, the junior creditors had waived and consented to amendments and modifications to the revolving credit agreement and had agreed that the senior revolving loans meant all obligations of any nature owed by the debtor under the agreement. 386 BR at 436.

Under the so-called "Rule of Explicitness," bankruptcy and other courts may not permit unsecured or undersecured senior creditors to recover postpetition interest or fees from distributions otherwise payable to the junior creditor unless those items are specifically included as senior debt in the subordination agreement. See *Chemical Bank v First Trust of New York (In re Southeast Banking Corp.)* (11th Cir 1999) 179 F3d 1307. But see *HSBC Bank USA v Branch (In re Bank of New England Corp.)* (1st Cir 2004) 364 F3d 355.

Unless there is deep subordination, the senior lender often permits the junior lender to receive interest payments or other regularly scheduled payments until there is a default.

If a default is called, there is often a period of time in which the junior creditor agrees not to get paid, known as a "blockage period." A deeply subordinated creditor will probably be subject to a permanent payment blockage until the senior creditor is paid in full or the default is waived. Other creditors, however, should be able to negotiate a blockage period. The blockage period is designed to give the senior creditor time to act and receive payment, but does not permanently stop the junior creditor from receiving payment.

The subordination agreement will probably also require the junior creditor to turn over any unauthorized payments received to the senior creditor. These types of obligations in an intercreditor agreement are honored by courts. In *PPM Fin., Inc. v Norandahl USA* (ND Ill 2004) 297 F Supp 2d 1072, the court found that a junior creditor had breached the subordination agreement by not turning over money it had received.

Junior and senior creditors should also agree on which lender will have the right to call a default and exercise remedies. Again, a deeply subordinated creditor is rarely afforded these rights. Other junior creditors, however, may insist on the right to call a default, even if they are not permitted to exercise remedies after the default is called. Sometimes a junior creditor will agree to take no action for a period of time. This is called a "standstill period." As with a blockage period, the standstill period gives the senior creditor the right to take any action it feels necessary to enforce its rights without interference from the junior creditor.

The senior creditor may also require the junior creditor to agree to provide the senior creditor certain rights in bankruptcy. In deep subordination, the senior creditor often requires the right to vote the junior creditor's debt, as well as to approve its proof of claim before filing. In virtually all subordinations, the senior creditor also receives the junior creditor's distributions if they consist of proceeds of the senior creditor's collateral or, in a debt subordination, if the senior creditor has not been paid in full.

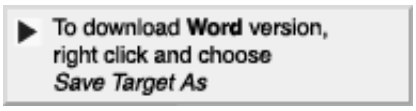
In *General Elec. Capital Corp. v Dial Bus. Forms (In re Dial Bus. Forms, Inc.)* (8th Cir 2003) 341 F3d 738, the court examined the effect of a subordination of liens in connection with a plan of reorganization and held that the subordination in the plan trumped the general rules of priority set forth in the Uniform Commercial Code. The secured creditor had not perfected its lien, but because the plan of reorganization subordinated the interest of a class of creditors to the lien, the court held that the plan controlled over state law.

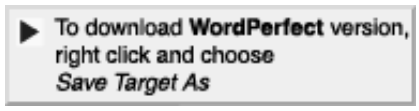
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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/ D. Subordination Agreement/§4.76 1. Form: Introduction, Recitals, and Definitions

D. Subordination Agreement

§4.76 1. Form: Introduction, Recitals, and Definitions





4.76-1 Introduction, recitals, and definitions

SUBORDINATION AGREEMENT

THIS SUBORDINATION AGREEMENT ("Agreement") is entered into as of _ _[*date*]_ _ between SENIOR CREDITOR ("Senior Creditor") and JUNIOR CREDITOR ("Junior Creditor"), with reference to the following facts:

RECITALS

A. _ _[*name*]_ _ a _ _[*type of entity*]_ _ ("Debtor") and Senior Creditor have entered into a _ _[*name of senior creditor loan and security agreement*]_ _ and certain related documents (the "Senior Creditor Documents").

B. The obligations under the Senior Creditor Documents are secured by substantially all of the personal property of Debtor (the "Senior Creditor Collateral").

C. Debtor and Junior Creditor are entering into that certain_ _[*name of junior creditor loan and security agreement*]_ _ and certain related documents (the "Junior Creditor Documents").

D. Pursuant to the Junior Creditor Documents, the obligations under the Junior Creditor Loan Documents are secured by substantially all of the personal property of Debtor (the "Junior Creditor Collateral").

E. Junior Creditor and Senior Creditor desire to confirm, as between themselves, their agreement and understanding with respect to the extent and priority of their respective liens on and security interests in the property of Debtor, and as to certain other rights and matters as between Junior Creditor and Senior Creditor.

NOW, THEREFORE, in consideration of the foregoing and the mutual covenants contained in this agreement, and for other good and valuable consideration, the receipt of which is hereby acknowledged, Junior Creditor and Senior Creditor agree as follows:

1. DEFINITIONS

The following terms, as used in this Agreement, have the following meanings:

"Agreement" means this Subordination Agreement and any amendments, modifications, exhibits, and schedules to it.

"Junior Creditor Collateral" has the meaning set forth in Recital D.

"Junior Creditor Documents" has the meaning set forth in Recital C.

"Junior Creditor Indebtedness" means and refers to any presently existing or hereafter arising indebtedness, claims, debts, liabilities, or obligations of Debtor owing to Junior Creditor, whether direct or indirect, contingent or of any other nature, character, or description, arising under or in connection with the Junior Creditor Documents.

"Payment Default" means a "Default" or an "Event of Default" for the failure to make a payment when due (including any applicable grace period) under the Senior Creditor Documents.

"Senior Creditor Collateral" has the meaning set forth in Recital B.

"Senior Creditor Documents" has the meaning set forth in Recital A.

"Senior Creditor Indebtedness" means any and all presently existing or hereafter arising indebtedness, claims, debts, liabilities, or obligations of Debtor owing to Senior Creditor, whether direct or indirect, contingent or of any other nature, character, or description, including interest and fees accruing after the commencement of a bankruptcy case by or against the Debtor, whether or not the claim for such interest or fees is allowed or allowable in the bankruptcy case, arising under or in connection with the Senior Creditor Documents outstanding at any time in any amount not to exceed _ _[*dollar amount*]_ _.

"Standstill Period" means the period of _ _[*number*]_ _ days beginning on the date of written notice by Senior Creditor to Junior Creditor that a Payment Default has occurred and is continuing and that a Standstill Period has commenced with respect to any action by Junior Creditor on a "Default" or "Event of Default" under any of the Junior Creditor Documents; provided, that the Standstill Period shall continue after the _ _[*number*]_ _-day period set forth above until the Senior Creditor Indebtedness is paid in full if, during such ___-day period, Senior Creditor commences the enforcement of its rights and remedies with respect to the Senior Creditor Collateral and the Senior Creditor Indebtedness and thereafter continues enforcement; and provided, further, that there can be but one (1) Standstill Period for any specific occurrence of a "Default" or an "Event of Default" under the Senior Creditor Documents.

Comment: The subordination agreement uses the concept of a standstill period. See §4.75B. The standstill period under the agreement will only commence after a payment default, although parties often agree to standstill periods that start after any default under the senior creditor documents. As noted in §4.75B, a blockage period may also be used.

The provisions in this subordination agreement are not appropriate for deep subordination. See §4.75B.

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§4.76A 2. Form: Payments on Junior Creditor Indebtedness

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4.76A-1 Payments on junior creditor indebtedness

2. PAYMENTS ON JUNIOR CREDITOR INDEBTEDNESS

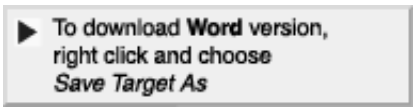
2.1 Payments on Junior Creditor Indebtedness. To the extent and in the manner set forth in this Agreement, all amounts payable with respect to the Junior Creditor Indebtedness are expressly made subordinate in priority and subject in right and priority of payment to the prior performance and final payment in full of the Senior Creditor Indebtedness, and Junior Creditor hereby subordinates all of the Junior Creditor Indebtedness in right and time of payment to the Senior Creditor Indebtedness. Notwithstanding the foregoing, and provided that no Payment Default has occurred and is continuing, Debtor may make and Junior Creditor may receive payments as and when due and payable under the Junior Creditor Documents.

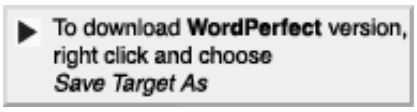
2.2 Distributions on Bankruptcy. Without limiting the generality of Section 2.1, on any payment or distribution of assets or securities of Debtor, as the case may be, of any kind or character, whether in cash, property, or securities, on any dissolution or winding up or total or partial liquidation, reorganization, or marshalling of assets of Debtor, whether voluntary or involuntary or in bankruptcy, insolvency, receivership, or other proceedings, all amounts payable on or in connection with the Senior Creditor Indebtedness shall first be paid in full, before Junior Creditor shall be entitled to receive any payment on account of the Junior Creditor Indebtedness. Without limiting the generality of the foregoing, unless the Senior Creditor Indebtedness has been paid in full, Junior Creditor shall cause to be delivered to Senior Creditor all payments and other distributions otherwise payable or distributable to Junior Creditor in any such proceeding.

Comment: This form constitutes the debt subordination section of the subordination agreement. See §4.75A. With respect to Section 2.1, whether the junior creditor will receive any payments is a negotiated point. Deeply subordinated creditors will probably not receive even regularly scheduled payments. See §4.75B.

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§4.76B 3. Form: Priority of Liens





4.76B-1 Priority of liens

3. PRIORITY OF LIENS

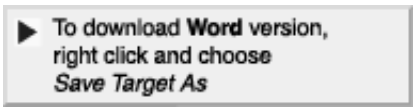
Notwithstanding the time, order, or manner of the grant of their respective liens or security interests (including the time or order of the execution, filing, or recording of any security agreements, financing statements, fixture filings, assignments, or any other similar documents granting, evidencing, or perfecting such liens or security interests under any other applicable law), or any provision of applicable law, any and all valid and perfected security interests, liens, or other interests (consensual, statutory, or otherwise) that Junior Creditor may at any time have or acquire, whether under the Junior Creditor Documents or otherwise, in any of the Senior Creditor Collateral shall be subordinate to the valid and perfected liens and security interests of Senior Creditor in such Senior Creditor Collateral, whether arising under Senior Creditor Documents or under any other instrument, document, or agreement now or hereafter existing, but only to the extent that the Senior Creditor Collateral secures the Senior Creditor Indebtedness.

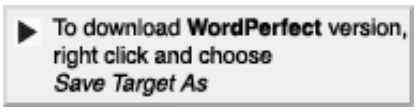
Comment: This form is the lien subordination section of the subordination agreement. See §4.75A. Note that the junior creditor only subordinates its interests to "valid and perfected" liens of the senior creditor. This is a typical provision. A deeply subordinated creditor may be required to subordinate to any lien, perfected or not.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.76C 4. Form: Consent to Junior Liens

§4.76C 4. Form: Consent to Junior Liens





4.76C-1 Junior liens

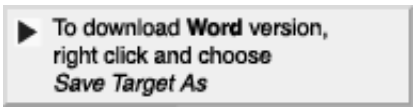
4. CONSENT TO JUNIOR LIENS

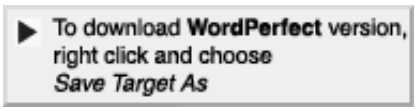
Senior Creditor hereby consents to the junior liens and security interests in the Senior Creditor Collateral granted by Debtor to Junior Creditor under the Junior Creditor Documents, and agrees that the grant or existence of such liens and security interests does not constitute a "Default" or "Event of Default" under the Senior Creditor Documents.

Comment: In a lien subordination, it is important to have the senior creditor consent to the junior creditor's liens if the senior creditor documents prohibit additional liens. See §4.75B.

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§4.76D 5. Form: Events of Default





4.76D-1 Default

5. EVENTS OF DEFAULT

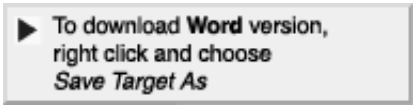
5.1 Notices Under Junior Creditor Documents. Junior Creditor shall use commercially reasonable efforts to send Senior Creditor a copy of any written notice sent by Junior Creditor to Debtor of a "Default" or "Event of Default" under the Junior Creditor Documents, which copy will be sent contemporaneously with the sending of such notice to Debtor.

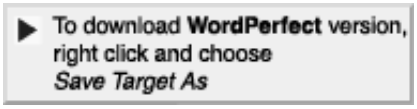
5.2 Notices Under Senior Creditor Documents. Senior Creditor shall use commercially reasonable efforts to send Junior Creditor a copy of any written notice sent by Senior Creditor to Debtor of a "Default" or an "Event of Default" under the Senior Creditor Documents, which copy will be sent contemporaneously with the sending of such notice to Debtor.

Comment: The creditors may wish to notify each other of defaults under the documents.

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§4.76E 6. Form: Restrictions on Enforcement





4.76E-1 Restrictions on enforcement

6. RESTRICTIONS ON ENFORCEMENT OF CERTAIN RIGHTS AND REMEDIES

6.1 Restrictions Affecting Junior Creditor. Until the Senior Creditor Indebtedness has been paid and satisfied in full, Junior Creditor shall not: (a) take any action to enforce any of Junior Creditor's liens and security interests in any Senior Creditor Collateral without Senior Creditor's prior written consent; (b) interfere with the enforcement of Senior Creditor's liens and security interests in any Senior Creditor Collateral; or (c) during or until the expiration of any applicable Standstill Period, take any action to enforce any of Junior Creditor's liens and security interests in any Senior Creditor Collateral.

6.2 Exercise of Other Remedies. Except as specifically restricted by Section 6.1, Junior Creditor and Senior Creditor shall be free to exercise any or all of their respective rights and remedies against Debtor and any collateral securing Debtor's respective obligations, including Junior Creditor's right to accelerate the Junior Creditor Indebtedness and to enforce its right to recover the payment of the Junior Creditor Indebtedness.

6.3 Receipt of Proceeds. In the event that Junior Creditor receives any payment or any proceeds from the sale, condemnation, or other disposition of any Senior Creditor Collateral before the Senior Creditor Indebtedness has been paid and satisfied in full, Junior Creditor will be deemed to have received such payment or proceeds for the account of Senior Creditor, and Junior Creditor will promptly deliver such payment or proceeds to Senior Creditor to the extent Senior Creditor is entitled to receive such payment or proceeds. If the Senior Creditor receives any payments from Debtor or any proceeds from the sale, condemnation, or other disposition after the Senior Creditor Indebtedness has been paid in full, Senior Creditor will be deemed to have received such payment or proceeds for the account of Junior Creditor, and Senior Creditor will promptly delivery such payment or proceeds to Junior Creditor to the extent Junior Creditor is entitled to receive such payment or proceeds.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.76F 7. Form: Actions Affecting Agreements with Debtor and Waiver of Marshalling

§4.76F 7. Form: Actions Affecting Agreements with Debtor and Waiver of Marshalling

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4.76F-1 Form: Agreement with debtor and waiver of marshalling

7. ACTIONS AFFECTING AGREEMENTS WITH DEBTOR

7.1 Actions Affecting Junior Creditor Documents. Junior Creditor may, in its sole discretion, amend or grant any waivers or consents under any of the Junior Creditor Documents as long as such amendment, waiver, or consent does not adversely affect any of the Senior Creditor Collateral.

7.2 Actions Affecting Senior Creditor Documents. Senior Creditor may, in its sole discretion, amend or grant any waivers or consents under any of the Senior Creditor Documents as long as such amendment, waiver, or consent does not adversely affect any of the Junior Creditor Collateral.

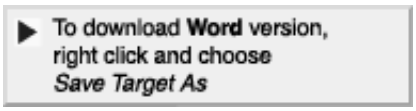
8. WAIVER OF MARSHALLING AND DUTIES

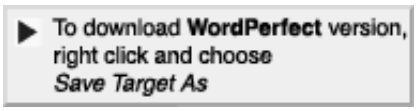
Junior Creditor and Senior Creditor specifically waive and renounce any rights under any applicable law that any of them may have, whether at law or in equity, to require the other to marshal any of the Junior Creditor Collateral or the Senior Creditor Collateral, as the case may be, or to otherwise seek satisfaction from any particular assets of Debtor or from any third party. Junior Creditor and Senior Creditor acknowledge and confirm that this Agreement shall create no joint venture, agency, or fiduciary relationship.

Comment: Senior creditors often require the junior creditor to waive marshalling rights. In this agreement, both junior and senior creditors waive these rights.

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§4.76G 8. Form: Claims in Bankruptcy





4.76G-1 Bankruptcy

9. CLAIMS IN BANKRUPTCY

In the event of any bankruptcy case, assignment for the benefit of creditors, or similar proceedings commenced by or against Debtor, Junior Creditor shall, at least fifteen days before any claims bar date, (a) file a proof or proofs of claims for the Junior Creditor Indebtedness, which proof of claim shall indicate Junior Creditor's subordination under this Agreement, and (b) direct the debtor in possession or trustee in bankruptcy, as appropriate, to pay over to Senior Creditor all amounts due to Junior Creditor on account of the Junior Creditor Indebtedness until the Senior Creditor Indebtedness has been fully satisfied. If Junior Creditor fails to file such claim or provide such direction, Senior Creditor may file such claim or provide such direction either in its own name or in the name of and on behalf of Junior Creditor.

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§4.76H 9. Form: Assurances, Agreement, Amendments, Notice, Severability, Successors, and Governing Law

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4.76H-1 Assurances, agreement, amendments, notice, severability, successors, and governing law

10. FURTHER ASSURANCES

Junior Creditor and Senior Creditor agree to execute and deliver, on the request of another party to this Agreement, such documents and instruments (appropriate for filing, if requested), and to take such further steps as may be reasonably requested to implement or evidence the understanding and agreements contained in this Agreement.

11. EFFECTIVENESS OF AGREEMENT

This Agreement shall remain in full force and effect (a) notwithstanding any subsequent amendment or modification of any party's respective agreements with Debtor, and (b) regardless of whether any party to this Agreement in the future seeks to rescind, amend, terminate, or reform, by litigation or otherwise, its respective agreements with Debtor.

12. COMPLETE AGREEMENT

This Agreement is the complete agreement and understanding of Junior Creditor and Senior Creditor and supersedes all prior or contemporaneous oral and written negotiations, agreements, and understandings, express or implied, with respect to its subject matter. There are no other agreements or obligations between the parties not set forth in this Agreement.

13. AMENDMENTS AND WAIVERS

No amendment or waiver of any provision of this Agreement, nor any consent to any departure therefrom, shall in any event be effective unless it is in writing and signed by the party to be charged, and then such waiver or consent shall be effective only in the specific instance and for the specific purpose for which given.

14. NOTICES

Whenever it is provided in this Agreement that any notice, demand, request, consent, approval, declaration, or other communication shall or may be given to or served on any of the parties, or whenever any of the parties desire to give or serve on the other communication with respect to this Agreement, each such notice, demand, request, consent, approval, declaration, or other communication shall be in writing and shall be delivered either in person, with receipt acknowledged, or by registered or certified mail, return receipt requested, postage prepaid, or by facsimile, addressed as set forth on the signature page.

Every notice, demand, request, consent, approval, declaration, or other communication under this Agreement shall be deemed to have been duly given, issued, or delivered on the date on which personally delivered, with receipt acknowledged, or actually received via facsimile transmission, or three (3) days after the same shall have been deposited in the United States mail.

15. SEVERABILITY

Whenever possible, each provision of this Agreement shall be interpreted in a manner so as to be effective and valid under applicable law, but if any provision of this Agreement shall be prohibited by or invalid under applicable law, such provision shall be ineffective to the extent of such prohibition or invalidity, without invalidating the remainder of such provision or the remaining provisions of this Agreement.

16. SUCCESSORS AND ASSIGNS; NO THIRD PARTY BENEFICIARIES

This Agreement shall be binding on, and inure to the benefit of, the respective successors and assigns of Junior Creditor and Senior Creditor. All of the understandings, covenants, and agreements contained in this Agreement are solely for the benefit of Junior Creditor and Senior Creditor and their respective successors and assigns, and there are no other parties (including Debtor, its creditors, and its successors or assigns) who are in any way intended to be benefited by, or entitled to enforce, this Agreement. Except as specifically set forth in this Agreement, nothing contained herein is intended to or shall affect or limit, in any way, the respective rights that Junior Creditor or Senior Creditor has with respect to Debtor or any third parties, all of which respective rights are specifically reserved, and nothing contained in this Agreement shall be construed to limit the obligation of Debtor to Junior Creditor and Senior Creditor under (a) the Junior Creditor Documents, and (b) the Senior Creditor Documents, respectively, all of which obligations remain absolute and unconditional.

17. SECTION HEADINGS

The Section headings contained in this Agreement are and shall be without substantive meaning or content of any kind whatsoever and are not a part of the agreement between the parties.

18. COUNTERPARTS

This Agreement may be executed in any number of separate counterparts, each of which shall be an original, but all of which shall constitute one and the same agreement.

19. GOVERNING LAW

THE VALIDITY OF THIS AGREEMENT, ITS CONSTRUCTION, INTERPRETATION, AND ENFORCEMENT, AND THE RIGHTS OF THE PARTIES HEREUNDER, SHALL BE DETERMINED UNDER, GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH THE LAWS OF THE STATE OF CALIFORNIA.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.76I 10. Form: Signatures and Acknowledgment

§4.76I 10. Form: Signatures and Acknowledgment

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4.76I-1 Signatures and acknowledgment

IN WITNESS WHEREOF, the parties to this Agreement have caused this Agreement to be duly executed as of the date first set forth above.

Date: _ _ _ _ _ _

SENIOR CREDITOR,
_ _[*NAME OF ENTITY*]_ _**,**
a _ _[*specify entity, e.g., California corporation*]_ _,
SENIOR

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _

JUNIOR CREDITOR
_ _[*NAME OF ENTITY*]_ _**,**
a _ _[*specify entity, e.g., California corporation*]_ _
JUNIOR

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

ACKNOWLEDGEMENT BY DEBTOR

_ _[*name*]_ _ **, a** _ _[*type of entity*]_ _ **, hereby (1) acknowledges that it has received a copy of the above Subordination Agreement, (2) consents to it, (3) agrees to recognize all rights granted thereby to the parties thereto, and (4) agrees not do any act or perform any obligation not in accordance with the agreements set forth in the Subordination Agreement as in effect from time to time.**

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _**,**
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: Both the senior and junior creditor should want the debtor to acknowledge and agree to abide by the terms of the intercreditor agreement.

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§4.77 IX. UCC INSURANCE POLICIES

Certain title insurance companies offer UCC insurance policies. Currently, First American Title Insurance Company and Fidelity National Title Insurance Company and its affiliates are providing UCC policy insurance in California. Companies offering the insurance in California must comply with the California Department of Insurance rules and regulations. Coverage varies, and practitioners should carefully review the various policies offered. For discussion of typical coverage and exclusions, see §§4.78-4.81.

CAUTION: It is important to remember that the insurance operates with regard to a specified search date, and will not cover filings that may have occurred after that date. Practitioners using UCC insurance should take care that the "search date" used by the title insurance company will coincide with the filing of the secured party's filing of the financing statement.

While UCC insurance may help limit risks in a transaction, it should not replace receiving representations and warranties of the debtor, or a secured party's own due diligence. Depending upon the circumstances, a secured creditor will still obtain a legal opinion from borrower's counsel. See chap 9.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.78 A. Coverage

§4.78 A. Coverage

Typical coverage under a UCC insurance policy includes the following:

- Failure of the insured security interest to attach;
- Failure of the insured security interest to be perfected;
- Priority of any other security interest or lien creditor over the insured security interest;
- Any purchaser of the collateral taking outside the ordinary course of business free of the insured security interest when the purchaser's rights or interests in the collateral are acquired after date of policy; and
- Any claim covered by other insured claims arising out of any case filed by or against the debtor under the Bankruptcy Code in connection with an adversary proceeding to determine the extent, validity, or priority of the insured security interest filed against the insured under Fed R Bankr P 7001(2).

In certain cases, the insurance covers the failure of the insured security interest to attach, be perfected, or have priority for invalid authentication of the security agreement or any financing statement because of forgery or fraud. UCC insurance will cover the correct name of a debtor if it is a registered organization.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.79 B. Exclusions

§4.79 B. Exclusions

UCC insurance policies typically contain several exclusions. These exclusions include (1) the failure of the insured security interest to attach to any of the collateral by reason of the debtor not having rights in the collateral and (2) the collateral being solely the proceeds of other collateral, when the proceeds are not identifiable.

NOTE: If any of the information provided on the schedule to the policy is incorrect, causing the security interest not to be perfected, coverage is excluded. Information regarding a debtor that is a registered organization, however, is carved out of this exclusion.

The UCC insurance policy also has exclusions for priority relating to rights of purchasers and lien holders not known to the title company, but of which the insured claimant has notice, to the extent the collateral is instruments, investment property, chattel paper, money, funds transferred from a deposit account, or a negotiable document of title.

Exclusions based on method of perfection are discussed in §4.80. Exclusions for claims arising under other laws are discussed in §4.81.

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§4.80 1. Excluded Methods of Perfection

Perfection by any method except for a security interest perfected (1) on attachment, (2) by the filing of a financing statement, (3) by possession of possessory collateral, or (4) by control of control collateral is also excluded. There is also an exclusion for liens held by a lien creditor on the collateral that were acquired by a method other than a filing in a filing office or by possession of possessory collateral.

The UCC insurance policy also has an exclusion for a purchaser of any of the collateral having priority over the insured security interest, when the insured security interest is perfected only by the filing of a financing statement or when it attaches, when the purchaser has purchased:

- Tangible chattel paper, if the purchaser gave value and obtained possession of the tangible chattel paper in the ordinary course of the purchaser's business;
- A security entitlement or a securities account, if the purchaser gave value and obtained control of the security entitlement or securities account;
- A certificated security, if the purchaser has control or possession of the certificated security;
- An instrument, if the purchaser has possession of the instrument;
- Electronic chattel paper, if the purchaser gave value and obtained control of the electronic chattel paper; or
- Letter-of-credit rights, if the purchaser obtained control of the letter-of-credit rights.

These exclusions derive from the priority rules regarding perfection by possession or control under Com C §§9301-9342. See chap 3.

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§4.81 2. Claims Arising Under Other Laws

Any claim arising as a result of the operation of bankruptcy, receivership, assignment for the benefit of creditors, insolvency, or similar creditors' rights laws or proceedings, or any laws that operate only in the event of such proceedings (including any claim based on fraudulent transfer or fraudulent conveyance, or the application of the doctrine of equitable subordination, or preferential transfer (*except* when the preferential transfer results from the failure of the company to follow the instructions of the insured to timely file a financing statement)) is excluded.

Any claim arising as a result of applicable usury, interest rate limitation, truth-in-lending, or consumer protection laws is also excluded.

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X. RIGHTS OF THIRD PARTIES

§4.82 A. Scope of Division 9, Chapter 4

Chapter 4 of Division 9 of the Commercial Code (Com C §§9401-9409) deals with the rights of parties other than the debtor and the secured party. Such parties include account debtors and licensors who may be obligated on collateral but who are not parties to the secured transaction. Official Comment 2 to UCC §9-401.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.83 B. Other Law Governs Alienability of Debtors' Rights

§4.83 B. Other Law Governs Alienability of Debtors' Rights

With limited exceptions, as discussed in §4.84, law other than Division 9 of the Commercial Code governs whether a debtor's rights in collateral may be transferred. Com C §9401(a); Official Comment 4 to UCC §9-401.

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§4.84 C. Exceptions to General Rule

Commercial Code §§9401(b), 9406-9409 provide exceptions to or limitations on the general rule of Com C §9401(a) that other law governs the transferability of a debtor's rights in collateral. See §§4.85-4.89.

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§4.85 1. Prohibition of Transfer Does Not Prevent Transfer From Taking Effect

An agreement between the debtor and the secured party that prohibits a transfer of the debtor's rights in collateral (usually referred to as a "negative pledge") does not prevent the transfer from taking effect. Com C §9401(b). However, if the debtor makes a prohibited transfer, the debtor will have breached its agreement with the secured party. Official Comment 5 to UCC §9-401.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.86 2. Assignment of Accounts, Chattel Paper, Payment Intangibles, and Promissory Notes

§4.86 2. Assignment of Accounts, Chattel Paper, Payment Intangibles, and Promissory Notes

Contractual restrictions on the assignment of accounts, chattel paper, payment intangibles, or promissory notes are ineffective, except as provided in Com C §§9406, 9407, 10303. This limitation applies to provisions in agreements that (i) prohibit the assignment without the consent of the account debtor or person obligated on a promissory note or (ii) provide that an assignment is a breach or default. Com C §9406(d). These restrictions also apply to statutes and regulations that prohibit the transfer of accounts or chattel paper or provide that the transfer is in breach or default. Com C §9406(f).

Health care insurance receivables and the sale of payment intangibles or promissory notes are not covered by Com C §9406, but are covered by Com C §9408. Com C §9406(e), (i). See §4.88. In addition, other laws regarding consumers may affect a consumer's rights under this provision. Com C §9406(h). For example, state law regarding the assignment of a consumer receivable may affect the application of this section. Finally, claims or rights relating to compensation for injuries or sickness under 26 USC §104 are not affected by Com C §9406(f). Com C §9406(j).

NOTE: Although a restriction on assignment in an agreement will not be effective, other provisions in an agreement that may affect the ability to transfer collateral are not affected. For example, if a secured party prohibits the assignment of accounts receivable but also has a cash management system including a lock-box, Com C §9406 does not render the lock-box arrangement ineffective. Official Comment 5 to UCC §9-406.

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§4.87 3. Ineffective Terms in Lease Agreement

Contractual restrictions on assignment in a lease agreement are generally ineffective. Com C §9407(a). However, the following types of lease terms are enforceable: (1) prohibitions against a transfer of the lessee's right to possession or use of goods in violation of the terms of the agreement; and (2) a prohibition against a delegation of material performance of the lease in violation of the term. Com C §9407(b).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/4 Priorities/§4.88 4. Assignments of Promissory Notes, Health Care Insurance Receivables, and Certain General Intangibles

§4.88 4. Assignments of Promissory Notes, Health Care Insurance Receivables, and Certain General Intangibles

With certain exceptions, Com C §9408 generally makes ineffective any contractual, statutory, or regulatory limitations on the assignment of general intangibles, health care insurance receivables, or promissory notes. See Com C §§9408(a) and 9408(c). Any provision in a contract, rule of law, statute, or regulation that would prohibit—or create a breach or penalty for—the creation, attachment, or perfection of a security interest in a promissory note, general intangible, or health care insurance receivable is ineffective. Com C §9408(a), (c). The purpose of Com C §9408 is to enhance the ability of certain debtors to obtain credit. Official Comment 2 to UCC §9-408.

NOTE: Commercial Code §9408(a) only applies to a security interest in a promissory note or payment intangible if the security interest arises from the sale of the promissory note or payment intangible. Com C §9408(b). Commercial Code §9406 applies to those types of collateral if no sale is involved. See §4.86.

Commercial Code §9408(d) protects the account debtor from adverse effects arising from the security interest if the restriction that Com C §9408(a) and (c) overrides would be effective under law other than the Commercial Code. Under Com C §9408, the secured creditor should be able to receive the payment stream from a license or royalty.

EXAMPLE: A nonexclusive patent license prohibits the licensee from making an assignment of its rights under the license and the license provides that a breach of this provision entitles the licensor to terminate the agreement. Under Com C §9408(a), these two provisions do not prevent the creation, attachment, and perfection of a security interest in the license and the licensor cannot call a default. The secured party, however, does not gain the rights of the licensee and cannot enforce the license or use the license. The licensor need not recognize the security interest or pay or remedy performance to the secured party. The secured party is entitled to enforce the security interest against the debtor.

Official Comment 9 to UCC §9-408 notes that this section will not override federal law on these issues, but anticipates that it will provide a template for decisions applying that law.

PRACTICE TIP: As a practical matter, the secured party will need the consent of the licensor to enforce remedies. It is usually difficult to obtain consent at the time the security interest is granted, but obtaining consent at that time is most beneficial to the secured creditor. The licensor will have more bargaining power if the secured party waits to seek consent until foreclosure.

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§4.89 5. Restrictions on Assignment of Letter-of-Credit Rights

The same types of prohibitions on assignment and default clauses discussed in §4.88 are ineffective with respect to assignment of letter-of-credit rights under Com C §9409, patterned after Com C §9408. Com C §9409(a); Official Comment 2 to UCC §9-409. However, the issuer and beneficiary of a letter of credit are protected under Com C §9409(b). To the extent that a term in a letter of credit would be effective under other law or in custom or practice, the creation, perfection, and attachment to the letter of credit rights is subject to the following limitations: (1) it is not enforceable against the applicant, issuer, nominated person, or transferee beneficiary; (2) it imposes no duties or obligations on such persons; and (3) it does not require such persons to recognize the security interest, perform for the secured party, or accept payment or performance from the secured party. Com C §9409(b).

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§4.90 D. Rights Acquired By Assignee of Accounts

An assignee generally takes an assignment subject to the defenses and claims of the account debtor. See Com C §9404. Specifically, the assignee takes subject to (1) all terms of the agreement between the account debtor and assignor and any defense or claim in recoupment arising from the transaction that gave rise to the contract (Com C §9404(a)(1)), and (2) any other defense or claim of the account debtor against the assignor which occurs before the account debtor receives notification of the assignment authenticated by the assignor or the assignee (Com C §9404(a)(2)).

The rules are different with respect to a consumer transaction when the account debtor is a consumer. See Com C §9404(c), (d). Commercial Code §9404 is subject to other laws for consumers—in particular rules of the Holder in Due Course Requirements of the Federal Trade Commission. Official Comment 4 to UCC §9-404. The account debtor can enter into an agreement not to assert defenses pursuant to Com C §9404(a). For a discussion of the Federal Trade Commission Holder in Due Course rules, see §7.71.

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5

Remedies

Ellen A. Friedman
Hill Blackett, III ("Buzz")

I. INTRODUCTION
- A. Scope of Chapter §5.1
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I. INTRODUCTION

§5.1 A. Scope of Chapter

The remedies on default available to a secured creditor with a valid and enforceable security agreement are more effective than those available to an unsecured creditor. An unsecured creditor who wants to liquidate a claim against an uncooperative debtor may have to file a lawsuit, win a judgment, and ask the sheriff to levy on the debtor's property and hold a sale. Under Division 9 of the California Commercial Code, on the other hand, a secured creditor may be able to collect on or sell intangible collateral, and to repossess tangible collateral and put it up for sale, in each case without judicial action. The procedure does not always work, but when it does, it is much quicker, cheaper, and more convenient for the creditor than any alternative. This chapter examines the rights and obligations of the secured creditor, the debtor, obligors, and other third parties after the debtor's default. The rules governing these postdefault rights and obligations are set forth in Chapter 6 of Division 9 (Com C §§9601-9629).

For detailed discussions of the genesis of and policies behind the remedies provisions in Article 9 of the Uniform Commercial Code, almost all of which are applicable to Division 9 of the Commercial Code, see Rapson, *Default and Enforcement of Security Interests Under Revised Article 9*, 74 Chi-Kent L Rev 893 (1999), and Zennecker, *The Default Provisions of Revised Article 9 of the Uniform Commercial Code: Parts I and II*, 54 Bus Law 1113, 1737 (1999). For discussion of the effect of bankruptcy on secured transactions, see chap 6.

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§5.2 B. Debtors, Obligors, and Secondary Obligors

The remedies of Division 9 are available to a secured party against a debtor and the collateral. See Com C §9601(a). The term "debtor" is defined in Com C §9102(a)(28) to mean a person who has an interest, other than a security interest or lien, in the collateral. The term includes transferees of collateral if the transfer was effected subject to the security interest granted by the debtor-transferor.

An "obligor" is defined in Com C §9102(a)(59) as a person who owes payment or performance of an obligation secured by a security interest. A "secondary obligor" is defined in Com C §9102(a)(71) as an obligor whose obligation is "secondary" or who has a right or recourse against the debtor, another obligor, or property of either. In practical terms, a secondary obligor is a guarantor or other surety. Division 9 imposes various notice obligations on a secured party enforcing its security interest in favor of obligors and secondary obligors. See §5.30.

Depending on the structure of the secured transaction or transactions, a party may be a debtor *and* an obligor or secondary obligor.

EXAMPLE: Borrower borrows money from Lender, secured by all of Borrower's equipment, and Borrower's sole shareholder guarantees payment of Borrower's obligations and grants to Lender a security interest in the shareholder's brokerage account to secure the shareholder's guaranty obligations. In a foreclosure on Borrower's equipment, Borrower is the debtor and the shareholder is a secondary obligor. In a foreclosure against the shareholder's brokerage account, the shareholder is the debtor and Borrower is an obligor. See Official Comment 2a to UCC §9-102.

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II. DEFAULT

§5.3 A. Definition of Default

After default by the debtor, the secured creditor may exercise statutory remedies under Division 9 and contractual remedies under its security agreement with the debtor. Com C §9601(a). The Commercial Code intentionally does not define "default" or what would constitute a waiver by the secured creditor of any default. The drafters concluded both that it was better to let the parties define default for themselves, and that it was better for parties and courts to continue to decide whether a default has been waived. However, the Commercial Code and other provisions of law may limit the creditor's right to define default. See §§5.4-5.6.

NOTE: The need for a careful definition of default in the agreement may seem obvious, but creditors sometimes overlook it. In *Whisenhunt v Allen Parker Co.* (Ga App 1969) 168 SE2d 827, a debtor who was current on his monthly payments to the secured creditor died. The secured creditor treated the death as a default and took possession of its collateral of house trailers, vehicles, and related equipment, destroying a structure on the debtor's property in the process. The court, however, found that the debtor's death would not constitute a default unless specifically listed as such in the security agreement, and that the secured creditor had violated the debtor's rights in the collateral. See also *Boudreau v Borg-Warner Acceptance Corp*. (9th Cir 1980) 616 F2d 1077; *Lindley v Sale* (1934) 140 CA 662, 36 P2d 130.

A well-drafted security agreement contains specific language defining what constitutes a default. For an example of such a clause, see §2.32. Counsel should also be aware of, or ask the client about industry-specific problems that should give rise to a default so that they may be included in the documentation.

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B. Limits on Security Agreement Provisions Related to Default

§5.4 1. Acceleration Clause

A note and security agreement covering tangible personal property collateral often provide for installment payments. The debtor's default of a single payment does not automatically constitute default of the entire obligation. The creditor must either find some provision of law, such as the doctrine of "anticipatory repudiation" (see Com C §2610), or include an acceleration clause in the security agreement.

An acceleration clause typically allows the secured party to declare the debtor's entire obligation due immediately in case of a default. Some clauses define default in terms of the secured party's state of mind, allowing a default to be declared on the creditor's insecurity. Commercial Code §1309 limits the effect of such a clause:

> A term providing that one party or that party's successor in interest may accelerate payment or performance or require collateral or additional collateral "at will" or when the party "deems itself insecure," or words of similar import, means that the party has power to do so only if that party in good faith believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against which the power has been exercised.

Good faith is defined in Division 1 (Com C §1201(b)(20)) and in Division 7 (Com C §7102(a)(6)) as "honesty in fact and the observance of reasonable commercial standards of fair dealing."

Another limitation on acceleration clauses is presented by CC §1804.1(b), which provides that a retail installment contract may not contain any provision by which the holder may accelerate in "the absence of the buyer's default." See §7.27.

Because the creditor and debtor may define default in the contract, the meaning of CC §1804.1(b) is not obvious. Possibly the drafters were aiming at "insecurity" clauses, supposing that such clauses represented something other than a "default." But a contract that defines default in terms of the secured party's perceived insecurity has made that perception an event of default. The limitation, then, must apply only to an "at will" acceleration or, perhaps, to an act of bad faith on the secured party's part.

A similar provision applicable to automobile sale contracts, with similar problems, appears in CC §2983.3(a). See §7.43.

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§5.5 2. Due-on-Sale Clause

A typical default clause may provide that the obligation is entirely due and payable on the transfer of collateral by any means from the debtor to a third party. Superficially, there is no basis to object to such a clause. It is specific, it is objectively measurable, and there are any number of reasons why the creditor might want the obligation paid off in the event of transfer. In *Wellenkamp v Bank of America* (1978) 21 C3d 943, 148 CR 379, however, the California Supreme Court ruled that the automatic acceleration by an institutional lender is not allowed on the sale of real estate, even though the contract provides for it. The holding in *Wellenkamp* does not apply to federal savings and loan associations. *Fidelity Fed. Sav. & Loan Ass'n v de la Cuesta* (1982) 458 US 141, 73 L Ed 2d 664, 102 S Ct 3014.

In *Guild Wineries & Distilleries v Land Dynamics* (1980) 103 CA3d 966, 163 CR 348, the court expressly refused to extend this rule to personal property. Thus, the due-on-sale clause seems alive and well in personal property security law, despite *Wellenkamp*. See Com C §9401(b); Official Comment 5 to UCC §9-401.

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§5.6 3. Bankruptcy Clause

Traditionally, creditors have included clauses in their agreements providing that the filing of a bankruptcy proceeding by or against the debtor is an event of default. Such clauses are not enforceable under 11 USC §§365(e)(1) and 541(c), which provide that property passes to the trustee despite such a clause and that a right or obligation in a lease or executory contract may not be terminated or triggered based on a bankruptcy filing. In addition, 11 USC §363 authorizes the use, sale, or lease of the property despite a contractual provision or applicable law forfeiting the debtor's interest in property on bankruptcy. For further discussion of the trustee's power to use collateral, see §§6.22-6.29.

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§5.7 C. Notice of Default

If a "default" or an "event of default" exists under the security agreement and the creditor determines that the appropriate course of action is to demand immediate payment, terminate any obligation it may have to make further loans, or foreclose on some or all of the collateral, the creditor should deliver a formal notice of default.

The notice should be delivered to the debtor at the notice address specified in the security agreement (and at the debtor's current address if the creditor knows of a change). Copies should be sent to any obligor or secondary obligor. The purpose of the notice is to alert the debtor formally that the creditor has elected to take action. The notice may also include notification of the creditor's election to dispose of the collateral (see §5.30), but is often limited to notice of the existence of defaults and acceleration of the underlying debt.

The notice should be as specific and complete as possible. It should identify the security agreement and, if relevant, the other loan documents, list each section of the security agreement or relevant document that the debtor has breached, and reference the section or sections of the security agreement under which the listed breach constitutes a default. If the debtor has any right to cure a breach before it becomes a default, that right should be mentioned in the notice.

The notice should explicitly reserve all of the creditor's rights and remedies under the security agreement and other loan documents, the Commercial Code, and applicable law. Finally, it should provide the creditor's contact information in case the debtor has any questions or wishes to discuss its situation with the creditor.

PRACTICE TIP: Although the notice need not include an acceleration of the debt or demand for immediate payment, such a provision should be included if the secured creditor has decided to act, since acceleration will eliminate the debtor's ability to redeem the collateral prior to sale by tendering only the payment necessary to bring its debt current. A notice that lists multiple, material defaults may be helpful to the secured creditor attempting to demonstrate to a court the impossibility for a debtor to provide adequate protection in a suit to enjoin a foreclosure sale or a bankruptcy case.

A well-drafted notice of default, delivered to the appropriate parties and addresses, should eliminate the debtor's ability to claim it was taken by surprise and, in some cases, provide the debtor with an opportunity to work out its obligations with the creditor before a foreclosure. See §5.17.

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III. SECURED PARTY'S REMEDIES ON DEFAULT

§5.8 A. Election of Remedies

After default, a secured party has the remedies provided by Division 9 and the remedies provided by the security agreement. Com C §9601(a). As a practical matter, the secured creditor has a number of choices available when the debtor defaults:

- To take possession of, collect, and conduct one or more foreclosure dispositions of the collateral without judicial process.
- To proceed against the collateral and seek to obtain a deficiency judgment in a single proceeding or in separate proceedings.
- To ignore the security interest altogether and seek judgment against the debtor without regard to the collateral.

There are important limitations, however, on the secured party's choice of remedies. See §§5.9-5.14. Additional remedies are discussed in §§5.15-5.18. Repossession and disposition of collateral are discussed in §§5.19-5.64.

Normally, the secured creditor will proceed against the collateral. There are circumstances, however, in which the creditor may choose not to do so.

Whether or not there are limitations on the ability to proceed against the collateral, the creditor may determine that the collateral or its value has been destroyed, or that the debtor has other assets more valuable and more amenable to liquidation than the collateral subject to the security agreement. For any of those reasons, the creditor may choose to go to court and ignore the collateral.

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§5.9 1. Effect of Election on Guarantors

Before making any election of remedies, the secured creditor should consider whether there are any guarantors (secondary obligors) of the debtor's obligations, and whether the election of any remedy could exonerate a guarantor or any collateral owned by the guarantor that secures payment of the guaranty obligation. See CC §§2819, 2845. In particular, the secured creditor should review the guaranties for waivers of suretyship defenses, including defenses arising under the Civil Code.

In preparing and reviewing guaranties, it is important to note that CC §2856(d) approves the following language to effectively waive guarantor defenses relating to creditor election of remedies:

> The guarantor waives all rights and defenses arising out of an election of remedies by the creditor, even though that election of remedies, such as a nonjudicial foreclosure with respect to security for a guarantee obligation, has destroyed the guarantor's rights of subrogation and reimbursement against the principal by the operation of Section 580d of the Code of Civil Procedure or otherwise.

If the secured creditor is considering a foreclosure sale and a credit bid or a strict foreclosure (see §§5.27, 5.62-5.64), it should consider whether that strategy could result in a waiver of its claims against guarantors and other third parties. See *GN Mortgage Corp. v Fidelity Nat'l Title Ins. Co.* (1994) 21 CA4th 1802, 27 CR2d 47 (full credit bid by lender at nonjudicial foreclosure sale extinguished all of lender's claims against third parties related to underlying loan). See also *Pacific Inland Bank v Ainsworth* (1995) 41 CA4th 277, 48 CR2d 489 (full credit bid at nonjudicial foreclosure sale of real estate bars claims other than fraud claims against third party nonborrowers); *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 1241, 44 CR2d 352 (full credit bid by a lender did not bar a fraud claim against third party nonborrowers when the lender claimed that the third parties defrauded the lender into making that full credit bid).

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§5.10 2. Remedies Provided in Security Agreement

In addition to the statutory remedies, the secured creditor may use the remedies provided in the security agreement. Com C §9601(a). The parties' power to contract is not unlimited. The Commercial Code includes a number of limitations on provisions of the agreement. See, *e.g.,* Com C §9602. See also §5.4 and the discussion of waiver in §5.69. Nevertheless, the rule of Com C §9601(a) does serve as a helpful reminder to counsel to provide precise, careful, and thoughtful drafting. At the very least, counsel should think through the possibilities in advance and provide possible protections.

EXAMPLE: Counsel for the secured creditor should consider whether the creditor has the ability, in a foreclosure, to transfer title to a purchaser. In *Resolution Trust Corp. v Winslow* (1992) 9 CA4th 1799, 12 CR2d 510, the debtor had pledged stock as security, but the agreement did not mention any obligation to convey the stock to the creditor. The court held that a secured creditor could not use specific performance to enforce its security interest in stock pledged by the debtor, because the agreement did not provide for conveyance. To address such problems, creditors receiving a pledge and actual possession of certificated securities should also require the debtor to deliver a separate "blank" stock power, executed by the debtor, but undated and with a blank for the name of the transferee. If the creditor later forecloses on the securities, it can add the name of the purchaser and fill in the date of the transfer.

This problem may also arise in connection with foreclosure on intellectual property. As discussed in §§6.46-6.50, the anti-assignment provisions of an intellectual property license may prevent a foreclosing secured creditor from assigning the license to a third person without the licensor's consent.

In general, Com C §9609(c) allows a secured creditor to require the debtor to assemble and deliver the collateral after default, if the security agreement so provides; accordingly, every security agreement should include an assembly and delivery covenant to confirm that the debtor is required to assemble and deliver the collateral to the secured creditor in the event of default. See §2.33. However, secured creditors often discover that a debtor in default, already faced with probable loss of its collateral, is not eager to assist the secured creditor in its efforts to foreclose.

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§5.11 3. Mixed Collateral, One-Action Rule, and Antideficiency Rules

If the creditor has a security interest in both personal property and real property for the same obligation, the remedies on default may involve both real and personal property law. In general, a secured creditor may not obtain a deficiency judgment after a nonjudicial sale of real property security. CCP §580d. Similarly, a deficiency judgment may not be available on a purchase money security interest in real property if the real property is a dwelling for no more than four families, occupied in whole or in part by the purchaser. CCP §580b. The same rule applies when the debtor grants a purchase money security interest in real property and personal property together. CCP §580b.

NOTE: Section 580b refers to the personal property security interest as "a chattel mortgage," a pre-Code anachronism that has never been brought up to date. A court would probably read the language broadly enough to cover any kind of Division 9 security interest. See Com C §9109(a).

Another risk to the secured party is the loss of a deficiency judgment by violation of the "one-action" or "one form of action" rule governing real property security. See CCP §726. The rule was applied to mixed collateral in *Walker v Community Bank* (1974) 10 C3d 729, 111 CR 897.

In response to *Walker* and the antideficiency statutes described above, California has adopted a detailed, nonuniform version of Com C §9604 to address foreclosure of mixed real and personal property collateral. See §5.12. For discussion of rights of creditors secured by fixtures alone, see §5.13.

For further discussion of the one-action and antideficiency rules, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 4-5 (4th ed Cal CEB 2009). Security agreements covering mixed real and personal property collateral are also discussed in California Real Estate Finance Practice: Strategies and Forms, chap 7 (Cal CEB 2000).

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§5.12 a. Rights of Creditor Secured by Mixed Collateral

Commercial Code §9604 allows the secured party to proceed, in any sequence, as follows:

- Against the real property security under real property procedures and against the personal property or fixtures security under Division 9. Com C §9604(a)(1)(A).
- Against some or all of the real property security and some or all of the personal property or fixtures security, by including the selected personal property or fixtures in the judicial or nonjudicial foreclosure against the real property security. The secured party's choice of property becomes final only after the selected property is sold at a "unified sale." Com C §9604(a)(1)(B).
- By dividing the personal property and fixtures security and using each of the above procedures for some of the collateral. Com C §9604(a)(1)(C).

NOTE: Even the secured party's realization of proceeds from personal property or fixtures will not cure a nonmonetary default. Com C §9604(a)(4)(A). For example, if the debtor willfully injures the collateral, the creditors may be able to terminate the agreement although compensated for the damage. Nor will the secured party's rights against remaining personal property or fixture collateral be affected by the disposition of the collateral, or the realization or application of proceeds from its disposition, although the application of those proceeds will reduce the amount of an unsatisfied monetary default. Com C §9604(a)(4)(B).

If the secured party uses the Division 9 personal property default remedies and procedures, as provided in Com C §9604(a)(1)(A), the limitations on real property security transactions and remedies such as the one-action rule of CCP §726 and the prohibitions against deficiency judgments generally do not apply to the personal property or fixtures. Com C §9604(a)(2). Certain exceptions are provided in Com C §9604(a)(3):

- No deficiency judgment is allowed if barred by CCP §580b or §580d. Com C §9604(a)(3)(A), (a)(3)(D). See §5.11.
- The one-action rule of CCP §726 bars later enforcement of an encumbrance on real property if the secured party obtains a money judgment against the debtor in a judicial action against the personal property or fixtures only. Com C §9604(a)(3)(B).
- Personal, family, and household credit transactions remain subject to all pertinent debtor protections. Com C §9604(a)(3)(E). See §§5.4, 5.8; chap 7.
- The right to reinstatement after default continues to be required for nonjudicial sales of real property (although not for personal property and fixtures) under CC §2924c. Com C §9604(a)(3)(C).

For a detailed discussion of Com C §9604 and the one-action rule see *Kearns v Transamerica Home Loan (In re Kearns)* (BAP 9th Cir 2004) 314 BR 819.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.13 b. Rights of Creditor Secured by Fixtures Alone

§5.13 b. Rights of Creditor Secured by Fixtures Alone

In general, the rights of a creditor secured by fixtures alone are the same as those of any other personal property secured creditor. There is, for example, no antideficiency rule for fixtures. See CCP §730.5. There are, however, a few special rules governing damage to the real property to which the fixture collateral is attached. Specifically, unless otherwise agreed, the secured party must pay the owner or an encumbrancer (other than the debtor) for physical damage caused by removal of the fixture and may be required to give security for the cost of damage. See CC §1013.5.

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§5.14 4. Accessions

Accessions are goods that are installed in or affixed to other goods in such a way that the identity of the original goods is not lost. Com C §9102(a)(1). The creditor with a priority claim in accessions (see §4.41) may, after the debtor's default, remove the collateral from the goods to which the accessions are attached. Com C §9335(e). The secured party must reimburse any creditor with a security interest in the other goods and any prior owner other than the debtor for the cost of repair or physical injury to the other goods. Com C §9335(f). The secured party need not reimburse for any diminution of value of the whole caused by the absence of the goods removed or by the necessity for replacing them. A person entitled to reimbursement may refuse permission to remove until the secured party gives adequate security for the performance of this obligation. Com C §9335(f).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.15 B. Prejudgment Attachment

§5.15 B. Prejudgment Attachment

An unsecured creditor generally may invoke prejudgment attachment of the debtor's assets under CCP §§481.010-493.060. See CCP §483.010(a). A secured creditor, however, may use attachment only when, without any act of the secured party (or plaintiff), the collateral has become valueless or has decreased in value to less than the amount then owing on the claim. CCP §483.010(b).

In the case of a decrease in value, the amount of the attachment writ cannot exceed the lesser of the following (CCP §483.010(b)):

- The amount of the decrease; or
- The difference between the value of the security and the amount owing on the claim.

The creditor must also meet the other requirements of the attachment statute, and is subject to its limitations. For example, attachment is not available if the obligation was for personal, family, or household purposes. See CCP §483.010(c).

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§5.16 C. Claim and Delivery

The creditor who needs the court's help to repossess the collateral must obtain a writ of possession under the claim and delivery law. CCP §§511.010-516.050. Claim and delivery is an action to recover possession of personal property before judgment. Claim and delivery usually requires notice and a hearing, which add both delay and expense to the secured party's burden. See Debt Collection Practice in California, chap 6 (2d ed Cal CEB 1999).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.16A D. Charging Orders

§5.16A D. Charging Orders

Under the Corporations Code, judgment creditors of debtors whose assets include member interests in limited liability companies or limited partner interests in limited partnerships may obtain judicial charging orders against those member and limited partner interests. Corp Code §§15522, 15673, 15907.03, 17302. Charging orders create liens against those interests and enable the judgment creditors to foreclose judicially against those interests. Corp Code §§15522, 15673, 15907.03, 17302. Because Com C §9601(a)(1) permits a secured creditor to "reduce a claim to judgment, foreclose, or otherwise enforce the claim [or] security interest…by any available judicial procedure," and makes such judicial remedies cumulative with foreclosure and other remedies under Division 9 (Com C §9601(c)), a secured creditor may wish to consider obtaining judgments and charging orders to facilitate its foreclosure on a debtor's member and limited partner interests. The secured creditor should assess the cost and time necessary to obtain these judicial remedies and should also consider collateral issues, including the possibility of other judgment liens against the collateral that might be junior to the secured creditor's security interest but senior to any judgment lien the secured creditor could obtain.

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§5.17 E. Informal Workout

Aside from the formal remedies described in §§5.8-5.16, the secured creditor may try to work out a compromise with the debtor in default. The secured creditor may find it practically and financially advantageous to compromise instead of asserting legal rights. Frequently the creditor is more likely to get paid through a workout than through strict insistence on rights under the law. In addition, the creditor will avoid the expense and potential liability of repossession and sale. The debtor may urge that more time will result in payment. It may make more economic sense for the secured creditor to accept that premise than to deny it.

PRACTICE TIP: The secured creditor may respond by insisting on additional credit support, such as a guaranty, or additional security, such as a deed of trust on the debtor's or secondary obligor's house. The creditor may lose the additional security if the debtor goes into bankruptcy and the transfer is avoided as a preference. See §§6.78-6.83. Ordinarily, however, the creditor must merely return the additional collateral and is no worse off than before taking it. A letter of credit may also provide the secured creditor with additional credit support. If the borrower or guarantor is financially troubled, however, a letter of credit may be difficult to obtain.

Bankruptcy poses special concerns and risks for a secured creditor. Although protected in a bankruptcy proceeding by the interest in collateral, the secured creditor may be left with nothing but a discharged claim for a deficiency. With the appointment of a bankruptcy trustee, the secured creditor has acquired a new adversary, who may try to invalidate the secured claim. In a bankruptcy case, the creditor may find collection delayed or the claim reduced. For a discussion of bankruptcy and its effect on secured creditors, see chap 6.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.18 F. Collection of Accounts

§5.18 F. Collection of Accounts

In addition to the formal public or private sales of collateral, Com C §9607(a)(3) permits a secured creditor to collect accounts and general intangibles from account debtors of its debtor, without a formal notice to the debtor as required for a formal foreclosure sale. However, actions by a secured creditor to collect or enforce claims against account debtors or other persons with obligations to the debtor must be commercially reasonable. Com C §9607(c).

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IV. REPOSSESSION

§5.19 A. Secured Creditor's Right to Repossession

The secured creditor who exercises rights on default under Division 9 often begins with Com C §9609(a), which provides that the secured creditor may, after default, (1) take possession of the collateral, or (2) without taking possession, render equipment collateral unusable and dispose of collateral on the debtor's premises (§5.24).

These steps may be taken either by judicial process or without judicial process, if the steps are achievable without a breach of the peace. Com C §9609(b). See §5.21. In addition, the secured creditor may, after default, if the security agreement so provides, require the debtor to assemble the collateral and deliver to the place requested by the secured creditor that is reasonably convenient to both parties. Com C §9609(c). See §5.23.

Section 9609 gives the secured creditor the right to repossess—a right not enjoyed by a general creditor, not even a creditor who seeks payment of the price of goods sold. Only if the security agreement expressly excludes the right is the secured creditor barred from repossession. Agreements excluding the right to repossess are rare because of the superior bargaining position of the typical secured party.

In the consumer context, the Unruh Retail Installment Sales Act (Unruh Act) (CC §§1801-1812.12), governing consumer sales, and the Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.5) impose important limitations on the secured creditor's right to repossession. The Unruh Act specifically prohibits any contract clause permitting the creditor "to enter upon the buyer's premises unlawfully." CC §1804.1(d). See §7.27. See also Debt Collection Practice in California §4.6 (2d ed Cal CEB 1999).

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§5.20 B. Constitutionality of Repossession

The constitutionality of repossession has been questioned but never successfully challenged. The due process requirements of the Fourteenth Amendment do not apply, because repossession is not state action. *Adams v Southern Cal. First Nat'l Bank* (9th Cir 1973) 492 F2d 324; *Kipp v Cozens* (1974) 40 CA3d 709, 115 CR 423.

Although the U.S. Supreme Court has never decided the question of repossession under Article 9 directly, the Court held in *Flagg Bros., Inc. v Brooks* (1978) 436 US 149, 56 L Ed 2d 185, 98 S Ct 1729, that a private sale to enforce a warehouseman's lien under the New York version of UCC §7-210 was not state action.

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§5.21 C. Breach of Peace

The secured creditor may repossess by private action only if the repossession is possible without breach of the peace. Com C §9609(b)(2). The right to immediate possession by a secured party must be effectuated through judicial action rather than self-help if force or threats of force are necessary to secure possession of the collateral without judicial intervention. See *Hartford Fin. Corp. v Burns* (1979) 96 CA3d 591, 600, 158 CR 169. One court has set forth a five-part test to determine if a secured party has breached the peace: (i) the location of the repossession; (ii) whether the debtor consents (expressly or impliedly); (iii) the reaction of third parties; (iv) the type of premises entered; and (v) the secured party's use of deception. *Giles v First Virginia Credit Servs., Inc.* (NC App 2002) 560 SE2d 557, 46 UCC Rep Serv 2d 913. Even color of authority may be insufficient to turn an unlawful entry into a lawful one. In *Stone Mach. Co. v Kessler* (Wash App 1970) 463 P2d 651, the court held that there was a breach of the peace when a debtor yielded possession of collateral to an armed sheriff only because he thought he was required to do so as a matter of law, although in fact the sheriff had no lawful authority to act as he did.

PRACTICE TIP: Counsel should advise debtors that violence is unnecessary to protect their rights. The debtor should quietly and firmly state to the secured creditor attempting repossession that the property may not be taken. The debtor may also stand between the property and the creditor. Debtors should also be advised to offer no resistance when repossession is attempted under a court order.

The practical consequence of this rule is that the secured creditor may be able to repossess if the collateral, such as an automobile, is unattended in a public place. But the creditor may not break into a private place or retake the collateral if any party in interest objects. See *Boudreau v Borg-Warner Acceptance Corp*. (9th Cir 1980) 616 F2d 1077. The secured creditor's duty not to breach the peace may not be avoided by delegation; the creditor remains liable for the actions of any independent contractor who carries out the repossession. *Clark v Associates Commercial Corp.* (D Kan 1994) 877 F Supp 1439 (breach of the peace can result in creditor liability for punitive damages); *Merrell v Consumer Portfolio Serv., Inc.* (WD Mo, Feb. 14, 2007, No. 05-0735-CV-W-ODS) 2007 US Dist Lexis 14518, 2007 WL 530784 (secured creditor responsible for agent's breach of peace but not for agent's common law torts such as trespass); *Klingbiel v Commercial Credit Corp.* (10th Cir 1971) 439 F2d 1303.

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§5.22 D. Debtor's Wrongful Retention

The debtor's retention of collateral after default may be wrongful and give rise to liability. In *Hartford Fin. Corp. v Burns* (1979) 96 CA3d 591, 158 CR 169, a secured party's right to possession on default created a cause of action for conversion against a person who refused to let the secured party take possession of collateral. The defendant was not the debtor, but the court's reasoning supports a similar cause of action against the debtor on appropriate facts.

A bailee in possession of the collateral has a duty to investigate a secured party's claim to the right of possession of the collateral. The court in *Messerall v Fulwider* (1988) 199 CA3d 1324, 245 CR 548, held that a secured creditor has a cause of action for conversion when a bailee wrongfully withholds personal property collateral.

In addition to tort or contract liability, a debtor who impedes the creditor's efforts to realize on collateral may violate criminal law. See Pen C §§504a-504b, 538. In *People v Richerson* (1985) 169 CA3d 1006, 215 CR 706, the court rejected the argument that Pen C §538, which prohibits the sale of personal property subject to a security interest, is unconstitutionally vague. It is unlikely, however, that a prosecutor would be willing to prosecute except in extreme cases.

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§5.23 E. Assembling the Collateral

The security agreement may provide the secured creditor with the right to require the debtor to assemble the collateral where the secured party designates. Com C §9609(c). The right is not often used, but it may be useful in some cases.

EXAMPLE: In *Clark Equip. Co. v Armstrong Equip. Co.* (5th Cir 1970) 431 F2d 54, the collateral was heavy road-building equipment spread out over five states. Because a clause in the security agreement required the debtor to assemble the collateral on the secured party's request, the court ordered issuance of a mandatory injunction under Fed R Civ P 64, requiring the debtor to assemble the collateral so the creditor could sell it on foreclosure.

A creditor who tries to compel the debtor to assemble collateral will almost certainly have to provide the debtor some sort of due-process notice and opportunity to be heard. The secured creditor may find claim and delivery helpful. See §5.16.

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§5.24 F. Secured Party's Right to Render Collateral Unusable and Dispose of Collateral on Debtor's Premises

After default, the secured creditor may render equipment (*i.e.,* collateral) unusable, without removing it from the debtor's possession. The creditor also may dispose of collateral on the debtor's premises. Com C §§9609(a)(2), 9610.

The right to enter the debtor's premises is restricted by the prohibition against breach of the peace. Com C §9609(b). See §5.21. Even if the security agreement provides for entry onto the premises, the effectiveness of this provision may be limited. See *Civic W. Corp. v Zila Indus., Inc*. (1977) 66 CA3d 1, 16, 135 CR 915 (ejecting employees and changing locks may have exceeded scope of consent).

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V. AFTER REPOSSESSION

§5.25 A. Secured Creditor's Rights on Repossession

After default and repossession, if the debtor neither reinstates nor redeems, the creditor may, under some circumstances, accept the collateral in discharge of the obligation. Com C §9620. See §§5.62-5.64.

Otherwise, the secured creditor may dispose of the collateral. Com C §9610. See §§5.26-5.51. After disposition, the secured creditor must account to the debtor for any surplus or may sue the debtor for any deficiency. Com C §9615. See §§5.52-5.61.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.26 B. Disposition of Collateral

§5.26 B. Disposition of Collateral

The secured creditor may sell, lease, license, or otherwise dispose of collateral. Com C §9610(a). A secured creditor that disposes of any collateral "shall account to and pay a debtor for any surplus," and an obligor "is liable for any deficiency." Com C §9615(d)(1)-(2). See §5.58. For this reason, the debtor benefits if the creditor gets the maximum return on resale of the collateral. The Commercial Code attempts to ensure the maximum return in three ways.

- Rules distinguish public and private sales and impose limitations on the time, place, and conditions of sale. Com C §9610. See §§5.27-5.29.
- Rules provide for notice to the debtor, any secondary obligor, and other secured parties. Com C §§9611, 9613. See §§5.30-5.41.
- The secured party must act in good faith and in a commercially reasonable manner. Com C §9610. See §§5.42-5.49.

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§5.27 1. Public or Private Dispositions

Whether to conduct a public or private sale under Com C §9610 will to some extent be a function of what is commercially reasonable, based on the facts of the case. The Uniform Commercial Code "encourages private dispositions on the assumption that they frequently will result in higher realization on collateral for the benefit of all concerned." Official Comment 2 to UCC §9-610.

The distinction between a public and private sale continues to be less than clear. Neither term is defined in the Code, although Official Comment 7 to UCC §9-610 provides some guidance:

> [A]s used in this Article, a "public disposition" is one at which the price is determined after the public has had a meaningful opportunity for competitive bidding. "Meaningful opportunity" is meant to imply that some form of advertisement or public notice must precede the sale (or other disposition) and that the public must have access to the sale (disposition).

See also *Bank of America v Lallana* (1998) 19 C4th 203, 77 CR2d 910.

An auction is usually, but not necessarily, a public disposition. Repossessed automobiles are frequently sold at dealer auctions that are closed to the public and may therefore not qualify as public sales. Even if a dealer auction is not a public sale, it may qualify as a commercially reasonable sale. See §§5.42-5.49.

Limitations on rights of secured creditors in private sales and place of sale are discussed in §§5.28-5.29.

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§5.28 a. Limitations on Private Sale

Under CCP §726, a creditor who wishes to preserve the right to a deficiency judgment on a debt secured by real property must proceed by judicial foreclosure, including public sale, but the Commercial Code provides different treatment for personal property. In general, the creditor will have a right to a deficiency judgment after public or private sale. See Com C §9615(d)(2).

A critical distinction between public sales and private sales is in the secured party's right to buy collateral at the sale. If the sale is public, the secured party may buy the collateral, usually by credit bidding all or a portion of its claim. Com C §9610(c)(1). If the sale is private, the secured party may buy only "if the collateral is of a kind customarily sold on a recognized market or the subject of widely distributed standard price quotations." Com C §9610(c)(2); *Barber v LeRoy* (1974) 40 CA3d 336, 115 CR 272 (sale disapproved).

It is unclear whether a nonpublic automobile auction would qualify as a recognized market or whether the dealer's price book (*e.g.,* the Blue Book) would qualify as a standard price quotation. Cases from other jurisdictions, however, seem to suggest that they would not qualify. See, *e.g., Nelson v Monarch Inv. Plan* (Ky App 1970) 452 SW2d 375; *Cheshire v Walt Bennett Ford, Inc.* (Ark App 1990) 788 SW2d 490.

In *Aspen Enters. v Bodge* (1995) 37 CA4th 1811, 44 CR2d 763, the court held that a stock of new tires was enough of a commodity item "customarily sold on a recognized market" to justify the repossession of the tires in exchange for a credit against the debtor's account.

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§5.29 b. Place of Sale

Commercial Code §9610 does not specify the place of any public or private foreclosure sale, other than to require that it be commercially reasonable.

Accordingly, the creditor must select a location suited to achieve a fair sales price. Selection of a location likely to reduce attendance at the sale may not be commercially reasonable (see §5.42) and, if blatant enough, may indicate a lack of good faith.

The place of sale must be the one stated in the notice of sale. In *C.I.T. Corp. v Anwright Corp.* (1987) 191 CA3d 1420, 237 CR 108, the court found the creditor had failed to comply with the predecessor to Com C §9610(b) by holding the public sale of the debtor's property at a location other than that specified in its notice of sale. Even though the location was not far from the one specified, the court held that substantial compliance was not enough to meet the notice requirement. See §5.30.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.30 2. Notice of Disposition

§5.30 2. Notice of Disposition

Under Com C §9611(b), (d), the secured creditor must give notice of the prospective disposition of collateral, unless:

- The collateral is perishable;
- The collateral threatens to decline speedily in value; or
- The collateral is a type customarily sold on a recognized market.

Application of the notice requirement is discussed in §5.31. The required contents of the notice are discussed in §5.32. A safe harbor form of notice is provided in §5.33. Persons entitled to notice are discussed in §§5.34-5.38. Time of notice is discussed in §5.39. The "two-try" rule is discussed in §5.40. The effect of failure to provide notice is discussed in §5.41.

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§5.31 a. Application of Notice Requirement

In some cases, the notice requirements of Division 9 are not applicable to a sale of collateral. In *Security Pac. Nat'l Bank v Geernaert* (1988) 199 CA3d 1425, 245 CR 712, the court held that when collateral was sold by a court-appointed receiver, the secured party was not required to notify the debtor of the sale, because the sale of collateral by the court-appointed receiver fell outside the ambit of Division 9. However, compliance with one notification regime does not excuse compliance with the notification requirements of Division 9, if also applicable. *Bank of America v Lallana* (1998) 19 C4th 203, 77 CR2d 910 (secured creditor foreclosing on motor vehicle under Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.5) must also comply with notification provisions of Division 9); *Hollander v California Mfg. Enters.* (1996) 44 CA4th 561, 51 CR2d 694 (landlord giving required 18 days' notice for sale of tenant's personal property under Civil Code not excused from notice provisions under Division 9).

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§5.32 b. Contents of Notice

Commercial Code §9613(1) prescribes the contents of a notice of sale in a non-consumer-goods transaction. A notice is sufficient if it does all of the following:

- Describes the debtor and secured party.
- Describes the collateral that is the subject of the intended disposition.
- States "the method of intended disposition" (*i.e.*, public or private).
- States that the debtor is entitled to an accounting of the unpaid indebtedness and states the charge, if any, for an accounting.
- States the time and place of a public sale or the time after which any other disposition is to be made.

Section 9613(2)-(4) makes clear that neither the inclusion of additional information nor minor errors that are not seriously misleading will render the notice insufficient.

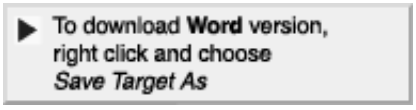
Section 9613(5) includes a safe harbor form of notice that provides sufficient information, which the careful secured creditor should almost always use as its model, with alternative provisions for public and private dispositions. See §5.33.

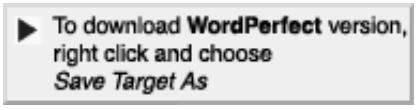
NOTE: Commercial Code §9614 similarly sets forth the required contents of a notice of sale in a consumer-goods transaction (which are somewhat more detailed), and provides a safe harbor form of notice for such foreclosures. See §§7.12-7.13.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.33 c. Form: Form of Notice

§5.33 c. Form: Form of Notice





NOTIFICATION OF DISPOSITION OF COLLATERAL

To: _ _[*Name of debtor, obligor, or other person to which the notification is sent*]_ _

From: _ _[*Name, address, and telephone number of secured party*]_ _

Name of Debtor(s): _ _[*Include only if debtor(s) are not an addressee*]_ _

[*For a public disposition*]

We will sell _ _[*or lease or license, as applicable*]_ _ **the** _ _[*describe collateral*] [*to the highest qualified bidder*]_ _ **in public as follows:**

Day and Date: _ _[*date*]_ _

Time: _ _[*time*]_ _

Place: _ _[*place*]_ _

[*For a private disposition*]

We will sell _ _[*or lease or license, as applicable*]_ _ **the** _ _[*describe collateral*]_ _ **privately sometime after** _ _[*day and date*]_ _**.**

You are entitled to an accounting of the unpaid indebtedness secured by the property that we intend to sell _ _[*or lease or license, as applicable*]_ _ _ _[*for a charge of $*_ _[*amount*]_ _]_ _**. You may request an accounting by calling us at** _ _[*telephone number*]_ _**.**

Comment: This form of notice is provided by Com C §9613(5). See §5.32.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.34 d. Persons Entitled to Notice

§5.34 d. Persons Entitled to Notice

Commercial Code §9611(c) provides detailed information on the persons to whom the secured creditor must send notice of disposition of collateral. The notice must be sent to the debtor, any secondary obligor, and, in non-consumer-goods transactions:

- Persons who have previously delivered to the secured creditor a signed statement claiming an interest in the collateral (for a form of statement, see §5.38);
- Persons who, 10 days before the notification date, hold a security interest perfected by a filed financing statement that identifies the relevant collateral, is filed in the proper filing office (usually the office of the secretary of state), and is properly indexed under the debtor's name, and
- Persons who, 10 days before the notification date, hold a security interest perfected by compliance with other applicable federal or state registration or filing requirements (such as aircraft or automobile registration rules).

PRACTICE TIP: A secured party who learns about a third party interested in the collateral should also give notice to the third party, although this is not required by Com C §9611. Giving notice is evidence of good faith and commercial reasonableness, especially because a third party who wants to buy the collateral may offer the best chance for a reasonable price.

A secured creditor may satisfy its obligations to notify other secured parties perfected by the filing of financing statements by conducting an official search of the relevant filing office between 20 and 30 days before the notification date, and delivering the notice to all secured parties revealed in that search. Com C §9611(e).

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§5.35 (1) Waiver of Notice by Debtor or Secondary Obligor

The debtor or secondary obligor may waive its right to notice of disposition of collateral "only by an agreement to that effect entered into and authenticated after default." Com C §9624(a).

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§5.36 (2) Notice to Guarantor

In *Alcock v Small Bus. Admin. (In re Alcock)* (BAP 9th Cir 1993) 157 BR 23, rev'd on other grounds (9th Cir 1995) 50 F3d 1456, the court held that the guarantors of a secured obligation were not entitled to formal notice of sale of the collateral under Division 9 when the debtor, rather than the secured party, was selling the collateral and the guarantor had constructive notice of the sale.

The same estoppel principle was applied in *Earl of Loveless, Inc. v Gabele* (1991) 2 CA4th 27, 2 CR2d 829, when the guarantor helped the secured creditors dispose of the collateral and then tried to defend against their claim for a deficiency by arguing that he did not have formal notice of the disposition. In *Cerritos Valley Bank v Stirling* (2000) 81 CA4th 1108, 97 CR2d 432, however, the court held that the guarantor was not estopped by postdefault correspondence between the guarantor's attorney and the secured creditor. For an estoppel to occur, the secured creditor would have had to show that the guarantor had induced the secured creditor in writing not to give notice, yet the correspondence showed no such inducement.

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§5.37 (3) Notice to Levying Creditor

If the secured creditor has received a notice of levy on its collateral under a writ of execution for a third party creditor, the secured creditor should also give notice of sale to the levying creditor. See *Oliver v Bledsoe* (1992) 5 CA4th 998, 7 CR2d 382, in which the secured creditor was required to provide notice of its intent to retain the collateral in satisfaction of its debt under the predecessor of Com C §9620. Because it failed to provide that notice, the secured creditor's foreclosure did not extinguish the levying creditor's lien.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.38 (4) Form: Third Party's Request for Notice of Sale

§5.38 (4) Form: Third Party's Request for Notice of Sale

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

5.38-1 Request for notice of sale

_ _[*Date*]_ _

_ _[*Secured party's name and address*]_ _

Re: _ _[*Debtor's name*]_ _**, Debtor**

Financing Statement No. _ _[*number*]_ _

Filing Date: _ _[*date*]_ _

Please send written notice of any private sale, public sale, or other disposition of the collateral covered by the Financing Statement referred to above to:

[*Insert name and address*]

The undersigned has a security interest in the collateral under a security agreement executed by Debtor, dated _ _[*date*]_ _**.**

_ _[*Signature of requester*]_ _
_ _[*Typed name*]_ _

Copies: Original to secured party; copy for client; file copy.

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§5.39 e. Time of Notice

Under Com C §§9610(b) and 9612(a), the notification must be sent within a reasonable time of the disposition. Whether a notification was sent within a reasonable time is a question of fact; however, a notification sent after default and 10 days or more before the disposition is conclusively presumed to be sent within a reasonable time. Com C §9612(b).

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§5.40 f. "Two-Try" Rule

The "two-try" rule requires the creditor to make a second attempt to notify the debtor if the first fails and the creditor has any information on which to base the second attempt. In *Wells Fargo Bank v Carter (In re Carter)* (9th Cir 1975) 511 F2d 1203, the creditor sent a notice to the debtor by certified mail. An officer of the creditor knew of the debtor's whereabouts, but made no further attempt to contact him. The court held that the notice requirement had not been satisfied.

NOTE: The extent of any "second try" notification obligation of the secured creditor under Com C §9611 continues to be left to the courts. Official Comment 6 to UCC §9-611.

California courts are not likely to be sympathetic to secured creditors who do not take reasonable steps to deliver the notice to the debtor or other person's known address. See *Estate of Yates* (1994) 25 CA4th 511, 32 CR2d 53 (real property foreclosure notice sent to deceased trustor's address, rather than to known administrator of his probate estate, was insufficient).

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§5.41 g. Effect of Failure to Provide Notice

Failure to comply with notice requirements can cost secured parties remedies otherwise available to them. See, *e.g., Ford Motor Credit Co. v Price* (1985) 163 CA3d 745, 210 CR 17; *General Elec. Credit Corp. v Bo-Mar Constr. Co*. (1977) 72 CA3d 887, 140 CR 417; *Atlas Thrift Co. v Horan* (1972) 27 CA3d 999, 104 CR 315; *Nixdorf Computer, Inc. v Jet Forwarding, Inc.* (9th Cir 1978) 579 F2d 1175. The safest course for the creditor is to give notice early, often, and in strict compliance with the Commercial Code's requirements, because the courts have not forgiven defects in notice. In *J.T. Jenkins Co. v Kennedy* (1975) 45 CA3d 474, 119 CR 578, the notice stated that the collateral would be sold at the end of seven days from the date of the letter, and that the collateral could be inspected at the creditor's premises. The letter failed to specify the exact date, time, or place of the prospective sale. The court held that the notice did not comply with former Division 9. In *Clark Equip. Co. v Mastelotto, Inc*. (1978) 87 CA3d 88, 150 CR 797, however, a technical error that could not have misled anyone or affected the sale of the collateral at auction did not invalidate the notice of sale.

PRACTICE TIP: Using the safe harbor notice provided in Com C §9613(5) will help avoid these issues. See §5.33.

In general, courts will not validate a disposition of perishable collateral without the required notice if the secured creditor has delayed enforcement after default until the prescribed notice could not be given. See, *e.g.*, *Backes v Village Corner, Inc.* (1987) 197 CA3d 209, 242 CR 716; *Hollander v California Mfg. Enters.* (1996) 44 CA4th 561, 51 CR2d 694.

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§5.42 3. Commercial Reasonableness of Disposition

Commercial Code §9610(b) provides a broad requirement of commercial reasonableness for disposition of collateral:

> Every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable. If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and place and on any terms.

As Com C §9610(b) indicates and case law has confirmed, the requirement that any disposition of collateral be commercially reasonable is a fluid, open-ended concept that requires a thoughtful approach by the secured creditor. The standard embodies a balancing of the competing interest of the debtor to get full value of its assets and of the debtor's other creditors to realize any equity in those assets, against the interest of the secured party to realize on a timely and economical basis the benefit of its bargain if the debtor defaults.

In general, the creditor must act responsibly to try to get the best value or highest recovery without expending an unreasonable amount of time or resources. In many situations, the burden is self-enforced, because the secured creditor needs to realize full value (or more) to obtain full payment.

The secured creditor should consult with knowledgeable debtors or secondary obligors regarding any anticipated disposition, and the identity of potentially interested purchasers. See *Ralston-Purina Co. v Bertie* (9th Cir 1976) 541 F2d 1363. However, a secured creditor is not obligated to overcome obstacles to a sale created by the debtor. See *Kennedy v Fournie* (Mo App 1995) 898 SW2d 672.

The relationship of price to reasonableness is discussed in §§5.43-5.45. Other tests of reasonableness are discussed in §5.46. Issues involving advertising, preparation of collateral, and credit sale of collateral are discussed in §§5.47-5.49.

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§5.43 a. Relationship of Price to Reasonableness

Commercial Code §9627(a) addresses the relationship of price paid or amount collected to commercial reasonableness under Com C §9610(b):

> The fact that a greater amount could have been obtained by a collection, enforcement, disposition, or acceptance at a different time or in a different method from that selected by the secured party is not of itself sufficient to preclude the secured party from establishing that the collection, enforcement, disposition, or acceptance was made in a commercially reasonable manner.

The fact that a creditor could have received a better price at an earlier time does not make the sale commercially unreasonable. Uniform Commercial Code §9-610 "does not address *whether* a lender should dispose of its collateral, but rather once the decision has been made, *how* it should occur." *Layne v Bank One Ky., N.A.* (6th Cir 2005) 395 F3d 271, 280. Relying on Kentucky law, the Sixth Circuit held that the sale by Bank One of stock on NASDAQ, a nationally recognized exchange, was commercially reasonable, despite the fact that a better price could have been obtained if a sale had been made earlier. See §5.46 for a discussion of sales in nationally recognized markets.

The creditor does not have to get the best price, but it does not mean that any price is reasonable. See *California Airmotive Corp. v Jones* (6th Cir 1969) 415 F2d 554. See generally *Clark Equip. Co. v Mastelotto, Inc*. (1978) 87 CA3d 88, 96, 150 CR 797 (equipment worth $75,000 resold for $49,500; sale held commercially reasonable on review of all facts).

NOTE: Under Com C §9615(f), if a disposition is to the secured party, a person related to the secured party, or a secondary obligor, and the proceeds of the disposition are "significantly below the range of proceeds that a complying disposition to [an unrelated, non-guarantor person] would have brought," the amount of any deficiency claim is based on what a sale to an unrelated, non-guarantor person would have yielded. See §5.61.

If a secured party receives a lower price, this does not necessarily mean that the secured party has not complied with Division 9. See *Whitney Nat'l Bank v Air Ambulance by B&C Flight Mgmt.* (SD Tex 2007) 516 F Supp 2d 802 (creditor not obligated to enhance value of collateral airplanes by bringing them into FAA compliance for sale to be commercially reasonable); *Lister v Lee Swofford Invs., LLP* (Tex App 2006) 195 SW 3d 746 (sale of tractor parts commercially reasonable despite low price because foreclosure sale was heavily advertised and well-attended). However, if the proceeds received at the sale are very low, then the price may signal the need for greater judicial scrutiny. See Official Comment 6 to UCC §9-615; Official Comment 10 to UCC §9-610; 195 SW3d at 748.

As a practical matter, the lower the sales price, the greater the scrutiny of the sale and the more the creditor must show to justify the sale. In *Credit Bureau Metro, Inc. v Mims* (1975) 45 CA3d Supp 12, 119 CR 622, the court held that when a car sold for less than 50 percent of wholesale book value, with no explanation of the discrepancy, the sale was commercially unreasonable as a matter of law. See also *Barber v LeRoy* (1974) 40 CA3d 336, 115 CR 272.

On the other hand, one court found that an accounts collection program that yielded less than 10 percent of the face amount of accounts was commercially reasonable, on evidence showing that the creditor was doing the best it could, and that the value of the accounts was overstated on the debtor's books. *Western Decor & Furnishings Indus., Inc. v Bank of America* (1979) 91 CA3d 293, 154 CR 287.

Perhaps the most extreme disparity to win judicial approval is the sale for $500 of collateral with an alleged fair market value of $27,616, in *Sierra Fin. Corp. v Brooks-Farrer Co*. (1971) 15 CA3d 698, 93 CR 422. In that case, however, the property was in the hands of a competing creditor who refused to permit prospective buyers to determine its exact quantity or condition. Moreover, the court noted that the debtor was no longer in business, and thus treated the collateral as "distress" merchandise.

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§5.44 (1) Block Sale of Stock

The block sale of stock on foreclosure has been held to be commercially reasonable, against the allegation that such a disposition would depress the market. *Hutchison v Southern Cal. First Nat'l Bank* (1972) 27 CA3d 572, 103 CR 816.

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§5.45 (2) Wholesale Liquidation Price

A difficult issue is whether a creditor may use a wholesale liquidation price to establish a deficiency claim against a retail debtor. The practice occurs frequently in the automobile industry, in which repossessed cars are normally sold to other dealers at auction. Dealers argue that wholesale liquidation is quick and efficient and thus avoids expenses that would be passed on to the debtor. Debtors argue that any benefits to them are a sham because the collateral once sold at wholesale will be sold again at retail at a higher price in a short time. Courts have sometimes required particular secured creditors to utilize retail markets where the secured creditor dealt in those markets and a retail sale would generate materially better prices. *U.S. v Terrey* (5th Cir 1977) 554 F2d 685; *Hancock County Bank v America Fletcher Nat'l Bank & Trust Co.* (Ind App 1971) 276 NE2d 580. See *Clark Equip. Co. v Mastelotto, Inc.* (1978) 87 CA3d 88, 150 CR 797.

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§5.46 b. Other Tests of Reasonableness

Commercial Code §9627(b) provides some affirmative guidance on commercial reasonableness in a few particular types of dispositions. A disposition is commercially reasonable if made:

- In the usual manner on any recognized market (such as a stock or commodities exchange);
- At the price current in any recognized market at the time of the disposition; or
- In conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.

In addition, a collection, enforcement, disposition, or acceptance is deemed commercially reasonable if approved by a court, an official creditors committee (usually in a bankruptcy case), a representative of creditors, or an assignee for the benefit of creditors, although the failure to obtain approval does not establish commercial unreasonableness. Com C §9627(c)-(d).

Courts will consider unusual circumstances to determine if a disposition is commercially reasonable. See, *e.g.*, *Aspen Enters. v Bodge* (1995) 37 CA4th 1811, 44 CR2d 763 (secured creditor's repossession of tires and return of the tires to inventory for resale and issuance of credit memo to debtor for value of tires constituted commercially reasonable private sale of commodity traded on "recognized market").

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§5.47 c. Advertising or Solicitation

Compliance with the notice provisions under Division 9 does not necessarily satisfy the requirement that a disposition be commercially reasonable. See *Ford & Vlahos v ITT Commercial Fin. Corp.* (1994) 8 C4th 1220, 36 CR2d 464 (secured creditor's failure to publish notice of sale in any trade publications or to contact aircraft brokers to advise that the aircraft was available raised the question of whether the sale was conducted in a commercially reasonable manner). Advertising or solicitation should be aimed at likely buyers by advertising in newspapers or trade journals, preparing brochures, contacting competitors or auctioneers, and allowing inspection prior to sale. See *Poti Holding Co. v Piggott* (Mass App 1983) 444 NE2d 1311.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.48 d. Preparation of Collateral

§5.48 d. Preparation of Collateral

Under some circumstances, a secured creditor may be required to take affirmative steps to preserve or prepare the collateral for sale, such as cleaning or making equipment operable through minor repairs. *Liberty Nat'l Bank & Trust Co. v Acme Tool Div. of Rucker Co.* (10th Cir 1976) 540 F2d 1375.

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§5.49 e. Credit Sale of Collateral

Whether a secured creditor assumes the risk of nonpayment for credit extended to purchasers at foreclosure sales depends on whether it is commercially reasonable for the secured creditor not to apply the noncash proceeds to the obligation. In circumstances in which the secured creditor accepts credit in the ordinary course of business, the secured creditor should apply noncash proceeds such as a note to the obligation. Official Comment 3 to UCC §9-615. In *Elster's Sales v El Bodrero Hotel, Inc.* (1967) 250 CA2d 258, 58 CR 492, a case decided under former Division 9, the creditor repossessed restaurant equipment after default and sold it to a third party at a price high enough to yield a surplus for the debtor. When the third party defaulted, the creditor repossessed and sold again. This time the sales price was lower, and the creditor sought a deficiency judgment against the debtor. The court refused the judgment, holding that the creditor assumed the risk that the third party had good credit. On the other hand, the court also held that the debtor was not entitled to any surplus from the creditor, because the creditor had not collected any. See also §5.57.

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§5.50 4. Effect of Sale

A transferee at a disposition sale takes all of the debtor's rights in the collateral, free from all interests of the debtor, the disposing secured party, or secured parties junior to the disposing secured party. Com C §9617(a). The transferee acting in good faith takes free of these interests even if the secured party fails to comply with the requirements of the default provisions imposed by the Commercial Code or by judicial proceedings. Com C §9617(b). If the transferee does not act in good faith, the assets will remain subject to other security interests and the interests of the debtor. Com C §9617(c).

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§5.51 5. Transfer Statements

A transfer statement may be provided to the transferee following a secured party's disposition of collateral. The transfer statement is an authenticated record of the secured party stating that the debtor has defaulted, that the secured party has exercised postdefault remedies, and that the transferee has acquired the rights of the debtor in the collateral by reason of the transfer. Com C §9619(a). The transfer statement includes the name and mailing address of the secured party, debtor, and transferee. Com C §9619(a). The transfer statement entitles the transferee to the transfer of record of all rights of the debtor in the collateral specified in the statement. Com C §9619(b).

The transfer statement provides a mechanism for transferees to obtain a transfer of record or legal title. This mechanism is expected to be used when other laws (such as vehicle registration) do not govern. Practitioners should be aware that Com C §9619 may be preempted by federal law. Official Comment 2 to UCC §9-619.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.52 C. Application of Proceeds of Collateral

§5.52 C. Application of Proceeds of Collateral

Under Com C §9615(a), the cash proceeds of disposition of collateral must be applied in the following order:

(1) Expenses of sale (see §5.53).

(2) Secured creditor's claim.

(3) Interests subordinate to the secured creditor's claims (see §§5.54-5.56).

Special rules apply to noncash collateral. Com C §9615(c). See §5.57. In most circumstances, any balance goes to the debtor and the debtor is responsible to the secured creditor for any deficiency. Com C §9615(d). See §§5.58-5.61.

NOTE: The Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.5) contains a rule on proceeds of disposition that closely tracks the Commercial Code. See CC §2983.2(b). The Unruh Retail Installment Sales Act (CC §§1801-1812.20) has a provision that uses somewhat different language but with no great difference in result. See CC §1812.4. See also chap 7.

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§5.53 1. Expenses of Sale

Expenses of sale include the "reasonable expenses of retaking, holding, preparing for disposition, processing and disposing." Com C §9615(a)(1). In *J.T. Jenkins Co. v Kennedy* (1975) 45 CA3d 474, 119 CR 578, the court gave its approval to the payment of delinquent taxes necessary to clear title before sale. Those expenses may also include the cost of a receivership. *Schreiber v Ditch Road Invs.* (1980) 105 CA3d 675, 164 CR 633.

The secured party is allowed to recover reasonable attorney fees and legal expenses if provided for in the agreement and not prohibited by law. Com C §9615(a)(1). Civil Code §1717 provides, however, that if a contract allows a specified party to recover attorney fees, the prevailing party may recover them regardless of whether that party is the specified party. Therefore, the debtor who prevails in court may recover attorney fees even though the security agreement specifies that only the secured party may recover them. See CC §1811.1 on attorney fee provisions in retail installment contracts under the Unruh Retail Installment Sales Act (CC §§1801-1812.20) and CC §2983.4 on attorney fee provisions in automobile sale contracts under the Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.5). For further discussion, see chap 7.

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§5.54 2. Junior Lienor's Demand for Satisfaction

In order for a junior lienholder to receive any surplus, the lienholder must make an authenticated demand on the secured creditor foreclosing on the collateral. Com C §9615(a)(3)(A). The demand for proceeds must be made before the distribution of the proceeds is completed. If a consignor has an interest in the collateral, the junior lienholder's interest must be senior to that of the consignor.

If requested by the senior creditor, the junior lienholder must supply the senior secured creditor with reasonable proof of the interest or lien within a reasonable time. The senior creditor does not have to comply with the demand for proceeds if the junior lienholder does not do so. Com C §9615(b).

The senior creditor also may request a stipulation from the debtor for payment of the claim. See §5.55. A form of demand that may be used by a junior lienholder is provided in §5.56.

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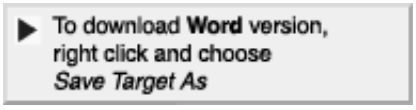
§5.55 a. Request for Stipulation by Debtor

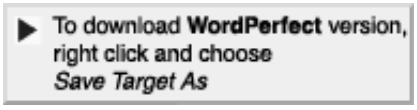
The creditor who receives a junior lienor's demand for satisfaction may request a stipulation from the debtor for payment of the claim. If the debtor refuses, the creditor should seek indemnification from the junior lienor. If neither can be obtained, the secured creditor should interplead—forcing resolution of the differences between the claims of the debtor and the junior lienor. See CCP §§386-386.6; California Civil Procedure Before Trial, chap 28 (4th ed Cal CEB 2004).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.56 b. Form: Junior Lienor's Demand for Satisfaction

§5.56 b. Form: Junior Lienor's Demand for Satisfaction





5.56-1 Junior lienor's demand for satisfaction

_ _[*Date*]_ _

_ _[*Secured party's name and address*]_ _

Re: _ _[*Debtor's name*]_ _, Debtor

Financing Statement No. _ _ _ _ _ _

Filing Date _ _[*date*]_ _

_ _[*I/We*]_ _ **hereby demand that Debtor's indebtedness to _ _[*me/us*]_ _ in the amount of $_ _[*amount*]_ _, secured by a security interest in the property you intend to _ _[*e.g., sell at* [*public/private*] *sale/retain in satisfaction of indebtedness*]_ _ be satisfied from the proceeds of that _ _[*disposition/retention*]_ _.**

_ _[*Our/My*]_ _ **security interest was perfected by filing the Financing Statement referred to above. A copy of the file-stamped Financing Statement is attached.**

__[*Signature of junior lienor*]__
_ _[*Typed name*]_ _

Copies: Original to secured party; copy for client; file copy.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.57 3. Noncash Proceeds

§5.57 3. Noncash Proceeds

A secured party need not apply noncash proceeds, such as a note, unless the failure to do so would be commercially unreasonable. If noncash proceeds are applied, it must be done in a commercially reasonable manner. Com C §9615(c). See Official Comment 4 to UCC §9-608; Official Comment 3 to UCC §9-615.

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§5.58 4. Surplus and Deficiency

In general, the secured party's sale of the collateral will either result in the secured party not receiving the full amount of the obligations through the sale, or in the secured party receiving in excess of the amount owed to it.

Provided that the secured party properly followed the foreclosure procedures set forth in Division 9, the obligor is liable for a deficiency. Com C §9615(d)(2). If there is a surplus, the debtor generally receives the surplus. Com C §9615(d)(1).

Special rules apply to sales of accounts and similar collateral, dispositions in consumer goods transactions, and dispositions to related parties. See §§5.59-5.61.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.59 a. Sale of Accounts, Chattel Paper, Payment Intangibles, and Promissory Notes

§5.59 a. Sale of Accounts, Chattel Paper, Payment Intangibles, and Promissory Notes

If the underlying transaction is a sale of accounts, chattel paper, payment intangibles, or promissory notes, the debtor is not entitled to a surplus and the obligor is not liable for any deficiency. Com C §9615(e).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.60 b. Consumer Transactions

§5.60 b. Consumer Transactions

Special rules apply to dispositions in consumer goods transactions and consumer obligors. Com C §9616. See §§5.61, 7.15.

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§5.61 c. Low-Price Dispositions to Related Parties

If the secured party, a person "related" to the secured party, or a secondary obligor acquires the collateral on foreclosure and the proceeds received are significantly lower than would be received in a disposition to a disinterested third party, the deficiency (or surplus) will be calculated based on the amount that would have been received if the collateral had been sold to a disinterested party. Com C §9615(f); Official Comment 6 to UCC §9-615.

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§5.62 D. Secured Party's Retention of Collateral—Strict Foreclosure

In a nonconsumer transaction, the secured creditor may retain or receive collateral in partial or full satisfaction of the claim rather than sell the collateral if the following conditions are met:

- The debtor consents. Com C §9620(a)(1). See §5.63.
- No objection is received by the secured party following a notice of proposal. Com C §§9620(a)(2), 9621. See §5.64.

The secured party's acceptance of collateral in partial or full satisfaction discharges the obligation to the extent consented to by the debtor and discharges any subordinate interest in the collateral. Com C §9622.

This procedure is generally known as strict foreclosure. The secured party does not need to be in possession of the collateral in order to strictly foreclose on it. However, if the collateral is consumer goods, the debtor cannot be in possession of it. Com C §9620(a)(3); Official Comment 7 to UCC §9-620.

In a consumer transaction, the secured creditor may not retain the collateral in partial satisfaction. Com C §9620(g). Special rules apply to consumer goods if 60 percent of the purchase price has been paid. Com C §9620(e). See §7.17.

There can be no "involuntary" or "constructive" strict foreclosure by the secured creditor in the absence of its written agreement or proposal to retain the collateral. Official Comment 5 to UCC §9-620. Moreover, as with all remedies under the Commercial Code, a default is required before the secured party may exercise its remedies. In *In re Cadiz Props., Inc.* (Bankr ND Texas 2002) 278 BR 744, the court found that an escrow of stock did not effect a disposition of the stock in favor of the secured party when the secured party had not called a default or delivered the required notice.

If the secured party does not follow all of the requirements of Com C §§9620 and 9621, the secured party may still strictly foreclose but may be liable for payment of damages. Com C §9625(b); Official Comment 6 to UCC §9-620. See §5.72.

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§5.63 1. Debtor's Consent to Retention of Collateral

The debtor may consent to the secured creditor's retention of collateral in a record authenticated after default. Com C §9620(c)(1). This method may be used when the obligation is being fully or only partially satisfied. A debtor will also be deemed to have consented when the obligation is fully satisfied if (Com C §9620(c)(2)):

- The secured creditor sends the debtor a proposal after default;
- The proposal is unconditional (or is only subject to the collateral not in the possession of the secured party being preserved or maintained) and states that the collateral will be accepted in full satisfaction of the obligation; and
- The secured party does not receive an authenticated notification of objection from the debtor within 20 days after the notification was sent.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.64 2. Notice of Proposal

§5.64 2. Notice of Proposal

Under Com C §9621(a), the secured party must notify the following parties that it intends to keep the collateral in satisfaction of the obligor's obligations:

- Any person from which the secured party has received, before the debtor consented to the acceptance, an authenticated notification of a claim of an interest in the collateral.
- Any other secured party that held a perfected security interest 10 days before the debtor consented to the strict foreclosure.

If any person required to receive notice or any other person holding a subordinate interest in the collateral objects in writing to the proposed strict foreclosure within 20 days of the delivery of the notices, the secured creditor must proceed to conduct a public or private foreclosure sale. Com C §9620(a)(2), (d)(2). The safe harbor found in Com C §9611(e) for foreclosure sales, which provides that a search may be conducted before the notice is sent to other secured creditors, is not applicable to strict foreclosure.

PRACTICE TIP: If a proposal is to be sent to a junior secured creditor, the proposal should contain specific language setting forth the terms under which the secured creditor is willing to accept the collateral. The proposal should include the method to calculate or the exact amount of the secured obligations to be satisfied. Any other conditions, such as for revocation, should be included.

If the secured creditor is seeking only partial satisfaction of the debt through strict foreclosure, all secondary obligors must receive the same type of notice, and have the same veto rights, as junior secured creditors. Com C §9621(b).

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§5.65 VI. WAIVERS BY DEBTORS AND OBLIGORS

A debtor or obligor may waive certain of the secured creditor requirements under Division 9. However, there are several provisions that may not be waived.

Many of the default provisions of Division 9 are designed to protect the debtor against oppression or overreaching by the secured creditor. Those provisions impose obligations on and limit the rights of the secured party, *e.g.,* by requiring that the sale of collateral take place only after notice and in prescribed ways. See Com C §9615.

PRACTICE TIP: The waiver rules apply to secondary obligors as well as debtors. Practitioners may not enforce waivers from guarantors of rights that are expressly nonwaivable under the Commercial Code.

The Commercial Code further protects the debtor by making ineffective the debtor's waiver of protection in circumstances of particular importance. Com C §9602. See §5.66. Permissible waivers are specified in Com C §9624. See §5.67.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/5 Remedies/§5.66 A. Nonwaivable Debtor Protections

§5.66 A. Nonwaivable Debtor Protections

Commercial Code §9602 provides that the following protective rules are not waivable:

- The rules with respect to consumer goods on the use and operation of collateral by the secured party. Com C §9207(b)(4)(C).
- The rules requiring creditor compliance with requests for lists of collateral and statement of account. Com C §9210.
- The rules on collection and enforcement of collateral. Com C §9607(c).
- The rules requiring the application or payment of noncash proceeds of collection, enforcement, or disposition. Com C §§9608(a), 9615(c).
- The rules requiring accounting for surplus after disposition of collateral. Com C §§9608(a), 9615(d).
- The rules requiring a secured party not to breach the peace when taking possession of collateral without judicial process. Com C §9609.
- The rules regarding disposition of collateral. Com C §§9610(b), 9611, 9613-9614.
- The rules regarding the calculation of deficiency or surplus in a disposition to a related party. Com C §9615(f).
- The rules regarding the explanation of the calculation of deficiency or surplus in a consumer goods transaction. Com C §9616.
- The rules regarding acceptance of collateral in satisfaction of an obligation. Com C §§9620, 9621-9622.
- The rules regarding redemption of collateral. Com C §9623.
- The rules regarding permissible waivers. Com C §9624. See §5.67.
- The rules regarding the secured party's failure to comply with Division 9 and the existence and extent of any deficiency claim. Com C §§9625-9626.

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§5.67 B. Waivable Debtor Protections

Commercial Code §9624 modifies Com C §9602 (see §5.66) by permitting the following waivers by written agreement after default:

- A debtor or a secured obligor may waive the right to notification of disposition of collateral under Com C §9611. Com C §9624(a).
- A debtor may waive the right to require disposition of collateral under Com C §9620(e). Com C §9624(b).
- Other than in a consumer-goods transaction, a debtor may waive the right to redeem collateral under Com C §9623. Com C §9624(c).

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VII. DEBTOR'S RIGHTS AND REMEDIES

A. Secured Party's Failure to Comply With Division 9

§5.68 1. Effect on Collateral

If the secured party fails to comply with Division 9, the court may order or restrain collection, enforcement, or disposition of collateral on appropriate terms and conditions. Com C §9625(a). The debtor may seek an injunction if the collateral has not been disposed of. CCP §§525-527, 529; Fed R Civ P 64. See California Civil Procedure Before Trial, chap 32 (4th ed Cal CEB 2004).

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§5.69 2. Basic Remedy of Damages

The basic remedy under Division 9 is damages. The measure of damages is the loss resulting from noncompliance. Com C §9625(b); Official Comment 3 to UCC §9-625. A loss caused by a failure to comply with a request for an accounting under Com C §9210 may include loss resulting from the debtor's inability to obtain, or increased cost of, alternative financing. Com C §9625(b). A debtor, obligor, or other secured party may recover damages under Com C §9625(b). Com C §9625(c).

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§5.70 3. Effect on Deficiency Judgment

Failure to comply with the requirements of Division 9 may affect the ability of the secured creditor to obtain a deficiency judgment after disposition of collateral. Other than in a consumer transaction, the following rules apply under Com C §9626(a):

- The secured creditor does not need to prove compliance with Division 9 unless challenged by the debtor or a secondary obligor.
- The secured party has the burden of proving compliance.
- If the secured party has not complied with Division 9, the liability of a debtor or secondary obligor for a deficiency is limited to an amount by which the sum of the primary or secondary obligation (as applicable), expenses, and attorney fees exceeds the greater of:
- the proceeds of the collection, enforcement, disposition, or acceptance, or
- the amount of proceeds that would have been realized had the noncomplying secured party proceeded in accordance with the provisions of Division 9.

If a deficiency or surplus is calculated under Com C §9615(f) (application of proceeds after a disposition of collateral to insiders of the secured creditor), the debtor has the burden of establishing that the amount of proceeds of the disposition was significantly below the range of prices that a complying disposition would have obtained. Com C §9626(a)(5). See §5.61. Special rules apply in connection with a consumer transaction. Com C §9626(b). See §7.21.

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§5.71 4. Conversion

Aside from relief from a deficiency judgment (see §5.70), the debtor may seek an affirmative remedy if, for example, the creditor wrongly repossesses while the debtor is not in default or if the creditor wrongly sells collateral held under pledge. The remedy for common law conversion seems to be appropriate in such cases.

In *Varela v Wells Fargo Bank* (1971) 15 CA3d 741, 93 CR 428, the purchaser of dealer paper was held liable in conversion for wrongful repossession. The debtor's recovery may be limited to the balance that remains after deducting the indebtedness from the value of the converted property. See *Neumeyer v Union Bank* (1974) 43 CA3d 873, 118 CR 116. A secured creditor who foreclosed on stock prior to calling a default and then proceeded to accept interest on the obligation was held liable for conversion in *Segovia v Equities First Holdings, LLC* (Del Super Ct, May 30, 2008, No. 06C-09-149-JRS) 2008 Del Super Lexis 197 (unpublished).

Junior secured creditors should also be wary. The Eighth Circuit has held that a junior secured party that proceeds with a foreclosure sale after objection from the senior secured creditor may be liable for conversion. *JCB, Inc. v Union Planters Bank, NA* (8th Cir 2008) 539 F3d 862.

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§5.72 5. Accounting

After disposition of collateral, the secured creditor must account to the debtor for any surplus. Com C §9615(d)(1). See §5.58.

In *Civic W. Corp. v Zila Indus., Inc.* (1977) 66 CA3d 1, 14, 135 CR 915, a debtor in default was held entitled to an accounting to untangle the issue of the amount owed, to whom, and by whom.

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§5.73 6. Consumer Remedies

See chap 7 for a detailed discussion of consumer remedies.

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§5.74 7. Effect of Automatic Stay in Bankruptcy

A frequently used shield against the power of the secured creditor to pursue remedies on the debtor's default is the intervention of bankruptcy. If the debtor files for bankruptcy, or if another creditor files a bankruptcy against the debtor, the secured creditor must refrain from any further action against the debtor or the collateral except with permission of the bankruptcy court under the automatic stay of 11 USC §362.

The stay is effective on filing of the petition. The extent of the stay is set forth in broad language in 11 USC §362(a). Exceptions to the stay are provided in 11 USC §362(b), but most of these ordinarily are not available to the secured creditor. For a discussion of the effect of bankruptcy and the automatic stay, see chap 6.

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§5.75 8. Redemption of Collateral

Any debtor, secondary obligor, or other secured party or lienholder may redeem collateral as long as the secured party exercising its remedies has not taken any of the following actions (Com C §9623(a), (c); Official Comment 2 to UCC §9-623):

- Collected on the collateral under Com C §9607 (see §5.18);
- Disposed of the collateral or entered into a contract to dispose of the collateral pursuant to Com C §9610 (see §5.26); or
- Accepted the collateral in full or partial satisfaction of the obligations under Com C §9622 (see §5.62).

In order to redeem the collateral, a person must tender fulfillment of all obligations secured by the collateral and the reasonable expenses and attorney fees described in Com C §9615(a)(1). Com C §9623(b). If the debt is accelerated, then payment in full of the entire amount of the debt is required. The payment of a portion, such as the last interest payment that caused the default, will not permit redemption. Official Comment 2 to UCC §9-623. The redemption right under the Commercial Code may be waived by agreement entered into after default. Com C §9624.

NOTE: The Unruh Retail Installment Sales Act (CC §§1801-1812.20) describes the right to redeem under a retail installment contract as "absolute," implying that it may not be waived. CC §1812.2. Such a requirement could also be read into the Rees-Levering Motor Vehicle Sales and Finance Act (CC §§2981-2984.5). See chap 7.

A debtor may be able to redeem the collateral as part of a plan under Chapter 11 or Chapter 13 of the Bankruptcy Code. In a liquidation under Chapter 7 of the Bankruptcy Code, an individual debtor may be permitted to redeem by paying the holder of the lien the amount of the allowed secured claim if (1) the collateral is tangible personal property intended primarily for personal, family, or household use; (2) the lien secures a dischargeable consumer debt; and (3) the property is exempted or has been abandoned. 11 USC §722. See §6.114.

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§5.76 B. Contract of Adhesion

A possible limitation on default clauses in the security agreement is the effect of a finding that the security agreement is a contract of adhesion. A contract of adhesion is a standardized form of contract entered into by parties of unequal bargaining power, with the weaker party given no opportunity to negotiate terms; *i.e.,* the weaker party has only the choice of accepting or rejecting the contract. *Graham v Scissor-Tail, Inc.* (1981) 28 C3d 807, 171 CR 604. Generally, the weaker party has no realistic alternative to the product or service. *Madden v Kaiser Found. Hosps.* (1976) 17 C3d 699, 131 CR 882; *Tunkl v Regents of Univ. of Cal.* (1963) 60 C2d 92, 32 CR 33. An adhesion contract is fully enforceable, subject to the following limitations:

- Terms that frustrate the reasonable expectations of the inured party are unenforceable.
- Terms that are unfair, unconscionable, or contrary to public policy are unenforceable.

See *California Grocers Ass'n v Bank of America* (1994) 22 CA4th 205, 27 CR2d 396; *Dean Witter Reynolds, Inc. v Superior Court* (1989) 211 CA3d 758, 259 CR 789.

However, in *Arcwel Marine, Inc. v Southwest Marine, Inc.* (9th Cir 1987) 816 F2d 468, the Ninth Circuit interpreted California law to find that an otherwise unconscionable contract was valid if negotiated in a commercial context between commercial entities of equal bargaining power.

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§5.77 C. Secured Party's Waiver and Estoppel by Conduct

Even if the debtor's actions violate the requirements of a well-drafted default clause, the secured creditor may waive its protection, or may be estopped from relying on it, if its enforcement has been casual. See *Varela v Wells Fargo Bank* (1971) 15 CA3d 741, 93 CR 428 (secured creditor estopped from taking action because late payments were frequently accepted).

In addition, creditors should be careful in using a mere technical default to deprive the debtor of a substantial benefit. A secured creditor is required to act in good faith, which includes "reasonable commercial standards of fair dealing." Com C §1201(b)(20).

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§5.78 D. Lender Liability

Lender liability is a complex topic that is beyond the scope of this book. The following brief discussion was designed to alert practitioners to problems that may arise in relations between lenders and borrowers. Lenders may be liable for damages to borrowers in connection with extensions of credit under both breach of contract (see §5.79) and tort theories (see §§5.80-5.85).

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§5.79 1. Breach of Contract

Breach of contract is the most basic type of lender liability. The borrower sues because the lender has not provided what is required under the loan document. Defaults, covenants, and representations should all be carefully drafted to permit a lender to cease funding and exercise its other remedies. Loan documents should contain language expressly prohibiting oral modification and requiring that all amendments be in writing. Oral agreements should be avoided. Civil Code §1624(a)(7) specifically provides that a contract, promise, undertaking, or commitment to loan money or to grant or extend credit, in an amount greater than $100,000, not primarily for personal, family, or household purposes, made by a person engaged in the business of lending or arranging for the lending of money or extending credit is invalid, unless the contract, or some note or memorandum of the contract, is in writing and is subscribed by the party to be charged or by the party's agent.

Even if an agreement is not a binding agreement, a lender can still be liable under the theory of promissory estoppel. Cases reviewing promissory estoppel outside the lending context focus on the actions of the parties after an agreement or term sheet has been signed. See, *e.g.*, *Budget Marketing, Inc. v Centronics Corp.* (8th Cir 1991) 927 F2d 421, 427; *Arcadian Phosphates, Inc. v Arcadian Corp.* (2d Cir 1989) 884 F2d 69, 73. The determination of whether promissory estoppel exists will depend on whether a promise has been made that may be reasonably relied on by the borrower. Lenders should be aware that oral promises will be considered in this context. In addition, lenders should properly set expectations of borrowers and potential borrowers, correct misinformation promptly, and avoid detailed discussions or activities with potential borrowers unless an appropriate letter of intent is in place that confirms the absence of any promise or commitment by the lender.

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2. Tort Theories

§5.80 a. Fraud, Negligent Misrepresentation, and Intentional Misrepresentation

Fraud, negligent misrepresentation, and intentional misrepresentation are similar in concept to promissory estoppel discussed in §5.79. Like promissory estoppel, fraud, negligent misrepresentation, and intentional misrepresentation can be found even if there is no binding agreement setting forth the terms of a transaction. See, *e.g., Clardy Manufacturing Co. v Marine Midland Bus. Loans, Inc.* (5th Cir 1996) 88 F3d 347, 356; *Skycom Corp. v Telstar Corp.* (7th Cir 1987) 813 F2d 810, 817.

To the extent that representations or assurances provided by a lender are misleading and the borrower acts on those assurances and suffers a loss, the lender may be liable to the borrower. As with promissory estoppel, lenders should properly set expectations of the borrower and correct misinformation promptly. The credit approval process (including funding requests under existing documentation) must be carefully monitored. In *Kruse v Bank of America* (1988) 202 CA3d 38, 248 CR 217, damages of nearly $47 million, including punitive damages of $26.6 million, were awarded against Bank of America based on allegations that bank personnel had falsely described amounts available under a loan. Although the jury verdict was reduced by the trial court and the judgment was later reversed, *Kruse* is a warning to lenders of the dangers of informal communications with borrowers.

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§5.81 b. Control

Tort liability may arise if a lender is found to have a fiduciary relationship with the borrower, and the lender is found to have misused that fiduciary relationship. The simple lending relationship does not in and of itself create a fiduciary relationship between borrower and lender. *Price v Wells Fargo Bank* (1989) 213 CA3d 465, 261 CR 735. A fiduciary relationship may be found between a lender and its borrower, however, if the borrower is otherwise a customer of the lender and reasonably relies on the lender for financial advice. Courts have also found a fiduciary relationship for purposes of equitable subordination (see §§5.85, 6.103) if the lender has exercised control over the financial affairs of the borrower. In determining whether control exists, these courts have examined whether the lender (1) participated in the borrower's business decisions, (2) had control over the borrower's financial affairs, or (3) had voting control of the borrower or the power to select management. Such control can exist if the lender has control of the use of funds of borrower. For example, if the lender dictates how funds will be used for general corporate purposes or if the lender dictates corporate policy, the lender may be found to have control. Dictating layoffs or which creditors are to be paid can be seen as control. See, *e.g.*, *Aluminum Mills Corp. v Citicorp N. Am., Inc. (In re Aluminum Mills Corp.)* (Bankr ND Ill 1991) 132 BR 869, 894.

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§5.82 c. Duress

Duress occurs when a lender threatens to take an action that the lender has no right to take, causing the borrower to act in a way that is not legally required. CC §1569(2); Restatement (Second) of Torts §892B (1979). For duress to exist, the lender must appear to have the power to injure the borrower other than by legal means. If the lender is acting within its legal rights, duress cannot be found. *Sanders v Republic Nat'l Bank* (Tex App 1965) 389 SW2d 551, 554. Hard negotiation is not duress. *Rich & Wheelock, Inc. v Ashton Dev., Inc.* (1984) 157 CA3d 1154, 204 CR 86; *Sheehan v Atlanta Int'l Ins. Co.* (9th Cir 1987) 812 F2d 465, 469.

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§5.83 d. Interference With Contract or Business Relationship

In cases of fraud (see §5.80) and duress (see §5.82), one often finds serious misconduct by the lender. Liability for interference with contract or a business relationship may arise without proving the existence of misconduct, if the lender causes or induces the borrower to breach existing contracts. Restatement (Second) of Torts §766A (1979). See, *e.g.*, *J.B.L. Enters., Inc. v Jhirmack Enters., Inc.* (9th Cir 1983) 698 F2d 1011, 1019.

However, acting to protect the lender's own financial interest is a recognized defense. A lender is allowed to act to protect itself if the business or financial reason for that action outweighs the harm suffered. The Restatement provides that interference is not wrongful if the party "(a) does not employ wrongful means and (b) acts to protect his interest from being prejudiced by the relation." Restatement (Second) of Torts §769.

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§5.84 e. Tort Liability in Connection With Breach of Contract

California, like many other jurisdictions, no longer permits tort liability in connection with breach of a contract unless there is a special relationship, such as a fiduciary relationship, between the parties, because of the inherently different nature of contract and tort liability and the resulting differences in damages. *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 900 P2d 669, 44 CR2d 420, overruling *Seaman's Direct Buying Service v Standard Oil Co.* (1984) 36 C3d 752, 686 P2d 1158, 206 CR 354. See also Freeman & Mills, Inc. v Belcher Oil Co.: *Yes, the Seaman's Tort Is Dead* (1996) 27 Pac LJ 1405.

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§5.85 f. Equitable Subordination

If a breach of fiduciary relationship or egregious conduct is shown, the lender may also find that its claim is equitably subordinated, which ordinarily means that the lender will be paid only after other creditors. See §6.103.

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§5.86 E. Deepening Insolvency

Another area in which secured creditors may find they have liability is the tort known as "deepening insolvency." Deepening insolvency occurs when someone's actions prolong the existence of an insolvent entity and result in the dissipation of corporate assets, leaving less for unsecured creditors in a liquidation. Courts disagree on whether deepening insolvency is a distinct cause of action or a measure of damages. See *OHC Liquidation Trust v Credit Suisse First Boston (In re Oakwood Homes Corp.)* (Bankr D Del 2006) 340 BR 510 for a comprehensive discussion of the history of deepening insolvency. Simply lending money into a financially troubled situation should not give rise to a claim of deepening insolvency. *Kittay v Atlantic Bank* (*In re Global Serv. Group LLC)* (Bankr SD NY 2004) 316 BR 451. Generally, deepening insolvency is found to be a cause of action only in connection with fraud or other egregious conduct, although some courts have found that negligence may give rise to deepening insolvency. *Seitz v Detweiler, Hershey & Assocs., PC (In re CitX Corp.)* (3rd Cir 2006) 448 F3d 672 (finding negligence not sufficient for deepening insolvency, but discussing other cases in which it is). Deepening insolvency claims generally arise in the context of a bankruptcy, and some courts have held that a trustee or committee has standing to bring an action for deepening insolvency on behalf of the debtor but not on behalf of other creditors. *Smith v Arthur Andersen, LLP* (9th Cir 2005) 421 F3d 989 (court declined to make "any general pronouncements on the theory of deepening insolvency" in the opinion); *Official Comm. of Unsecured Creditors v RF Lafferty & Co.* (3rd Cir 2001) 267 F3d 340 (creditors committee could bring cause of action standing in the shoes of the debtor). See also *Nisselson v Ford Motor Co. (In re Monahan Ford Corp.)* (Bankr ED NY 2006) 340 BR 1.

NOTE: The Delaware Chancery Court has held that Delaware does not recognize a cause of action for deepening insolvency. *Trenwick Am. Litig. Trust v Ernst & Young, LLP* (Del Ch 2006) 906 A2d 168.

The tort of "improvident lending" was discredited in *Official Comm. of Unsecured Creditors of Fedders N. Am., Inc. v Goldman Sachs Credit Partners LP (In re Fedders N. Am., Inc.)* (Bankr D Del 2009) 405 BR 527. Holding that there is no separate cause of action of "improvident lending," the *Fedders* court recognized that many other causes of action may be alleged against a lender who lends to a distressed borrower, such as lender liability, fraud, and aiding and abetting breach of fiduciary duty.

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6

The Secured Creditor and Bankruptcy

Ellen A. Friedman

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§6.1 I. INTRODUCTION

The Bankruptcy Code (Title 11 of the United States Code) provides the framework for individuals and various organizations to seek relief from the payment of debts. Chapters 1, 3, and 5 of the Bankruptcy Code apply generally to bankruptcy cases of all kinds. Chapters 7, 9, 11, 12, and 13 provide different systems of bankruptcy relief. Chapter 15, which was added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 23), provides special rules relating to international insolvency cases.

NOTE: The BAPCPA substantially amended the Bankruptcy Code, with most amendments effective for cases filed on or after October 17, 2005. Relevant changes are discussed in this chapter.

Chapter 7. Chapter 7 (11 USC §§701-767) establishes the procedures for liquidation. Under Chapter 7, a trustee, appointed by the court or elected by the creditors, takes control of the debtor's property, converts it into cash, and pays creditors under a system of priorities. At the end of the process, provided that the debtor is eligible for a discharge under the new BAPCPA requirements, the debtor is discharged and is no longer liable for most prebankruptcy debts. The BAPCPA tightened the eligibility requirements for Chapter 7, and may force more debtors into repayment plans under Chapter 13.

Chapter 9. Chapter 9 (11 USC §§901-946) allows municipalities to file for bankruptcy protection.

Chapter 11. Chapter 11 (11 USC §§1101-1174) permits a debtor, usually an ongoing business, to reorganize itself according to a plan confirmed by the bankruptcy court, to retain possession of its property as debtor in possession, and to continue or liquidate its business under the bankruptcy court's jurisdiction.

Chapter 12. Chapter 12 (11 USC §§1201-1231) provides the family farmer or fisherman with a means of keeping the farm or fishing operation while restructuring debts. Farmers having (1) regular annual income and debts up to $3,544,525 and (2) at least 50 percent of their noncontingent liquidated aggregate debts arising from farming operations may restructure their debts by paying their net disposable income as provided in a Chapter 12 plan. 11 USC §101(18)(A); 11 USC §109(f). Family fishermen having (1) regular annual income and aggregate debts not exceeding $1,642,500 and (2) not less than 80 percent of their noncontingent liquidated debts arising from a family commercial fishing operation similarly may restructure their debts under Chapter 12. 11 USC §101(19A)(A)(i); 11 USC §109(f). A Chapter 12 plan must provide for payments within 3 years, unless the court approves a longer period not exceeding 5 years. 11 USC §1222(c).

Chapter 13. Chapter 13 (11 USC §§1301-1330) allows an individual debtor with a regular income to restructure his or her debts under a confirmed Chapter 13 plan under the court's jurisdiction. The debtor pays his or her net disposable income to the Chapter 13 trustee for a period of 3 to 5 years, and the Chapter 13 trustee makes disbursements to the debtor's creditors. As a result of changes introduced by the BAPCPA, it is anticipated that an increased number of debtors will opt for relief under Chapter 13.

This chapter addresses the major concepts of bankruptcy law that affect secured transactions, but it does not cover all the issues that may arise in a bankruptcy. Moreover, it concentrates on Chapters 7 and 11 of the Bankruptcy Code. Certain issues relating to individual debtors are included, but in general consumer bankruptcy issues are not discussed. See Collier on Bankruptcy (15th ed rev 1996) for discussion of Chapters 9 and 12.

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II. COMMENCING BANKRUPTCY PROCEEDINGS

§6.2 A. Jurisdiction of Bankruptcy Cases

Original and exclusive jurisdiction over all cases under the Bankruptcy Code resides in the federal district courts. 28 USC §1334(a). In this context, "cases" means bankruptcy cases as a whole.

The grant of jurisdiction further provides that "the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11." 28 USC §1334(b). "Proceedings" includes, for example, a secured creditor's action to recover collateral or a trustee's action to avoid a security interest.

Finally, the grant provides that "the district court in which a case under title 11 is commenced or is pending shall have exclusive jurisdiction of all of the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate." 28 USC §1334(e)(1).

In general, district courts refer all proceedings arising in or related to a bankruptcy case to a bankruptcy judge, whose appointment, term, salary, and duties are spelled out in 28 USC §§151-158. 28 USC §157(a). The bankruptcy court may issue any order, process, or judgment necessary or appropriate to carry out the provisions of the Bankruptcy Code. 11 USC §105(a).

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§6.3 B. Who May Be a Debtor

Any individual, partnership, or corporation-except a railroad, insurance company, or financial institution-may be the debtor in a Chapter 7 case. 11 USC §109(b). Railroads may reorganize or liquidate under 11 USC §§1161-1174. Stockbrokers and commodity brokers, who may liquidate under Chapter 7, are not eligible for relief under Chapter 11 or 13. 11 USC §109(d)-(e). In general, most persons or entities may file for relief under Chapter 7 or 11. Chapter 13 is reserved for individual debtors. See §6.4. The BAPCPA has introduced stringent new eligibility requirements for Chapter 7 filings. An individual debtor may not be a debtor unless the individual has obtained credit counseling from an approved nonprofit budget and credit counseling agency during the 180-day period preceding the filing of the petition. 11 USC §109(h). This requirement may be avoided in certain cases of hardship, as detailed in 11 USC §109(h)(3), which provides a three-prong test that must be met by the debtor, including a description of exigent circumstances. Since the BAPCPA went into effect, several courts have examined the nature of exigent circumstances that will excuse an individual from receiving credit counseling in advance of filing for bankruptcy. Some courts have held that an impending foreclosure is an exigent circumstance; others have not. Even if exigent circumstances are found to exist, whether the debtor is eligible for a waiver of the credit counseling requirement may depend on whether the other requirements of 11 USC §109(h)(3) are met. See *Hedquist v Fokkena (In re Hedquist)* (8th Cir BAP 2006) 342 BR 295 (waiting to file for bankruptcy on eve of foreclosure is not exigent circumstance; *In re DiPinto* (Bankr ED Pa 2006) 336 BR 693 (foreclosure an exigent circumstance, but sworn statement that debtor attempted to obtain credit counseling is prerequisite for waiver); *In re Childs* (Bankr D Md 2005) 335 BR 623 (foreclosure an exigent circumstance, but petitions dismissed because of deficient certifications regarding waiver of counseling). Threat of garnishment may also meet the exigent circumstances requirement. *In re Romero* (Bankr ND Cal 2006) 349 BR 616 (garnishment an exigent circumstance when debtor tried but was unable to obtain credit counseling within specified period). In addition, an individual Chapter 7 debtor must meet certain financial criteria (the so-called means test) or risk having his or her case dismissed for abuse under 11 USC §707(b). The Internal Revenue Service provides standards for the means test. For more information on means testing and the standards that apply see the U.S. Trustee website at http://www.usdoj.gov/ust/eo/bapcpa/meanstesting.htm.

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§6.4 C. Who May File a Petition

Bankruptcy cases may be voluntary (begun by the debtor) or involuntary (begun by creditors). Subject to a number of special limitations and requirements, either a debtor or a creditor may initiate a bankruptcy case under Chapter 7 or 11, but only a debtor may initiate a case under Chapter 13. 11 USC §§301, 303.

An involuntary petition may be filed under Chapter 7 or 11 against any debtor who may file a voluntary petition except a farmer, family farmer (see 11 USC §101(18)-(20)), or a nonprofit corporation. 11 USC §303(a). An involuntary case may be brought only by three or more creditors with noncontingent, undisputed claims aggregating at least $13,475 more than the value of liens against the debtor's assets, unless the total number of creditors is fewer than 12, in which case one of them may initiate the case. 11 USC §303(b). A secured creditor whose collateral value is at least $13,475 less than the obligation it secures, if otherwise eligible, may therefore begin involuntary proceedings. The minimum amount of claims for creditors to bring involuntary proceedings is adjusted for inflation at 3-year intervals. See 11 USC §104(b).

PRACTICE TIP: An involuntary bankruptcy should be undertaken only after careful review of alternatives, such as attachment or appointment of a receiver under state law.

A creditor who initiates a petition under Chapter 7 or 11 must meet high threshold requirements before filing a bankruptcy petition. See 11 USC §303(b). The BAPCPA added the requirement that the creditor's claims may not be contingent or disputed. Therefore, a creditor that only has a disputed claim or is relying on a guaranty that has not been called will not be able to file an involuntary case. In addition, if the creditor and the debtor are involved in litigation and no determination as to liability has been made, that creditor will not be able to file an involuntary petition. It may be difficult to assemble the petitioning creditors and prove the required allegations, and the creditor may be liable to the debtor for costs, attorney fees, and damages (including punitive damages) if the debtor defeats the petition. 11 USC §303(i). A debtor was awarded $4.1 million in compensatory damages and $2 million in punitive damages in a case in which the court found that the creditor filed the involuntary petition to pressure the debtor into settling a contract dispute. *Adell v John Richards Homes Bldg. Co. (In re John Richards Homes Bldg. Co.*) (6th Cir 2006) 439 F3d 248.

If the debtor contests the involuntary petition, the petitioning creditors must show that the debtor is not paying debts as they become due or that a custodian was appointed within the past 120 days to take charge of all or substantially all of the debtor's property. 11 USC §303(h).

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§6.5 D. Appointment of Trustee

A trustee is appointed in every case under Chapters 7 and 13. The trustee has broad responsibilities to supervise the collection and distribution of the debtor's assets. See 11 USC §§704, 1106, 1302.

Under Chapter 7, an interim trustee is appointed by the U.S. Trustee at the beginning of the case from a panel of private trustees. 11 USC §701. Creditors have the power to elect a trustee at the first meeting of creditors (11 USC §702), but they seldom do, and the interim trustee usually continues to serve as the case trustee.

In a Chapter 11 reorganization, if a party in interest or the U.S. Trustee requests, a trustee may be appointed (1) for cause, or (2) if in the interest of the creditors, or (3) if grounds exist to convert or dismiss the case under 11 USC §1112, but the court determines that the appointment of a trustee or examiner is in the best interests of creditors and the estate. 11 USC §1104. Usually, however, a Chapter 11 debtor remains in possession of the property, with most of the powers of a trustee. 11 USC §§1101, 1107-1108. The debtor in possession may be ousted for fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the debtor's affairs, in which case a trustee will be appointed. 11 USC §1104(a)-(b).

NOTE: As in the Bankruptcy Code itself, references in this chapter to a trustee also apply to a debtor in possession.

A trustee or debtor in possession has several powers that affect the rights of secured creditors. The trustee has power to set aside security interests in certain circumstances and to recover property (otherwise available to the secured creditor) on behalf of general creditors. See §§6.58-6.77. The trustee also has certain independent powers that exist without regard to the rights of creditors outside bankruptcy, most notably the power to avoid preferences. See §§6.78-6.96.

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§6.6 E. Creditors' Committee

In a Chapter 7 case, a committee of creditors of not fewer than three and no more than 11 members may be elected by the creditors attending the initial meeting of creditors held and presided over by the U.S. Trustee under 11 USC §341.

In most Chapter 11 cases, a committee of creditors holding unsecured claims is appointed by the U.S. Trustee. Usually, the largest creditors are appointed to the committee. However, the court may change the membership if the court determines that the change is necessary to ensure adequate representation. 11 USC §1102(a)(4). The court may expand the committee to include a small business concern if the amount owed it by the debtor is disproportionately large compared with the small business concern's annual revenues. The creditors' committee will oversee the actions of the trustee or debtor in possession and may have a big influence on matters before the court, particularly if the debtor in a Chapter 11 case is not going to reorganize. There is also a possibility of multiple committees, including an equity security holders' committee. 11 USC §1102.

The committee has the following duties (11 USC §1102(b)(3)):

- To provide access to information for creditors who hold claims of the kind represented by that committee and are not appointed to the committee;
- To solicit and receive comments from noncommittee creditors; and
- To comply with any court order that compels any additional report or disclosure to be made to noncommittee creditors.

The requirement that the committee provide information to noncommittee creditors is new under the BAPCPA and is intended to ensure that all creditors receive vital information regarding the debtor. The BAPCPA, however, does not address issues relating to the need for the committee to maintain attorney-client privileged information. Committee members also often receive confidential information from the debtor. This provision may cause debtors to be wary about disclosing such information. It is unclear whether a confidentiality agreement would be sufficient to excuse a committee member from providing confidential information to other creditors. It could be argued that disclosure is required by law. Some creditors' committees have filed motions seeking clarification of their duties and asking the court to deem privileged and confidential matters exempt from disclosure to the general creditor body. See, *e.g., In re Refco* (Bankr SD NY 2006) 336 BR 187.

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III. AUTOMATIC STAY

§6.7 A. Imposition of Automatic Stay

In general, in most cases, the filing of a bankruptcy petition invokes an automatic statutory injunction that prohibits any act to collect a debt from the debtor or to retrieve property from the debtor or from the bankruptcy estate. 11 USC §362. If the secured creditor has not yet reclaimed the collateral, or has reclaimed the collateral but has not held a sale, the automatic stay of 11 USC §362(a)(3) enjoins further action without specific court approval. The secured creditor may even be compelled to return the collateral to the estate. 11 USC §542(a). See §6.33. If the sale has occurred, the secured creditor may not pursue a deficiency judgment outside of bankruptcy. 11 USC §362(a)(1).

The effect of the automatic stay is further discussed in §§6.8-6.9. Liability for violation of the stay is discussed in §6.10. Relief from stay is discussed in §§6.11-6.21.

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§6.8 1. Operation of Stay

In most bankruptcy cases, the stay operates from the time the petition is filed (11 USC §362(a)) and continues to affect property until it is no longer the property of the estate (11 USC §362(c)(1)), the case is dismissed, or the discharge is granted or denied, whichever occurs first (11 USC §362(c)(2)).

Creditors are also enjoined from postdischarge collection actions. 11 USC §524(a). See §6.113. Because the stay protects both the debtor and the property of the estate, a creditor seeking relief from the stay should be sure the court terminates the stay as to both. See *In re Cruseturner* (Bankr D Utah 1981) 8 BR 581, 589. However, for individuals who have filed another Chapter 7, 11, or 13 case within the previous year (11 USC §362(c)(3)-(4)):

- the stay will terminate after 30 days if the individual was a debtor in a case pending in the previous year and the case was dismissed, or
- no stay will go into effect if the individual was a debtor in two or more cases that were dismissed.

In either case, the debtor may request the court to implement the stay. The debtor must make a showing that the later filing was a good faith filing. 11 USC §362(c)(3)-(4).

NOTE: Courts are not in agreement as to the meaning of 11 USC §362(c)(3)(A). Some courts have found that the automatic stay terminates with respect to the repeat debtor or property of the debtor but not with respect to the property of the estate, while others have found that the stay terminates with respect to property of the estate as well. Compare *In re Moon* (Bankr ND Ohio 2006) 339 BR 668 (stay terminated as to debtor's property), *In re Jones* (Bankr ED NC 2006) 339 BR 360 (stay terminated as to debtor and debtor's property), and *In re Johnson* (Bankr WD Tenn 2006) 335 BR 805 (stay terminated as to debtor's property) with *In re Jumpp* (BAP 1st Cir 2006) 356 BR 789 (stay terminated only with regard to debtor and property of debtor, not property of estate) and *In re Jupiter* (Bankr D SC 2006) 344 BR 754 (stay terminated as to property of debtor and property of estate).

The automatic stay applies to creditors, not debtors. Therefore, a debtor may transfer its property without regard to the automatic stay, although the debtor must observe the requirements of the Bankruptcy Code or risk having the transfer avoided pursuant to 11 USC §549. See *Burkart v Coleman (In re Tippett)* (9th Cir 2008) 542 F3d 684.

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§6.9 2. Exceptions to Automatic Stay

There are 28 exceptions to the automatic stay listed in 11 USC §362(b). Certain courts have also considered whether a bona fide purchaser defense under 11 USC §549(c) might be an additional exception. However, in *40235 Washington St. Corp. v Lusardi* (9th Cir 2003) 329 F3d 1076, the Ninth Circuit held that there was no exception for a purchaser at a foreclosure sale, because the foreclosure sale itself was void. A secured creditor has a limited right to complete perfection of the security interest after the petition in bankruptcy has been filed. 11 USC §§362(b)(3), 546(b). See §6.63. For instance, a towing operator who refused to turn over a vehicle to Chapter 13 debtors until after receiving payment for charges was found to be maintaining its possessory lien on the vehicle, not violating the automatic stay. *Hayden v Wells (In re Hayden)* (BAP 9th Cir 2004) 308 BR 428.

EXAMPLE: The filing of a UCC continuation statement (see §3.107) would be a violation of the automatic stay without a specified exception. However, 11 USC §§362(b)(3) and 546(b) make it clear that a bankruptcy trustee's avoiding powers (such as the power to avoid preferences or fraudulent transfers) are subject to a secured creditor's right to continue the perfection of a lien.

In addition, 11 USC §§1110 and 1168 limit the rights of debtors in Chapter 11 reorganizations who have given a security interest in aircraft, vessels, or railroad rolling stock. Under 11 USC §§1110 and 1168, financiers and lessors of aircraft, vessels, or rolling stock are generally entitled to take possession of their equipment 60 days after the order for relief, unless the trustee or debtor in possession cures monetary defaults under the security agreement or lease and agrees to perform all other postpetition obligations under the security agreement or lease. The special protections afforded by those sections to financiers and lessors of aircraft, vessels, and railroad rolling stock apply to nonpurchase money security interests, as well as purchase money security interests, in such equipment. In *United Airlines, Inc. v U.S. Bank, N.A.* (7th Cir 2005) 406 F3d 918, United Airlines attempted to avoid the requirements of USC §1110 by filing an adversary proceeding stating that the indenture trustees for three lenders had violated antitrust laws. The Seventh Circuit held that the aircraft financiers had a right to repossess the aircraft if the full payment was not made.

The automatic stay does not apply where the debtor is a small business debtor (as defined in 11 USC §101(51D)), if the debtor (11 USC §362(n)(1)(A)-(C)):

- is a debtor in a small business case pending at the time of filing of the petition;
- was a debtor in a small business case that was dismissed within 2 years of the latest filing; or
- was a debtor in a small business case that was confirmed in the 2-year period ending on the date of the new petition.

An entity that acquires the small business will be subject to the same rule unless the acquiror can demonstrate that the acquisition was in good faith and not for the purpose of evading the automatic stay. 11 USC §362(n)(1)(D). The stay may apply to a small business debtor that meets the above requirements if the debtor proves by a preponderance of the evidence that the filing of the petition resulted from unforeseeable circumstances beyond its control and that the court is likely to confirm a plan of reorganization that is not a liquidating plan. 11 USC §362(n)(2). In addition, the limitation on the automatic stay does not apply to involuntary cases provided that there is no collusion between the debtor and the filing creditors. 11 USC §362(n)(2)(A). It is important to note that the limitation on the applicability of the automatic stay only applies to small businesses that are serial filers. The automatic stay will apply in cases in which a small business has not previously filed for bankruptcy.

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§6.10 B. Violation of Automatic Stay

A creditor who willfully violates a stay is liable for actual damages, including attorney fees and costs and, under appropriate circumstances, punitive damages to an individual injured by the violation. 11 USC §362(k)(1). Moreover, the Ninth Circuit has held that actual damages can include harm to nonfinancial interests, and that damages for emotional distress are available for willful violations of the automatic stay. *Dawson v Washington Mut. Bank (In re Dawson)* (9th Cir 2004) 390 F3d 1139. A violation of the automatic stay may also constitute contempt of court, and trustees and corporate debtors may sue under 11 USC §105. See *Havelock v Taxel (In re Pace)* (9th Cir 1995) 67 F3d 187, 193; *Johnston Envt'l Corp. v Knight (In re Goodman)* (9th Cir 1993) 991 F2d 613, 618. It is therefore critical that the secured party act carefully after the debtor files for bankruptcy. Written demand for past due amounts is a violation of the automatic stay.

In *McCurdy v Prentice Hall, Inc. (In re McCurdy)* (Bankr D NH 1992) 142 BR 11, the court assessed punitive damages in the amount of $5000 each against creditors who continued to send demand letters to the debtor for nearly a year after bankruptcy even after receiving phone calls and letters from debtor's counsel confirming that bankruptcy had been filed and those creditors listed.

The Ninth Circuit has held that 11 USC §362(a) imposes an affirmative duty on creditors to discontinue collection actions. *Eskanos & Adler, P.C. v Leetien* (9th Cir 2002) 309 F3d 1210 ($1000 sanction for willful violation of automatic stay). In addition, the Ninth Circuit Bankruptcy Appellate Panel found in a case in which a landlord proceeded with a sale of the debtor's property confiscated in connection with a default judgment, that the landlord violated the automatic stay. *Ozenne v Bendon (In re Ozenne)* (BAP 9th Cir 2006) 337 BR 214. The violation was willful because the landlord knew that the debtor had filed for bankruptcy and knowledge of the bankruptcy would constitute knowledge of the stay, and the sale of the property was intentional. 337 BR at 220. In *In re Prairie Trunk Ry.* (Bankr ND Ill 1990) 112 BR 924, the court held that an award of damages for willful violation of the stay is available only to the debtors or their prepetition creditors and not to third parties. In addition, the court held that not every willful violation of the automatic stay triggers liability under 11 USC §362(h) [now §362(k)].

In addition to fines and penalties, enforcement actions taken by a creditor may be of no force or effect. *Far Out Prods., Inc. v Oskar* (9th Cir 2001) 247 F3d 986 (violation of automatic stay is void, not voidable). A judgment obtained in a state court suit filed in violation of the automatic stay was held to be void even though the creditor who filed the state court action was not listed on the debtor's bankruptcy schedules and had no notice of the debtor's bankruptcy filing. *In re Martinez* (Bankr MD Ga 1990) 112 BR 46.

With respect to leased or secured personal property, the BAPCPA provides that where a creditor believes in good faith that the stay has been terminated because the debtor has failed to perform, damages are limited to actual damages. 11 USC §362(k).

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§6.11 C. Relief From Automatic Stay

A secured creditor may request the court to lift the stay to enforce its lien rights. The court will make a determination whether the stay should be terminated, conditioned, or modified as is necessary to provide adequate protection to the secured creditor. For discussion of the criteria that will govern the court's decision, see §§6.16-6.21.

PRACTICE TIP: Before filing a motion, a secured creditor should seek to negotiate a solution with the debtor to avoid uncertainty and delay. However, if an agreement cannot be reached, the creditor can file a motion.

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§6.12 D. Local Rules

Practitioners should also remember to consult the local rules for each federal judicial district when preparing a motion for relief from the automatic stay, because many districts have their own local rules governing relief-from-stay procedures. They may be required by local rules to provide a declaration in support of the motion and also a memorandum of points and authorities setting forth appropriate case law.

Local rules may be found on the bankruptcy court websites at http://www.cacb.uscourts.gov (U.S. Bankruptcy Court, Central District of California), http://www.caeb.uscourts.gov (U.S. Bankruptcy Court, Eastern District of California), http://www.canb.uscourts.gov (U.S. Bankruptcy Court, Northern District of California), and http://www.casb.uscourts.gov (U.S. Bankruptcy Court, Southern District of California). For discussion of the procedure for determination of a request for relief from stay, see §§6.13-6.15.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/6 The Secured Creditor and Bankruptcy/§6.13 2. Determination of Request for Relief From Stay

§6.13 2. Determination of Request for Relief From Stay

The action for relief is a contested matter under Fed R Bankr P 9014. That rule establishes a modified motion procedure for contested matters. The action usually involves a preliminary hearing and a final hearing. See §§6.14-6.15. The criteria for relief from stay are discussed in §§6.16-6.21.

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§6.14 a. Preliminary Hearing

The creditor has a right to a preliminary hearing within 30 days after filing a petition requesting relief from a stay. *Collateral Funding, Inc. v Herrera (In re Herrera)* (BAP 9th Cir 1982) 23 BR 796. The stay "is terminated … unless the court, after notice and a hearing, orders such stay continued in effect" until a final hearing and determination under 11 USC §362(d). 11 USC §362(e)(1). The court may continue the stay after the preliminary hearing on a finding that there is a reasonable likelihood that the party opposing relief will prevail at the final hearing. 11 USC §362(e)(1). See §6.15.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/6 The Secured Creditor and Bankruptcy/§6.15 b. Final Hearing

§6.15 b. Final Hearing

The final hearing should take place 30 days after the conclusion of the preliminary hearing; however, 11 USC §362(e)(1) provides that a final hearing on relief from stay can be concluded later than 30 days after the conclusion of the preliminary hearing if the 30-day period is extended with the consent of the parties in interest or if the 30-day period is extended for a specific time that the court finds is required by compelling circumstances. With respect to a debtor under Chapter 7, 11, or 13 who is an individual, the applicable time period is 60 days, rather than 30 days. 11 USC §362(e)(2).

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§6.16 3. Criteria for Relief From Stay

Relief from stay may be granted for cause, including lack of adequate protection for the creditor. 11 USC §362(d)(1). See §§6.17-6.19. Relief from stay also may be granted if the debtor does not have equity in the property and the property is not necessary for effective reorganization. 11 USC §362(d)(2). See §6.20. The rights of junior lienholders are considered under 11 USC §362(d)(2) but not under 11 USC §362(d)(1). See §6.21. Special rules apply to relief from stay in a single-asset real estate case. 11 USC §362(d)(3). For discussion of single-asset real estate cases, see California Real Estate Finance Practice: Strategies and Forms §1.96 (Cal CEB 2000).

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§6.17 a. Lack of Adequate Protection

Bankruptcy Code §362(d)(1) provides that the creditor may obtain relief from stay for cause, including the lack of adequate protection of the creditor's interest. The standard of adequate protection is the issue over which most stay litigation is fought. In the ordinary case, the standard means that if the court finds that the creditor has adequate protection without relief from the stay, the court will not grant the relief. See, *e.g., In re Dixie-Shamrock Oil & Gas*, *Inc.* (Bankr MD Tenn 1984) 39 BR 115. Forms of adequate protection are discussed in §§6.18-6.19.

NOTE: In *United Sav. Ass'n v Timbers of Inwood Forest Assocs., Ltd.* (1988) 484 US 365, 98 L Ed 2d 740, 108 S Ct 626, the Court held that adequate protection does not include the lost opportunity cost of a secured creditor and that an undersecured creditor is not entitled to interest on its collateral during the stay to assure adequate protection.

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§6.18 (1) Statutory Forms of Adequate Protection

Under 11 USC §361, adequate protection may be provided by any one of the following:

- Requiring the trustee to make a cash payment or periodic cash payments to the creditor (11 USC §361(1));
- Providing to the creditor an additional or replacement lien to the extent that the value of the security interest has been decreased by action of the court or the trustee (11 USC §361(2)); or
- Other relief that will allow the creditor to realize the "indubitable equivalent" of the creditor's interest (11 USC §361(3)).

NOTE: Section 361(3) also provides that adequate protection may not take the form of an administrative expense priority under 11 USC §503(b)(1).

The requirement of periodic cash payments under 11 USC §361(1) is one common way to provide adequate protection. See *Bank of Hawaii v Daws (In re Daws)* (Bankr D Haw 1981) 13 BR 101, 104; *ABD Fed. Credit Union v Williams (In re Williams)* (Bankr ED Mich 1980) 6 BR 789, 792. The purpose of payments is to assure that the secured creditor's position does not deteriorate during the stay. The provision for cash payments is most appropriate if the creditor is undersecured or marginally secured.

An additional or replacement lien (see 11 USC §361(2)) is used most often if new collateral will become available to an ongoing business. See *In re Thomas Parker Enters., Inc.* (Bankr D Conn 1981) 10 BR 783.

The term "indubitable equivalent" in 11 USC §361(3) reflects prior case law, specifically *Metropolitan Life Ins. Co. v Murel Holding Corp. (In re Murel Holding Corp.)* (2d Cir 1935) 75 F2d 941.

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§6.19 (2) Equity Cushion as Adequate Protection

Another widely used form of adequate protection, not identified in 11 USC §361, is the equity cushion. This "cushion" is the surplus value (real or alleged) that may exist in the collateral over and above the secured creditor's claim.

EXAMPLE: A $30,000 debt is secured by equipment worth $100,000. The secured party's equity cushion is $70,000.

The Ninth Circuit has held that an equity cushion may provide adequate protection for purposes of 11 USC §361. *Pistole v Mellor (In re Mellor)* (9th Cir 1984) 734 F2d 1396.

The larger the cushion, the more likely the court will be to leave the stay in place. *City Nat'l Bank v San Clemente Estates (In re San Clemente Estates)* (Bankr SD Cal 1980) 5 BR 605; *Diversified Mortgage Investors v Lake Tahoe Land Co. (In re Lake Tahoe Land Co.)* (Bankr D Nev 1980) 5 BR 34. In general, a determination of whether an equity cushion is adequate will be a question of fact based on expert testimony regarding the value of the collateral and whether or not the collateral may decline in value. *In re St. Peter's School* (Bankr SD NY 1983) 26 BR 589; *Castle Ranch I v Castle Ranch, Inc. (In re Castle Ranch, Inc.)* (Bankr SD Cal 1980) 3 BR 45.

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§6.20 b. Lack of Equity in Property That Is Not Necessary for Effective Reorganization

Whether relief will be granted under 11 USC §362(d)(2) depends on whether the debtor has equity in the property and whether the property is necessary for an effective reorganization. The stay will most likely remain in place if the court determines that either of these standards is met. The debtor has the burden of proving that the property is necessary for an effective reorganization. 11 USC §362(g). Because a Chapter 7 case is a liquidation, the question of whether the collateral "is necessary for an effective reorganization" will not arise.

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§6.21 c. Rights of Junior Lienholders

In determining whether the automatic stay should be lifted for cause under 11 USC §362(d)(1) (see §6.17), the rights of junior lienholders are not considered. *Pistole v Mellor (In re Mellor)* (9th Cir 1984) 734 F2d 1396; *La Jolla Mortgage Fund v Rancho El Cajon Assocs.* (Bankr SD Cal 1982) 18 BR 283. In determining whether the debtor has equity in the property under 11 USC §362(d)(2) (see §6.20), however, the rights of all lienholders will be considered. *Bankers Life Ins. Co. v Alyucan Interstate Corp. (In re Alyucan Interstate Corp.)* (Bankr D Utah 1981) 12 BR 803.

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IV. ACTIONS TAKEN BY TRUSTEE OR DEBTOR IN POSSESSION

§6.22 A. Use, Sale, or Lease of Property

The Bankruptcy Code severely limits the actions that a debtor may take with respect to property of the estate. Before filing a bankruptcy case, a debtor may operate its business subject only to applicable nonbankruptcy laws and regulations. Once a bankruptcy case has been filed, however, the trustee or debtor in possession must seek court approval to take any actions (such as a sale, lease, or other use) with respect to estate property that are outside of the ordinary course of business. See §6.27. The trustee or debtor in possession, however, may use, lease, or sell estate property in the ordinary course of a continuing business without notice and hearing, subject to certain exceptions. 11 USC §363(c). See §§6.23-6.24. Special rules apply to use of cash collateral. See §§6.25-6.26. With court approval, after notice and hearing, the trustee may use, lease, or sell the property, either free of liens or subject to liens. 11 USC §363(b), (f). See §§6.27-6.29. A trustee may not avoid a postpetition transfer of real property by a debtor in possession unless a copy of the petition was recorded prior to the transfer. *Burkart v Coleman (In re Tippett)* (9th Cir 2008) 542 F3d 684 (automatic stay does not prohibit debtor from transferring assets postpetition, although 11 USC §549(c) may permit avoidance of an unauthorized transfer).

The trustee may act only to the extent not inconsistent with provisions governing relief from the automatic stay. 11 USC §363(d)(2). See §6.11. With respect to nonprofit corporations, the trustee must act in accordance with applicable nonbankruptcy law. 11 USC §363(d)(1). On request of any entity with an interest, the court must prohibit or condition the use, sale, or lease as necessary to provide adequate protection. 11 USC §363(e). Forms of adequate protection are described in 11 USC §361. See §§6.17-6.19. The trustee has the burden of proof on the issue of adequate protection. 11 USC §363(p)(1). These rules apply alike in cases under Chapters 7 and 11.

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§6.23 1. In Ordinary Course of Business

The use, sale, or lease of property in the ordinary course of business without notice and hearing is allowed by 11 USC §363(c)(1). The principal relevance of this provision is in Chapter 11 when a business operates pending reorganization. In general, the debtor in possession may use, sell, or lease property of the estate in the ordinary course of business when the operation of the business is authorized. The order authorizing continuation of the business may prohibit or condition the use, sale, or lease of particular items of property. 11 USC §363(e). Special rules also apply to the use of cash collateral. See §6.24.

PRACTICE TIP: A sale of inventory to a buyer in the ordinary course of business, who takes free of the relevant security interest, is one of the most common ways for a secured party to lose its lien. Com C §9320(a). See §§4.64-4.67.

"Ordinary course of business" is narrowly construed. For a debtor to sell assets without notice and hearing, the sale must be consistent with what is expected of a particular debtor. For instance, the sale by a retailer of merchandise is in the ordinary course. However, a bulk sale of the majority of such manufacturer's inventory, such as a liquidation sale, would not be in the ordinary course. The Ninth Circuit has recognized two tests for determining "whether a transaction is within the ordinary course of business for purposes of §363(c)—the vertical dimension, or creditor's expectation, test, and the horizontal dimension test." *Aalfs v Wirum* (*In re Straightline Invs., Inc.* (9th Cir 2008) 525 F3d 870, 879, citing *Burlington N.R.R. Co. v Dant & Russell, Inc.* (*In re Dant & Russell, Inc.*) (9th Cir 1988), 853 F2d 700, 704.) The vertical test looks at the transaction from the point of view of a hypothetical creditor to see whether the transaction subjects a creditor to economic risk different from the risks the creditor accepted when the creditor extended credit. 853 F2d at 705. See also *Committee of Asbestos-Related Litigants and/or creditors of Johns-Manville Corp.* (*In re Johns-Manville Corp.*) (Bankr SDNY 1986) 60 BR 612, 616. Courts often look at the debtor's prepetition business practices. *In re Straightline*, 525 F3d at 880. The horizontal test looks to whether similar businesses would engage the same type of transaction as ordinary business. 525 F3d at 881. In the Ninth Circuit both tests must be met in order for the court to conclude that the subject transaction occurred in the ordinary course of business. 525 F3d at 879. The *Straightline* court held that the postpetition transfer of accounts from the debtor to the lender did not occur in the ordinary course of business. The lender was required to turn over amounts collected on the accounts plus uncollected accounts. This case demonstrates how important it is for a lender to determine whether a transaction is in the ordinary course of business and to insist on court approval of a transaction if there is any doubt.

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§6.24 2. Special Rules for Cash Collateral

Special rules apply when the property to be used is "cash collateral." 11 USC §363(c)(2). The trustee may not use cash collateral without obtaining the consent of each party with an interest (11 USC §363(c)(2)(A)), or authorization by the court after notice and a hearing (11 USC §363(c)(2)(B)). See §§6.25-6.26.

Cash collateral is broadly defined to include "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents … in which the estate and an entity other than the estate have an interest … and includes the proceeds, products, offspring, rents, or profits of property … subject to a security interest." 11 USC §363(a). The phrases "have an interest" and "subject to a security interest" in the definition complicate a determination of what constitutes cash collateral subject to 11 USC §363(c).

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§6.25 a. Adequate Protection for Cash Collateral

Cash collateral can only be used by a debtor if the secured creditor receives adequate protection for the debtor's use of the cash. 11 USC §363(e). See §§6.17-6.19. In many instances, even if the secured creditor with an interest in cash collateral has had an interest in accounts, the secured creditor will lose that interest in accounts after the petition date. 11 USC §552(a). See §6.68. However, as adequate protection, the debtor may grant the secured party a replacement lien on future accounts or perhaps may make interest payments going forward.

PRACTICE TIP: If the court orders new liens or replacement liens, it is not necessary for the secured party to file financing statements. Cautious practitioners, however, may wish to make such filings and should request relief from stay in the order approving the use of cash collateral in order to file the financing statements.

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§6.26 b. Stipulation to Use of Cash Collateral

A secured creditor and the trustee or debtor in possession will often stipulate to the use of cash collateral. If the secured creditor is willing for cash collateral to be used, it is often the best way for the secured creditor to protect its interests. In many cases the secured creditor will require the debtor to use only the amounts specified in a budget filed with the court.

NOTE: Before entering into a stipulation regarding the use of cash collateral, counsel for the secured creditor should check to determine whether the bankruptcy court or the judge before whom the case is pending has issued guidelines for cash collateral stipulations. See, *e.g.,* U.S. Bankr. Ct., N.D. Cal., *Guidelines for Cash Collateral and Financing Stipulations,* available at http://www.canb.uscourts.gov/rules/guidelines.

If the secured creditor does not wish to consent to the use of cash collateral, then the debtor and the secured party will have a contested hearing. Bankruptcy Code §363(c)(3) provides for prompt disposition of the matter. Frequently, a court will have a preliminary hearing shortly after service of the motion, and then a final hearing no earlier than 14 days after service of the motion. Fed R Bankr P 4001(b). The debtor in possession or trustee has the burden of proof regarding whether the secured creditor is adequately protected and the secured creditor has the burden of proof regarding the validity and extent of its security interest in the cash collateral. 11 USC §363(p).

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§6.27 3. Not in Ordinary Course of Business

Bankruptcy Code §363(b) establishes a mechanism for the trustee's use, sale, or lease of property of the estate other than in the ordinary course of business. Special rules added by the BAPCPA to promote consumer privacy apply to the transfer of personally identifiable information. See 11 USC §363(b)(1).

Section 363(b) allows the trustee to act "after notice and a hearing." Federal Rules of Bankruptcy Procedure 2002(a) requires a 21-day notice period to parties in interest unless the court orders otherwise. The form of notice and service on the correct interested parties are important to an effective sale under 11 USC §363. The notice must clearly state what is being sold. See Fed R Bankr P 6004.

To sell the assets in question, the trustee or debtor must be able to demonstrate a "business justification" for the transaction. See *Stephen Indus. v McClung* (6th Cir 1986) 789 F2d 386.

PRACTICE TIP: If the sale is to be free and clear of liens, the lienholders must be notified. Certain courts have held that if the secured party does not receive notice, the sale is not effective as to that secured party. See *Esposito v Title Ins. Co. (In re Fernwood Markets)* (Bankr ED Pa 1987) 73 BR 616. But see *In re Edwards* (7th Cir 1992) 962 F2d 641 (bona fide purchaser has superior rights to unnoticed secured party). The Bankruptcy Appellate Panel for the Ninth Circuit has held that a sale order could be set aside for violation of due process because of lack of notice. *Citicorp Mortgage, Inc. v Brooks (In re Ex-Cel Concrete Co.)* (BAP 9th Cir 1995) 178 BR 198 (decided in real-estate context).

The trustee's sale may be subject to the creditor's security interest. The trustee may also sell free and clear of liens, but only if one of the five conditions in 11 USC §363(f) is satisfied. See §6.28. Usually, the sale is made by a form of competitive bidding. See §6.29.

NOTE: The reversal on appeal of an authorization of a sale or lease under 11 USC §363(b) or (c) does not affect the validity of the sale or lease by a purchaser or lessee in good faith. 11 USC §363(m). Therefore, if a sale closes pending appeal and subject to a valid order, the appeal is moot. *Ewell v Diebert (In re Ewell)* (9th Cir 1992) 958 F2d 276.

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§6.28 a. Sale Free and Clear of Liens and Claims

The trustee can sell free and clear of liens and claims or interests of third parties if:

- The sale would be permitted free and clear under applicable nonbankruptcy law (11 USC §363(f)(1));
- The creditor consents (11 USC §363(f)(2));
- The sale price is greater than the aggregate value of the liens (11 USC §363(f)(3));
- There is a bona fide dispute about the validity of the security interest (11 USC §363(f)(4)); or
- The creditor could be compelled in a legal or equitable proceeding to accept a money satisfaction of the security interest (11 USC §363(f)(5)).

Only one of the criteria set forth in 11 USC §363(f) need be met. *Citicorp Homeowners Servs. v Elliot (In re Elliot)* (ED Pa 1988) 94 BR 343. The creditor has no constitutional right to the property itself, as long as the creditor gets the value of its security. *Wright v Union Cent. Life Ins. Co.* (1940) 311 US 273, 85 L Ed 184, 61 S Ct 196. The property may be sold free and clear of other claims, not just security interests. *In re Crabtree* (WD Okla 1989) 112 BR 420. Before property may be sold free and clear of claims or interests of third parties, the court must determine that the property is "property of the estate" under 11 USC §363(f).

Valuation of a lien in connection with 11 USC §363(f)(3) is difficult. Certain courts have held that the sales price need only exceed the "value" of the collateral and need not exceed the debt, with the value of the collateral determined by the sale itself. See *In re Beker Indus. Corp.* (Bankr SD NY 1986) 63 BR 474. Other courts, however, including the Bankruptcy Appellate Panel of the Ninth Circuit and the Bankruptcy Court for the Northern District of California, have held that the sale price must exceed the face amount of the debt. See *Clear Channel Outdoor, Inc. v Knupfer (In re PW, LLC)* (BAP 9th Cir 2008) 391 BR 25; *In re Canonigo* (Bankr ND Cal 2002) 276 BR 257; *Scherer v Federal Nat'l Mortgage Ass'n (In re Terrace Chalet Apartments, Ltd.)* (ND Ill 1993) 159 BR 821.

An objection to a sale under §363(f) must be timely made; waiting until after a sale closes when the third party had notice of the sale is too late. *Canzano v Ragosa (In re Colarusso)* (1st Cir 2004) 382 F3d 51. The Bankruptcy Appellate Panel of the Ninth Circuit has also held that outside a plan of reorganization, 11 USC §363(f)(5) does not permit a senior secured lender to credit bid its debt in order to purchase property free and clear of valid junior liens. *Clear Channel Outdoor, Inc. v Knupfer* (*In re PW, LLC)* (BAP 9th Cir 2008) 391 BR 25.

NOTE: Under the same facts as *Clear Channel,* if the senior secured creditor had moved for relief from the automatic stay to foreclose on the secured property, it would have been able to credit bid at a public sale and wipe out a junior lien.

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§6.29 b. Bidding Procedure

Generally, once the debtor in possession or trustee decides to sell an asset, the asset must be sold to the entity offering the best price under the circumstances. *In re Integrated Resources, Inc*. (SD NY 1992) 147 BR 650. Therefore, there is often a court-supervised auction process with one entity acting as a lead bidder. That bidder may seek a break-up fee or topping fee to protect itself in case another bidder wins. The topping fee and bidding procedures should be approved by the bankruptcy court. See *In re Integrated Resources, Inc*. (SD NY 1992) 147 BR 650.

PRACTICE TIP: If the secured creditor wishes to purchase the assets, the secured creditor is permitted to "credit bid" by bidding up to the full amount of its debt at the auction.

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§6.30 B. Debtor-in-Possession Financing

If a trustee or debtor in possession believes that the estate cannot be managed without a loan, a debtor may seek to obtain court approval to borrow money. 11 USC §364. This is commonly known as debtor-in-possession or DIP financing.

A secured creditor may wish to loan money to a debtor under 11 USC §364 because of the benefits that it brings, including a superpriority claim or replacement liens in collateral. See §6.31.

If the secured creditor was providing the debtor with revolving credit, the prepetition debt may simply revolve through as part of a DIP loan during the course of the case. In crafting orders approving a DIP financing, many creditors request that the court validate prepetition security interests and relief from the automatic stay to enforce remedies. Not all courts are willing to do so and some courts have published guidelines describing what will or will not be approved. See §6.32.

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§6.31 1. Priority of Financing

The trustee or debtor in possession may obtain unsecured credit allowable as an administrative expense, either without notice and hearing in the ordinary course of business or after notice and hearing. 11 USC §§364(a)-(b), 503(b)(1). If unsecured credit in the ordinary course of business is unavailable, after notice and hearing, the trustee or debtor in possession may obtain:

- Credit eligible for a "superpriority" under 11 USC §503(b) or §507(b) (11 USC §364(c)(1));
- Credit secured by a lien on property not otherwise subject to a lien (11 USC §364(c)(2)); or
- Credit secured by a junior lien on property subject to a senior lien (11 USC §364(c)(3)).

A "superpriority" claim is a claim superior to those of all other creditors. Failing these, the court may authorize the trustee (or debtor in possession) to obtain credit secured by a lien senior or equal to a lien already on specific property. There must be "adequate protection" for existing secured creditors, and the trustee has the burden of proof. 11 USC §364(d). It is very difficult to prime another lender.

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§6.32 2. Court Approval of Financing

The court may act quickly to approve DIP financing. A court may hear the matter on an expedited basis, issue an interim order, and then have a final hearing 14 days thereafter. Fed R Bankr P 4001(c). The creditor is protected during the time period of the interim order for loans that are made. 11 USC §364(e).

PRACTICE TIP: If the court orders new liens or replacement liens, it is not necessary for the secured party to file financing statements. Cautious practitioners, however, may wish to make such filings and should request relief from stay in the order approving the DIP financing in order to file the financing statements.

Some creditors seek to cross-collateralize loans so that the prepetition debt and postpetition debt are secured equally. Courts generally do not permit cross-collateralizations. See *In re Ames Dep't Stores* (Bankr SD NY 1990) 115 BR 34. Both the Northern District of California and the Eastern District of California have established guidelines under which their bankruptcy courts are willing to permit the use of DIP financing. The Northern District of California Guidelines for Cash Collateral and Financing Stipulations can be found under the "Guidelines" tab at http://www.canb.uscourts.gov/rules/guidelines. The Eastern District of California's guidelines are posted at http://www.caeb.uscourts.gov/data/formpubs/GL.Cash.pdf. The bankruptcy court in Delaware also has certain guidelines.

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§6.33 C. Turnover of Property to Trustee

If a creditor takes possession of the debtor's property intending to use it to liquidate the claim just before a petition in bankruptcy is filed, the trustee (or debtor in possession) has broad powers to compel the property to be turned over to the estate. 11 USC §§542-543. See §6.34. The seizure of property by the secured creditor generally does not prevent turnover to the estate. See §§6.35-6.39. Special rules apply to turnover by custodians under 11 USC §543. See §6.40.

The trustee's power is limited, however, to the property that the trustee may use, sell, or lease under 11 USC §363, or that is exempt under 11 USC §522. 11 USC §542(a). It is therefore necessary to read 11 USC §542, on turnover orders, and 11 USC §363, on use, sale, or lease, together. For example, the trustee may not use property without providing (on appropriate demand) adequate protection. 11 USC §363(e). See §6.22.

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§6.34 1. Property Subject to Turnover Powers

The property subject to the trustee's turnover powers includes all the debtor's legal and equitable interests in property when the case begins. 11 USC §541(a)(1). If the trustee establishes rights in property by use of avoiding powers (11 USC §§544-548, 550), by turnover from a custodian (11 USC §543), by other specified means (11 USC §§329(b), 363(n), 553, 723), or because it is after-acquired property, that property becomes property of the estate. 11 USC §541(a)(3)-(a)(7).

The breadth of the definition of property of the estate under 11 USC §541(a) and the trustee's turnover powers under 11 USC §542 is illustrated by *Austein v Schwartz (In re Gerwer)* (9th Cir 1990) 898 F2d 730. *Gerwer* held that the trustee's failure to act within the time period set forth in 11 USC §108(b), giving the trustee 60 days to cure the debtor's prepetition defaults, did not preclude the debtor from retaining an equitable interest in promissory notes and deeds of trust that were in the possession of the secured creditor when the secured creditor failed to successfully foreclose on the property and extinguish the equity of redemption in accordance with California law.

Because the debtor was found to have had an equitable interest in the promissory notes, the notes were property of the estate under 11 USC §541(a), thus giving the bankruptcy trustee the power to obtain turnover of the promissory notes for subsequent sale to a third party with the proceeds inuring to the benefit of the estate.

The *Gerwer* court held that the trustee could obtain turnover of the property from the secured creditor who was in possession of the property before any default even though the proceedings were under Chapter 7 liquidation as opposed to a reorganization under Chapter 11.

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§6.35 2. Effect of Seizure

In *U.S. v Whiting Pools, Inc.* (1983) 462 US 198, 209, 76 L Ed 2d 515, 524, 103 S Ct 2309, the Court held that "the reorganization estate includes property of the debtor that has been seized by a creditor prior to the filing of a petition for reorganization." In *Whiting Pools*, the IRS seized tangible personal property of the debtor. The Court held that the property was subject to the turnover powers of 11 USC §542. The Court concluded that the secured creditor remains entitled to adequate protection of its interests under 11 USC §363(e). 462 US at 212, 76 L Ed 2d at 526. See §6.33.

Federal courts at all jurisdictional levels have struggled to apply the turnover rule in *Whiting Pools*. The lower courts are divided over the treatment of intangible property such as accounts receivable and bank accounts subject to an IRS levy. See §§6.36-6.37.

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§6.36 a. Accounts Receivable

A secured creditor's seizure of the debtor's accounts receivable does not divest the debtor of an interest in those accounts. Therefore, the bankruptcy court may properly compel the entities owing money under the accounts receivable to turn over such funds to the debtor's estate. The ownership of property seized by the secured creditor is transferred only when the seized property is sold to a bona fide purchaser. *Dewhirst v Citibank (Arizona) (In re Contractors Equip. Supply Co.)* (9th Cir 1988) 861 F2d 241, 244.

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§6.37 b. Bank Accounts Subject to IRS Levy

A heavily contested issue in turnover litigation cases is whether the ownership of funds in a debtor's bank account is transferred to the IRS when a prepetition notice of levy is served on the bank by the IRS, so that the proceeds of the bank account are not property of the debtor's estate as of the petition date under 11 USC §541(a). The courts have split on this question. See §§6.38-6.39.

NOTE: The Ninth Circuit has recognized this split of authority, but has not resolved the issue for the circuit. See *Dewhirst v Citibank (Arizona) (In re Contractors Equip. Supply Co.)* (9th Cir 1988) 861 F2d 241, 244 n6.

A bankruptcy court has held, however, that under California law, service of notice of levy by the state taxing authority on the debtors' bank accounts was sufficient to deprive the debtors of all interest therein and to prevent the accounts from becoming property of the estate under 11 USC §541. *Paul v State Bd. of Equalization (In re Paul)* (Bankr ED Cal 1988) 85 BR 850.

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§6.38 (1) Majority View

A majority of the courts after *U.S. v Whiting Pools, Inc.* (1983) 462 US 198, 76 L Ed 2d 515, 103 S Ct 2309 (see §6.35), focusing on whether the property at issue was tangible or intangible, have held that a prepetition notice of levy by the IRS of a debtor's bank account is analogous to a prepetition repossession of tangible property, and that the bank account remains property of the debtor's estate subject to turnover. See, *e.g., U.S. v Challenge Air Int'l Inc. (In re Challenge Air Int'l, Inc.)* (11th Cir 1992) 952 F2d 384; *Hunter v U.S. (In re Hunter)* (Bankr ED Ark 1996) 201 BR 959.

PRACTICE TIP: Even in jurisdictions following the majority view, debtor's counsel must be cognizant of the IRS's secured claims when initiating turnover litigation.

Two cases that adopt the majority view resulted in a favorable outcome to the IRS nonetheless. In *Gouveia v IRS (In re Quality Healthcare)* (Bankr ND Ind 1997) 215 BR 543 and *Hancock Bank v IRS (In re Creel)* (Bankr ED La 1997) 214 BR 838, the courts held that, despite the fact that the bank account funds on which the IRS issued a prepetition levy were property of the bankruptcy estate, the IRS was entitled to receive these funds as adequate protection of its secured claim under 11 USC §§361 and 363.

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§6.39 (2) Minority View

A minority of courts, focusing on the distinction between salable and nonsalable property, hold that a notice of levy by the IRS is enough to terminate a debtor's ownership in a bank account because the bank account consists only of the right to payment, and postlevy the IRS is the only entity that can enforce that right. The minority view is well analyzed in *In re Smiley* (Bankr ED Pa 1995) 189 BR 338, in which a Chapter 13 debtor moved to enjoin her bank from transferring funds in her bank account to the IRS under a prepetition notice of levy on the grounds that the IRS's postpetition demand for turnover violated the automatic stay. In *U.S. v Coghlan (In re Coghlan)* (D Ariz 1998) 227 BR 304, the court held that the debtor retained no interest in money already paid to the IRS.

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§6.40 3. Turnover From Custodians

Special rules apply to the turnover of property from nonbankruptcy custodians under 11 USC §543. A custodian is an assignee under a general assignment for the benefit of creditors, or a liquidation receiver or any receiver or trustee appointed before bankruptcy for any of the property of the debtor, or any agent or receiver appointed for the purpose of lien enforcement. 11 USC §101(11).

The turnover order against custodians is not limited to situations in which the trustee may use, sell, or lease the property. 11 USC §543(b). The court may allow property to remain in the custodian's control if the interests of the creditors would be better served. 11 USC §543(d).

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§6.41 D. Assumption or Rejection of Executory Contracts and Unexpired Leases

During the pendency of a bankruptcy case, the trustee normally has the right to continue to perform under an executory contract or unexpired lease, although there are certain limitations discussed below in §§6.44-6.49. If the debtor needs or wishes to continue the benefits of the contract, the nondebtor party can be forced to perform by court order. The trustee also may reject any executory contract or unexpired lease of the debtor. 11 USC §365(a). See §§6.42-6.43. Limitations on assumption and assignment of executory contracts and unexpired leases are discussed in §§6.44-6.49.

The ability to assume or reject a contract can have a dramatic effect on the debtor's estate, because rejection permits the debtor to shed liabilities if it no longer wishes to perform a contract. In evaluating whether the rejection of a contract should be approved, courts apply the business judgment rule. *Agarwal v Pomona Valley Med. Group, Inc. (In re Pomona Valley Med. Group, Inc.*) (9th Cir 2007) 476 F3d 665, 670. See also *In re Old Carco LLC* (Bankr SD NY 2009) 406 BR 180. On rejection, the debtor is treated as if breach of the lease or executory contract occurred immediately prior to the petition being filed, thus making any claim of the lessor or other contracting party a prepetition claim. 11 USC §365(g)(1). Although the debtor will not receive future benefits, the debtor will retain any pending claim or defenses that it had with respect to the lease or executory contract. *First Ave. W. Bldg., LLC v Jones* (*In re Onecast Media, Inc.*) (9th Cir 2006) 439 F3d 558. If a license is rejected by a debtor licensor, however, the licensee may retain certain rights under the license. 11 USC §365(n). See §6.50.

Special rules apply to real property leases. 11 USC §365(b)(3), (c)(3), (d). The detailed rules regarding real property leases are beyond the scope of this chapter.

In connection with a plan of reorganization, if the debtor does not provide that all contracts will be rejected, the executory contracts that have not previously been rejected and that are not in breach "ride through" the bankruptcy. These executory contracts remain in full force and effect, and pass with other property to the reorganized debtor. See *Diamond Z Trailer, Inc. v JZ LLC* (*In re JZ LLC)* (BAP 9th Cir 2007) 371 BR 412, for a discussion of the "ride through" doctrine.

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§6.42 1. Ipso Facto Clauses Prohibited

Bankruptcy Code §365(e)(1) prevents the termination of executory contracts by nondebtor parties. It bars the enforcement of what is known as an "ipso facto clause," which is a clause providing for the termination of a contract on the bankruptcy of one of the parties to the contract. Bankruptcy Code §365(e)(2) provides exceptions to the prohibition of enforcement of an ipso facto clause. To the extent that applicable law excuses a nondebtor party to the contract or lease from accepting performance from or rendering performance to the debtor or trustee, an ipso facto clause will be enforceable. 11 USC §365(e)(2)(A). The Fifth Circuit has examined the applicability of Bankruptcy Code §365(e)(2)(A) and determined that the relief from stay must be obtained in order to take advantage of §365(e)(2)(A) and that §365(e)(2)(A) may not be enforced against the debtor in possession. *Bonneville Power Admin. v Mirant Corp. (In re Mirant Corp.)* (5th Cir 2006) 440 F3d 238.

Financial accommodation contracts, *i.e.,* loan agreements and other contracts providing for debt financing, are also excepted from the prohibition on enforcement of ipso facto clauses in Bankruptcy Code §365(e)(1). 11 USC §365(e)(2)(B). See §6.45.

Bankruptcy Code §525(a) prohibits a governmental unit from denying, revoking, suspending, or refusing to renew a license, permit, franchise, or other similar grant because a person is a debtor, has been insolvent prior to the commencement of the case, or has not paid a debt that is dischargeable under the Bankruptcy Code. See *FCC v NextWave Personal Communications, Inc.* (2003) 537 US 293, 154 L Ed 2d 863, 123 S Ct 832 (Court saw no conflict with Federal Communications Act, which would have allowed cancellation of license, because Act did not require that cancellation of license be sanction for failure to make timely payments). The Ninth Circuit distinguished *NextWave* in *Thacker v FCC* (*In re Magnacom Wireless, LLC)* (9th Cir 2007) 503 F3d 984, cert denied (2008), __ US __, 170 L Ed 2d 793, 128 S Ct 2076. In *Magnacom*, the FCC sought relief from stay, cancelled the debtor's licenses, and sold at auction the rights to the spectrum previously licensed to Magnacom. In rejecting the trustee's claim to the auction proceeds, the court found that once the FCC cancelled the licenses, they had no value, and because the trustee did not challenge the cancellation under Bankr C §525, *NextWave* did not apply. 503 F3d at 990. See also *Urban Communications PCS, Ltd v Gabriel Capital, LP* (SD NY 2008) 394 BR 325.

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§6.43 2. Protective Effect of Automatic Stay

Contract rights are considered the property of the estate and are protected by the automatic stay, even when one party would otherwise have the power to terminate at will. *Elder-Beerman Stores v Thomasville Furniture Indus., Inc. (In re Elder-Beerman Stores)* (Bankr SD Ohio 1996) 195 BR 1019, 1023. In addition, the automatic stay is applicable to contract termination notices. 195 BR at 1024. See also *Coates v Peachtree Apartments (In re Coates)* (Bankr MD Ga 1989) 108 BR 823, 826 (month-to-month tenancy at will is property of the estate that debtor's landlord cannot terminate until it obtains relief from the automatic stay); *Schewe v Fairview Estates (In re Schewe)* (Bankr WD Mich 1989) 94 BR 938.

Although loan agreements and other financial accommodation contracts cannot be assumed (see §6.45), there is a conflict in the case law regarding whether it is a violation of the automatic stay for a lender to terminate a financial accommodation contract without seeking relief from the automatic stay. See *Computer Communications, Inc. v Codex Corp. (In re Computer Communications, Inc.)* (9th Cir 1987) 824 F2d 725, 730 (termination of unassumable executory contract barred by the automatic stay even if such termination is permitted under 11 USC §365(e)(2)(A)); *Wegner Farms Co. v Merchants Bonding Co. (In re Wegner Farms Co.)* (Bankr ND Iowa 1985) 49 BR 440 (same). But see *Watts v Pennsylvania Hous. Fin. Co. (In re Watts)* (3d Cir 1989) 876 F2d 1090, 1096 (termination of unassumable financial accommodation contract is not barred by the automatic stay because termination of such contract is permitted under 11 USC §365(e)(2)(B)).

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§6.44 3. Limitations on Assumption and Assignment

In order to assign a contract to a third party, the third party must demonstrate that it will be able to perform adequately in the future. 11 USC §365(b). In addition, a trustee may not assume an executory contract or unexpired lease if there has been a default, unless the default is cured or the trustee provides adequate assurance that the default will be cured promptly. 11 USC §365(b)(1). This requirement does not apply to defaults that are a breach related to the debtor's financial condition, the filing of the bankruptcy case, the appointment of a trustee postpetition or custodian prepetition, or the satisfaction of any penalty rate or penalty provision. 11 USC §365(b)(2). If, however, the default is a noncurable default, other than one relating to a penalty rate or penalty provision, the contract may not be assumed. There is an exception for "going dark" clauses in nonresidential real property leases, which may be cured at the time of assumption. 11 USC §365(b)(1)(A). Once a contract is assumed by the debtor, all amounts owing under the contract are treated as administrative expenses under 11 USC §503.

Under 11 USC §365(c)(2), certain executory contracts cannot be assumed by a debtor, including a contract to make a loan or extend other debt financing or financial accommodations to or for the benefit of the debtor, and the debtor cannot force continued performance under those contracts. Such contracts are generally referred to as financial accommodation contracts. See §6.45.

Certain types of contracts governed by nonbankruptcy law cannot be assumed or assigned under 11 USC §365(c)(1). The fact that "applicable law" prohibits the assumption and assignment of these contracts by the debtor may have a direct impact on the value of a secured party's collateral. See §§6.46-6.49.

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§6.45 a. Financial Accommodations

There is a split of authority regarding whether financial accommodation contracts may be assumed with the consent of the secured party. In *Transamerica Com. Fin. Corp. v Citibank (In re Sun Runner Marine)* (9th Cir 1991) 945 F2d 1089, the court held that a financial accommodation could not be assumed even if the secured party consented, based on the plain language of 11 USC §365(c)(2). See also *In re Whiteprize, LLC* (Bankr D Ariz 2002) 275 BR 868. Other courts that have considered the issue have held that if the debtor and the secured party agree, the contract may be assumed. *Huntington Nat'l Bank v Alix (In re Cardinal Indus., Inc.)* (Bankr SD Ohio 1992) 146 BR 720; *In re TS Indus, Inc.* (Bankr D Utah 1990) 117 BR 682.

PRACTICE TIP: Practitioners in the Ninth Circuit should be aware that a financial accommodation contract cannot be assumed.

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§6.46 b. Assumption and Assignment Prohibited by Applicable Nonbankruptcy Law

Bankruptcy Code §365(c)(1) provides that a trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if "applicable law" excuses a party from performing or accepting performance under the contract or lease and the party does not consent to the assumption or assignment. This provision has been applied to prohibit assumption and assignment by debtor licensees of certain rights under licenses of intellectual property. See §§6.47-6.49. Rights of licensees under licenses rejected by debtor licensors are discussed in §6.50.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/6 The Secured Creditor and Bankruptcy/§6.47 (1) Patents

§6.47 (1) Patents

Courts have upheld prohibitions on assignment in bankruptcy cases based on federal patent law. See *Everex Sys., Inc. v Cadtrak Corp. (In re CFLC, Inc.)* (9th Cir 1996) 89 F3d 673. Therefore, if a licensor does not want a patent assigned to a third party, the licensor should include a prohibition in the license agreement so that it will not be assignable by the debtor. Bankruptcy Code §365(c)(1) refers to both assumption and assignment. Therefore, the same arguments to prohibit assignment to a third party can apply to the assumption by the debtor of executory contracts and leases. In *Perlman v Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)* (9th Cir 1999) 165 F3d 747, the debtor tried to assume a nonexclusive patent license. The Ninth Circuit found that because applicable patent law would not permit the assignment, under the plain language of 11 USC §365(c)(1), the debtor could not even assume the license. Several courts have followed the Ninth Circuit analysis in *Catapult*, finding that a debtor cannot assume a contract. See §§6.47-6.49A. This has become known as the "hypothetical" test. Other courts, however, have found that if there is no "actual" assignment to be considered, the debtor may assume the contract. See *Institut Pasteur v Cambridge BioTech Corp.* (1st Cir 1997) 104 F3d 489; *In re Aerobox Composite Structures* (Bankr D NM 2007) 373 BR 135 (nondebtor party to contract may not compel debtor in possession to reject contract when debtor continued to operate under license agreement without seeking to assume or reject it).

PRACTICE TIP: A lender should be aware of what licenses are held by the borrower, because the borrower may not be able to retain important licensing relationships in bankruptcy without the written consent of its licensor.

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§6.48 (2) Copyrights

Courts have also found that copyright licenses may not be assigned without the copyright owner's consent. See *In re Patient Educ. Media, Inc.* (Bankr SD NY 1997) 210 BR 237. See also *In re Golden Books Family Entertainment, Inc.* (Bankr D Del 2001) 269 BR 300. The Ninth Circuit has held that even an exclusive license is not assignable without consent. *Gardner v Nike, Inc.* (9th Cir 2002) 279 F3d 774. Several courts have criticized *Gardner* for holding that an exclusive licensee may not freely transfer its rights to third parties. See, *e.g., Traicoff v Digital Media, Inc.* (SD Ind 2006) 439 F Supp 2d 872, 877.

The Fourth Circuit has examined the question of whether a software license may be assumed by a debtor. Using the same logic found in *Perlman v Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)* (9th Cir 1999) 165 F3d 747 (see §6.47), the Fourth Circuit has held that 11 USC §365(c) prohibits a debtor in possession from assuming a nonexclusive software license if applicable law would prohibit the assignment without the consent of the other party to the contract, and copyright law prohibits the assignment. *RCI Technol. v Sunterra Corp. (In re Sunterra Corp.)* (4th Cir 2004) 361 F3d 257.

Although not accepting the "actual" assignment reasoning in *Institut Pasteur,* discussed in §6.47 above, the U.S. Bankruptcy Court for the Southern District of New York has also found that if the debtor in possession, rather than a trustee, is seeking to assume the contract, the assumption will be permitted under 11 USC §365(c)(1). *In re Footstar, Inc.* (Bankr SD NY 2005) 323 BR 566 (case does not specify type of intellectual property but presumably it was copyright or trademark). The Supreme Court has indicated a willingness to resolve the split in the circuits over the "actual" and "hypothetical" test for assumption of intellectual property contracts. In denying certiorari in *N.C.P. Mktg. Group, Inc. v BG Star Prods., Inc. (In re N.C.P. Mktg. Group, Inc.)* (D Nev 2005) 337 BR 230, aff'd (9th Cir 2008) 279 Fed Appx 561 (unpublished opinion), cert denied (2009) 556 US __, 173 L Ed 2d 1028, 129 S Ct 1577, Justices Kennedy and Breyer noted that "[t]he division over the meaning of 365(c)(1) is an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization"; the N.C.P. case, however, was "not the most suitable case for our resolution of the conflict."

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§6.49 (3) Trademarks

Some courts have permitted the assignment of trademark licenses. See *In re Rooster, Inc.* (Bankr ED Pa 1989) 100 BR 228. However, courts reviewing this question more recently have held that trademark licenses may not be assigned without the consent of the trademark owner. See *Wellington Vision, Inc. v Pearle Vision, Inc.*(SD Fla 2007) 364 BR 129; *N.C.P. Mktg. Group, Inc. v BG Star Prods., Inc. (In re N.C.P. Mktg. Group, Inc.)* (D Nev 2005) 337 BR 230, aff'd (9th Cir 2008) 279 Fed Appx 561 (unpublished opinion), cert denied (2009) 556 US __, 173 L Ed 2d 1028, 129 S Ct 1577; *In re The Travelot Co.* (Bankr SD Ga 2002) 286 BR 447.

In jurisdictions in which assignment is permitted, the licensor can protect itself to some degree by including quality assurance protections and certain financial qualifications. In order for the debtor to assume and assign a contract, the assignee must be able to perform the terms of the contract.

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§6.49A (4) Anti-Assignment Language

Practitioners should note that the discussion in §§6.47-6.49 relates only to licenses in which assignments are prohibited. If the assignment language in the license permits assignment, then the license may be assigned. *In re Quantegy, Inc.* (Bankr MD Ala 2005) 326 BR 467. A clause that prohibits the unreasonable withholding of consent is not equivalent to a clause that permits assignment. *Wellington Vision, Inc. v Pearle Vision, Inc.* (*In re Wellington Vision, Inc.*) (SD Fla 2007) 364 BR 129.

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§6.50 4. Special Provision for Licensee's Rights in Intellectual Property of Debtor Licensor

Bankruptcy Code §365(n) covers intellectual property of the debtor as defined in the Bankruptcy Code, including trade secrets, patents, copyrightable material, and mask works. Trademarks are not included in the definition of intellectual property under the Bankruptcy Code. 11 USC §101(35A). See *Raima UK Ltd. v Centura Software Corp. (In re Centura Software Corp.)* (Bankr ND Cal 2002) 281 BR 660 (trademarks not given protection of 11 USC §365(n)).

Bankruptcy Code §365(n) provides that if the debtor is the licensor under an intellectual property license, even if the debtor rejects the license, the licensee is provided with certain rights including the ability to receive any source code. This provision is supposed to permit the licensee to avoid business disruption should the licensor be forced to file for bankruptcy. Bankruptcy Code §365(n) may or may not apply to licenses of intellectual property registered under foreign laws (*e.g.,* Japanese patents).

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V. SECURED CREDITOR'S CLAIM

§6.51 A. Filing Creditor's Claim

A proof of claim is considered filed for any scheduled debt unless it is scheduled as disputed, contingent, or unliquidated. 11 USC §1111(a). However, the creditor itself will also usually file a proof of claim. See §6.52. In Chapter 7 cases, the claim must be filed within 90 days after the date first set for the meeting of creditors. Fed R Bankr P 3002(c). The court will generally set a bar date in Chapter 11 cases at which time all claims must be filed.

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§6.52 1. Proof of Claim

To protect a secured claim in a bankruptcy case, the secured creditor should file a proof of claim under 11 USC §501(a). The official bankruptcy form Proof of Claim (Form B10) is reprinted in §6.53. The creditor should attach evidence of the underlying agreement and perfection to the claim. Failure to claim security may waive it. See *Ford Motor Credit Co. v Salsbury (In re Salsbury)* (Bankr ED Mich 1982) 23 BR 615.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/6 The Secured Creditor and Bankruptcy/§6.53 2. Form: Proof of Claim (United States Bankruptcy Court Form B10)

§6.53 2. Form: Proof of Claim (United States Bankruptcy Court Form B10)



B 10 (Official Form 10) (04/10)

UNITED STATES BANKRUPTCY COURT	**PROOF OF CLAIM**
Name of Debtor:	Case Number:

NOTE: *This form should not be used to make a claim for an administrative expense arising after the commencement of the case. A request for payment of an administrative expense may be filed pursuant to 11 U.S.C. § 503.*

Name of Creditor (the person or other entity to whom the debtor owes money or property):

Name and address where notices should be sent:

Telephone number:

☐ Check this box to indicate that this claim amends a previously filed claim.

Court Claim Number:_____
(*If known*)

Filed on:_____

Name and address where payment should be sent (if different from above):

Telephone number:

☐ Check this box if you are aware that anyone else has filed a proof of claim relating to your claim. Attach copy of statement giving particulars.

☐ Check this box if you are the debtor or trustee in this case.

1. Amount of Claim as of Date Case Filed: $_____

If all or part of your claim is secured, complete item 4 below; however, if all of your claim is unsecured, do not complete item 4.

If all or part of your claim is entitled to priority, complete item 5.

☐ Check this box if claim includes interest or other charges in addition to the principal amount of claim. Attach itemized statement of interest or charges.

2. Basis for Claim: _____
(See instruction #2 on reverse side.)

3. Last four digits of any number by which creditor identifies debtor: _____

3a. Debtor may have scheduled account as: _____
(See instruction #3a on reverse side.)

4. Secured Claim (See instruction #4 on reverse side.)
Check the appropriate box if your claim is secured by a lien on property or a right of setoff and provide the requested information.

Nature of property or right of setoff: ☐ Real Estate ☐ Motor Vehicle ☐ Other
Describe:

Value of Property:$_____ **Annual Interest Rate**_____**%**

Amount of arrearage and other charges as of time case filed included in secured claim,

if any: $_____ **Basis for perfection:** _____

Amount of Secured Claim: $_____ **Amount Unsecured: $**_____

6. Credits: The amount of all payments on this claim has been credited for the purpose of making this proof of claim.

7. Documents: Attach redacted copies of any documents that support the claim, such as promissory notes, purchase orders, invoices, itemized statements of running accounts, contracts, judgments, mortgages, and security agreements. You may also attach a summary. Attach redacted copies of documents providing evidence of perfection of a security interest. You may also attach a summary. (*See instruction 7 and definition of "redacted" on reverse side.)*

DO NOT SEND ORIGINAL DOCUMENTS. ATTACHED DOCUMENTS MAY BE DESTROYED AFTER SCANNING.

If the documents are not available, please explain:

5. Amount of Claim Entitled to Priority under 11 U.S.C. §507(a). If any portion of your claim falls in one of the following categories, check the box and state the amount.

Specify the priority of the claim.

☐ Domestic support obligations under 11 U.S.C. §507(a)(1)(A) or (a)(1)(B).

☐ Wages, salaries, or commissions (up to $11,725*) earned within 180 days before filing of the bankruptcy petition or cessation of the debtor's business, whichever is earlier – 11 U.S.C. §507 (a)(4).

☐ Contributions to an employee benefit plan – 11 U.S.C. §507 (a)(5).

☐ Up to $2,600* of deposits toward purchase, lease, or rental of property or services for personal, family, or household use – 11 U.S.C. §507 (a)(7).

☐ Taxes or penalties owed to governmental units – 11 U.S.C. §507 (a)(8).

☐ Other – Specify applicable paragraph of 11 U.S.C. §507 (a)(__).

Amount entitled to priority:

$_____

**Amounts are subject to adjustment on 4/1/13 and every 3 years thereafter with respect to cases commenced on or after the date of adjustment.*

Date:	**Signature:** The person filing this claim must sign it. Sign and print name and title, if any, of the creditor or other person authorized to file this claim and state address and telephone number if different from the notice address above. Attach copy of power of attorney, if any.	**FOR COURT USE ONLY**

Penalty for presenting fraudulent claim: Fine of up to $500,000 or imprisonment for up to 5 years, or both. 18 U.S.C. §§ 152 and 3571.

INSTRUCTIONS FOR PROOF OF CLAIM FORM

The instructions and definitions below are general explanations of the law. In certain circumstances, such as bankruptcy cases not filed voluntarily by the debtor, there may be exceptions to these general rules.

Items to be completed in Proof of Claim form

Court, Name of Debtor, and Case Number:
Fill in the federal judicial district where the bankruptcy case was filed (for example, Central District of California), the bankruptcy debtor's name, and the bankruptcy case number. If the creditor received a notice of the case from the bankruptcy court, all of this information is located at the top of the notice.

Creditor's Name and Address:
Fill in the name of the person or entity asserting a claim and the name and address of the person who should receive notices issued during the bankruptcy case. A separate space is provided for the payment address if it differs from the notice address. The creditor has a continuing obligation to keep the court informed of its current address. See Federal Rule of Bankruptcy Procedure (FRBP) 2002(g).

1. **Amount of Claim as of Date Case Filed:**
State the total amount owed to the creditor on the date of the Bankruptcy filing. Follow the instructions concerning whether to complete items 4 and 5. Check the box if interest or other charges are included in the claim.

2. **Basis for Claim:**
State the type of debt or how it was incurred. Examples include goods sold, money loaned, services performed, personal injury/wrongful death, car loan, mortgage note, and credit card. If the claim is based on the delivery of health care goods or services, limit the disclosure of the goods or services so as to avoid embarrassment or the disclosure of confidential health care information. You may be required to provide additional disclosure if the trustee or another party in interest files an objection to your claim.

3. **Last Four Digits of Any Number by Which Creditor Identifies Debtor:**
State only the last four digits of the debtor's account or other number used by the creditor to identify the debtor.

   3a. Debtor May Have Scheduled Account As:
   Use this space to report a change in the creditor's name, a transferred claim, or any other information that clarifies a difference between this proof of claim and the claim as scheduled by the debtor.

4. **Secured Claim:**
Check the appropriate box and provide the requested information if the claim is fully or partially secured. Skip this section if the claim is entirely unsecured. (See DEFINITIONS, below.) State the type and the value of property that secures the claim, attach copies of lien documentation, and state annual interest rate and the amount past due on the claim as of the date of the bankruptcy filing.

5. **Amount of Claim Entitled to Priority Under 11 U.S.C. §507(a).**
If any portion of your claim falls in one or more of the listed categories, check the appropriate box(es) and state the amount entitled to priority. (See DEFINITIONS, below.) A claim may be partly priority and partly non-priority. For example, in some of the categories, the law limits the amount entitled to priority.

6. **Credits:**
An authorized signature on this proof of claim serves as an acknowledgment that when calculating the amount of the claim, the creditor gave the debtor credit for any payments received toward the debt.

7. **Documents:**
Attach to this proof of claim form redacted copies documenting the existence of the debt and of any lien securing the debt. You may also attach a summary. You must also attach copies of documents that evidence perfection of any security interest. You may also attach a summary. FRBP 3001(c) and (d). If the claim is based on the delivery of health care goods or services, see instruction 2. Do not send original documents, as attachments may be destroyed after scanning.

Date and Signature:
The person filing this proof of claim must sign and date it. FRBP 9011. If the claim is filed electronically, FRBP 5005(a)(2), authorizes courts to establish local rules specifying what constitutes a signature. Print the name and title, if any, of the creditor or other person authorized to file this claim. State the filer's address and telephone number if it differs from the address given on the top of the form for purposes of receiving notices. Attach a complete copy of any power of attorney. Criminal penalties apply for making a false statement on a proof of claim.

DEFINITIONS

Debtor
A debtor is the person, corporation, or other entity that has filed a bankruptcy case.

Creditor
A creditor is a person, corporation, or other entity owed a debt by the debtor that arose on or before the date of the bankruptcy filing. See 11 U.S.C. §101 (10)

Claim
A claim is the creditor's right to receive payment on a debt owed by the debtor that arose on the date of the bankruptcy filing. See 11 U.S.C. §101 (5). A claim may be secured or unsecured

Proof of Claim
A proof of claim is a form used by the creditor to indicate the amount of the debt owed by the debtor on the date of the bankruptcy filing. The creditor must file the form with the clerk of the same bankruptcy court in which the bankruptcy case was filed.

Secured Claim Under 11 U.S.C. §506(a)
A secured claim is one backed by a lien on property of the debtor. The claim is secured so long as the creditor has the right to be paid from the property prior to other creditors. The amount of the secured claim cannot exceed the value of the property. Any amount owed to the creditor in excess of the value of the property is an unsecured claim. Examples of liens on property include a mortgage on real estate or a security interest in a car.

A lien may be voluntarily granted by a debtor or may be obtained through a court proceeding. In some states, a court judgment is a lien. A claim also may be secured if the creditor owes the debtor money (has a right to setoff).

Unsecured Claim
An unsecured claim is one that does not meet the requirements of a secured claim. A claim may be partly unsecured if the amount of the claim exceeds the value of the property on which the creditor has a lien.

Claim Entitled to Priority Under 11 U.S.C. §507(a)
Priority claims are certain categories of unsecured claims that are paid from the available money or property in a bankruptcy case before other unsecured claims.

Redacted
A document has been redacted when the person filing it has masked, edited out, or otherwise deleted, certain information. A creditor should redact and use only the last four digits of any social-security, individual's tax-identification, or financial-account number, all but the initials of a minor's name and only the year of any person's date of birth.

Evidence of Perfection
Evidence of perfection may include a mortgage, lien, certificate of title, financing statement, or other document showing that the lien has been filed or recorded.

INFORMATION

Acknowledgment of Filing of Claim
To receive acknowledgment of your filing, you may either enclose a stamped self-addressed envelope and a copy of this proof of claim or you may access the court's PACER system (www.pacer.psc.uscourts.gov) for a small fee to view your filed proof of claim.

Offers to Purchase a Claim
Certain entities are in the business of purchasing claims for an amount less than the face value of the claims. One or more of these entities may contact the creditor and offer to purchase the claim. Some of the written communications from these entities may easily be confused with official court documentation or communications from the debtor. These entities do not represent the bankruptcy court or the debtor. The creditor has no obligation to sell its claim. However, if the creditor decides to sell its claim, any transfer of such claim is subject to FRBP 3001(e), any applicable provisions of the Bankruptcy Code (11 U.S.C. § 101 *et seq.*), and any applicable orders of the bankruptcy court.

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§6.54 B. Allowing Secured Claims

A claim is deemed allowed unless it is challenged. 11 USC §502(a). If the claim is challenged, the court must still allow it unless it fails one of the statutory tests stated in 11 USC §502(b)(1)-(9). For the ordinary secured creditor, the most important of these tests is the first: The claim must be allowed except to the extent that it is unenforceable against the debtor or the debtor's property under any agreement or applicable law. 11 USC §502(b)(1). See §§6.58-6.70. Special rules apply to creditors with allowed secured claims. See §§6.55-6.57.

An oversecured creditor is entitled to legal fees to the extent provided in the loan documentation and permitted by state law. 11 USC §506(b); *In re Hoopai* (BAP 9th Cir 2007) 369 BR 506 (decided under Hawaii law). The Supreme Court decided that an unsecured creditor is not precluded from recovering attorney fees authorized under a prepetition contract and incurred in postpetition litigation. *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199.

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§6.55 1. Bifurcation of Claim

If the value of the secured creditor's collateral is less than the outstanding amount of the debt, the creditor is undersecured. Under 11 USC §506(a), in certain cases, the amount of a secured claim may be reduced or "stripped down" to the fair market value of the collateral as of the petition date. See also 11 USC §506(d). Section 506(a)(1) provides that

> an allowed claim of a creditor secured by a lien on property in which the estate has an interest… is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, … and is an unsecured claim to the extent that the value of such creditor's interest… is less than the amount of such allowed claim.

If the debtor is permitted to strip a secured creditor's claim down to the value of the collateral, the claim will be bifurcated into secured and unsecured portions. The creditor is treated as a secured creditor to the extent of the value of the collateral and as an unsecured creditor as to the remainder of the amount owed.

Despite the language of §506(a)(1), lien-stripping has been significantly restricted as a strategy for bankruptcy debtors. Under 11 USC §506(a)(2), added by the BAPCPA, lien-stripping has been limited for personal property collateral in individual Chapter 7 and 13 cases. Section 506(a)(2) requires the value of personal property securing an allowed claim to be determined based on the replacement value of the property as of the petition date without deduction for costs of sale or marketing. If the property was acquired for personal, family, or household purposes, the replacement value is its retail replacement value, taking into account its age and condition. Further, 11 USC §1325(a) was amended by the BAPCPA to prohibit lien-stripping altogether in Chapter 13 cases with regard to purchase money security interests in (1) motor vehicles acquired for the debtor's personal use within 2½ years before the petition date, and (2) any other type of property acquired within 1 year before the petition date. Even before the BAPCPA, in *Dewsnup v Timm* (1992) 502 US 410, 116 L Ed 2d 903, 112 S Ct 773, the Supreme Court held that 11 USC §506 was ambiguous and that a debtor in Chapter 7 case could not strip a creditor's real estate lien down to the value of the real property collateral when the creditor's claim had already been allowed as a secured claim. *Dewsnup* is generally understood to prohibit lien-stripping in Chapter 7 cases only. See *In re Castro* (Bankr D Ariz 2002) 285 BR 703, 705. Lien-stripping is also prohibited in cases in which the lien is completely unsecured. *Concannon v Imperial Capital Bank (In re Concannon)* (9th Cir BAP 2006) 338 BR 90 (wholly unsecured nonconsensual lien); *Laskin v First Nat'l Bank (In re Laskin)* (9th Cir BAP 1998) 222 BR 872 (wholly unsecured deed of trust). Lien-stripping is also prohibited in Chapter 11 and Chapter 13 cases for liens on a debtor's principal residence. 11 USC §§1123(b)(5), 1322(b)(2).

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§6.56 2. Interest on Secured Claim

An unsecured creditor has no right to interest on the claim, unless the debtor is solvent. 11 USC §502(b)(2). See *Thompson v Kentucky Lumber Co. (In re Kentucky Lumber Co.)* (6th Cir 1988) 860 F2d 674, 676. But when the value of a secured creditor's collateral exceeds the value of the claim, interest on the debt is allowed up to the value of the collateral. 11 USC §506(b). The interest rate to be charged is the rate listed in the agreement or what is provided by the state statute under which the claim arose. See §6.100 for a more detailed discussion of interest rates.

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§6.57 3. Recovery of Costs From Secured Claim

The trustee may recover the reasonable, necessary costs of dealing with the collateral to the extent of any benefit to the holder of an allowed secured claim to the collateral. 11 USC §506(c). Only the trustee or debtor in possession may take advantage of 11 USC §506(c). Creditors and other third parties do not have standing. *Hartford Underwriters Ins. Co. v Union Planters Bank* (2000) 530 US 1, 147 L Ed 2d 1, 120 S Ct 1942.

Courts are careful in permitting a surcharge against collateral and have narrowly construed §506(c). The trustee should be prepared to prove each element of §506(c) in quantifiable terms. Furthermore, the expenses should be those the secured creditor would have incurred. In *Compton Impressions, Ltd. v Queen County Bank (In re Compton Impressions, Ltd.)* (9th Cir 2000) 217 F3d 1256, a surcharge on encumbered real property was denied because the expenses exceeded those the secured creditor had approved in a cash-collateral stipulation.

For the trustee to surcharge the collateral, the secured creditor's claim must be an allowed claim. If the trustee waits until the claim is disallowed, no surcharge is permitted. *Poonja v Allegheny Props. (In re Los Gatos Lodge, Inc.)* (9th Cir 2002) 278 F3d 890.

In *Security Leasing Parties, LP v ProAlert, LLC (In re ProAlert, LLC)* (BAP 9th Cir 2004) 314 BR 436, a secured creditor tried to argue that an order approving the use of cash collateral was an impermissible §506(c) surcharge. The court held that although the debtor was required to meet the requirements for use of cash collateral, the debtor did not need to meet the requirements of a §506(c) surcharge. On the use of cash collateral, see §§6.24-6.26.

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§6.58 C. Challenging Validity of Secured Claim

The secured creditor faces several potential challenges to the validity of the claim:

- The claim may be attacked because it is invalid for nonbankruptcy reasons. 11 USC §558. See §6.59.
- The trustee may use the strong-arm clause to invalidate a secured creditor's claim. 11 USC §544(a). See §§6.60-6.63.
- The trustee can avoid security interests based on the rights of unsecured creditors. 11 USC §544(b). See §§6.64-6.66.
- The debtor's property may be exempt or not subject to the secured creditor's lien. See §§6.67-6.70.

Bankruptcy trustees and debtors in possession can avoid fraudulent transfers under 11 USC §544(b) or directly under 11 USC §548. See §§6.71-6.77. Bankruptcy trustees and debtors in possession also can avoid security interests as preferential transfers under 11 USC §547 if the security interests are not perfected when the secured creditor makes the loan. See §§6.78-6.96.

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§6.59 1. Assertion of Debtor's Defenses

For a creditor to have a secured claim in bankruptcy (*i.e.,* to be entitled to the benefit of the security interest in specific collateral), the creditor must have a security interest that is enforceable against the debtor (Com C §9203), because the trustee can assert any defense to enforceability that the debtor could assert outside bankruptcy. 11 USC §558. This provision permits the trustee to test the fundamental validity of the agreement. Thus, for example, if the debtor could have rescinded for misrepresentation or fraud, then presumably the trustee also may do so.

A secured claim would be disallowed, for example, if the secured creditor could not establish the attachment of the security interest under Com C §9203.

The claim is also subject to such personal defenses as the statute of limitations, the statute of frauds, and usury; the debtor's waiver of any of these defenses after the bankruptcy case begins does not bind the estate. 11 USC §558.

In addition to having a security interest enforceable against the debtor, the secured party must also have a security interest that would not be junior to a "hypothetical lien creditor" as described in §6.60.

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§6.60 2. The "Strong-Arm" Clause

Probably the single most important power in the hands of the bankruptcy trustee or debtor in possession, acting against secured creditors, is the "strong-arm clause" or the "hypothetical lien creditor" power of 11 USC §544(a)(1), which provides that the trustee may avoid any transfer by the debtor that would be voidable by a creditor that extended credit to the debtor and obtained a judicial lien on all property on which the creditor could have obtained a judicial lien, whether or not such a creditor actually exists.

Section 544(a)(1) gives the trustee the power to avoid a security interest if the security interest is not validly perfected under state law. If the security interest is perfected under state law, it survives in bankruptcy; if it is not perfected, it does not survive. The relevant California law is Com C §9317(a)(2), which provides that a security interest is subordinate to a person that becomes a lien creditor before the security interest is perfected or a financing statement is filed and a security agreement is in place. See §§4.43-4.47.

The rights of a trustee against unperfected and perfected security interests as a hypothetical lien creditor are discussed in §§6.61-6.62. An exception to the strong-arm rule that provides a 20-day grace period for purchase money interests is discussed in §6.63. The trustee also may avoid transfers as a successor to actual creditors under 11 USC §544(b). See §§6.64-6.66.

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§6.61 a. Subordination of Unperfected Security Interests

The Bankruptcy Code grants the trustee the rights of a judicial lien creditor; the Commercial Code provides that an unperfected security interest is subordinate to the rights of a lien creditor. Although the phrase "lien creditor" in the Commercial Code is not the same as the phrase describing the creditor in 11 USC §544(a)(1), for this purpose the differences are immaterial. The Commercial Code defines a "lien creditor" to include a trustee in bankruptcy. Com C §9102(a)(52). See also 11 USC §101(36) (definition of "judicial lien").

EXAMPLE: The secured party lends money to the debtor and takes a security interest in the debtor's accounts receivable on January 1. Filing of a financing statement with the Secretary of State is the appropriate means of perfection, but the secured party neglects to file. If the debtor goes into bankruptcy on February 1, the debtor's trustee can avoid the security interest.

The Bankruptcy Code provides that the trustee prevails if there could have been a lien creditor, "whether or not such a creditor exists." Thus, if, in the above example, there was no actual intervening creditor between January 1 and the date of the bankruptcy filing, the trustee would nevertheless be able to set aside the security interest. The rights of a trustee against perfected secured creditors are discussed in §6.62. The 20-day grace period for purchase money security interests is discussed in §6.63.

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§6.62 b. Superior Rights of Perfected Secured Creditors

In contrast to the situation described in §6.61, if the secured creditor perfects before bankruptcy, even the existence of an actual creditor (who does not obtain a lien during the time a security interest is unperfected) will not defeat the secured party.

EXAMPLE: The secured party lends money to the debtor and takes a security interest in the debtor's equipment on January 1. On January 5 a third party extends unsecured credit to the debtor. On January 8 the secured party files a financing statement. A year later, the debtor goes into bankruptcy with both debts unpaid. The trustee would not be able to avoid the security interest. (This assumes that the secured party is not an "insider" for purposes of the one-year preference rule. See §6.83.)

In this example, there is a creditor who lent money while the security interest was in existence and unperfected, but that creditor could not have obtained a prior judicial lien on the property on the date of bankruptcy. The fact that the secured party did file cut off the other creditor's right to do so. Note, however, that it is not always enough to perfect before bankruptcy. In an appropriate situation (although not in the above example), delayed filing could make the security interest avoidable under the preference rules. See §§6.78-6.96.

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§6.63 c. 20-Day Grace Period for Purchase Money Security Interests

Ordinarily, for the secured party to prevail over the trustee in bankruptcy, the secured party must perfect its security interest before the filing of the petition that initiates the bankruptcy case. This is so because an unperfected security interest is subordinate to the rights of the bankruptcy trustee, and because the filing of the petition operates as a stay against any action to perfect the security interest. 11 USC §362(a).

There is, however, one important exception to this rule. The Commercial Code allows a 20-day "grace period" for the perfection of purchase money security interests. Com C §9317(e). If the secured creditor files before or within 20 days after the debtor receives possession of the collateral, the secured party takes priority over a lien creditor whose rights arose between the time that the security interest arose and the time of filing. See §4.10. Because the bankruptcy trustee stands in the shoes of a lien creditor, Com C §9317(e) has the effect of giving the secured party a grace period against the bankruptcy trustee.

To allow the secured creditor to utilize the grace period despite the stay against postpetition perfection, the Bankruptcy Code provides an exception to the automatic stay. 11 USC §§362(b)(3) (30-day grace period), 546(b). See §6.9. The Bankruptcy Code also provides that if the appropriate mode of perfection is by seizure (*i.e.,* possession), then after bankruptcy the secured party achieves the same result by notice. 11 USC §546(b). This provision permits the secured creditor to enjoy its priority, while permitting the trustee or debtor in possession to retain possession of the property.

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§6.64 3. Trustee as Successor to Unsecured Creditor

Bankruptcy Code §544(b) provides that the trustee or debtor in possession may avoid any transfer that is voidable under applicable law by a creditor holding an unsecured claim. This provision is both narrower and broader than the "lien creditor" power of 11 USC §544(a). See §§6.60-6.63. Section 544(b) is narrower in that it requires the trustee to find an actual creditor to claim under, while 11 USC §544(a) permits the trustee to exercise the rights of a hypothetical creditor, whether or not there is an actual creditor. Section 544(b) is broader in that it gives the trustee the rights of any unsecured creditor, not only a "lien creditor" as required under 11 USC §544(a). Uses of the trustee avoiding power are discussed in §6.65. Questions concerning the amount and beneficiary of avoided interests are discussed in §6.66.

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§6.65 a. Uses of Trustee Avoiding Power

In principle, 11 USC §544(b) permits the trustee to avoid an unperfected security interest. Almost anything that the trustee could do with respect to a security interest under 11 USC §544(b), however, could also be done under 11 USC §544(a). Most of the litigation against secured creditors arises under 11 USC §544(a). Section 544(b) is most significant in relation to state statutes that give rights to unsecured creditors. See §§6.71-6.77 for a discussion of fraudulent transfers, one of the most significant uses of 11 USC §544(b).

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§6.66 b. Amount and Beneficiary of Avoided Interest

If a particular transfer is avoidable under 11 USC §544(b), the transfer may be avoided altogether, and recovery will run in favor of the creditors as a group, not just those who give grounds for avoidance. However, through settlements and other means, a creditor or other party may negotiate payment to the debtor's estate rather than return of property.

EXAMPLE: A $100,000 debt is secured by an unperfected security interest on property that is worth $100,000. The day before bankruptcy another creditor achieves an attachment lien for a $50 claim. That creditor is the creditor needed under 11 USC §544(b). One way of settling the claims would be to give that creditor $50 and let the other $99,950 go to the secured creditor. But this is not the way the Bankruptcy Code settles it. Rather, the filing of the $50 claim will permit the trustee to strike down the entire $100,000 security interest and recapture the property for distribution among creditors generally (including, presumably, the secured creditor, now a general creditor).

This doctrine, derived from *Moore v Bay* (1931) 284 US 4, 76 L Ed 133, 52 S Ct 3, has been much criticized, but it was carried over to 11 USC §544(b) from former 11 USC §70(e), according to the legislative history. See S Rep No. 95-989, 95th Cong, 2d Sess, 85 (1978), reprinted in 1978 US Code Cong & Ad News 5787, 5871.

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§6.67 4. Effect of Exemptions of Debtor's Property

Ordinarily, some of the property of a judgment debtor is exempt from execution by a judgment creditor. The Bankruptcy Code provides its own list of exempt property in 11 USC §522(d), but that list does not apply if its use is not authorized by state law. 11 USC §522(b)(2). California does not permit its use, providing instead a list of exemptions for specified amounts in CCP §703.140 (adjusted for inflation under CCP §703.150). See CCP §703.130; 11 USC §522(b)(3).

Normally, the debtor's exemption is not valid against a secured creditor with a security interest in the property otherwise exempt. But the Bankruptcy Code substantially alters this rule by allowing the debtor to avoid certain security interests that otherwise would be valid under state law. 11 USC §522(f)(1)(B).

To qualify for avoidance, the security interest must be nonpossessory and for something other than purchase money. It must be in one of three classes of property: (1) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry held primarily for personal, family, or household use of the debtor or a dependent; (2) implements, professional books, or tools of the trade of the debtor or a dependent; or (3) professionally prescribed health aids of the debtor or a dependent. 11 USC §522(f)(1)(B)(i)-(iii).

The security interest may be avoided even if the debtor has no equity in the property as a result of its being overencumbered by unavoidable liens. 11 USC §522(f)(2)(A). See *Higgins v Household Fin. Corp. (In re Higgins)* (BAP 9th Cir 1996) 201 BR 965.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/6 The Secured Creditor and Bankruptcy/§6.68 5. Security Interests in After-Acquired Property

§6.68 5. Security Interests in After-Acquired Property

After-acquired property of the estate "is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." 11 USC §552(a). For example, if the debtor grants a lien to a secured creditor in its accounts receivable, the secured creditor does not have a lien on accounts receivable generated postpetition. The issue is most likely to arise in Chapter 11 cases when the trustee or the debtor in possession is seeking to operate a business pending reorganization. Special rules apply to proceeds of property and hotel revenues. See §§6.69-6.70.

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§6.69 a. Proceeds and Profits

The Bankruptcy Code protects security interests in proceeds, product, offspring, or profits of the debtor's property, when these arise after bankruptcy, to the extent permissible outside bankruptcy, but this provision is limited "to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise." 11 USC §552(b)(1). The legislative history suggests that if the "proceeds" are worth more than the original collateral, then the trustee can recapture the difference for the estate. See S Rep No. 95-989, 95th Cong, 2d Sess, 91 (1978), reprinted in 1978 US Code Cong & Ad News 5787, 5877.

NOTE: Section 552(b)(1) is expressly conditioned on the trustee's various avoidance powers, and also on the general provision for costs. It is also conditioned on the trustee's power to use or sell collateral under 11 USC §363.

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§6.70 b. Rents and Hotel Revenues

Bankruptcy Code §552(b)(2) provides that, as a matter of bankruptcy law, a security interest in property of the debtor continues postpetition in "amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties." This provision is limited "to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise." 11 USC §552(b)(2). The Ninth Circuit has found that, under California law, hotel revenue from room rental is "rent" for purposes of 11 USC §552(b), but that revenues from other services such as the sale of food are accounts and not rents subject to 11 USC §552(b)(2). See *Chequers Inv. Assocs. v Hotel Sierra Vista Ltd. Partnership (In re Hotel Sierra Vista Ltd. Partnership)* (9th Cir 1997) 112 F3d 429. See also *Financial Sec. Assur., Inc. v Days Cal. Riverside Ltd. Partnership (In re Days Cal. Riverside Ltd. Partnership)* (9th Cir 1994) 27 F3d 374 (decided before 1994 amendment to 11 USC §552(b).

NOTE: Section 552(b)(2) is expressly conditioned on the trustee's various avoidance powers, and also on the general provision for costs. It is also conditioned on the trustee's power to use or sell collateral under 11 USC §363.

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§6.71 D. Avoiding Fraudulent Transfers

Fraudulent transfers are transfers of property by the debtor with the effect of depriving creditors of the benefit of that property. The transfer may be made by the debtor with the actual intent to delay or hinder creditors, or may be based on a constructive fraud. 11 USC §548(a)(1); CC §3439.04. Constructive fraud is the more common type of fraudulent transfer, and is the only type of fraudulent transfer discussed in this chapter.

The trustee or debtor in possession has the power to avoid fraudulent transfers on the basis of two separate, though parallel, provisions. First, 11 USC §544(b) permits the trustee to avoid any transfer that is voidable under applicable state law by a creditor holding an unsecured claim. This permits the trustee to use state fraudulent conveyance laws such as the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12). Second, 11 USC §548 directly empowers the trustee to avoid fraudulent transfers.

NOTE: There are some differences between the California and federal fraudulent transfer laws. Under former 11 USC §548, the trustee could avoid transfers made 1 year before the filing of the bankruptcy petition; the BAPCPA extended the period to 2 years for bankruptcy cases filed after April 20, 2006. Under California law, which the trustee may invoke under 11 USC §544(b), the statute of limitations for a fraudulent transfer is 4 years. CC §3439.09.

A creditor or creditors' committee may take advantage of 11 USC §544(b). See *Official Comm. of Unsecured Creditors v Chinery (In re Cybergenics Corp.)* (3d Cir 2003) 330 F3d 548. The holding in *Hartford Underwriters Ins. Co. v Union Planters Bank* (2000) 530 US 1, 147 L Ed 2d 1, 120 S Ct 1942, discussed in §6.57, does not prohibit creditors' committee from asserting claims under 11 USC §544(b)). But see *In re Hannah* (Bankr NJ 2004) 316 BR 57, stating that *Cybergenics* does not apply to Chapter 7 and 13 cases.

Courts have also held that that a creditor may assert a fraudulent transfer claim vested in the trustee under 11 USC §548(a) if the trustee consents, and the court finds that the action is in the best interest of the estate and is necessary and beneficial to the efficient resolution of the bankruptcy proceedings. *Hyundai Translead, Inc. v Jackson Truck & Trailer Repair, Inc.* (*In re Trailer Source, Inc.)* (6th Cir 2009) 555 F3d 231; *Glinka v Murad (In re Housecraft Indus. USA, Inc.)* (2d Cir 2002) 310 F3d 64, 70; *In re Smith Bros. Motors, Inc.* (Bankr CD Cal 2002) 286 BR 905, 908. But see *United Phosphorus, Ltd. v Fox (In re Fox)* (BAP 10th Cir 2004) 305 BR 912 (only trustee may bring avoidance actions); *Gecker v Marathon Fin. Ins. Co., Inc.* (*In re Auto. Professionals, Inc.*) (Bankr ND Ill 2008) 389 BR 630 (committee or creditor may obtain derivative standing only where trustee does not sue on its own behalf).

The elements of constructive fraud are discussed in §§6.72-6.75. Remedies and liability of transferees for constructive fraud are discussed in §6.76. The application of fraudulent transfer laws to leveraged buyouts (LBOs) is discussed in §6.77.

Section 548 specifically provides that a transfer to or for the benefit of an insider under an employment contract may constitute a fraudulent transfer. 11 USC §548(a)(1).

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§6.72 1. Constructive Fraud

The requirements of constructive fraud under California and federal law are very similar. Under 11 USC §548(a)(1)(B), a trustee or debtor in possession may avoid a transfer for constructive fraud if the debtor received less than reasonably equivalent value in exchange for a transfer made or obligation incurred within 1 year (for bankruptcy cases filed before April 20, 2006) or 2 years of the filing date (for cases filed after April 20, 2006), and the debtor:

- Was insolvent on the date of such transfer or the date that such obligation was incurred or became insolvent as a result of that obligation;
- Was engaged in business or a transaction (or was about to engage in business or a transaction) for which the property remaining with the debtor constituted unreasonably small capital;
- Intended to incur debts that would be beyond the debtor's ability to pay as such debts matured; or
- Made the transfer to or for the benefit of an insider, or incurred the obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

Under CC §3439.07, in an action for relief under the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12), a creditor may avoid for constructive fraud:

- Any transfer regardless of the transferor's intent if the transferor does not receive a reasonably equivalent value in exchange for the transfer and it can also show either of the following:
- The debtor was engaged in, or was about to engage in, a business or transaction for which the debtor's remaining assets were unreasonably small in relation to the business or transaction (CC §3439.04(b)(1)); or
- The debtor intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due (CC §3439.04(b)(2)).
- Any transfer if the debtor does not receive reasonably equivalent value and was insolvent at the time of, or became insolvent as a result of, the transfer. CC §3439.05.

The provision relating to employment contracts in 11 USC §548(a)(1)(B) was added by the BAPCPA in response to corporate practices of giving lucrative employment contracts and loans to executives without requiring repayment. The California Civil Code does not contain comparable sections, but a fraudulent transfer argument may be made under California law if an insider employee receives a beneficial employment contract while the employer was insolvent and the employer does not receive reasonably equivalent value for it.

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§6.73 a. Reasonably Equivalent Value

If the debtor received reasonably equivalent value, there can be no fraudulent transfer under the theory of constructive fraud. This is a question of fact that has been the subject of much litigation. In general, reasonably equivalent value does not mean a dollar-for-dollar equivalence. See *Butler Aviation Int'l, Inc. v Whyte (In re Fairchild Aircraft Corp.)* (5th Cir 1993) 6 F3d 1119. An indirect benefit may be sufficient to meet the standard. See *HBE Leasing Corp v Frank* (2d Cir 1995) 48 F3d 623.

The U.S. Supreme Court has held that the purchase price received in a regularly conducted, noncollusive foreclosure sale of real property is considered to be reasonable and equivalent value and therefore is not a fraudulent transfer avoidable under 11 USC §548. *BFP v Resolution Trust Corp.* (1994) 511 US 531, 128 L Ed 2d 556, 114 S Ct 1757. But see *Sensenich v Molleur (In re Chase)* (Bankr D Vt 2005) 328 BR 675 (*Resolution Trust* test for determining reasonably equivalent value does not apply to strict foreclosure of real property under Vermont law).

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§6.74 b. Insolvency

Whether the debtor or transferor is insolvent is a key question in determining whether a fraudulent transfer has occurred. The Bankruptcy Code provides that an entity, other than a partnership, is insolvent when the sum of such entity's debts is greater than all of such entity's property at a fair valuation (with certain exceptions). 11 USC §101(32). The Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12) defines "insolvency" in a manner similar to 11 USC §101(32). The UFTA provides that a debtor that does not pay its debts as they become due will be presumed insolvent. CC §3439.02(c).

The Ninth Circuit has held that the debtor did receive reasonably equivalent value in a case in which shareholders received a loan and the proceeds were provided directly to the corporate debtor. The debtor provided security to the bank providing the loan. The Ninth Circuit found that although the debtor was not party to the loan, it clearly benefited from the loan. *Frontier Bank v Brown (In re Northern Merchandise, Inc.)* (9th Cir 2004) 371 F3d 1056.

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§6.75 c. Unreasonably Small Capital

Neither the Bankruptcy Code nor the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12) define insufficiency of capital. Case law indicates that the debtor must not be left with "unreasonably small capital" at the time of the alleged fraudulent transfer. See *Credit Managers Ass'n v Federal Co.* (CD Cal 1985) 629 F Supp 175; *Moody v Security Pac. Credit, Inc.* (3d Cir 1992) 971 F2d 1056.

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§6.75A d. Self-Settled Trusts

A BAPCPA provision regarding self-settled trusts enables a trustee to look back and recover transfers to the trust for a 10-year period. 11 USC §548(c). Actual fraud is required. Section 548(e)(1) provides that the trustee may avoid a transfer of an interest of the debtor in property that was made on or within 10 years before the date of filing if:

- The transfer was made to a self-settled trust (or similar entity or device);
- The transfer was made by the debtor;
- The debtor is the beneficiary of the trust; and
- The debtor made the transfer with the actual intent to hinder, delay, or defraud any entity to whom he or she was or became indebted.

This section includes transfers made in anticipation of a judgment or settlement in connection with violations of the securities laws. 11 USC §548(e)(2).

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§6.76 2. Remedies/Liability of Transferees

The Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12) provides that a creditor may seek the avoidance of the transfer to the extent necessary to satisfy the creditor's claim or attachment of the asset. If a judgment has been obtained, the creditor may seek to levy against the asset transferred. In certain circumstances, the creditor may seek to have a receiver appointed or an injunction against further transfers. CC §3439.07.

The Bankruptcy Code permits a debtor in possession or a trustee to recover the property transferred or its value. The trustee or debtor in possession may seek such recovery from "any immediate or mediate transferee." 11 USC §550(a).

A good-faith transferee is protected to the extent the transferee took for value and in good faith. To the extent that a good faith transferee gave value, the good faith transferee has a lien on, may retain any interest transferred, or may enforce any obligation incurred to the extent the transferee. 11 USC §548(c); CC §3439.08. See also 11 USC §550(b).

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§6.77 3. Leveraged Buyouts (LBOs)

In the 1980s, many corporations were purchased by management or outside groups through leveraged buyouts (LBOs). Many were failures and spawned substantial bankruptcy court litigation. In *Lippi v City Bank* (9th Cir 1992) 955 F2d 599, the Ninth Circuit ruled that the bankruptcy trustee could challenge an LBO of the debtor on behalf of creditors who came into existence after the transfer occurred on the basis that the buyout was a fraudulent transfer. The court ruled that the creditors could recover from the financing bank that received the initial transfer and that a fact issue existed whether the shareholders had received payments in good faith. There are two reported LBO cases in the Ninth Circuit after *Lippi*, both of which resulted in LBOs being set aside as fraudulent transfers under federal and California law.

In *Kendall v Sorani (In re Richmond Produce Co.)* (Bankr ND Cal 1993) 151 BR 1012, aff'd (ND Cal 1996) 195 BR 455, a Chapter 11 trustee successfully argued that the transfer of funds in connection with an LBO involving a debtor's business was an avoidable transfer under both 11 USC §548(a) and CC §§3439.04(b)(1) and 3439.05. The bankruptcy court found that the secured creditor knew suspicious facts that required the secured creditor to investigate the source of the funds that the debtor used to purchase the certificate of deposit that was the subject of the fraudulent transfer action.

In *Bay Plastics, Inc. v BT Commercial Corp. (In re Bay Plastics, Inc.)* (Bankr CD Cal 1995) 187 BR 315, the bankruptcy court allowed the debtor to recover the funds the shareholders had received in the buyout transaction. Although the Chapter 11 debtor corporation also brought suit against the bank that financed the transaction, the bank settled. The court held that the transaction was a constructively fraudulent transfer under the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12). *Bay Plastics* is instructive for its detailed history of fraudulent transfer law in the Ninth Circuit.

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VI. PREFERENCES

§6.78 A. Preferential Transfers

A preferential transfer favors one creditor at the expense of others. It is not inherently wrong to make a preferential transfer. California law specifically permits preferential payments. See CC §3432. The purpose of a bankruptcy system, however, is to provide for the orderly distribution of assets under some principle of equity. Therefore, the Bankruptcy Code gives the trustee in bankruptcy a means for undoing preferential transfers that violate that principle. The basic rules are provided in 11 USC §547. Transactions that may not be avoided as preferential transfers are described in 11 USC §547(c). See §§6.84-6.96.

The elements of the trustee's prima facie case for avoiding a preference are specified in 11 USC §547(b):

(1) A transfer of the debtor's property (including the giving of a security interest) to or for the benefit of a creditor (see §6.79)

(2) Made for or on account of an antecedent debt (see §6.80)

(3) While the debtor was insolvent (see §6.81)

(4) Within 90 days (see §6.82) or within 1 year for an insider preference (see §6.83) of the filing of the bankruptcy petition

(5) That enables the creditor to receive more than he or she would have received in a Chapter 7 liquidation had the transfer not been made.

For example, a payment on a fully secured debt is not a preferential transfer. See §6.86.

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§6.79 1. Transfer to Creditor

A "transfer" to or for the benefit of a creditor for purposes of 11 USC §547(b)(1) may be a transfer of money or property. It may also include the granting of a security interest. This is clear under the broad definition of transfer in 11 USC §101(54). The same conclusion can be reached by negative inference from 11 USC §547(c)(3), which specifies which types of security interests will not be regarded as preferential. A second transfer of an interest in the debtor's property takes place when the security interest is foreclosed. *Ehring v Western Community Moneycenter (In re Ehring)* (9th Cir 1990) 900 F2d 184.

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§6.80 2. For an Antecedent Debt

The payment or transfer must be made for or on account of an antecedent debt. 11 USC §547(b)(2). An antecedent debt is a debt already in existence. Practitioners should be aware that if a lender loans money to the borrower and does not promptly perfect interest in collateral, the perfection of the collateral may be considered preferential because it will be a transfer of property on account of an antecedent debt. See §6.84 for a discussion of the timing of perfection of a security interest.

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§6.81 3. Made While Insolvent

A creditor can rebut the presumption of insolvency under 11 USC §547(f) by presenting evidence to show that the debtor was not insolvent at the time of the transfer. In *Akers v Koubourlis (In re Koubourlis)* (9th Cir 1989) 869 F2d 1319, the creditor used copies of the debtors' own schedules and statement of affairs to show that their assets may have been greater than their liabilities. Accordingly, the Ninth Circuit held that the burden shifted back to the debtors to prove their insolvency at the time of the transfer.

In *Campbell v Cannington (In re Economy Milling Co.)* (D SC 1983) 37 BR 914, the court held that the presumption under 11 USC §547(f) of a debtor's insolvency during the 90-day period before filing the petition for relief does not deny a creditor due process. The only legal effect of the presumption is to require the creditor to produce evidence to the contrary; furthermore, the presumption is rationally related to the fact of insolvency on the date of filing. The present statute does not provide a saving clause for the good-faith transferee; the transferee must give up the property even if he or she took it without knowing of the insolvency.

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§6.82 4. Made Within 90 Days

The most common type of preference is a preference made on or within 90 days before the date of the filing of the bankruptcy petition. 11 USC §547(b)(4)(A). If the alleged transfer occurred within the 90-day period, the trustee need prove only that fact and the other elements listed in §6.78. Moreover, the trustee is aided by a presumption that the debtor was insolvent during that period. 11 USC §547(f). See §6.81. It appears that the transferee must provide evidence of solvency if the transferee wants to raise that issue, but that the trustee retains the ultimate burden of proof. Fed R Evid 301.

The Supreme Court has established the basic rule that transfer by check occurs on the date the check is honored rather than on the date it is delivered, for purposes of avoidable postpetition transfer analysis under 11 USC §547(b)(4). *Barnhill v Johnson* (1992) 503 US 393, 118 L Ed 2d 39, 112 S Ct 1386. See also *Spear v CEMA Distrib. (In re Rainbow Music, Inc.)* (Bankr ND Cal 1993) 154 BR 559. A different rule applies for purposes of the new-value exception under 11 USC §547(c). See §6.91.

For the purpose of determining whether a transaction occurred within or outside the 90-day period, a transfer is considered to be made (11 USC §547(e)(2)):

- At the time it takes effect between the parties (*e.g.,* execution and delivery of the security agreement, not the date that the financing statement was filed), if it is perfected within 10 days after that time;
- At the time of perfection, if this occurs after the end of that 10-day period; or
- Immediately before the petition is filed, if the interest is unperfected at the later of the date of commencement of bankruptcy or 10 days after the transfer takes effect between the parties.

For this purpose, "a transfer of a fixture or property other than real property is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee." 11 USC §547(e)(1)(B). This standard closely resembles the "lien creditor test" in the strong-arm clause. 11 USC §544(a). See §6.60.

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§6.83 5. Made Within One Year (Insider Preferences)

In addition to the 90-day preference period (see §6.82), a 1-year preference period exists for "insiders" under 11 USC §547(b)(4)(B). Under this section, the trustee may reach transfers to insiders within one year (instead of 90 days) from the date of filing. If the transfer is made more than 90 days before bankruptcy, but within the 1-year limit, the trustee does not have the benefit of the presumption of insolvency in that period. The trustee must present some evidence, even though the transferee presents none. An "insider" for purposes of this provision is broadly defined to include relatives, partners, directors, officers, or affiliates of the debtor. 11 USC §101(31). An insider may also be a "person in control of the debtor." 11 USC §101(31). When a corporation was wholly owned by an individual, the corporation loaned money to the debtor and took a security interest, and the individual's husband was a 10 percent shareholder of the debtor, the corporation was not a per se insider of the debtor for 11 USC §101(31) purposes. *Miller Ave. Prof. & Promotional Servs., Inc. v Brady (In re Enter. Acquisition Partners, Inc.)* (BAP 9th Cir 2004) 319 BR 626. See §6.83. An investment bank was held to be an insider for preferences purposes in *In re National Century Fin. Enters., Inc. Inv. Litig.* (SD Ohio 2009) 604 F Supp 2d 1128. The court found that the investment bank had a controlling influence on decisions made by the architect of the failed Ponzi scheme, turned debtor. The Third Circuit established a broader standard for determining whether a party is an insider in *Schubert v Lucent Technologs., Inc. (In re Winstar Communications, Inc.)* (3rd Cir 2009) 554 F3d 382. The court held that actual control was not necessary: "The question is whether there is a close relationship…and anything other than closeness to suggest that any transactions were not conducted at arm's length." 554 F3d at 396.

For the 1-year rule to apply, the person must be an insider at the time of the transfer. 11 USC §547(b)(4)(B). The date on which the transfer is made for this purpose is determined in the same way as for the 90-day preference period.

NOTE: If a transfer is made between 90 days and 1 year before the filing of a bankruptcy petition, a trustee cannot recover the transfer from a noninsider transferee, even if the transfer was made for the benefit of another creditor that was an insider at the time. 11 USC §550(c).

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B. Nonpreferential Transactions

§6.84 1. Contemporaneous Exchange

Not every transfer within the preference period is preferential. An example of such a nonpreferential transaction is a contemporaneous exchange of value, *e.g.,* the taking of a security interest in exchange for an advance of money. 11 USC §547(c)(1). In order to be preferential, a transfer must be for or on account of an antecedent debt. 11 USC §547(b)(2). If the creditor lends, takes a security interest, and perfects all in the same day, and the debtor files bankruptcy the next day, the transaction is not a preference and not avoidable. In order to fall within this rule, the parties must intend the transaction to be a contemporaneous exchange for new value, and the exchange must in fact be substantially contemporaneous. 11 USC §547(c)(1). Section 547(e)(2) provides secured creditors 30 days within which to perfect security interests in order for the transfer to be considered a contemporaneous exchange. (The BAPCPA increased that time period from 10 days to 30 days.) 11 USC §547(e)(2)(A). Before this change, courts had ruled that the phrase "substantially contemporaneous" would be determined on a case-by-case basis taking into account all of the relevant circumstances. *Lindquist v Dorholt (In re Dorholt, Inc.)* (8th Cir 2000) 224 F3d 871; *Pine Top Ins. Co. v Bank of America* (7th Cir 1992) 969 F2d 321; *Dye v Rivera (In re Marino)* (BAP 9th Cir 1996) 193 BR 907, aff'd (9th Cir 1997) 117 F3d 1425 (unpublished opinion) (court found filing substantially contemporaneous because circumstances out of creditor's control caused delay in filing); but see *DT Acceptance Corp. v Manera* (*In re Anderson* (D Ariz, June 26, 2007, No. CV 06-2410-PHX-JAT) 2007 WL 1839699 (case decided under Arizona law; lien could be avoided although delay in perfection was caused by state officials rather than lender)).

Courts may look at the issue on a case-by-case basis, but it is prudent for a secured creditor to perfect its security interest as soon as possible after making the loan, preferably within 30 days. It is also important to note that with respect to purchase money security interests, the California Commercial Code has not expanded the grace period for perfection beyond 20 days. See §3.32, discussing perfection of purchase money security interests. See also §6.87.

If a check is dishonored and the creditor receives a replacement check, the replacement check will not be considered contemporaneous exchange for value. *Endo Steel, Inc. v Janas (In re JWJ Contracting Co.)* (BAP 9th Cir 2004) 371 F3d 1079.

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§6.85 2. Payment of Debt in Ordinary Course of Business

A separate provision recognizes that ordinary business payments take a certain amount of time. Thus, a payment of a debt that was incurred in the ordinary course of business, paid in the ordinary course of business, or made according to ordinary business terms is not an avoidable preference. 11 USC §547(c)(2). The phrase "ordinary business terms" refers to "the broad range of terms that encompasses the practices employed by those debtors and creditors, including terms that are ordinary for those under financial distress." *Ganis Credit Corp. v Anderson* (*In re Jan Weilert RV, Inc.*) (9th Cir 2003) 315 F3d 1192, 1198.

EXAMPLE: If a creditor receives interest from a debtor on a monthly basis on the 15th of each month, those payments, if made at generally the same time each month, should be treated as ordinary course payments, even if they are made within the 90-day preference period.

Prior to the BAPCPA, a preference defendant would have had to prove both that the transfer was made in the ordinary course of business of the debtor and the preference defendant *and* that it was made according to ordinary business terms. The BAPCPA changed this requirement so that a preference defendant now needs to establish only one of these elements. This change provides a more flexible standard for preference defendants to show that payments were made in the ordinary course. Preference defendants should be aware that late payments and other payments that do not fit the typical course of conduct between the parties will still be treated as preferential transfers.

In *Union Bank v Wolas* (1991) 502 US 151, 116 L Ed 2d 514, 112 S Ct 527, the Supreme Court held that not only payments of short-term debt, but payments made on long-term debt may be shielded from attack as a preference under 11 USC §547(c)(2) under the "ordinary course of business" exception. See also *Logan v Basic Distrib. Corp. (In re Fred Hawes Org.)* (6th Cir 1992) 957 F2d 239 ("ordinary-course" defense requires showing of ordinariness both between the parties and in industry as whole). The Ninth Circuit has also held that the "ordinary course" defense is available for first-time transactions. *Wood v Stratos Prod. Dev., LLC* (*In re Ahaza Sys., Inc.)* (9th Cir 2007) 482 F3d 1118, 1125. Ordinary course can be determined in reference to the parties' practice with other similarly situated parties. 482 F3d at 1126.

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§6.86 3. Payment on Fully Secured Debt

The debtor's payment to a secured creditor on a fully secured debt ordinarily is not avoidable as a preference because the transfer does not give the creditor more than the creditor would get in a liquidation. 11 USC §547(b)(5). The transaction is not a preference.

It has also been held that a payment within the preference period to a secured creditor whose claim exceeds the value of the collateral must be allocated to the unsecured portion of the debt when applying the test of 11 USC §547(b)(5). *Barash v Public Fin. Corp.* (7th Cir 1981) 658 F2d 504.

In *Ehring v Western Community Moneycenter (In re Ehring)* (9th Cir 1990) 900 F2d 184*,* the security interest was perfected outside the 90-day preference period, but the foreclosure sale took place within the 90-day preference period. The Ninth Circuit held that, because the creditor who purchased a Chapter 11 debtor's house at a prepetition, nonjudicial, noncollusive foreclosure sale did not receive more from the foreclosure than it would have under a Chapter 7 liquidation, the transfer was not an avoidable preference under 11 USC §547, even though before the petition was filed the creditor resold the property for more than the amount of the outstanding debt. The court saw no reason to allow avoidance of an otherwise properly conducted sale solely because the secured creditor holding the sale was the highest bidder at the sale. The same logic should apply in a judicial foreclosure sale. See also *Newman v FIBSA Forwarding, Inc. (In re FIBSA Forwarding, Inc.)* (Bankr SD Tex 1999) 230 BR 334, aff'd 244 BR 94 (SD Tex 1999).

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§6.87 4. Enabling Loan—Purchase Money Security Interest

Certain transfers that might otherwise be voidable as preferences are specifically exempted by statute. An important example is the "enabling loan" exemption for certain loans made to enable the debtor to acquire the collateral. 11 USC §547(c)(3). For example, assume that the debtor borrows money to purchase certain property, and does purchase that property. If the written security agreement contains a description of the property as the collateral, and if the security interest is perfected within 30 days after the debtor acquires rights in the property, then the transfer will not be avoidable as a preference. Note, however, that the California Commercial Code only provides for a 20-day grace period for perfection of a purchase money security interest. See Com C §9324. Therefore, practitioners should still be sure to perfect security interests within the 20 days provided under §9324.

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§6.88 5. New Value Extended

A transfer that otherwise would be avoidable as a preferential transfer is not avoidable to the extent that the creditor later extends new value. 11 USC §547(c)(4).

EXAMPLE: An insolvent debtor pays a creditor $500 on a two-year-old debt. Two weeks later, the creditor advances the debtor another $200. The debtor then files a petition in bankruptcy, and the trustee sues the creditor to recover the $500 payment as a preferential transfer. Under these circumstances, the trustee could recover only $300.

In order for a creditor to enjoy the protection of 11 USC §547(c)(4), the new value must not be secured by an otherwise unavoidable security interest (11 USC §547(c)(4)(A)), and the debtor must not make an otherwise unavoidable transfer in exchange for the new value (11 USC §547(c)(4)(B)). Applications of the new-value exception are discussed in §§6.89-6.91.

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§6.89 a. "Net Results" Test

The rule of 11 USC §547(c)(4) is sometimes called a "net results" test. See S Rep No. 95-989, 95th Cong, 2d Sess, 88 (1978), reprinted in 1978 US Code Cong & Ad News 5787, 5874. The name suggests that the trustee can recover only the net result of all transfers between the two parties. Actually, it is somewhat less than a pure net-results test. Consider the following variation on the example in §6.88.

EXAMPLE: The debtor owes the creditor $500 on a two-year-old debt. The creditor, 89 days before bankruptcy, advances an additional $200 to the debtor. The debtor, 25 days before bankruptcy, pays the creditor $500. Under a true net-results test, the trustee would be able to recover only $300, the net of the $200 advance offset against the $500 payment. The trustee will, however, be able to recover $500, because 11 USC §547(c)(4) protects only new value given after the preferential transfer. In this case the new value, although advanced within 90 days before bankruptcy, was advanced before the preferential transfer.

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§6.90 b. Release of Lien on Valueless Property

With respect to the "new-value" exception to a preference action under 11 USC §547(c)(4), it is clear that a release of lien, or release of a right to file a statutory lien by the creditor in exchange for receipt of money from the debtor, does not fall within the new-value exception if the property subject to the lien was valueless at the time of the transfer. See *In re Nucorp Energy, Inc.* (9th Cir 1990) 902 F2d 729. In *Nucorp*, a creditor argued that its release of a mechanic's lien on a "dry hole" and the surrounding oil field constituted "new value" within the meaning of 11 USC §547(c)(4). The court disagreed, holding that the creditor had not made any showing of the value of the released lien and noting that the bankruptcy court was required to measure the amount of the new value to determine the net extent of the preference received by the creditor.

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§6.91 c. When Transfer Made by Check for Purposes of New-Value Exception

Generally, courts have held that delivery of a check—as opposed to the honoring of a check—is the date of a transfer for purposes of determining whether the creditor gave new value to the debtor after the transfer for purposes of 11 USC §547(c)(4). See *National Enters., Inc. Liquidating Trust v Tee-Lok Corp. (In re Nat'l Enters., Inc.)* (Bankr ED Va 1994) 174 BR 429. Although the Supreme Court decision in *Barnhill v Johnson* (1992) 503 US 393, 118 L Ed 2d 39, 112 S Ct 1386, held that the date of honor of a check determines the date of transfer for purposes of 11 USC §547(b) (see §6.82), the Court noted that every court of appeals decision to consider 11 USC §547(c) had ruled that the date of delivery determined the date of transfer under 11 USC §547(c). The court found that recognition of a date of delivery rule would promote the policies underlying the preference provisions of the Bankruptcy Code by encouraging parties to continue to do business with distressed businesses by delivering goods and services without waiting for checks to clear.

It is important to note, however, that the Ninth Circuit has held that for purposes of determining new value, the delivery of a check is the operative date as long as the check is honored within 10 days. See *Hall-Mark Elecs. Corp. v Sims (In re Lee)* (9th Cir 1997) 108 F3d 239; *McClendon v Cal-Wood Door (In re Wadsworth Bldg. Components, Inc.)* (9th Cir 1983) 711 F2d 122. In *Wadsworth*, the court relied upon the then 10-day grace period in 11 USC §547(e), which the BAPCPA extended to 30 days. The 10-day grace period will continue to apply to the new value analysis unless the Ninth Circuit or another court revisits the issue.

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§6.92 6. Special Rule for Inventory and Receivables

A special provision of the Bankruptcy Code prevents a security interest in inventory and receivables, or the proceeds of that collateral, from being preferential except to the extent that the secured creditor improves its position at the expense of unsecured creditors during the preference period. 11 USC §547(c)(5).

Normally, the creditor's position at the beginning of the 90-day preference period is measured against its position on the date that the bankruptcy petition is filed for purposes of determining a reduction in value of the inventory. 11 USC §547(c)(5)(A)(i). Correspondingly, if the creditor is an "insider," then the beginning of the one-year period for insider preferences is the first measuring date. 11 USC §547(c)(5)(A)(ii). If the secured creditor did not acquire its initial interest until sometime within the preference period, however, the date on which it first gave new value is the point at which its beginning position is measured or, with respect to an insider, when the insider became an insider. 11 USC §547(c)(5)(B).

Applications of the exception are discussed in §§6.93-6.95. The definition of inventory and receivables is discussed in §6.96. An increase in the amount of debt during the preference period may act as a counterbalance to the increase in collateral under 11 USC §547(c), and debt will include all amounts owing under a loan agreement, including fees, interest and other charges, not just advances. *Qmect, Inc. v Burlingame Capital Partners, II, LP* (*In re Qmect, Inc.)* (Bankr ND Cal, Dec. 11 2007, No. 04-41044 TK) 2007 Bankr Lexis 4172, 2007 WL 4357566.

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§6.93 a. New Additions to Inventory

The rule of 11 USC §547(c)(5) is most commonly applied when there are new additions to the inventory.

EXAMPLE: The debtor, 91 days before bankruptcy, owes $500 to the secured creditor, secured by inventory with a value of only $400. The creditor is thus unsecured to the extent of $100. The debtor acquires new inventory worth $100 during the 90-day period, so that on the date that the bankruptcy petition is filed the creditor's $500 loan is secured by $500 worth of inventory. The secured creditor has improved its position at the expense of unsecured creditors to the extent of $100, and that amount is vulnerable as a preference.

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§6.94 b. Downward Fluctuation in Value of Collateral

Another practical consequence of the rule of 11 USC §547(c)(5) is to protect the secured creditor against downward fluctuations in the value of collateral during the preference period.

EXAMPLE: In the example in §6.93, suppose there was $400 worth of inventory on hand 90 days before bankruptcy, only $200 worth of inventory on hand on the 45th day before bankruptcy, and $500 worth of inventory available on the filing date. The relevant measuring point is the value of inventory on the 90th day, not the 45th day; the trustee should be able to avoid only the $100 difference between $400 and $500.

The Bankruptcy Code does not specify the appropriate standard to be used in valuing the collateral. If the debtor is reorganizing, as under Chapter 11, the court should use a going-concern value. Whether the court should use a liquidation value in other cases is open to debate.

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§6.95 c. Increase in Value of Inventory

The rule applies only if the fluctuation is "to the prejudice of other creditors holding unsecured claims." 11 USC §547(c)(5). One function of this qualifier is to protect the security interest when there is a natural increase in the market value of inventory presently held, as distinct from an increase in value that results from new contributions to inventory.

EXAMPLE: In the example in §6.93, suppose there was $400 worth of inventory on hand 90 days before bankruptcy and the same inventory is worth $500 on the filing date. The secured creditor is now fully secured but has not improved its position against other creditors. Therefore, the trustee would not be able to avoid the $100 difference between $400 and $500.

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§6.96 d. Collateral Covered by Rule

The special rule of 11 USC §547(c)(5) (see §6.92) covers a "security interest in inventory or a receivable." The definitions of these terms in the Bankruptcy Code do not coincide completely with the corresponding definitions in the Commercial Code.

"Inventory" is defined in 11 USC §547(a)(1) as "personal property leased or furnished, held for sale or lease, or to be furnished under a contract for service, raw materials, work in process, or materials used or consumed in a business, including farm products such as crops or livestock, held for sale or lease." This definition is broader than the definition in Com C §9102(a)(48). The Bankruptcy Code explicitly includes farm products; the Commercial Code definition does not.

"Receivable" is defined in 11 USC §547(a)(3) as a "right to payment, whether or not such right has been earned by performance." This definition appears to include accounts as defined in Com C §9102(a)(2), as well as instruments (see Com C §9102(a)(47)), chattel paper (see Com C §9102(a)(11)), payment intangibles (see Com C §9102(a)(61)), and possibly general intangibles (see Com C §9102(a)(42)).

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§6.96A 7. Earmarking Doctrine

A transfer is not preferential when a third party lends money to a debtor for the specific purpose of paying a selected creditor if the debtor had no control of the money and no choice but to pay the creditor. *Adams v Anderson (In re Superior Stamp & Coin Co.)* (9th Cir 2000) 223 F3d 1004. The debtor's lack of control over the funds is a key factor in the earmarking doctrine. An agreement outlining that the funds are to be paid to a particular creditor will be important to prove the earmarking doctrine. See *Metcalf v Golden* (*In re Adbox, Inc.*) (9th Cir 2007) 488 F3d 836, for a discussion of meeting the burden of proof on an earmarking defense.

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§6.96B 8. Limit on Preference Lawsuit Amount and Venue

Aggregate transfers to a creditor of less than $600 made by an individual debtor on account of a consumer debt are excepted from avoidance as a preference. 11 USC §547(c)(8). In cases in which the debtor's debts are not primarily consumer debts, the trustee or debtor in possession cannot avoid as preferential a transfer if the aggregate value of all property that constitutes or is affected by such transfer is less than $5000. 11 USC §547(c)(9), added by the BAPCPA. Because the definition of a preference in 11 USC §547(b)(1) refers to a single creditor, the $5000 cap should apply separately to each of the debtor's creditors. These new provisions help creditors from being plagued by minor lawsuits that are not worth their time to defend.

In addition, if the amount in controversy in a preference lawsuit is less than $10,000, the debtor must bring suit in the federal judicial district in which the creditor is located, unless the creditor is an insider. 28 USC §1409(b).

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§6.96C 9. Bankruptcy Code §547(i)

Bankruptcy Code §547(i), added by the BAPCPA, provides that if the trustee avoids a transfer by the debtor to an entity that is not an insider for the benefit of a creditor made between 90 days and 1 year before the filing of the petition, the transfer will be considered avoided only with respect to the insider. Section 547(i) is intended to overrule *Levit v Ingersoll Rand Fin. Corp. (In re Deprizio)* (7th Cir 1989) 874 F2d 1186 and other cases that allowed the trustee or debtor in possession to avoid transfers to noninsider creditors made within the 90-days-to-1-year period if the insider benefited from the transfer. *Deprizio* and related cases chilled the ability of lenders and other third parties from obtaining guaranties from insiders. Bankruptcy Code §550 was amended to address this issue but not to address a preferential lien. H Rep No. 31, 109th Cong, 1st Sess (2005). In *Official Comm. of Unsecured Creditors v Bank of America, N.A. (In re ABC-NACO, Inc.)* (Bankr ND Ill 2005) 331 BR 773, the court ruled the statute is constitutional and may be applied retroactively.

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VII. PRIORITIES OF PAYMENT OF CLAIMS IN BANKRUPTCY

§6.97 A. Order of Priorities

A fundamental purpose of a bankruptcy case is to collect the property of the debtor and to distribute it to creditors as their interests may appear. In the ordinary case, there is not enough property to satisfy all claims.

The Bankruptcy Code generally provides that all unsecured creditors of a debtor in a Chapter 7 case share equally, pro rata, in the bankruptcy estate. 11 USC §726(a)(2), (b).

But the Bankruptcy Code also recognizes that not all claims should be treated equally. Consequently, it establishes a system of "priorities," situations in which a creditor will get more (or less) than a prorata share. The basic priority rules are set forth in 11 USC §507. These priorities apply to debtors in cases under both Chapters 7 and 11. See §§6.98-6.99.

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§6.98 1. Priority of Secured Creditors

The secured creditor has first right to any collateral in which the secured creditor has a valid security interest.

EXAMPLE: There are three creditors, *A* with a claim of $150, *B* with a claim of $100, and *C* with a claim of $50. The estate has one asset with a value of $60. *A* had a security interest in that asset, and the other two creditors were unsecured. *A* would get all of the $60 and the other two creditors would get nothing. *A* would have an unsecured claim for the $90 deficiency, and would be entitled to share pro rata with other unsecured creditors in other property of the debtor for this deficiency. On the other hand, if *C* (not *A*) had a security interest in the $60 asset, and the other two creditors were unsecured, *C* would be entitled to be paid $50 from the liquidation of the collateral. The $10 surplus would be distributed pro rata between the unsecured creditors, *A* and *B,* whose claims total $250. Assuming no other unsecured creditors, *A* would get $6 (($150 ÷ $250) ´ $10); *B* would get $4 (($100 ÷ $250) ´ $10).

Although the secured creditor's priority is clearly the law, the Bankruptcy Code never spells it out in detail. The secured creditor, at the head of the priority list, is not mentioned in 11 USC §§507 and 726. The omission is historical. Earlier in the history of bankruptcy, secured creditors were free to foreclose against collateral without involvement in the bankruptcy proceeding. Even when bankruptcy law reached the secured creditor, no one felt a need to spell out the fundamental principle that the secured creditor's interest was paramount. Other priorities are listed in §6.99. The allowance of interest on a secured claim is discussed in §§6.100-6.102.

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§6.99 2. List of Priorities

In addition to the "regular" priority under 11 USC §507 and the "superpriority" for secured credit, there is a ladder of "subpriorities" in 11 USC §726. It itemizes a number of classes of claims that are subordinate to the claims of general creditors.

PRACTICE TIP: Practitioners should review 11 USC §§507 and 726 for a list of administrative priority claims and the distribution scheme in a Chapter 7 case.

If the creditor cannot establish a claim as secured, the claim will normally be treated as a general unsecured claim and thus be given priority below the types of claims listed in 11 USC §507.

When a Chapter 11 case is converted to a Chapter 7 case, the administrative expenses of liquidation in the Chapter 7 case take priority over those in the previous case under 11 USC §726(b). Similarly, there is a separate system of marshaling when the debtor has community property interests (11 USC §726(c)) and a special scheme for tax liens (11 USC §724). Subordination of claims may also affect priority. See §6.103.

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§6.100 B. Interest on Secured Claims

Interest on a secured claim is generally allowed only to the extent that the value of the collateral is greater than the allowed secured claim. 11 USC §506(b). (In some cases undersecured creditors may receive interest. See §6.102.) Reasonable fees, costs, or charges provided under the agreement under which the claim arose may also be allowed. 11 USC §506(b).

The U.S. Supreme Court held that 11 USC §506(b) entitles a creditor to receive postpetition interest on a nonconsensual (*i.e.,* statutory) oversecured claim when that claim is allowed in a bankruptcy proceeding. *U.S. v Ron Pair Enters., Inc.* (1989) 489 US 235, 103 L Ed 2d 290, 109 S Ct 1026. See §6.101.

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§6.101 1. Contractual Rate of Interest

In *In re Laymon* (5th Cir 1992) 958 F2d 72, the court held that oversecured creditors are entitled to the contractual rate of interest and not the federal interest rate on judgments. The court concluded that the Supreme Court's decision in *U.S. v Ron Pair Enters., Inc.* (1989) 489 US 235, 103 L Ed 2d 290, 109 S Ct 1026*,* allowing interest for nonconsensual claims, did not require the use of the federal rate for consensual claims, because the Court did not address the issue of what rate of interest is applied under 11 USC §506(b). The Fifth Circuit then held that whether the contractual rate should be the pre- or postdefault rate set by the contract depends on the equities of each case. See also *In re Carter* (Bankr D NM 1998) 220 BR 411, 415. Section 506(b) has now been clarified by the BAPCPA to state that the interest rate will be as provided in the agreement or state statute under which the claim arose. Section 506(b) applies to default interest as well. The Ninth Circuit has held that an oversecured creditor will receive a default rate of interest if the contract so provides, subject to qualifying or contrary provisions. *General Elec. Capital Corp. v Future Media Prods., Inc.* (*In re Future Media Prods., Inc.*) (9th Cir 2008) 536 F3d 969. *Future Media* was decided in the context of a §363 sale, and the Ninth Circuit held that *In re Entz-White Lumber & Supply, Inc.* (9th Cir 1988) 850 F2d 1338, was inapplicable to this circumstance. *Entz-White* provided that a cure of a default pursuant to a plan of reorganization would prohibit recovery of default interest.

In *Hassen Imports Partnership v KWP Fin. VI (In re Hassen Imports Partnership)* (BAP 9th Cir 2000) 256 BR 916, the court held that the default rate is not automatic and that courts should examine whether the default rate should compensate for actual loss of the lender.

To the extent interest is payable, the rate of interest for an unsecured claim will be the "legal rate," which may be the federal judgment rate. See, *e.g.,* 11 USC §726(a)(5). *Onink v Cardelucci (In re Cardelucci)* (9th Cir 2002) 285 F3d 1231 (federal judgment rate, not contract rate, is correct rate for unsecured creditors). But see *In re Fast* (Bankr D Colo 2004) 318 BR 183.

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§6.102 2. Solvent Debtor Exception

The undersecured creditor has no right to interest under 11 USC §506(b). However, if the debtor is solvent, interest is appropriate. In Chapter 7 cases, interest on unsecured claims is provided by 11 USC §726(a)(5). See §6.99. In Chapter 11 cases involving solvent debtors, courts recognize that the "best interest of creditors" test cannot be satisfied unless each impaired creditor that does not accept the plan receives the full amount of its allowed claim, plus postponement interest. See *United Sav. Ass'n v Timbers of Inwood Forest Assocs., Ltd.* (1988) 484 US 365, 379, 98 L Ed 2d 740, 753, 108 S Ct 626; *Groundhog, Inc. v San Joaquin Estates, Inc. (In re San Joaquin Estates, Inc.)* (BAP 9th Cir 1986) 64 BR 534; *In re Carter* (Bankr D NM 1998) 220 BR 411, 414; *In re David Green Prop. Mgmt.* (Bankr WD Mo 1994) 164 BR 92, 98. See also *Thompson v Kentucky Lumber Co. (In re Kentucky Lumber Co.)* (6th Cir 1988) 860 F2d 674, 676 (recognizing solvent debtor exception and its purpose "to prevent debtors from abusing the bankruptcy process by merely using it to delay payments and avoid interest obligations"). For discussion of reorganization under Chapter 11, see §§6.104-6.112.

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§6.103 C. Subordination

A secured creditor may agree by contract to subordinate the claim to some other claim or claims. 11 USC §510(a). Furthermore, the court has power to impose equitable subordination for substantial "bad acts" by the creditor. 11 USC §510(c). If a creditor is equitably subordinated, that creditor will be paid below general unsecured creditors or may lose its lien, which may be transferred to the estate. Equitable subordination may directly affect creditors who attempt to control the debtor's business or in other ways force the debtor to take action because of amounts owed to such creditor.

Most cases on equitable subordination involve corporate insiders, fraudulent conduct, undercapitalization, or some mix of the three. See, *e.g., Pepper v Litton* (1939) 308 US 295, 84 L Ed 281, 60 S Ct 238; *Wood v Richmond (In re Branding Iron Steak House)* (9th Cir 1976) 536 F2d 299; *In re Delta Smelting & Refining Alaska, Inc.* (Bankr D Alaska 1985) 53 BR 877. In *Bayer Corp. v Mascotech, Inc. (In re Autostyle Plastics, Inc.)* (6th Cir 2001) 269 F3d 726, 744, the Sixth Circuit adopted a three-part test for establishing equitable subordination:

(1) The claimant must have engaged in inequitable conduct;

(2) The misconduct must have resulted in injury to the creditors of the debtor or conferred an unfair advantage on the claimant; and

(3) Equitable subordination of the claim must not be inconsistent with the Bankruptcy Code.

Satisfaction of the three-part test means that equitable subordination is permitted but not required. The court also noted that equitable subordination is an unusual remedy and should be applied only in limited circumstances. 269 F3d at 745. See also *Enron Corp. v Avenue Special Situations Fund II, LP (In re Enron Corp.)* (Bankr SD NY 2005) 333 BR 205 (claim transferred to third party could still be subordinated based on inequitable conduct of transferor). Generally, equitable subordination is a drastic remedy and should be used sparingly. *Official Comm. of Unsecured Creditors of Radnor Holdings, Inc. v Tennenbaum Capital Partners* (*In re Radnor Holdings, Inc.*) (Bankr D Del 2006) 353 BR 820.

A different yet similar remedy is the recharacterization of debt to equity. *Cohen v KB Mezzanine Fund II* (*In re Submicron Sys. Corp.*) (3rd Cir 2006) 432 F3d 448, 457; *Fairchild v Official Committee of Unsecured Creditors (In re Dornier Aviation, Inc.*) (4th Cir 2006) 453 F3d 225 (recharacterization of parent company debt as equity). Equitable subordination occurs when equity requires that the payment priority of an otherwise legitimate creditor be changed, while recharacterization examines whether there was ever any debt at all. The Third Circuit has held that intent of the parties is of paramount importance in determining whether recharacterization of debt to equity is appropriate. *In re Submicron*, 432 F3d at 457.

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VIII. REORGANIZATION AND CREDITORS' PLANS

§6.104 A. Secured Creditor's Rights in Reorganization

The goal of a Chapter 11 case is to have a plan of reorganization confirmed under which all creditors receive some type of property or payment on account of their debt. If the debtor will continue in business, the plan will also set forth the means by which the debtor will exit bankruptcy.

The debtor may choose how to satisfy a secured claim. The debtor may, for example, pay off the claim in cash. If the debtor is not in default, the debtor may leave the claim in place. If the debtor is in default, the debtor may cure the default and reinstate the claim. Or the debtor may rewrite the terms of the agreement with the secured creditor, as long as the secured creditor retains value equal to the allowed amount of the claim. 11 USC §§1124, 1129.

The plan will describe how payments will be made to various classes of creditors, such as secured creditors, administrative expenses, employee wage claims, and general unsecured creditors. 11 USC §§1122-1123. See §6.105. The plan generally must be accepted by each class of creditors. 11 USC §1126. See §§6.106-6.111. Special rules apply to the confirmation of a plan of reorganization of a small business. Treatment of nonrecourse lenders under Chapter 11 is discussed in §6.112.

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§6.105 B. Classification of Claims

Bankruptcy Code §1122(a) provides for the placing of claims or interests in a particular class only if such claim or interest "is substantially similar" to other claims or interests of that class. *In re Drexel Burnham Lambert Group, Inc.* (Bankr SD NY 1992) 138 BR 723, 757. Case law generally supports broad discretion of the court to determine proper classification according to the factual circumstances of each individual case. *Brady v Andrew (In re Commercial W. Fin. Corp.)* (9th Cir 1985) 761 F2d 1329, 1334; *Teamsters Nat'l Freight Indus. Negotiating Comm. v U.S. Truck Co. (In re U.S. Truck Co.)* (ED Mich 1985) 47 BR 932, 938, aff'd (6th Cir 1986) 800 F2d 581. It is a question of fact whether a claim is substantially similar to other claims, and courts have discretion in determining whether classification is appropriate. *Steelcase, Inc. v Johnston (In re Johnston)* (9th Cir 1994) 21 F3d 323.

NOTE: Although all claims within a given class must be substantially similar, all substantially similar claims need not be placed in the same class. *Teamsters Nat'l Freight Indus. Negotiating Comm. v U.S. Truck Co. (In re U.S. Truck Co.)* (6th Cir 1986) 800 F2d 581, 586.

In exercising their discretion, courts generally have concentrated on two factors in determining whether claims in a given class are substantially similar. Claims have been held substantially similar if the claims are of the same legal character or quality as they relate to or affect the assets of the debtor. *Aoki v Light (In re Los Angeles Land & Invs., Ltd.)* (D Haw 1968) 282 F Supp 448, 453, aff'd (9th Cir 1971) 447 F2d 1366; *In re Fantastic Homes Enters., Inc.* (MD Fla 1984) 44 BR 999. The Ninth Circuit has set forth the following test for determining whether there has been unfair discrimination (*Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650, 656):

- The discrimination has a reasonable basis;
- The plan could not be confirmed or consummated without the discrimination;
- The discrimination is proposed in good faith; and
- The degree of the discrimination is related to the basis or rationale for the discrimination.

The court's discretion is not limitless, however, and a deficiency claim may not be separately classified from other general unsecured claims without business or economic justification. *Barakat v Life Ins. Co. of Va. (In re Barakat)* (9th Cir 1996) 99 F3d 1520, 1526. Trade creditor claims may not be separated based only on whether the debtor plans to continue to do business with certain trade creditors. *Oxford Life Ins. Co. v Tucson Self-Storage (In re Tucson Self-Storage)* (BAP 9th Cir 1994) 166 BR 892, 898.

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§6.106 C. Acceptance and Confirmation of Chapter 11 Plan

To be effective, a Chapter 11 plan generally must be accepted by vote of each class of those who hold a claim or interest under 11 USC §502. 11 USC §1126. See §6.107. Then the court must confirm the plan. 11 USC §§1128-1129. See §6.108.

NOTE: The court may not confirm a plan if it is likely to be followed by liquidation or further reorganization unless that is proposed as part of the plan. 11 USC §1129(a)(11). This requirement is sometimes called the "feasibility" requirement.

A class of creditors need not accept for the plan to be confirmed if the plan does not impair the class (11 USC §1129(a)(8)(B)) or if the court approves the plan over the objection of the class (11 USC §1129(b)). See §§6.109-6.111. If any impaired class of creditors objects to the plan, however, at least one impaired class must accept the plan for the plan to be confirmed. 11 USC §1129(a)(10). Special rules for nonrecourse lenders are discussed in §6.112.

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§6.107 1. Acceptance by Impaired Creditors

If creditors are "impaired," the proponent of the plan will need to solicit creditors' acceptance of the plan. 11 USC §§1126(a), 1129(a)(8)(A). A creditor is unimpaired if the plan (1) leaves the claim unaltered, (2) decelerates and reinstates the claim, or (3) provides for cash payoff. 11 USC §1124. The courts, however, have read the definition of impairment quite broadly. See *In re Smith* (Bankr CD Cal 1991) 123 BR 863; *In re Barrington Oaks Gen. Partnership* (Bankr D Utah 1981) 15 BR 952. Almost any alteration in the claim will impair the claim. Therefore, if a plan provides that a creditor will be paid the full amount of the claim, but over a longer time or at a lesser interest rate, the claim will be impaired.

A plan's proponent who must solicit acceptances may do so only after obtaining court approval of a disclosure statement. 11 USC §1125. A favorable vote by a majority in number and two-thirds in amount of the allowed claims in a class is required to accept a plan. 11 USC §1126(c). Acceptance by a class of owners (usually stockholders) requires a favorable vote of two-thirds in amount of those voting, without regard to number. 11 USC §1126(d). But any class that is not impaired by the plan will be deemed to have accepted the plan. 11 USC §1126(f).

Under these provisions, an appropriate majority can bind dissenters. 11 USC §1126(c)-(d). There are no means to bind dissenters outside Chapter 11. Sometimes the debtor and a majority of creditors reach agreement before the Chapter 11 case is filed, and then take the case into Chapter 11 solely for the purpose of binding dissenters. The Bankruptcy Code specifically recognizes this possibility. 11 USC §1126(b).

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§6.108 2. Confirmation Procedure

The court may order confirmation of the plan in appropriate circumstances and after notice and a hearing. Fed R Bankr P 3020(b)(2). Most bankruptcy courts have local rules that clarify those found in the Federal Rules of Bankruptcy Procedure. The federal rules require that all parties receive at least 28 days' notice of the hearing on confirmation. Fed R Bankr P 2002(b). Objections to confirmation must be filed within a time set by the court. Fed R Bankr P 3020(b)(1). The order of confirmation must be mailed promptly to all parties in interest. Fed R Bankr P 3020(c)(2).

Aside from the specific standards for acceptance discussed in §6.107, the proponent of a plan must meet a number of other standards in order to win confirmation. See generally 11 USC §1129(a). A secured creditor is a party to a confirmation inquiry and may object to confirmation if the plan fails to meet any of the standards. For example, the plan must be proposed in good faith and not by any means forbidden by law. 11 USC §1129(a)(3). A discussion of these other standards is beyond the scope of this book.

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§6.109 3. "Cram-Down" and Absolute Priority Rule

If one class of impaired creditors accepts the plan, and the plan otherwise meets the requirements of 11 USC §1129(a) (see §§6.106-6.108), the court may confirm a plan without the creditors' acceptance "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 USC §1129(b)(1). Bankruptcy Code §1129(b)(2) provides a framework to determine whether a plan is fair and equitable to a dissenting class. This standard is known as the fair and equitable requirement (for secured creditors) and the absolute priority rule (for unsecured creditors). Because the court can compel a dissenter to accept a plan that it does not want, the colloquial name of this rule is the "cram-down" rule. The fair and equitable requirement is discussed in §6.110.

In general, the absolute priority rule provides that unsecured creditors or equity interest holders at a lower level of priority cannot obtain payment under the plan if a more senior class is not receiving anything of value. See *Norwest Bank Worthington v Ahlers* (1988) 485 US 197, 99 L Ed 2d 169, 108 S Ct 963; *In re Armstrong World Indus., Inc.* (3rd Cir 2005) 432 F3d 507 (proposed Chapter 11 plan providing warrants would be distributed to equity holders if class of unsecured creditors rejected plan violated absolute priority rule); *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650. However, a secured creditor may be able to "carve out" a recovery for unsecured creditors in a settlement without violating the absolute priority rule based on the theory that the property belongs to the secured creditor and not the estate. *Armstrong World Indus.,* 432 F3d at 514 (analysis of carve out cases, although court found absolute priority claims violated); *In re World Health Alternatives, Inc.* (Bankr D Del 2006) 344 BR 291.

In *Norwest Bank*, the Supreme Court held that Chapter 11 debtors could not retain nonexempt property over the objection of unsecured creditors who were not paid in full, because retention violated the absolute priority rule of 11 USC §1129(b). The Court found the absolute priority rule to be violated despite the debtor's promise to contribute future labor, experience, and expertise to the operation of the farm under the future contribution or new-value exception to the absolute priority rule established by *Case v Los Angeles Lumber Prods. Co.* (1939) 308 US 106, 84 L Ed 110, 60 S Ct 1. See §6.111.

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§6.110 a. Fair and Equitable Requirement

Bankruptcy Code §1129(b)(2) provides specific means to meet the condition that the plan be fair and equitable for secured creditors:

- The plan proponent may simply rewrite the loan if the creditor retains a lien equal to the allowed amount of the claim and receives deferred cash payments equal to the value of the claim. 11 USC §1129(b)(2)(A)(i). See *In re Sagewood Manor Assocs. Ltd. Partnership* (Bankr D Nev 1998) 223 BR 756, 767. The length of the payout period may not be too long. See *In re Pine Lake Village Apartment Co.* (Bankr SD NY 1982) 19 BR 819 (plan providing for payment of balance due over 30 years not fair and equitable).
- The secured creditor may receive the "indubitable equivalent" of its secured claim. 11 USC §1129(b)(2)(A)(iii). See §6.18.
- The property in dispute may be sold, the creditor's lien may attach to the proceeds, and the proceeds may be treated in either of the preceding two ways. 11 USC §1129(b)(2)(A)(ii).

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§6.111 b. New-Value Exception to Absolute Priority Rule

In circuits where it is recognized, the "new-value exception" to the absolute priority rule permits the confirmation of a plan of reorganization that provides equity to existing shareholders when existing shareholders provide additional capital to the bankrupt corporation in exchange for stock, even if creditors are not being paid in full. There is a split among the circuits, however, concerning whether 11 USC §1129 provides for a "new value" exception to the absolute priority rule.

In *In re 203 North LaSalle St. Partnership* (7th Cir 1997) 126 F3d 955, rev'd (1999) 526 US 434, 143 L Ed 2d 607, 119 S Ct 1411, the Seventh Circuit joined the Ninth Circuit in relying on a new-value exception to the absolute priority rule. See *Bonner Mall Partnership v U.S. Bancorp Mortgage Co. (In re Bonner Mall Partnership)* (9th Cir 1993) 2 F3d 899, 908. The Second and Fourth Circuits, by contrast, without explicitly rejecting the exception, have disapproved plans similar to the new-value plan proposed in *LaSalle*. See *Coltex Loop Central Three Partners, L.P. v BT/SAP Pool C Assocs. (In re Coltex Loop Central Three Partners, L.P.)* (2d Cir 1998) 138 F3d 39; *Travelers Ins. Co. v Bryson Props. XVIII (In re Bryson Props. XVIII)* (4th Cir 1992) 961 F2d 496, 504.

The U.S. Supreme Court granted certiorari in *LaSalle* to resolve the split among the circuits. However, the Supreme Court did not decide the question. The Court held that the proposed plan of reorganization failed to satisfy the absolute priority statute under any reading by providing for the vesting of equity in the reorganized business in the debtor's partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan. *Bank of America v 203 North LaSalle St. Partnership* (1999) 526 US 434, 143 L Ed 2d 607, 119 S Ct 1411.

By not squarely deciding the question, the Supreme Court seems to have left the new-value exception intact in the Ninth Circuit. In *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650, the court set forth a five-part test for when the new-value exception will be applied in the Ninth Circuit. The court held that

> former equity holders must offer value under the Plan that is (1) new, (2) substantial, (3) in money or money's worth, (4) necessary for successful reorganization, and (5) reasonably equivalent to the value or interest received.

115 F3d at 654. Because *LaSalle* holds that other parties should also have the opportunity to compete for the equity, market testing should be added as a requirement to the test enunciated in *Ambanc*.

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§6.112 D. Nonrecourse Lenders

The Bankruptcy Code provides special rules for nonrecourse lenders. A nonrecourse lender is one who agrees, by contract, to look only to the collateral for satisfaction of the claim, and, therefore, to forgo a deficiency judgment against the debtor. In a liquidation case, the lender has a claim to the value of his or her security and no more. See 11 USC §§502(b)(1), 506(a). But Chapter 11 permits the lender to have a secured claim in the amount of the value of the collateral and an unsecured claim for the deficiency. 11 USC §1111(b). See *In re Greenland Vistas, Inc.* (Bankr ED Mich 1983) 33 BR 366.

There are two limitations to this Chapter 11 rule:

- The nonrecourse lender is not permitted to assert an unsecured claim if the collateral is sold. 11 USC §1111(b)(1)(A)(ii).
- If the lender (or a class of which the lender is a member) elects to be treated as secured, and if the security is of more than inconsequential value, then the lender (or the class) may be treated as secured for the whole amount of the debt. 11 USC §1111(b)(1)(A)(i). In this case, the lender may not seek a deficiency judgment under an unsecured claim.

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IX. DISCHARGE, REDEMPTION, AND REAFFIRMATION

§6.113 A. Discharge

The majority of bankruptcy cases are filed to get a discharge that eliminates liability for past debts. It is important to recognize the difference between the concept of a "discharge" (which affects all obligations that can be discharged) and the concept of "dischargeability" of a particular debt. A discharge voids any judgment or lien against the debtor and operates as an injunction against any future action to recover the debt. 11 USC §524.

The entire discharge can be denied to a debtor under Chapter 7 only in accordance with the criteria stated in 11 USC §727. An objection to discharge is rarely successful. More common is that the debtor gets the discharge, but certain debts are excepted under 11 USC §523. In Chapter 11 cases filed by individuals, a discharge will not be available until payments under the plan are made in full, unless a court orders otherwise. 11 USC §1141(d)(5). A discharge is not available to a corporation that is liquidating rather than continuing in business. 11 USC §1141(d)(6). In addition, a corporation may not receive a discharge (1) with respect to money obtained by fraud, false pretenses, or false representation that is owed to a domestic governmental unit or (2) for tax or customs duties with respect to which the debtor made a fraudulent return or willfully attempted to evade or defraud such tax or duty. 11 USC §1141(d)(6). A detailed discussion of the scope of the discharge as well as the denial of the discharge is beyond the scope of this chapter. The debtor's right to redeem property that secures a dischargeable consumer debt is discussed in §6.114.

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§6.114 B. Redemption

An individual debtor in a Chapter 7 case has a limited right to redeem tangible personal property intended primarily for personal, family, or household use that secures a dischargeable consumer debt. 11 USC §722. If that property is exempt under 11 USC §522 or has been abandoned by the trustee under 11 USC §554, the debtor can redeem the property by paying the lienholder the amount of the allowed claim secured by the lien in full at the time of redemption. 11 USC §722. That payment must be in cash, not by installments. See *Arizona Bank v Carroll (In re Carroll)* (BAP 9th Cir 1981) 11 BR 725.

EXAMPLE: A debtor owes $500 for a refrigerator, secured by a lien. If the refrigerator is worth only $300, the value of the secured interest as an allowed claim is, likewise, only $300. If the debtor wants to redeem the refrigerator, he or she must first claim the exemption for household furnishings. The redemption rule then allows the debtor to keep the refrigerator by paying the secured creditor $300, not $500.

A debtor in bankruptcy may find it no easier to raise $300 than $500, but the possibility of redemption may make it easier to negotiate a reaffirmation agreement. See 11 USC §524(c). A creditor who knows that the debtor could redeem the collateral under 11 USC §722 by paying its value may agree to reaffirmation of a part of the original installment contract. See §6.115.

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§6.115 C. Reaffirmation

A debtor and creditor may agree to reaffirm a debt so that it will not be discharged. Reaffirmation is valid only to the extent it is enforceable under nonbankruptcy law and must be approved by the bankruptcy court. 11 USC §524(c)-(d). Restrictions and limitations on reaffirmation are discussed in §§6.116-6.118.

NOTE: A debtor's reaffirmation is restricted for the debtor's protection, but nothing prohibits the debtor from voluntarily paying a prebankruptcy debt. 11 USC §524(f).

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§6.116 1. Restrictions on Approval of Agreement

The court may approve an agreement only if:

- The agreement is made before the discharge is granted (11 USC §524(c)(1));
- It provides the disclosures set forth in Bankr C §524(k);
- It is filed with the court (11 USC §524(c)(3)); and
- The creditor has complied with measures to protect the debtor described in §6.117 (11 USC §524(c)(5), (d)).

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§6.117 2. Requirement of No Undue Hardship

If the debtor is represented by an attorney, the attorney must file a declaration with the agreement in the bankruptcy court stating that the debtor was fully informed and made the agreement to reaffirm voluntarily, and that the agreement does not impose an undue hardship on the debtor or the debtor's dependents. 11 USC §524(c)(3). If the debtor is an individual not represented by an attorney, the court must find that the agreement imposes no undue hardship on the debtor and is in the debtor's best interest. 11 USC §524(c)(6)(A). The required findings are made in the discharge hearing, at which the debtor, if an individual, must appear. 11 USC §524(d). If the debtor is an individual, the court must inform the debtor that the agreement is not required and advise of the agreement's legal effect and consequences and the consequences of default. 11 USC §524(d). Other restrictions on reaffirmation are discussed in §6.116. Practical limitations on the creditor's right to insist on reaffirmation are discussed in §6.118.

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§6.118 3. Creditor's Limited Right to Insist on Reaffirmation

At least one California court has concluded that, as a practical matter, secured creditors have only limited rights to insist on reaffirmation by an individual debtor of a consumer loan, despite the apparent requirement of 11 USC §521(a)(2) that the debtor reaffirm the debt, redeem the collateral, or surrender the collateral. In *In re Weir* (Bankr ED Cal 1994) 173 BR 682, the debtors filed for bankruptcy, stayed current on their consumer loans from Sears, but refused to either reaffirm the loan or redeem the collateral. The bankruptcy court held that Sears had no effective remedy unless the debtors defaulted; even though Sears might be entitled to request relief from the automatic stay, it was adequately protected by the ongoing payments.

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7

Consumer Transactions

Ellen A. Friedman

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§7.1 I. INTRODUCTION

This chapter reviews consumer transactions in connection with Division 9 and provides a brief overview of certain state and federal statutes and regulations that relate to consumer transactions. This chapter does not deal with real property secured transactions, credit card or revolving credit transactions, usury, licensing, or other aspects of the consumer loan industry. It also does not cover Division 2 issues relating to sales to consumers. Moreover, this chapter does not cover the many special requirements relating to consumers that were added to the Bankruptcy Code in 2005. See chap 6 for a general discussion of the amended Bankruptcy Code.

The treatment of consumer statutes and regulations in this chapter is intended only as a general summary of their principal features. For a more in-depth discussion of consumer financing transactions, practitioners should consult Bancroft-Whitney's California Civil Practice, Business Litigation, chaps 51-59 (1994).

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§7.2 II. DEFINITIONS UNDER DIVISION 9

There are several definitions in Division 9 that relate to consumer transactions:

- "Consumer debtor" means a debtor in a consumer transaction (Com C §9102(a)(22)).
- "Consumer goods" means goods that are used or bought for use primarily for personal, family, or household purposes (Com C §9102(a)(23)).
- "Consumer goods transaction" means a consumer transaction in which both of the following are satisfied (Com C §9102(a)(24)):
- An individual incurs an obligation primarily for personal, family, or household purposes; and
- A security interest in consumer goods secures the obligation.
- "Consumer obligor" means an obligor who is an individual and who incurred the obligation as part of a transaction entered into primarily for personal, family, or household purposes (Com C §9102(a)(25)).
- "Consumer transaction" means a transaction in which:
- An individual incurs an obligation primarily for personal, family, or household purposes;
- A security interest secures the obligation; and
- Any of the collateral is held or acquired primarily for personal, family, or household purposes.

The term includes consumer goods transactions. Com C §9102(a)(26).

The interplay of the definitions is critical in understanding consumer transactions under Division 9. A "consumer transaction" is a broad category of transactions relating to consumer obligors and consumer debtors. A transaction in which an obligation is incurred by an individual primarily for family, personal, or household purposes is a "consumer transaction." It is important to note that some of the collateral securing the obligation must be held or acquired primarily for personal, family, or household purposes. Com C §9102(a)(26). The collateral need not be "consumer goods," however, or goods used for personal or household purposes.

Therefore, a transaction in which an individual secures a loan to make home improvements with the individual's mutual funds is a "consumer transaction," even though mutual funds are not "consumer goods."

The more difficult question is how to determine whether a transaction with a consumer debtor or a consumer obligor meets the requirements that the obligation be primarily for personal, family, or household purposes and that some of the collateral is held or acquired primarily for personal, family, or household purposes.

For instance, in the above example of an individual obtaining a loan for home improvements, if the home improvements are to build a "home office" primarily for business purposes, the loan would not be a consumer transaction. If, however, the home improvements are primarily for household purposes and only occasionally for business purposes, the loan will be considered a consumer transaction.

Some of the collateral must also be used or held *primarily* for personal, family, or household purposes. If the loan in the above example was secured by an interest in the individual's business, it would not be considered a consumer transaction.

It is not always clear whether collateral is used for family or business purposes. For instance, if a sole proprietor uses a checking account for both business and personal expenditures, the question will be whether the checking account is used "primarily" for business or personal use.

It is important to note that Division 9 also deals with transactions relating to "consumer goods," even if the transaction relating to those "consumer goods" is not a "consumer transaction."

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§7.3 III. SPECIAL RULES FOR ATTACHMENT AND PERFECTION IN CONSUMER TRANSACTIONS

This chapter discusses special features of Division 9 relating to consumer goods and consumer transactions. For general rules about attachment, perfection, priority, and remedies, see chaps 1-5.

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§7.4 A. Description of Collateral

In a consumer transaction, certain collateral must be described with more specificity for a security interest to attach. In a nonconsumer transaction, a description of personal or real property collateral is sufficient, "whether or not it is specific, if it reasonably identifies what is described." Com C §9108(a). Typically, a description by type is a reasonable identification. Com C §9108(b). In a consumer transaction, however, collateral that consists of consumer goods, a security entitlement, a securities account, or a commodity account must be more specifically described; identification by the property's type alone is inadequate for a security interest to attach. Com C §9108(e)(2).

A security agreement in a consumer transaction also must satisfy CC §1799.100, which requires a statement of description reviewed and signed by the consumer, indicating each specific item of consumer goods in which the security interest is taken. CC §1799.100(b); Com C §9108(f).

The Commercial Code does not limit the use of category descriptions in general. Therefore, except as specifically excluded in Com C §9108(e), descriptions such as "all household furniture" should be sufficient, unless the transaction falls within CC §1799.100. That section applies to consumer credit contracts and other credit obligations incurred primarily for personal, family, or household purposes. CC §1799.100(a).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.5 B. After-Acquired Property Clause

§7.5 B. After-Acquired Property Clause

A security interest in consumer goods, other than an accession that is given as additional security (see §2.14), does not attach under an after-acquired property clause unless the debtor acquires rights in the consumer goods within 10 days after the secured party gives value. Com C §9204(b).

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C. Purchase Money Security Transactions

§7.6 1. Consumer Goods

A purchase money security interest in consumer goods is perfected when it attaches. Com C §9309(1). An exception to this is goods such as automobiles, which are the subject of another statute or treaty. Com C §§9309(1), 9311(a)-(b). Unlike other purchase money security interests, no filing is required for consumer goods. Official Comment 3 to UCC §9-309. See §3.32 for a general discussion of purchase money security interests.

A security agreement should include specific representations that consumer goods are the subject of the transaction. In *Nelson v John Deere Credit (In re Troupe)* (Bankr WD Okl 2006) 340 BR 86, the court found that John Deere had a perfected purchase money security interest in a tractor because John Deere was entitled to rely upon representations that the tractor would be used primarily for personal, family, or household purposes.

NOTE: It is important to note that filing is required to perfect a security interest in consumer goods in general. Com C §9310(a).

In addition, filing is necessary to prevent a buyer of consumer goods from taking free of a security interest under Com C §9320(b). Official Comment 3 to UCC §9-309. For discussion of consumer transactions and buyers in ordinary course of business, see §§7.7-7.8.

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§7.7 2. Consumer Transactions

Consumer transactions are explicitly excluded from the rules regarding priority of purchase money security interests in Com C §9103(e)-(g). See §§4.10-4.19.

Although consumer transactions are excluded from Com C §9103(e)-(g), the exclusion was merely to permit courts to determine what rules should properly apply in such transactions, and a court may well choose those set forth in Com C §9103(e)-(g). Com C §9103(h) and Official Comment 8 to UCC §9-103.

Comment 8 further specifically states that Com C §9103(h) is not

> intended to affect or influence characterizations under other statutes. Whether a security interest is a "purchase money security interest" under other law is determined by that law. For example, decisions under Bankruptcy Code §522(f) have applied both the dual status and the transformation rules. The Bankruptcy Code does not expressly adopt the state law definition of purchase money security interest. Where federal law does not defer to this Article, this Article does not, and could not, determine a question of federal law.

The provisions of Com C §9103(h) will have an impact in a bankruptcy case. As discussed in §§6.64-6.66, a trustee in bankruptcy has the power to avoid unperfected security interests. The trustee has the right to avoid nonpossessory, non-purchase money security interests in "household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family or household use of the debtor or a dependent of the debtor." 11 USC §522(f)(1)(B).

It is not clear how courts will rule under Com C §9103(h). It is prudent for lenders to follow the requirements set forth in Com C §9103(e)-(g). Filing will also avoid issues with buyers in the ordinary course (discussed in §7.8).

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§7.8 D. Buyers in Ordinary Course

A buyer in ordinary course of business takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence. Com C §9320(a); see §1.30 for a discussion of buyers in ordinary course.

A buyer of goods from a person who used or bought the goods primarily for personal, family, or household purposes takes free of a security interest, even if perfected, if all of the following conditions are satisfied (Com C §9320(b)):

- The buyer buys without knowledge of the security interest;
- The buyer buys for value;
- The buyer buys primarily for the buyer's personal, family, or household purposes; and
- The buyer buys before the filing of a financing statement covering the goods.

As discussed in §3.32, a purchase money security interest in consumer goods may be perfected without filing under Com C §9309(1). If the secured party does file, however, all buyers take subject to the interest. If the secured party does not file, a buyer who meets the qualifications of Com C §9320(b) will take free of the security interest. Official Comment 5 to UCC §9-320.

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§7.9 E. Deposit Accounts

Assignments of deposit accounts may not be made under Division 9 in connection with a consumer transaction. Com C §9109(d)(13). Division 9 does not apply to an assignment of a deposit account in a consumer transaction, but Com C §§9315 (secured parties' rights on disposition of collateral) and 9322 (priorities) apply with respect to proceeds and priorities in proceeds. Com C §9109(d)(13).

Under Division 9, deposit accounts are limited to demand, time, savings, passbook, or similar accounts maintained with a bank. Com C §9102(a)(29). "Deposit account" does not include investment property. Com C §9102(a)(29). Therefore, the limitation on assignment of deposit accounts does not relate to mutual funds or other similar types of accounts that may be held by consumers. See Official Comment 12 to UCC §9-102.

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§7.10 F. Consignment

Consumer consignors are given added protection under Division 9. The definition of "consignment" in Com C §9102(a)(20) excludes consumer goods. It also requires that with respect to each delivery, the aggregate value of the goods must exceed $1000. Com C §9102(a)(20). Commercial Code §9319 sets forth the rules for creditors of consignees and other third parties. See §1.29. However, because the definition of consignment excludes goods that were consumer goods before delivery, and which are valued at less than $1000, consumers will generally be shielded from the claims of the creditors of a consignee. The common law rule that creditors of a bailee are unable to reach the bailor's interest should prevail with respect to consumer consignors. See Com C §9109; Official Comment 6 to UCC §9-109. See also Benfield, *Consumer Provisions in Revised Article 9*, 74 Chi-Kent L Rev 1255, 1307 (1999).

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§7.11 IV. REMEDIES IN CONSUMER TRANSACTIONS

Although the rules set forth in §§7.2-7.10 demonstrate different treatment of consumer transactions and business transactions under Division 9, the main distinction between consumer transactions and business transactions relates to foreclosure and remedies. Special protections are given to consumer transactions and consumer goods transactions.

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§7.12 A. Notice of Disposition of Collateral

As discussed in §§5.30-5.41, in order for a secured party to foreclose on collateral, it must send a notice of disposition of collateral. Commercial Code §9614 provides specific rules for such a notice in connection with consumer goods transactions. The following information must be provided (Com C §9614):

(1) A description of the debtor and the secured party;

(2) A description of the collateral that is the subject of the intended disposition;

(3) The method of intended disposition;

(4) That the debtor is entitled to an accounting of the unpaid indebtedness and the charge for the accounting;

(5) The time and place of any public sale or the time after which a disposition will be made;

(6) A description of any liability for a deficiency of the person to which the notification is sent;

(7) A telephone number to call for the amount that must be paid to the secured party to redeem the collateral under Com C §9623; and

(8) The telephone number or mailing address from which additional information is available concerning the disposition of the obligation secured. Items (1)-(5) are also required in commercial (nonconsumer) transactions. See Com C §9613(1).

If the collateral is a motor vehicle, a public disposition includes the following categories (Com C §9614(7)):

- Retail dispositions by a seller of motor vehicles that offers the collateral for sale or lease to the general public in the same manner as other motor vehicles that the seller sells for itself; or
- Retail disposition made after advertising in a publication with recognized ability to attract buyers or lessees of retail motor vehicles.

The secured creditor must ensure that the consumer has reasonable access to the motor vehicles in order to be able to exercise his or her right of inspection. Com C §9614(8). Section 9614(7) is not intended to effect the requirements of the Rees-Levering Motor Vehicle Sales and Finance Act (Rees-Levering Act) (CC §§2981-2984.5), discussed in §§7.39-7.50.

If any of the information required under Com C §9614 is not included, the notice is insufficient as a matter of law. Official Comment 2 to UCC §9-614. Therefore, Com C §9614 provides a safe-harbor form of notification that will be considered sufficient. See §7.13. If the form in §7.13 is used, it will be deemed sufficient even if additional information is contained at the end of the form, or if it includes errors in the information not specifically required under Com C §9614, as long as the information that is incorrect is not misleading with respect to rights under Division 9. Com C §9614(4)-(5). If the secured party chooses not to use the safe-harbor form, other law will determine whether the form of notice is sufficient. Com C §9614(6). (It is not clear from the statute what other law will be applied.)

PRACTICE TIP: The cautious practitioner will use the safe-harbor form and should not include information that is not required under the form, as the secured creditor might subject itself to liability by stating incorrect information. See §5.72.

Finally, Com C §9614 refers to consumer goods transactions, not consumer transactions. Therefore, if the transaction in question is a consumer transaction and the secured party is foreclosing on a mutual fund, the provisions of Com C §9613 apply. See §5.32 for a description of foreclosure notices under Com C §9613.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.13 1. Form: Notice of Plan to Sell Property

§7.13 1. Form: Notice of Plan to Sell Property

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

_ _[*Name and address of secured party*]_ _

_ _[*Date*]_ _

NOTICE OF OUR PLAN TO SELL PROPERTY

_ _[*Name and address of any obligor who is also a debtor*]_ _

Subject: _ _[*identification of transaction*]_ _

We have your _ _[*describe collateral*]_ _, because you broke promises in our agreement.

[*Add one of the following alternatives*]

[*Alternative 1: For a public disposition*]

We will sell _ _[*describe collateral*]_ _ at public sale. A sale could include a lease or license. The sale will be held as follows:

Date:

Time:

Place:

You may attend the sale and bring bidders if you want.

[*Alternative 2: For a public disposition of motor vehicle*]

We will sell _ _[*describe type of motor vehicle*]_ _ beginning on _ _[*date*]_ _ by offering it for retail sale or lease to the general public through _ _[*select applicable provision*]_ _:

(A) Name of dealer:

Address of dealer:

You may inspect the motor vehicle and encourage people to purchase or lease it.

[*(OR)*]

(B) Advertising it for sale to the general public to be purchased from _ _[*name if secured creditor*]_ _ at _ _[*address where vehicle is to be sold*]_ _.

You may inspect the motor vehicle and encourage people to purchase or lease it.

[*Alternative 3: For a private disposition*]

We will sell _ _[*describe collateral*]_ _ at private sale sometime after _ _[*date*]_ _. A sale could include a lease or license.

[*Continue*]

The money we get from the sale (after paying our costs) will reduce the amount you owe. If we get less money than you owe, you _ _[*will or will not, as applicable*]_ _ still owe us the difference. If we get more money than you owe, you will get the extra money, unless we must pay it to someone else.

You can get the property back at any time before we sell it by paying us the full amount you owe (not just the past due payments), including our expenses. To learn the exact amount you must pay, call us at _ _[*telephone number*]_ _.

If you want us to explain to you in writing how we have figured the amount that you owe us, you may call us at _ _[*telephone number*]_ _, _ _[*or write us at _ _[secured party's address*]_ _]_ _ and request a written explanation. _ _[*We will charge you _ _[dollar amount*]_ _ for the explanation if we sent you another written explanation of the amount you owe us within the last six months.*]_ _

If you need more information about the sale call us at _ _[*telephone number*]_ _, _ _[*or write us at _ _[secured party's address*]_ _]_ _.

We are sending this notice to the following other people who have an interest in _ _[*describe collateral*]_ _ or who owe money under your agreement:

_ _[*Names of all other debtors and obligors, if any*]_ _

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§7.14 2. Timing of Notice of Disposition of Collateral

Just as there are special rules in consumer goods transactions for the contents of a notice of disposition of collateral, there are also special rules regarding the timing of such a notice. A notice sent after default and 10 days or more before disposition of the collateral is generally a timely notification. Com C §9612(b). See §5.39. Consumer transactions, however, are excluded from this provision. Com C §9612(b). (On the difference between a "consumer transaction" and a transaction that involves consumer goods, see §§7.6-7.7.) Whether notice is sent within a reasonable time is a question of fact. Com C §9612(a). Certain commentators have speculated that because consumer transactions were not included in the 10-day safe harbor, courts should infer that for them, a 10-day notice period is not reasonable. Benfield, *Consumer Provisions in Revised Article 9*, 74 Chi-Kent L Rev 1255, 1273-1274 (1999). It may be prudent to provide more than 10 days' notice in a consumer transaction.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.15 B. Notice After Disposition of Collateral

§7.15 B. Notice After Disposition of Collateral

If the debtor is entitled to a surplus or the consumer obligor is liable for a deficiency after the collateral's disposition, an explanation must be sent. Com C §9616(b). The explanation must be in writing and contain the following information (Com C §9616(a), (c)):

- The amount of the surplus or deficiency;
- An explanation of how the surplus or deficiency was calculated, which must include the following:
- The aggregate amount of obligations secured by the security interest under which the disposition was made, and if the amount reflects a rebate of unearned interest or credit service charge, an indication of that fact calculated by a specified date, which cannot be more than either 35 days before the secured party receives possession of the collateral (if the secured party took possession after default) or 35 days before the disposition of the collateral (if the secured party took possession before default or did not take possession);
- The amount of the proceeds of the disposition;
- The aggregate amount of the obligations after deducting the amount of proceeds;
- The amount of expenses, in the aggregate or by type of expense, related to retaking, holding, preparing for disposition, processing and disposing of the collateral, and attorney fees secured by the collateral that are known to the secured party and relate to the disposition of the collateral;
- The amount of credits or rebates; and
- The amount of the surplus or deficiency;
- Future debits, credits, charges (including additional credit service charges or interest), rebates, and expenses that may affect the amount of the surplus or deficiency, if applicable; and
- A telephone number or mailing address from which additional information can be obtained.

This explanation must be sent before the surplus is paid, or the demand for the deficiency is made, or 14 days after the debtor or consumer obligor requests the explanation. Com C §9616(b).

No particular phrasing of the explanation is required, and substantial compliance with the section is sufficient, even if the information includes minor errors that are not misleading. Com C §9616(d). The consumer obligor or debtor is entitled to one explanation within a six-month period. If the obligor or debtor requests additional explanations, the secured party is entitled to charge $25 for each additional explanation provided. Com C §9616(e).

If a secured party fails to provide the required explanation to a consumer obligor who is liable for a deficiency within 14 days after receipt of a request, the secured party may be liable for any loss plus $500. Com C §9625(b)-(c), (e)(6); Official Comment 4 to UCC §9-616. If the secured party fails to comply with Com C §9616 before the surplus is paid, or the demand for the deficiency is made, the secured party may be liable for any loss plus, if the failure to comply was part of a pattern of noncompliance, $500. Com C §§9625(b)-(c), (e)(5), 9628(d); Official Comment 4 to UCC §9-616.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.16 C. Prohibition Against Partial Strict Foreclosure for Consumer Transactions

§7.16 C. Prohibition Against Partial Strict Foreclosure for Consumer Transactions

Commercial Code §9620 governs the acceptance of collateral in full or partial satisfaction of obligations. It permits a debtor and a secured party to agree that the secured party will repossess collateral in partial satisfaction of debt and expect to receive the remainder from the debtor. Com C §9620(a). See §5.62. In a consumer transaction, however, a secured party may not accept collateral in partial satisfaction of the obligation it secures. Com C §9620(g).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.17 D. Disposition of Consumer Goods

§7.17 D. Disposition of Consumer Goods

Commercial Code §9620 imposes special obligations on the secured party in certain circumstances. A secured party must dispose of consumer goods within 90 days or whatever longer period of time is agreed to and authenticated by the debtor and all secondary obligors after default, if (Com C §9620(e)-(f)):

- 60 percent of the cash price has been paid in the case of a purchase money security interest in consumer goods; or
- 60 percent of the principal amount of the obligation secured has been paid in the case of a non-purchase money security interest in consumer goods.

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E. Waivers

§7.18 1. By Debtors and Obligors

In general, the rights and duties referred to in Com C §9602 may be waived or varied in a consumer transaction or consumer goods transaction. Except in a consumer goods transaction, a debtor or secondary obligor may waive the right to redeem collateral under Com C §9623 only by an agreement to that effect entered into and authenticated after default. Com C §9624(c).

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§7.19 2. By Secured Parties

A secured party must waive its rights to a deficiency if it is to receive any renunciation or modification of a debtor's rights with respect to consumer goods. Com C §9629.

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§7.20 F. Damages

Commercial Code §9625 sets forth damages for secured creditors who do not follow the rules set forth in Division 9. Com C §9625. See chap 5 for detailed discussion of those damages. Special minimum statutory damages are provided in connection with consumer goods transactions.

Under Com C §9625(b)-(c) a person is liable for damages in the amount of any loss caused by a failure to comply with Division 9. Those damages may include any loss resulting from the debtor's inability to obtain, or increased costs of, alternative financing. Com C §9625(b). A debtor or consumer obligor may recover additional damages of $500 for each instance in which a person without reasonable cause fails to provide requests for accounting as required in Com C §9210. Com C §9625(f).

A secured party will not be held liable more than once regarding any one secured obligation. Com C §9628(d); Official Comment 4 to UCC §9-625. Furthermore, a secured party is not liable for statutory damages if the secured party does not comply with Com C §9616 (explanation of calculation of surplus or deficiency; see §7.15). Com C §9628(a)(1); Official Comment 4 to UCC §9-625.

NOTE: It should be noted that Com C §9625 is a nonuniform provision. Uniform Commercial Code §9-625(c)(2) provides a specified statutory penalty if collateral is consumer goods.

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§7.21 G. Deficiency or Surplus

As discussed in §5.73, debtors may not be liable for a deficiency under certain circumstances. Com C §9626(a). Commercial Code §9626(a) specifically excludes consumer transactions from this general rule, and Com C §9626(b) governs the rules for consumer transactions.

The secured party has the burden of proof regarding compliance with Division 9 in enforcement of its security interest. Com C §9626(b)(1)(A). In addition, if the deficiency or surplus is calculated under Com C §9615(f), the secured party has the burden of showing that the amount of proceeds from the disposition is not significantly below the range of prices that would have been obtained in a complying disposition to another party. Com C §9626(b)(1)(B).

The debtor or any secondary obligor is liable for a deficiency only if the following conditions are met (Com C §9626(b)(2)):

- Notice has been proper (see §§7.12-7.14);
- The collection, enforcement, disposition, and acceptance by the secured party were conducted in good faith and in a commercially reasonable manner; and
- If the transaction is governed by the Unruh Act (CC §§1801-1812.20; see §§7.24-7.38), there have been no other agreements.

If the debtor is not liable for a deficiency, the secured party may not retain any interest in the collateral or obtain a deficiency judgment. Com C §9626(b)(3). If there are subsequent dispositions of the collateral, and the debtor is not liable for a deficiency under Com C §9626, the debtor may obtain the proceeds from the sale of that collateral. Com C §9626(b)(4).

The provisions of Com C §9626 do not operate to deprive the debtor of damages under Com C §9625(b) for the secured party's failure to comply with Division 9. Com C §9626(b)(5).

NOTE: The provisions of Com C §§9625-9626 are nonuniform. Uniform Commercial Code §9-626 does not provide a statutory framework for determining when a deficiency may be obtained in a consumer transaction; it leaves that issue to courts to decide. UCC §9-626(b); Official Comment 4 to UCC §9-626.

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§7.22 H. Nonliability of Secured Creditors in Certain Circumstances

Secured parties who do not follow the rules with respect to consumer transactions or consumer goods may nevertheless avoid liability under certain circumstances. Commercial Code §9628(c) provides:

> A secured party is not liable to any person, and a person's liability for a deficiency is not affected, because of any act or omission arising out of the secured party's reasonable belief that a transaction is not a consumer-goods transaction or a consumer transaction or that goods are not consumer goods, if the secured party's belief is based on its reasonable reliance on either of the following representations:
>
> (1) a debtor's representation concerning the purpose for which collateral was to be used, acquired, or held.
>
> (2) an obligor's representation concerning the purpose for which a secured obligation was incurred.

An example of a secured party forming a reasonable belief that a transaction was not a consumer transaction would be obtaining a representation from the debtor that collateral securing an obligation was used by the debtor for a business purpose, or a representation in the loan agreement that the debtor would be using the funds loaned for a business purpose. It is particularly important when lending funds to individuals or sole proprietorships to obtain representations regarding the purpose and use of the loan and secured collateral. If the secured party knew that the debtor's representations were not correct, however, the secured party could not rely on this section. Official Comment 2 to UCC §9-628.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.23 V. OTHER STATUTES GOVERNING CONSUMER TRANSACTIONS

§7.23 V. OTHER STATUTES GOVERNING CONSUMER TRANSACTIONS

Secured transactions in consumer goods, although subject to California Commercial Code Division 9, are also subject to various consumer protection statutes. In cases of conflict, the provisions of an applicable consumer protection statute control over the provisions of Division 9. Com C §9201(c). Statutes listed in Com C §9201(b) as controlling include:

- The Retail Installment Sales Act (Unruh Act) (CC §§1801-1812.20);
- The Automobile Sales Finance Act (Rees-Levering Act) (CC §§2981-2984.5); and
- The Manufactured Housing Act of 1980 (Health & S C §§18000-18153).

The two major California statutes concerned with consumer sales contracts are the Unruh Act, applicable to consumer goods generally, and the Rees-Levering Act, applicable to motor vehicles purchased for consumer use. Because their requirements differ, they are discussed separately. Other California statutes dealing with particular types of consumer goods or transactions are also discussed briefly in the sections that follow.

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A. Unruh Act

§7.24 1. Definitions and Exclusions

The Unruh Act (CC §§1801-1812.20), also referred to as the Retail Installment Sales Act, sets forth requirements for installment sales with consumers and prohibits various unfair practices under retail installment contracts.

Under the Unruh Act, "goods" means "tangible chattels bought for use primarily for personal, family or household purposes," but does not include vehicles required to be registered under the Vehicle Code or certain goods sold or leased with such a vehicle. CC §1802.1. A "retail installment sale" means the sale of goods by a "retail seller" to a "retail buyer" for a deferred payment price payable in installments. CC §§1802.3-1802.5. A "retail installment contract" is a contract for a retail installment sale, which (CC §1802.6):

- Provides for one of the following:
- A finance charge;
- No finance charge, but cash buyers get a lower price; or
- No finance charge, but cash buyers get additional or higher quality goods at no added cost; or
- Provides for payment in more than four installments.

The term "retail installment contract" also includes certain leasing agreements, as follows (CC §1802.6):

> When taken or given in connection with a retail installment sale, the term includes but is not limited to a security agreement and a contract for the bailment or leasing of goods by which the bailee or lessee contracts to pay as compensation for their use a sum substantially equivalent to or in excess of their value and by which it is agreed that the bailee or lessee will become, or for no other or for a nominal consideration has the option of becoming, the owner of the goods upon full compliance with terms of the contract.

The Unruh Act specifically excludes:

- Vehicles required to be registered under the Vehicle Code and goods sold or leased with the vehicle if sold under a contract governed by the Rees-Levering Act (CC §§2981-2984.5) or leased under a contract governed by the Vehicle Leasing Act (CC §§2985.7-2993) (CC §1802.1);
- Service contracts for the maintenance or repair of a vehicle subject to the Rees-Levering Act and sold in connection with the sale or lease of the vehicle (CC §1802.2);
- Services of physicians or dentists, and services for which the rates are federally regulated (CC §1802.2);
- Agreements for the financing of insurance premiums by industrial loan companies under the California Financial Code (CC §1801.7);
- Real estate contracts of various types (CC §1801.4);
- Contracts for the sale of aircraft required to be registered under the Federal Aviation Act of 1958 (49 USC §§40101-46507 (CC §1801.4); and
- Contracts for the sale of vessels whose cash price exceeds $25,000 (CC §1801.4).

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§7.25 2. Applicability of Unruh Act to Loans

By its terms, the Unruh Act (CC §§1801-1812.20) applies only to sales transactions. In *King v Central Bank* (1977) 18 C3d 840, 135 CR 771, however, the California Supreme Court held that because of a lender's relationship to an insurance agent whom the court treated as a seller, a credit transaction in the form of a loan made by a bank was, in substance, a credit sale subject to the Act. As a result of the *King* case, the Unruh Act was amended to clarify the law regarding the characterization of credit transactions as either loans or credit sales subject to the Unruh Act. CC §1801.6. The Act is inapplicable to loans made by a "supervised financial organization" (*e.g.,* a bank or savings and loan) to a consumer to finance purchase of goods or services. CC §1801.6(b).

NOTE: The substance of a transaction rather than its form will determine its characterization as a loan or credit sale. CC §1801.6(a).

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3. Contract Requirements

§7.26 a. Required Form and Contents

All contracts subject to the Unruh Act (CC §§1801-1812.20) must be in writing, dated, and (if printed) in at least 8-point type. CC §1803.1. The contract must be contained in a single document, and must include:

- The entire agreement regarding the cost and the terms of payment. CC §1803.2(a).
- The title "Security Agreement" if a security interest is retained or "Retail Installment Contract" if a security interest is not retained, in at least 12-point boldface type. CC §1803.2(b).
- Notice to the buyer in boldface type not to sign the agreement before reading it or if it contains any blank spaces, as well as notices of the buyer's right to prepay the full amount and receive a partial refund of the finance charge, and right to be furnished the amount and method of computation of the refund. CC §1803.2(c)-(e).
- Names and addresses of the buyer and seller and a description of the goods or services covered. CC §1803.3(a).
- Disclosure of all information required by federal Regulation Z (12 CFR pt 226, a part of Truth in Lending requirements), whether or not that regulation otherwise applies. CC §1803.3(b).
- Specified disclosures labeled "Itemization of the amount financed," a payment schedule as specified in Regulation Z, description of any property being traded in, method used to compute unearned finance charges if prepayment in full is made, disclosures regarding any insurance included in the contract, and notice of rights regarding any balloon payment. CC §§1803.3(c)-(g), 1803.5, 1807.3(a).

Information may be disclosed in any way required or permitted under Regulation Z. CC §1801.5.

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§7.27 b. Prohibited Provisions

The Unruh Act (CC §§1801-1812.20) forbids any of the following contractual provisions:

- A waiver of the provisions of the Act. CC §1801.1.
- An agreement by the buyer not to assert claims or defenses arising out of the sale, against the seller or the seller's assignee. CC §1804.1(a).
- Any provision accelerating the debt's maturity, absent default by the buyer. CC §1804.1(b).
- A power of attorney to confess judgment. CC §1804.1(c).
- Any unlawful assignment of wages. CC §1804.1(c).
- Authority to enter the buyer's premises unlawfully to repossess goods (CC §1804.1(d)), waiver of the buyer's right to sue for illegal acts committed in collecting or repossessing (CC §1804.1(e)), and a power of attorney appointing the seller or holder as the buyer's agent for collection or repossession (CC §1804.1(f)).
- Any provision relieving the seller from liability for any legal remedies that the buyer may have against the seller. CC §1804.1(g).
- The buyer's agreement to any charge for exercising the buyer's right to rescind or avoid the contract. CC §1804.1(h).
- A grant to the seller or holder of a right to bring suit in an improper venue. CC §1804.1(i).

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§7.28 c. Additional Requirements

The Unruh Act (CC §§1801-1812.20):

- Permits rescission by a buyer who is unable to obtain third party financing (CC §1803.9);
- Makes it unlawful for the seller to induce or attempt to induce a person to enter into a contract subject to the Act by offering a rebate, discount, commission, or other consideration, contingent on the happening of a future event, on the condition that the buyer either sells, or gives information or assistance for the purpose of leading to a sale by the seller of, the same or related goods (CC §1803.10);
- Prohibits security interests in goods not sold or goods fully paid for (CC §1804.3(a));
- Fixes ceilings on finance charges (CC §§1805.1-1805.9) and late charges (CC §1803.6); and
- Prohibits prepayment penalties (CC §1806.3).

The seller must deliver to the buyer a legible copy of the contract (and of any other document signed by the buyer at the seller's instance during contract negotiations) at the time of the buyer's signature. CC §1803.7. During the contract's lifetime, the seller or holder must provide the buyer with detailed written statements of amounts paid and owing. CC §1806.2. After payment in full, the seller or holder must deliver to the buyer any instruments necessary to acknowledge payment in full and to release all security in the goods under the contract. CC §1806.4.

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§7.29 d. Related Matters Covered by Unruh Act

The Unruh Act contains disclosure and other requirements with respect to refinancings and consolidations (CC §§1807.1-1807.3), add-on sales (CC §§1808.1-1808.5), and retail installment accounts (revolving accounts) between retail buyers and retail sellers (CC §§1810.1-1810.12). It also contains provisions relating to assignees' liability (CC §§1804.1(a), 1804.2), rights and obligations on default (CC §§1810.12, 1812.2-1812.5), and sanctions for failure to comply with its terms (CC §§1812.6-1812.9).

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4. Additional Provisions of Unruh Act

§7.30 a. Buyer Cannot Waive Rights

A waiver by the buyer of any provision of the Unruh Act (CC §§1801-1812.20) is void and unenforceable, and contract provisions in which the buyer agrees not to assert a claim or defense arising from the sale against the seller are prohibited. CC §§1801.1, 1804.1(a), (g).

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§7.31 b. Penalties for Violation

The seller or any person acquiring an Unruh Act contract with knowledge of its noncompliance under the Act is barred from recovering any finance charge or any delinquency, collection, extension, deferral, or refinance charge imposed in connection with the contract, and the buyer has the right to recover from that person an amount equal to any of those charges paid by the buyer. CC §1812.7. Special penalties are provided in connection with add-on sales. CC §1812.9.

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§7.32 c. Correction of Violations

A nonwillful violation may be corrected by delivery of a corrected copy of the contract to the buyer within 30 days of the buyer's execution of the original contract; if a holder makes such a correction, neither the holder nor the seller is subject to penalty. CC §1812.8. Correction of willful violations is not permitted, and a correction that would increase the amount owed by the buyer or the amount of any payment is not effective unless the buyer concurs in writing with the correction. CC §1812.8. Any amount improperly collected from the buyer must be credited against the indebtedness. CC §1812.8.

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§7.33 d. Assignee's Liability

An assignee of the seller's rights under the Unruh Act is subject to all of the buyer's equities and defenses against the seller arising out of the sale, but the assignee's liability may not exceed the amount owing to the assignee at the time of the assignment. CC §1804.2(a). The assignee is entitled to recourse against the seller to the extent of any liability incurred by the assignee regardless of whether the assignment is with or without recourse. CC §1804.2(b).

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5. Default and Remedies Under the Unruh Act

§7.34 a. Rights on Default Generally

If a buyer defaults in the performance of obligations under a contract subject to the Unruh Act (CC §§1801-1812.20), the holder (pursuant to any rights granted in the contract) may proceed to recover judgment for the balance due without retaking the goods, or may retake the goods and comply with specific procedures discussed in the following sections. CC §1812.2.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.35 b. Notice of Intention to Sell or Retain Goods

§7.35 b. Notice of Intention to Sell or Retain Goods

A holder who retakes the goods must within 10 days give notice to the buyer of its intention to sell the goods at public sale or its intention to retain the goods in satisfaction of the balance due. The notice must provide specified information, including the amount of the overdue payments (and other applicable expenses) that the buyer must pay within 10 days of the notice in order to redeem the goods. Notice of the time and place of any public sale of the goods must be given at least 10 days before the date of sale, by personal delivery or by regular U.S. mail, to the buyer and any other person liable on the contract at the last known address for each person. CC §§1812.2-1812.3.

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§7.36 c. Right to Redeem

The buyer has the absolute right to redeem the goods within 10 days after a notice of intention to sell or notice of intention to retain the goods is given (see §7.35), by paying or tendering the amount owing under the contract. If notice of election to sell the goods is given, the buyer also has the absolute right to redeem the goods at any time before the sale, by paying or tendering the amount owing plus expenses reasonably incurred by the holder of the contract in repairing the goods or preparing them for sale. CC §1812.2.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.37 d. Application of Proceeds

§7.37 d. Application of Proceeds

Proceeds of a resale must be applied (1) to the expenses of the sale; (2) to the expenses of the retaking (including reasonable attorney fees) and of keeping, repairing, or preparing the goods for sale; and (3) to satisfaction of the balance due. Any sum remaining must be paid to the buyer. CC §1812.4.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.38 e. Deficiency Judgments

§7.38 e. Deficiency Judgments

Deficiency judgments are prohibited under the Unruh Act. CC §1812.5.

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B. Rees-Levering Act

§7.39 1. Coverage of the Act

The Rees-Levering Motor Vehicle Sales and Finance Act (Rees-Levering Act) (CC §§2981-2984.5) applies to virtually all conditional sales of motor vehicles to consumers (*i.e.,* vehicles "bought for use primarily for personal or family purposes" (CC §2981(k)) by sellers who are "engaged in the business of selling or leasing motor vehicles under conditional sales contracts." CC §2981(b). Vehicles bought for use primarily for business or commercial purposes and "mobilehomes," as defined in Health & S C §18008, are excluded from coverage. CC §2981(k).

The Rees-Levering Act treats certain consumer vehicle leasing agreements as conditional sale contracts within its coverage, *i.e.,* those in which the lessee agrees to pay as compensation for use of the vehicle a sum substantially equivalent to or more than the vehicle's value at the time the contract was executed, and by which the lessee can become owner without further payment (or for a nominal consideration) when the contract has been fully complied with. CC §2981(a)(2). The Act, however, is expressly inapplicable to leasing agreements that establish the lessee's maximum liability at the end (or earlier termination) of the lease period by reference to the vehicle's value at that time. CC §2981.5.

However, the Rees-Levering Act was amended, effective July 1, 2006, by the Car Buyer's Bill of Rights (Stats 2005, ch 128). Highlights of the Car Buyer's Bill of Rights include:

- Requiring sellers of used motor vehicles with a purchase price of less than $40,000 to offer buyers a 2-day contract cancellation option agreement;
- Requiring sellers of motor vehicles to make certain additions to the "itemization of amounts financed" listing in a conditional sales contract, including the cost of a contract cancellation option agreement; and
- Prohibiting sellers, in consideration of an assignment of a conditional sale contract, from receiving or accepting from the assignee any payment or credit based on amounts collected or received under the contract.

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§7.40 2. Applicability to Loans From Banks or Other Supervised Financial Organizations

A loan made by a supervised financial organization, as defined by statute (*e.g.,* bank, credit union, savings and loan association), other than the seller, which is used to finance the purchase of a motor vehicle, is exempt from the requirements of the Rees-Levering Act. CC §2982.5(a). The courts have interpreted this exemption to be inapplicable to loan transactions for the purchase of a motor vehicle if the seller has assisted in arranging a loan between the buyer and the lender. *Hernandez v Atlantic Fin. Co.* (1980) 105 CA3d 65, 164 CR 279.

Subsection (b) provides specifically that nothing in the Act "shall be deemed to prohibit the seller's assisting the buyer in obtaining a loan upon any security from any third party" for use "as a part or all of the down payment or any other payment on a conditional sale contract," if specified disclosure requirements are met and if the seller does not provide any security or other guaranty of payment or receive any commission or other remuneration for assisting the buyer to obtain the loan. CC §2982.5(b).

Subsection (d) of CC §2982.5 was enacted in response to the courts' interpretation of subsections (a) and (b). Stats 1983, ch 405. It states that nothing in the Rees-Levering Act "shall be deemed to prohibit" the seller's assisting the buyer in obtaining a loan on any security from any third party to be used to pay for all or part of the purchase price of a motor vehicle, provided the loan is subject to various listed conditions. CC §2982.5(d). One such requirement is that the lender or the lender's successor in interest be subject to all claims and defenses that the buyer could assert against the seller, up to the amount of the loan. CC §2982.5(d)(4). Another condition is that the seller may not receive any commission or other remuneration for assisting the buyer to obtain the loan. CC §2982.5(d)(5). In *Kunert v Mission Fin. Servs. Corp.* (2003) 110 CA4th 242, 1 CR3d 589, however, the court held that this provision was not violated when the seller assigned conditional sales contracts to a finance company and the finance company paid the seller a portion of the finance charges due under the assigned contracts. The court held that the conditional sales contracts were bona fide credit sales—not loans—and were not "sham transactions" designed to evade the prohibition on payment of commissions on seller-assisted loans. Subsection (d) does not apply to state or federally chartered banks and savings and loan associations, "and shall not be construed to affect existing law" regarding a seller's assisting a buyer to obtain a loan from a bank or savings and loan association or any loan obtained by the buyer from those lenders. CC §2982.5(d)(6). Thus, under the statute and case law, CC §2982.5 does not exempt a "seller-assisted" personal loan used for the purchase price of an automobile from certain requirements of the Rees-Levering Act. *Hernandez v Atlantic Fin. Co.* (1980) 105 CA3d 65, 164 CR 279.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.41 3. Contract Requirements

§7.41 3. Contract Requirements

All contracts subject to the Rees-Levering Act must be in writing, dated, and (if printed) in at least 6-point type. The contract must contain in a single document all of the buyer's and seller's agreements with respect to the total cost and terms of payment for the motor vehicle, including any promissory notes or other evidences of indebtedness. CC §2981.9. It must be signed by the buyer and the seller, and a copy must be furnished to the buyer by the seller at the time they sign it and before the motor vehicle is delivered. CC §2981.9. The contract must also disclose all information required by federal Regulation Z (12 CFR pt 226, a part of Truth in Lending requirements), whether or not that regulation otherwise applies. CC §2982.

In addition to the information required by Regulation Z, the contract must include items such as the following:

- Specified disclosures labeled "Itemization of the Amount Financed" (CC §2982(a)) (these disclosures must be made together and in the sequence set forth in CC §2982(a));
- A description of any property being traded in (CC §2982(d));
- The names and addresses of all persons to whom certain notices must be sent (CC §2982(e));
- The type of finance charge used and the method used to compute unearned finance charges if prepayment in full is made (CC §2982(f));
- Certain notices and warnings to the buyer (CC §§2982(g)-(h), 2982.8, 2984.1); and
- Disclosures regarding any insurance included in the contract (CC §2982(i)).

Information may be disclosed in any way required or permitted under Regulation Z. CC §2982(m).

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§7.42 4. Other Requirements or Limitations

The Rees-Levering Act permits rescission if the buyer cannot obtain third party financing (CC §2982.9), fixes ceilings on finance charges and late charges (CC §2982(j)-(k)), and restricts the property that may be taken as collateral (CC §2984.2). It prohibits prepayment penalties, regulates prepayment refunds (CC §2982(*l*)), and regulates finance charges on advances made by the holder for insurance or repairs (CC §2982.8). It forbids certain contractual provisions limiting the buyer's rights (CC §2983.7), and restricts or prohibits certain other practices and charges by the seller (CC §§2982(i)(2), 2982(o), 2982.1, 2982.3, 2982.5(b)). The Act also contains provisions regarding rights and obligations on default (CC §§2982(*l*)(5), 2983.2-2983.4, 2983.8; see §7.43), the liability of assignees (CC §§2983.5, 2983.7), and sanctions for failure to comply with its terms (CC §§2983-2983.1, 2983.6).

The Act specifies how the contract for sale of a vehicle must indicate whether the vehicle is new or used. See CC §2982(q).

Agreements by a buyer not to assert claims or defenses arising out of the sale against either the seller or the seller's assignee are forbidden (CC §2983.7(a)), and the buyer cannot agree to waive the right to sue for illegal acts done in collecting or repossessing (CC §2983.7(c)) nor to relieve the seller from liability for any legal remedies that the buyer may have against the seller (CC §2983.7(e)).

An assignee of a Rees-Levering Act contract is subject to all "equities and defenses" of the buyer against the seller, but the assignee's liability may not exceed the amount of the debt owing to the assignee at the time of the assignment. CC §2983.5(a). The assignee is entitled to recourse against the seller to the extent of any such liability regardless of whether the assignment is with or without recourse. CC §2983.5(b).

Nonwillful violations of the Act may be corrected by the seller at any time before suit. CC §2984. Willful violations that appear on the face of the contract may also be corrected if done within 30 days of the contract's execution or within 20 days of its sale, assignment, or pledge, whichever is later. If notified by the buyer of a violation, the seller must correct it within 10 days of the notice. The buyer must concur in writing to any correction that increases the amount of the balance or of any installment. Any amount improperly collected from the buyer must be credited against the indebtedness or returned to the buyer. A violation of any kind that is properly corrected cannot be the basis of any recovery by the buyer or affect the enforceability of the contract by the seller. CC §2984.

If an assignee acquires a contract without actual knowledge that the contract violates CC §2981.9 (relating to the required form of the contract) or CC §2982(a), (j), or (k) (relating to required disclosures, financing charges, and delinquency charges), and the violation is uncorrected, the buyer is excused from paying the unpaid finance charge. If the assignee acquires with actual knowledge of a violation and it is not corrected, the contract is unenforceable. The buyer may elect to rescind the contract, return the vehicle, and recover the amount paid on the contract from the person to whom payment was made, or elect to retain the vehicle and continue the contract in force. CC §2983.1.

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5. Defaults and Remedies Under Rees-Levering Act

§7.43 a. Default

Under the Rees-Levering Act, the seller or holder may not accelerate the contract or repossess the vehicle unless the buyer is in default of contractual obligations. CC §2983.3(a).

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§7.44 b. Notice of Intent to Sell

Despite any contract terms to the contrary, at least 15 days' written notice of intent to dispose of a repossessed or surrendered vehicle must be given to all persons liable on the contract unless the vehicle has been seized as described in CC §2983.3(b)(6). The notice (1) must advise all persons liable on the contract of their rights to redeem the vehicle, reinstate the contract, request a 10-day extension of the redemption and reinstatement periods, and request a written accounting of the disposition; and (2) must give notice of the buyer's possible liability for a deficiency. CC §2983.2(a)(1)-(8).

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§7.45 c. Reinstatement

Ordinarily, anyone liable under the contract may reinstate it within a 15-day period (extendible for 10 more days on written request) from the date the notice was mailed, by paying the amounts due (including delinquency charges and expenses) or otherwise curing the default. CC §§2983.2(a), 2983.3(b)-(d). Acceleration is not permitted until the reinstatement period has expired. CC §2983.3(b). The right to reinstate does not apply if the seller reasonably and in good faith denies the right for one of the reasons specified in the statute. CC §2983.3(b), (d)(4). The buyer may exercise reinstatement rights only once in any 12-month period and only twice during the lifetime of the contract. CC §2983.3(c).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.46 d. Redemption

§7.46 d. Redemption

The buyer has the right to redeem the vehicle within a 15-day period (which may be extended for an additional 10 days on application) from the date that the notice of intent to sell is given or mailed. The seller or holder must provide the proper form for applying for the extension of time and inform the buyer of the statutory requirements for returning the form. See CC §2983.2(a)(1), (a)(3).

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§7.47 e. Penalties for Violations

A repossessing seller who violates the notice requirements of CC §2983.2 or improperly denies the buyer's right to reinstatement (see CC §2983.3(b)) loses the right to a deficiency judgment. CC §§2983.2(a), 2983.3(e). Loss of the right to a deficiency is not necessarily the exclusive penalty, however. A repossessing seller who resells the vehicle after failing to notify the buyer of his or her reinstatement rights and refusing to allow the buyer to reinstate may be liable to the buyer for conversion. *Cerra v Blackstone* (1985) 172 CA3d 604, 218 CR 15.

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§7.48 f. Calculation of Obligation Amount

Whenever the indebtedness is satisfied before its maturity through surrender of the vehicle, repossession of the vehicle, redemption of the vehicle after repossession, or judgment, the amount of the buyer's outstanding obligation must be determined in the manner set forth in the statute. CC §2982(*l*)(5).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.49 g. Accounting

§7.49 g. Accounting

If a sale after repossession results in a surplus, a written accounting must be given to the buyer within 45 days after disposition of the vehicle, whether or not the buyer requests it. CC §2983.2(c). Unless automatically provided to the buyer within 45 days after disposition, a written accounting of the disposition must be given to any person liable on the contract, within 45 days after written request made within one year after the disposition. CC §2983.2(b).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/7 Consumer Transactions/§7.50 h. Deficiency Judgments

§7.50 h. Deficiency Judgments

Deficiency judgments on Rees-Levering contracts are permitted except as follows:

- No deficiency is permitted if the required notice of intent to dispose of a repossessed vehicle is not given within 60 days of the repossession or if the notice does not give the required information. CC §2983.2(a).
- No deficiency is permitted if the holder has denied the buyer the right to reinstate and fails to sustain the burden of proof that the denial was reasonable and made in good faith. CC §2983.3(e).
- No deficiency is permitted after the sale of any mobilehome for which a permit is required under the Vehicle Code, unless there is substantial damage to the mobilehome other than wear and tear from normal usage. CC §2983.8.
- No deficiency is permitted under California case law if the resale of a repossessed vehicle was not conducted in a commercially reasonable manner in compliance with the requirements of Com C §9626(b). See §7.21. See also *Credit Bureau Metro, Inc. v Mims* (1975) 45 CA3d Supp 12, 119 CR 622.

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C. Vehicle Leasing Act

§7.51 1. Applicability

The Vehicle Leasing Act (CC §§2985.7-2993) applies only to consumer vehicle leases that do not come within the coverage of the Rees-Levering Act. CC §2990. Rees-Levering covers vehicle leases deemed the equivalent of sales. See §7.39. The Vehicle Leasing Act applies to other motor vehicle lease or bailment contracts, regardless of whether the lessee bears the risk of the motor vehicle's depreciation, if they are (1) intended primarily for personal, family, or household purposes; (2) for a term exceeding four months; and (3) between a lessor who is engaged in the business of leasing motor vehicles and a lessee who is a natural person. CC §2985.7(a)-(d).

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§7.52 2. Contract Requirements

The Vehicle Leasing Act, like the Rees-Levering Act and the Unruh Act (see §§7.24-7.38), contains detailed requirements regarding the form and contents of a contract governed by the Act. The lease contract must be in writing, must be signed by the parties, and must contain in a single document all of the lessor's and lessee's agreements with respect to the obligations of each party. CC §2985.8(a). Items required to be included are set forth in CC §2985.8(b)-(j). Disclosures may be made in the manner required or permitted by federal Regulation M (12 CFR pt 213).

For prohibited contractual provisions, see CC §2986.3. A copy of the contract must be furnished to the lessee at the time the lessor and lessee sign it and before the vehicle is delivered. CC §2985.8(g), (h).

Solicitations to enter into a lease contract (*i.e.,* advertisements) must state that the transaction is a lease, and must set forth the value of the vehicle, the amount of prepayment required, the term of the lease in months, and the total amount of periodic payments. CC §2985.71(a).

The Act imposes requirements in connection with the sale of a leased vehicle after termination or expiration of a lease (CC §2989.2) and sanctions for failure to comply with its terms, including rescission in some cases (CC §§2988.5, 2988.7, 2989.8). For other obligations and restrictions on the lessor, see CC §§2986.5-2986.6, 2986.12-2986.13, 2988, 2989.4-2989.5. For assignee liability, see CC §2986.10.

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§7.53 3. Other Requirements or Limitations

A lessor failing to comply with requirements of the Act is liable for (1) actual damages; (2) in individual actions, 25 percent of the total monthly payments under the lease, subject to a minimum of $100 and a maximum of $1000 (other limits apply to class actions); and (3) reasonable attorney fees and costs. CC §2988.5(a).

A lessor may avoid liability if, within 15 days after discovery of an error and before the institution of an action under the Act or receipt of written notice of the error, the lessor notifies the person concerned of the error and makes whatever adjustments are necessary in the appropriate account to ensure that the person will not have to pay an amount greater than the amount that should correctly have been disclosed. CC §2988.5(c).

A lessor may also avoid liability if it can establish that the violation was not intentional and resulted from a bona fide error, notwithstanding the maintenance of procedures reasonably adopted to avoid any such error. CC §2988.5(d). There is no liability for acts done or omitted "in good faith conformity with any rule, regulation or interpretation of federal law." CC §2988.5(g).

A civil action for a violation of the Act that may be brought against the original lessor and may be maintained against any subsequent assignee of the original lessor if the violation from which the alleged liability arose is apparent on the face of the instrument assigned, unless the assignment was involuntary. CC §2988.5(e).

As an alternative to suing for damages, the lessee may rescind the contract if the failure to comply was willful, or if correction would increase the amount of the contract balance, unless the lessor waives the collection of the increased amount. CC §2988.7.

An assignee of the lessor's rights under a lease contract covered by the Vehicle Leasing Act is subject to all "equities and defenses" of the lessee against the lessor, but the assignee's liability may not exceed the amount of the obligation owing to the assignee at the time of the assignment. CC §2986.10(a). The assignee is entitled to recourse against the lessor to the extent of any such liability incurred by the assignee, whether the assignment was with or without recourse. CC §2986.10(b).

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§7.54 4. Termination or Expiration of Lease

The Vehicle Leasing Act (CC §§2985.7-2993) does not deal with a lessor's remedies or rights of the parties on default. Its provisions for the sale of a leased vehicle apply only on termination or expiration of the lease.

At the termination or expiration of a lease, when disposing of a leased vehicle or obtaining cash bids for the purpose of setting the vehicle's fair market value, the lessor is required to "act in a commercially reasonable manner in the customary market for such vehicle." CC §2989.2(a). See also CC §2988(c).

Subject to certain exceptions, the lessor must give the lessee at least 10 days' written notice of its intent to sell the motor vehicle. The notice must set forth separately any charges or sums due, and must state that the lessee will be liable for the difference between the amount of liability imposed on the lessee at the expiration of the lease term and the actual cash value of the motor vehicle when it is sold. The notice must also state that the lessee has a right to submit a cash bid for the purchase of the vehicle. CC §2989.2(b).

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D. Manufactured Housing Act of 1980

§7.55 1. General Provisions

Mobilehomes are excluded from coverage of both the Unruh Act (§§7.24-7.38) and the Rees-Levering Act (§§7.39-7.50), but are regulated by a separate statute, the Manufactured Housing Act of 1980 (Health & S C §§18000-18153). This statute, following the pattern of the Unruh and Rees-Levering Acts generally, requires conditional sale contracts on mobilehomes to contain all applicable Truth in Lending disclosures required by federal Regulation Z (12 CFR pt 226). Health & S C §18036.5. The Act contains specific requirements with respect to sales, including the establishment of escrows (Health & S C §§18035-18036); it also includes provisions on rights and obligations on default (Health & S C §§18037.5, 18038.7), and on assignees' liability (Health & S C §§18036.5(d)-(e), (k), 18037).

Conditional sale contracts subject to this statute must contain all applicable disclosures required by Regulation Z (12 CFR pt 226). Health & S C §18036.5(b). As under the Truth in Lending Act (see §§7.62-7.68), uncorrected violations of disclosure requirements may render sellers liable, in individual or class actions, for actual damages and penalties. Health & S C §18036.5(c).

Likewise, the provisions on liability of assignees are parallel to those of the Truth in Lending Act (see §7.65). Notwithstanding any agreement to the contrary, a holder (assignee) is subject to all the buyer's equities and defenses against the seller (except as otherwise provided by Health & S C §18036.5), but the assignee's liability cannot exceed the amount of the debt at the time of assignment. Health & S C §18037. The assignee is entitled to recover the amount of any resulting liability from the seller whether the assignment was with or without recourse, except to the extent of any written agreement between the seller and the assignee that expressly references Health & S C §18037 and modifies its effect. Health & S C §18037.

Certain requirements of the Manufactured Housing Act of 1980 also apply to some or all of the following: manufactured homes (defined in Health & S C §18007), truck campers (defined in Health & S C §18013.4), and floating homes (defined in Health & S C §18075.55). The applicability of specific provisions to these other types of goods should be checked on a case-by-case basis.

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§7.56 2. Defaults and Remedies

The rules outlined in §§7.57-7.60 do not apply if the mobilehome is affixed to a permanent foundation or if the security for the mobilehome includes the real property to which it is affixed. Health & S C §§18039.1, 18551.

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§7.57 a. Notice of Default

In the event of default under a contract subject to the Manufactured Housing Act , the secured party may foreclose its security interest only by satisfying the requirements of the statute. Health & S C §18037.5(a). Unless the registered owner has abandoned the mobilehome or voluntarily surrendered possession to the foreclosing creditor, the creditor must provide each registered owner (as well as the legal owner and any junior lienholders shown on the registration card) with a notice of default as set forth in the statute. Health & S C §18037.5(a)(1). The notice must state that the buyer may cure the default by repayment of the outstanding secured obligation, in a specified dollar amount, plus other sums as provided in the contract, on or before a specified date no earlier than 45 days after the notice is mailed. The notice must be sent by registered or certified mail. Health & S C §18037.5(a).

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§7.58 b. Notice of Belief of Abandonment

As noted in §7.57, the requirement for a notice of default before foreclosure applies "unless the registered owner … has abandoned the property." Health & S C §18037.5(a). A secured party who reasonably believes a mobilehome has been abandoned can give a written "Notice of Belief of Abandonment" to the registered owner, specifying a date by which the owner's response must be received. The registered owner may in turn give written notice to the foreclosing creditor, before that date, stating that the owner has not abandoned the property and providing an address for service of process. If the registered owner fails to respond in this manner before the specified date, the mobilehome is deemed abandoned. Health & S C §18037.5(a)(6).

Although the statute is not entirely clear, presumably the secured party may sell the property without providing a notice of default if the registered owner does not respond within the appropriate time period. If the owner responds with a timely notice that the mobilehome has not been abandoned, presumably the secured party must give the owner a notice of default before proceeding to foreclose. In either case, a notice of sale (see §7.59) appears to be required.

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§7.59 c. Notice of Sale

If a default is not cured within the time period indicated in the notice of default, or if the mobilehome has been abandoned or voluntarily surrendered by the registered owner, the creditor may sell the property at private or public sale under Com C §9504. A notice of sale under Com C §9504, however, must be sent by registered or certified mail to each party to whom the notice of default was mailed, at least 10 days before the date fixed for a public sale or the date on or after which a private sale is to be conducted. Health & S C §18037.5(a)(4)-(5).

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§7.60 d. Sale Proceeds and Deficiency Judgment

The proceeds of a sale of a mobilehome must be applied in the order of priority set forth in the statute. Health & S C §18037.5(c).

Deficiency judgments are prohibited unless there is substantial damage to the mobilehome other than wear and tear from normal usage. Health & S C §18038.7; CC §2983.8.

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§7.61 E. Notice to Cosigners

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Creditors who obtain the signature of more than one person (other than a husband and wife) to a consumer credit contract are required to deliver a warning notice in English and Spanish to each cosigner or guarantor (*i.e.,* persons who will not receive any of the money, property, or services under the contract) before that person becomes obligated on the contract. CC §1799.91(a). If the contract is written in a language other than English or Spanish, the notice must be provided in English and, in addition to or in lieu of Spanish, in the language of the contract. CC §1799.91(b); see generally CC §§1799.90-1799.99 (Title 1.85, Consumer Credit Contracts).

For purposes of this statute, "consumer credit contract" is defined to include Rees-Levering Act (§§7.39-7.50) and Unruh Act (§§7.24-7.38) contracts, and (subject to certain exceptions such as loans secured by real property) secured or unsecured loans used primarily for personal, family, or household purposes. CC §1799.90(a). "Creditor" means an individual, partnership, corporation, association, or other entity that enters into or arranges for consumer credit contracts in the ordinary course of business. CC §1799.90(b).

The required wording of the notice in English is as follows (CC §1799.91(a)):

NOTICE TO COSIGNER

You are being asked to guarantee this debt. Think carefully before you do. If the borrower doesn't pay the debt, you will have to. Be sure you can afford to pay if you have to, and that you want to accept this responsibility.

You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees or collection costs, which increase this amount.

The creditor can collect this debt from you without first trying to collect from the borrower. The creditor can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, etc. If this debt is ever in default, that fact may become a part of *your* credit record.

This notice is not the contract that makes you liable for the debt.

Civil Code §1799.91(a)-(e) requires that the word "your" in the last sentence of the third paragraph of the notice in English be italicized. (The wording of this notice is the same as the notice required by the Federal Trade Commission's rule on credit practices, 16 CFR §444.3. Other state and federal requirements relating to cosigners, however, are not completely identical.)

Transactions subject to California law have been exempted from the "notice to cosigner" and "prohibitions against misrepresentation of cosigner liability" provisions of the FTC's rule on credit practices (16 CFR §444.3), on the grounds that state law currently provides substantially equivalent protection. 16 CFR §444.5.

If the statutory notice requirements are not complied with, creditors and their assignees are prohibited from bringing suit or enforcing a security interest against anyone entitled to notice who did not in fact receive any of the money, property, or services under the contract. CC §1799.95.

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§7.62 F. Truth in Lending Act and Regulations

The federal Truth in Lending Act (15 USC §§1601-1667f) and its Regulation Z (12 CFR pt 226, reprinted in United States Code Annotated (USCA) following 15 USC §1693r) apply generally to "credit sales" and other types of consumer credit transactions. The word "consumer," when used as an adjective with reference to a credit transaction, "characterizes the transaction as one in which the party to whom credit is offered or extended is a natural person, and the money, property or services which are the subject of the transaction are primarily for personal, family or household purposes." 15 USC §1602(h). "Credit sale" means any sale in which the seller is a "creditor," and includes certain bailments or leases (see below). 15 USC §1602(g). The term "creditor" refers only to a person who both (1) regularly extends consumer credit payable by agreement in more than four installments, and (2) is the person to whom the debt is initially payable. 15 USC §1602(f). Thus, the term does not include assignees.

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§7.63 1. Lease Contracts

Contracts in the form of a bailment or lease are considered credit sales if (15 USC §1602(g)):

- The bailee or lessee contracts to pay as compensation for use a sum substantially equivalent to or in excess of the aggregate value of the property and services involved; and
- It is agreed that the bailee or lessee will become, or for no other or a nominal consideration has the option to become, the owner of the property on full compliance with obligations under the contract.

See also Consumer Leasing Act, discussed in §7.69.

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§7.64 2. Disclosure Requirements

The Truth in Lending Act (15 USC §§1601-1667f) requires that creditors disclose certain information to consumers before credit is extended, as set forth in the statute itself and in regulations adopted by the Federal Reserve Board. 15 USC §§1631-1632, 1637-1638; 12 CFR pt 226 (Regulation Z). Most of these disclosure requirements have been adopted by California in its consumer protection statutes, and are reflected in standard forms for consumer transactions.

NOTE: The Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (Pub L 111-24, 123 Stat 1734) added further requirements to notice, interest rate, penalty, and credit card agreement provisions of the Truth in Lending Act.

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§7.65 3. Liability for Violations

A creditor failing to comply with applicable disclosure requirements with respect to consumer leases is liable, in an individual action, for (1) actual damages, (2) twice the amount of the transaction's finance charge (subject to a minimum of $100 and a maximum of $1000), and (3) attorney fees and costs. Class actions are also provided for under the Truth in Lending Act. 15 USC §1640(a). Liability for failing to make disclosures is imposed only on the creditor required to make disclosure, except as specifically provided by the statute. 15 USC §1640(a).

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§7.66 4. Assignee Liability

A civil action for violation of the Truth in Lending Act (15 USC §§1601-1667f) that could be brought against a creditor can ordinarily be maintained against an assignee only if the violation is apparent on the face of the applicable disclosure statement. "Apparent" includes but is not limited to (1) a disclosure that can be determined to be incomplete or inaccurate from the face of the disclosure statement or other documents assigned, or (2) a disclosure that does not use the terms required to be used by the Act. 15 USC §1641(a).

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§7.67 5. Correction of Errors

A creditor or assignee has no liability under the Truth in Lending Act (15 USC §§1601-1667f) if, within 60 days after discovering an error, and before the institution of a civil action under the Act or receipt of a written notice of the error from the obligor, the creditor or assignee notifies the person concerned of the error and makes whatever adjustments are necessary in the appropriate account to ensure that the person will not be required to pay an amount greater than the charge actually disclosed, or the dollar equivalent of the annual percentage rate actually disclosed, whichever is lower. 15 USC §1640(b).

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§7.68 6. Bona Fide Error

Creditors or assignees can be excused from liability by showing that a violation of the Truth in Lending Act was not intentional and resulted from a bona fide error, notwithstanding the maintenance of procedures reasonably adopted to avoid any such error. Bona fide error includes "clerical, calculation, computer malfunction and programming, and printing errors," but an error of legal judgment with respect to a person's obligations under the Act is not a bona fide error. 15 USC §1640(c). Creditors or assignees are not liable for acts performed or omitted in good-faith conformity with Regulation Z (12 CFR pt 226) or official staff interpretations. 15 USC §1640(f).

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§7.69 G. Consumer Leasing Act (Federal)

The federal Consumer Leasing Act (15 USC §1667-1667e) and its Regulation M (12 CFR pt 213) apply to certain consumer leases excluded from the Truth in Lending Act's definition of "credit sales" (15 USC §1602(g); see §7.62). Under the Consumer Leasing Act, a "consumer lease" is a contract in the form of a lease or bailment for the use of personal property by a natural person for a period of time exceeding four months, and for a total contractual obligation not exceeding $25,000, primarily for personal, family, or household purposes, whether or not the lessee has the option to purchase. 15 USC §1667(1). The lessor must be "a person who is regularly engaged in leasing, offering to lease, or arranging to lease under a consumer lease." 15 USC §1667(3).

Before a consumer lease is consummated, the lessor must give the lessee a dated written statement containing specified disclosures. 15 USC §1667a. If the lessee's liability on expiration of the lease is based on the estimated residual value of the property, that estimate must be reasonable and certain rebuttable presumptions apply. 15 USC §1667b(a). Charges or penalties for delinquency, default, or early termination may be specified in the lease, but must be reasonable. 15 USC §1667b(b).

Penalties for violation of the Consumer Leasing Act are the same as those imposed for violation of the Truth in Lending Act. 15 USC §1667d(a).

Lease transactions are exempt from this statute and subject instead to state law if the state's requirements are "substantially similar" or the state law "gives greater protection and benefit to the consumer," and if there is adequate provision for enforcement. 15 USC §1667e(b).

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§7.70 H. Equal Credit Opportunity Act

The federal Equal Credit Opportunity Act (ECOA) (15 USC §§1691-1691f) and its Regulation B (12 CFR pt 202) prohibit discrimination, with respect to any aspect of a credit transaction, by creditors against any applicant on the basis of (1) race, color, religion, national origin, sex, marital status, or age; (2) the applicant's receipt of income from a public assistance program; or (3) the applicant's good-faith exercise of rights under the Consumer Credit Protection Act (15 USC §§1601-1667f). 15 USC §1691. This statute has been held to apply to consumer leases. *Brothers v First Leasing* (9th Cir 1984) 724 F2d 789 (automobile lease). The Seventh Circuit, while not contradicting *Brothers,* has held that the ECOA does not apply to residential leases. *Laramore v Ritchie Realty Mgmt. Co.* (7th Cir 2005) 397 F3d 544.

Among other things, the Act prohibits a creditor from requesting the signature of a nonapplicant spouse or other nonapplicant if the applicant's own "creditworthiness" is sufficient to qualify the applicant for the requested credit.

A "creditor" includes an assignee who participates in the decision to extend, renew, or continue credit. 15 USC §1691a(e). Creditors who violate the Act or regulation are subject to civil liability for actual and punitive damages in individual or class actions. Costs and reasonable attorney fees may also be awarded to a successful plaintiff. 15 USC §1691e(a)-(b), (d). An assignee who "knew or had reasonable notice of the act, policy, or practice that constituted the violation before becoming involved in the credit transaction" is liable to the same extent as the creditor. 12 CFR §202.2(*l*).

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§7.71 I. FTC "Holder" Rule

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The Federal Trade Commission's Trade Regulation Rule on Preservation of Consumers' Claims and Defenses, referred to as the FTC "Holder" Rule (16 CFR pt 433), effectively abolishes the "holder in due course" doctrine with respect to most consumer credit contracts.

The Rule applies directly only to sellers, in that the burden of compliance is imposed on sellers, but its effect is to preserve claims and defenses that could be asserted against sellers for use against assignees and other holders of consumer credit contracts.

Under the first part of the Rule, 16 CFR §433.2(a), credit sellers must include in "credit sale" contracts the following notice preserving the debtor's claims and defenses:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

See *Diaz v Paragon Motors of Woodside, Inc.* (ED NY 2006) 424 F Supp 2d 519, for a discussion of the interaction between the Truth in Lending Act (see §7.62) and the FTC Holder Rule.

Under the second part of the Rule, 16 CFR §433.2(b), a seller may not accept the proceeds of a "purchase money loan" *(i.e.,* a cash advance to be applied to a purchase of consumer goods or services from a seller who refers consumers to the lender or is affiliated with the lender by common control, contract, or business arrangement) as full or partial payment for a sale to a consumer, unless the loan contract contains the following notice preserving consumer claims and defenses:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

A seller's failure to comply with the Rule is an "unfair or deceptive practice" for which the FTC may prosecute the seller and recover civil penalties. There is no provision for private enforcement by a consumer action.

The FTC Holder Rule impacts consumer transactions directly. Division 9 addresses the FTC Holder Rule in Com C §§9403-9404. These sections provide that an assignee of a contract without the required notice is subject to a consumer account debtor's claims and defenses to the same extent as if the notice had been included. Com C §9403(d); Official Comment 5 to UCC §9-403. Commercial Code §9403(d) effectively renders waivers-of-defense claims ineffective in the transactions with consumers to which it applies. Official Comment 5 to UCC §9-403. In addition, Com C §9404(d) limits an assignee's liability to the same extent that an assignor's liability is limited to amounts paid by the account debtor, whether or not the contract includes a statement to that effect. Com C §9404(d); see also Official Comment 4 to UCC §9-404. The FTC notice states "recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder." 16 CFR §433.2(a)-(b).

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§7.72 J. Debt Collection Statutes

California's Rosenthal Fair Debt Collection Practices Act (CC §§1788-1788.33) regulates persons who regularly engage in debt collection for themselves or others, except attorneys. CC §1788.2(c). It prohibits debt collectors from engaging in unfair or deceptive acts or practices in the collection of consumer debts. CC §1788.1(a)(2), (b). Prohibited acts include the use of threats, violence, or force (CC §1788.10); obscene or profane language (CC §1788.11); harassing telephone practices (CC §1788.11); communication of information about the debtor to others (CC §1788.12); false representations (CC §1788.13); and certain attempts to misuse the judicial process (CC §§1788.14-1788.16). The statute also establishes debtor responsibilities. CC §§1788.20-1788.22. Civil and criminal penalties are provided for the Act's violation. CC §§1788.30-1788.32. Any waiver of the Act's provisions is void and unenforceable. CC §1788.33. Additional requirements for notice to debtors by third-party debt collectors are provided by CC §§1812.700-1812.702, effective July 1, 2004. A violation of these provisions is considered a violation of the Act. CC §1812.702.

Practitioners should also be aware of the federal Fair Debt Collection Practices Act (FDCPA) (15 USC §§1692-1692p), which is similar to the California Act. The FDCPA does not preempt state law unless the state law is inconsistent with FDCPA, and FDCPA further provides that "state law is not inconsistent… if the protection such law affords any consumer is greater than the protection provided by… [FDCPA]." 15 USC §1692n. See also *Alkon v CitiMortgage* (ND Cal 2004) 336 F Supp 2d 1061. The California Act may be preempted by other federal law, depending upon the circumstances. See *Nelson v Equifax Info. Servs., LLC* (CD Cal 2007) 522 F Supp 2d 1222 (California FDCPA causes of action preempted by the Fair Credit Reporting Act, although federal FDCPA causes of action were still viable.)

The FDCPA prescribes how notices should be given to consumers by debt collectors. In *Camacho v Bridgeport Fin., Inc.* (9th Cir 2005) 430 F3d 1078, 1082, the Ninth Circuit held that a notice requiring that the debtor dispute the validity of a debt in writing was a violation of FDCPA. But see *Graziano v Harrison* (3d Cir 1991) 950 F2d 107, 112 (debt must be disputed in writing). This case points out the importance of ensuring that any notice to a consumer complies with FDCPA requirements.

Courts have considered whether letters to consumers' attorneys must follow the requirements of the FDCPA. In *Evory v RJM Acquisitions Funding LLC* (7th Cir 2007) 505 F3d 769, the Seventh Circuit examined under what circumstances attorneys should be treated differently from their consumer clients under the FDCPA. The Ninth Circuit has held that communications directed solely to a debtor's attorney are not actionable under the FDCPA. *Guerrero v RJM Acquisitions LLC* (9th Cir 2007) 499 F3d 926. *Guerrero*, however, related to a response letter sent to the consumer's attorney.

For a detailed discussion of debt collection, see Debt Collection Practice in California (2d ed Cal CEB 1999).

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8

Agricultural Financing

Ellen A. Friedman

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§8.1 I. INTRODUCTION

This chapter deals with security interests in agricultural personal property. General principles of the Commercial Code apply to this type of property. This chapter emphasizes the provisions that are particularly important to agriculture. It also discusses other state and federal statutes that directly or indirectly affect particular aspects of agricultural financing. In agricultural financing, a farmer often will receive loans from governmental or quasi-governmental entities. Government program payments are also part of a farmer's income. However, a detailed discussion of these statutes is beyond the scope of this chapter. Particular kinds of agricultural loans and secured transactions are discussed in §§8.2-8.28. For discussion of non-Commercial Code statutory liens and other kinds of security interests that arise in agriculture, see §§8.29-8.52.

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§8.2 A. Types of Loans

A farmer often will have several types of loans and will receive credit from various types of entities. Farmers typically will receive long-term credit secured by a farmer's real property. Like home mortgages, mortgages on farm property can be for a significant period of time, such as 30 years. While mortgages on real property are beyond the scope of this book, the interplay between liens on real property and security interests or agricultural liens on crops is discussed in §8.11.

In addition, farmers often receive shorter-term loans such as purchase-money loans for equipment or for livestock. See §8.13. (On purchase money security interests, see §§4.10-4.19.) Farmers also often receive several different types of seasonal loans to finance operating expenses and crop production.

In the typical crop financing arrangement, a crop loan is made at the beginning of the crop season to enable the farmer to buy seed and fertilizer and to provide working capital to carry on the farming operations until the crop is ready for sale. Ordinarily, the loan is not entirely disbursed when it is made. Funds are advanced as needed; often the borrower must submit a budget indicating the amounts needed and the time requested for disbursement. Frequently, the collateral for the loan is the crop itself. The secured party typically is a bank, but may be a packing or canning company or a federal agency.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/8 Agricultural Financing/§8.3 B. Role of the Government

§8.3 B. Role of the Government

In addition to the many financial institutions that typically provide credit to farmers, farmers often receive credit from governmental or quasi-governmental agencies, including the Farm Credit System, a network of cooperatively owned and federally supervised agricultural lending agencies (12 USC §§2001-2279aa-14; 7 USC §§1922-2009m), and the Consolidated Farm Service Agency, an agency of the Department of Agriculture that administers loans made by the Farmers Home Administration (7 USC §6932).

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II. AGRICULTURAL FINANCING UNDER DIVISION 9

§8.4 A. Scope of Division 9 and Important Definitions

Consensual security interests may be obtained and perfected against "farm products" and other agricultural property under the California Commercial Code Division 9. Com C §9109(a)(1). See §8.5. In addition, various provisions of Division 9 also apply to certain nonconsensual liens called "agricultural liens." Com C §9109(a)(2). See §8.6.

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§8.5 1. Farm Products

"Farm products" include crops, livestock, and supplies used or produced in a farming operation. Com C §9102(a)(34). Crops may be grown, growing, or to be grown and include crops produced on trees, vines, and bushes. Livestock may be born or unborn. Both crops and livestock include aquatic goods produced in aquaculture operations. Standing timber is not a farm product. Com C §9102(a)(34).

Farm products are a class of goods and are farm products only to the extent that the debtor is engaged in a farming operation with respect to the goods. "Farming operation" means raising, cultivating, propagating, fattening, grazing, or any other farming, livestock, or aquacultural operation. Com C §9102(a)(35).

Crops, livestock, and their products are no longer "farm products" when the debtor ceases to be engaged in farming operations with respect to them. They become inventory if a marketing agency possesses them for sale or distribution. *U.S. v Progressive Farmers Mktg. Agency* (8th Cir 1986) 788 F2d 1327. In addition, products of crops or livestock cease to be farm products and generally become inventory if they have been subject to a manufacturing process. This is true even if they are still in the possession of the debtor engaged in farming operations. Some processes are so closely related to farming that they are not manufacturing, such as pasteurizing milk or boiling sap to produce maple syrup. An extensive canning operation, however, would be considered manufacturing. Official Comment 4a to UCC §9-102.

The courts have taken various positions regarding the classification of plants grown by nurseries. See *Cookeville Prod. Credit Ass'n v Frazier (In re Frazier)* (Bankr MD Tenn 1981) 16 BR 674 (plants held to be farm products while growing, but inventory when mature); *Gruner v Hudson Valley Prod. Credit Ass'n (In re Houts)* (ND NY, Feb. 6, 1981, No. 79-BK-1392) 1981 US Dist Lexis 10724 (plants held to be farm product); *Ritter v Hughes (In re Heinl's Nursery, Inc.)* (Bankr SD Fla 1976) CCH Secured Transactions Guide ¶52,837 (plants held to be inventory).

In *Morgan County Feeders, Inc. v McCormick* (Colo App 1992) 836 P2d 1051, the court held that cattle purchased for use in recreational cattle drives, and not for the purpose of immediate or ultimate sale or lease, were equipment and thus were neither farm products nor inventory.

PRACTICE TIP: If there is any question as to how the collateral may be classified, the cautious lender should describe all possible categories in its security documents. Additional perfection may be necessary for proceeds. See §3.59.

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§8.6 2. Agricultural Lien

An "agricultural lien" is an interest, other than a security interest, in farm products that meets certain specified conditions. An agricultural lien must secure payment or performance of an obligation for either (1) goods or services in connection with a debtor's farming operation or (2) rent or real property leased by a debtor in connection with a debtor's farming operation. Com C §9102(a)(5)(A).

The agricultural lien must be created by statute in favor of a person that either (1) in the ordinary course of business furnished goods or services to a debtor in connection with the debtor's farming operation, or (2) leased property to a debtor in connection with the debtor's farming operation. Com C §9102(a)(5)(B). The effectiveness of an agricultural lien may not depend on the person's possession of the personal property. Com C §9102(a)(5)(C).

NOTE: The California Producers' Lien (Food & A C §§55631-55653) does not fit within the definition of an agricultural lien. See §8.30.

For example, the following types of liens may be agricultural liens:

- Harvester's lien (CC §§3061.5-3061.6) (see §8.35);
- Livestock service lien (CC §§3062-3064) (see §8.34);
- Dairy cattle supply lien (Food & A C §§57401-57414) (see §8.22);
- Poultry and fish supply lien (Food & A C §§57501-57545) (see §8.31); and
- Agricultural chemical and seed lien (Food & A C §§57551-57595) (see §8.32).

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Source: Business Law/Secured Transactions in California Commercial Law Practice/8 Agricultural Financing/§8.7 B. Attachment and Perfection of Security Interests and Agricultural Liens

§8.7 B. Attachment and Perfection of Security Interests and Agricultural Liens

In general, the rules discussed in chapter 3 regarding the attachment and perfection of security interests apply in the same manner to agricultural security interests. A security interest will be validly created if crops or other farm products are described in the security agreement. See §8.8. The security interest will be perfected if a financing statement referring to the collateral is filed with the Secretary of State. See §8.9.

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§8.8 1. Attachment of Security Interest in Crops

A financing statement or security agreement for crops does not need to contain a real property description for the security interest to attach. Case law under former Division 9 invalidating security interests in crops not containing an adequate real estate description is no longer valid.

To perfect a security interest in crops, the secured party needs to file a financing statement at the Secretary of State's office, not at the county level. To the extent that crops are considered fixtures, it may be necessary to perfect a security interest in crops as fixtures. See §1.37. Practitioners also may wish to search real estate records for fixture filings.

PRACTICE TIP: Although a land description usually is not required, it may nevertheless be included if the secured party and the debtor desire to limit the security interest to crops grown on particular property.

County-level filings are necessary for timber to be cut, for "as-extracted collateral," and for fixture filings. Com C §9501(a)(1). All of these filings require a description of the applicable real property. Com C §9502(b)(3).

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§8.9 2. Perfection of Security Interests and Agricultural Liens

A security interest is perfected when it attaches if all applicable requirements for perfection have been satisfied. Com C §9308(a). An agricultural lien is perfected when it becomes effective if all applicable requirements for perfection have been satisfied. Com C §9308(b). A financing statement must be filed to perfect a security interest or agricultural lien, subject to certain exceptions discussed in chap 3. Com C §9310(a).

PRACTICE TIP: Even though crops may not yet have come into existence, early filing of the financing statement may be important to establish priority with respect to other secured creditors because, under the "first-to-file" rule, priority is measured by the time of filing or perfection, whichever is earlier. See §8.10.

An agricultural lien, like a security interest, will be perfected continuously if it is originally perfected by one method and is later perfected by another method without an intermediate period when it was unperfected. Com C §9308(c). The five-year effective period of a financing statement is discussed in §3.103; continuation statements are discussed in §3.107.

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§8.10 C. Priority of Security Interest in Farm Products

As with the rules of perfection of security interests in farm products, the rules of priority of secured creditors with respect to farm products are the same as those for goods described in chapter 4. The general rules governing priority of security interests apply to agricultural collateral in the same manner that they apply to nonagricultural collateral. Priority issues involving mortgages, buyers of farm products, purchase-money interests, and cropshare arrangements are discussed in §§8.11-8.16.

EXAMPLE: Secured Party *A* makes a crop loan on January 5 and files a financing statement on February 25. On February 1, Secured Party *B* makes a crop loan on the same crop and files a financing statement immediately. The crop is planted in March. Both security interests were perfected in March when the crops were planted, but Secured Party *B* would have priority because it filed first.

Practitioners should be aware, however, of the decision in *Producers Cotton Oil Co. v Amstar Corp.* (1988) 197 CA3d 638, 242 CR 914, which allowed an unsecured creditor to obtain payment ahead of a secured creditor on an unjust enrichment theory when the secured creditor had knowledge of and acquiesced in expenditures necessary to the development of a crop that were made by the unsecured creditor without first obtaining subordination by the secured creditor. The decision has been criticized and has rarely been followed. See §4.73. On subordination, see §§4.74-4.76.

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§8.11 1. Mortgage on Real Property

In some jurisdictions, courts have considered the question whether a mortgage against real property might have an interest superior to that of a security interest or agricultural lien against crops growing on the land. The Commercial Code specifically provides that the secured party with the agricultural lien or security interests against the crops will be senior. Com C §9334(i); Official Comment 12 to UCC §9-334.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/8 Agricultural Financing/§8.12 2. Buyers of Farm Products

§8.12 2. Buyers of Farm Products

Under the uniform version of Com C §9320, a buyer of farm products in ordinary course of business does not acquire the farm products free and clear of a security interest created by the seller. See Official Comment 4 to UCC §9-320. California did not adopt the "farm products exception," with the result that a buyer of farm products in ordinary course of business is in the same position as a buyer of any other type of collateral in ordinary course of business. However, this issue is largely preempted by federal law. See §8.47.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/8 Agricultural Financing/§8.13 3. Purchase Money Security Interest in Livestock

§8.13 3. Purchase Money Security Interest in Livestock

Special rules apply to purchase-money security interests in livestock that are farm products. (On purchase money security interests, see §§4.10-4.19.) A purchase money security interest in livestock that are farm products will have priority over a conflicting interest in such livestock and its identifiable proceeds (other than security interests in deposit accounts covered by Com C §9327 (see §4.21)) and identifiable products in their unmanufactured states if all of the following conditions are satisfied (Com C §9324(d)):

- The purchase money security interest is perfected when the debtor receives possession of the livestock;
- The secured party sends a notice to the holder of the conflicting security interest and such holder receives the notice within six months before the debtor receives possession of the livestock; and
- The notice states that the person sending the notice has or expects to acquire a purchase money security interest in livestock of the debtor and describes the livestock.

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§8.14 4. Effect of Leasing Arrangement

In a traditional landlord-tenant relationship, the tenant pays rent in cash. Title to the crops is vested in the tenant unless there is an agreement to the contrary. CC §819; *Silveira v Ohm* (1949) 33 C2d 272, 201 P2d 387. Although the tenant is generally entitled to harvest the crops as long as the tenant is entitled to possession of the real property (*Lemon v Wolff* (1898) 121 C 272, 53 P 801), after repossession of the real property the landlord is entitled to all unharvested crops remaining on the property. *Agoure v Plummer* (1917) 175 C 543, 166 P 311; *Societa Italiana Di Mutua Beneficenza v Burr* (9th Cir 1934) 71 F2d 496.

The lease may provide, however, that the rent is to be paid in the form of a share of the crop rather than in cash. A typical arrangement is for the landlord to receive one-quarter or one-third of the crop as payment for the tenant's use of the land. This is the classic cropshare arrangement. Under this arrangement, the landlord and the tenant are typically considered to be co-tenants in the crop. A security interest granted by the tenant to a secured party will attach only to that portion of the crop owned by the tenant. Because the landlord's share of the crop is owned by the landlord, the tenant does not have rights in that portion of the crop to which the security interest can attach.

It is critical in financing farm products that the secured party understands who owns the land and whether there are any agreements regarding whether the landlord will have an interest in the farm products or if the lease permits the encumbrance of farm products. If so, the secured party may wish to enter into a subordination agreement with the landlord, or a waiver of the landlord's rights under the cropshare arrangement. See §8.15. On subordination, see §§4.74-4.76.

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§8.15 a. Use of Subordination Agreement

If the landlord is willing to enter into a subordination agreement or a waiver of the landlord's rights under a cropshare arrangement (see §8.14), the instrument should be acknowledged and recorded in the county where the real property is located. Sometimes the secured party finances a farmer who is farming various parcels owned by different persons. Amounts received from crops produced on the land of one landlord, above the financing necessary to produce those specific crops, typically will be available to pay the rent due that landlord. If one blanket crop security agreement covers all parcels, the waivers may be revised to subordinate each landlord's interest to the entire loan. The individual landlord can be expected to require that the waiver be limited to the amount of financing necessary for the crop grown on his or her land. For a form of subordination agreement, see §8.16.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/8 Agricultural Financing/§8.16 b. Form: Subordination Agreement

§8.16 b. Form: Subordination Agreement

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8.16-1 Subordination agreement for crops

SUBORDINATION AGREEMENT: CROPS

For consideration, the undersigned _ _[*describe signer's relationship to land or crops, e.g., lessor, trust deed holder, owner, lessee, contract seller*]**_ _ authorizes and ratifies the execution and delivery by _ _**[*name of debtor*]**_ _ of _ _**[*city*]**_ _, _ _ _ _ _ _ County, California, to _ _**[*name of secured party*]**_ _ ("Secured Party") of a security agreement covering all crops**

[*Add one of the following alternatives*]

[*Alternative 1*]

now standing, planted, or grown, and that may be planted or grown before payment in full of the indebtedness secured by that security agreement,

[*Alternative 2*]

to be grown during the season of _ _ _ _ _ _

[*Continue*]

on the land in _ _ _ _ _ _ County, California, described as follows:

[*Describe land*]

The undersigned agrees that the security interest of Secured Party shall be a prior lien on the crops, and that the Secured Party shall have all rights incidental to its priority security interest, including but not limited to the right to produce, harvest, and market the crops, notwithstanding any present or future claim, title, lien, right of entry, re-entry, or possession of the undersigned for the crops or lands or both, and that all of the crops or the sale proceeds arising from their sale may be applied toward the payment of the indebtedness secured by that security agreement, notwithstanding that the security agreement may cover security other than those crops, and that Secured Party shall not be required to enforce that security agreement as to any other security.

The undersigned certifies that the instrument or instruments creating the subordinated rights are owned by, and will be retained in the possession of, the undersigned, and agrees that in the enforcement of those rights, no transfer of the real property will be caused without Secured Party's prior written consent, unless the transfer is subject to the security agreement described above.

This agreement shall be binding on and inure to the benefit of the heirs, successors, and assigns of the undersigned and of Secured Party.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

ACKNOWLEDGMENT

State of California)
)
County of _ _[*name of county*]**_ _)**
)
)

_____)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s) of person(s) subscribed in instrument*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s)** _ _[*is/are*]_ _ **subscribed in this instrument and acknowledged to me that** _ _[*he/she/they*]_ _ **executed that instrument in** _ _[*his/her/their*]_ _ **authorized capacit**_ _[*y/ies*]_ _ **and that, by** _ _[*his/her/their*]_ _ **signature(s) on the instrument, the person(s) (or the entity on behalf of which the person(s) acted) executed the instrument.**

Witness my hand and official seal:

[*Officer's seal*] __[*Signature of officer*]__

Comment: An accurate legal description of the land should be included or attached as an exhibit and incorporated by reference in this waiver, or as part of the security agreement, or both. The provision in this form assumes that the land is described in both documents. The form of acknowledgment is required by CC §1189.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/8 Agricultural Financing/§8.17 D. Interests in Cooperatives

§8.17 D. Interests in Cooperatives

Many farmers are members of cooperatives that are owned by a group of farmers. They market and sell their products through the cooperative. In many cases, a farmer delivers his or her product to the cooperative and is paid for the products. A portion of the purchase price paid for the products is retained by the cooperative and is used for operations by the cooperative. The farmer receives an interest in the cooperative based on that portion of the purchase price that was retained by the cooperative.

A secured creditor may wish to obtain a security interest in the farmer's interest in the cooperative. The farmer's interest can take several forms. Sometimes a farmer receives a membership interest represented by a certificate. In other instances a book entry will be made in the cooperative's records. In certain cases, the interest is referred to as a capital account maintained by the cooperative for the benefit of the farmer. Several cases have held that uncertificated interests in cooperatives are general intangibles. See, *e.g.*, *Morton v Santa Ana Nat'l Bank (In re Bonnema)* (Bankr ND Tex 1998) 219 BR 951; *Sherman v Eugene Farmers Coop. (In re Cosner)* (Bankr D Ore 1980) 3 BR 445; *Valley Fed. Sav. Bank v Stahl* (NM 1990) 793 P2d 851.

Although many of these cases were decided before the definition of "investment property" was included in Division 9, cases decided after the definition of "investment property" was added have also held that these types of interests in cooperatives are general intangibles and not investment property. A secured party needs to consider under which Division 9 definition of collateral (*e.g*., account, general intangible, investment property) a particular payment obligation falls. If the interest is represented by certificates, courts have held that those certificates are instruments. *Leake v First Nat'l Bank (In re Shiflett)* (Bankr WD Va 1984) 40 BR 493. See §§3.38-3.39 for perfection of security interests in instruments and §3.19 for perfection of security interests in general intangibles.

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§8.18 E. Assignment of Proceeds

Separate assignments of proceeds are not necessary for the secured party to obtain an interest in proceeds of farm products. A security interest continues in any identifiable proceeds of collateral. Com C §9315(a). See §3.59.

An assignment of proceeds may, however, be an effective method of directing payment by processors. For a form of assignment of proceeds by the debtor, see §8.19. For a form of acceptance of assignment by the processor, see §8.20. For discussion of assignment of milk proceeds ("milk-check assignment"), see §8.24.

Not all proceeds may be forthcoming to the secured party under the assignment. It is standard practice for processors to deduct their charges for handling products before making remittance to the grower. Some processors, particularly agricultural cooperatives, also may seek to deduct other charges that do not necessarily relate to the processing or marketing of the product. For example, a processor may have made advances for the purchase of seed or fertilizer, which is a debt to be offset against the crop proceeds owed to the secured party.

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§8.19 1. Form: Assignment of Proceeds

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8.19-1 Crop assignment and order

CROP ASSIGNMENT AND ORDER

For consideration, _ _[*name of debtor*]_ _ ("Assignor") assigns to _ _[*name of secured party*]_ _ ("Assignee") all proceeds due or to become due Assignor from _ _[*name of obligor*]_ _ ("Processor-Marketer"), by reason of the delivery by Assignor to Processor-Marketer of certain agricultural products described as _ _[*describe crop*]_ _ ("Crops").

"Proceeds" means all money and payments of every kind, including but not limited to refunds, equities, benefits, book credits, returns, credits, revolving fund withholdings, return of capital, and certificates evidencing rights to receive payment in any form from Processor-Marketer.

Assignor directs and authorizes Processor-Marketer to deliver all proceeds to Assignee, and authorizes Assignee to receive and give releases for proceeds. This assignment is irrevocable except with Assignee's prior written consent.

Assignor has made no other assignment of proceeds.

As long as this assignment remains in force, Assignor agrees not to withdraw Crops from Processor-Marketer, not to sell or deliver any Crops to anyone other than Processor-Marketer, not to encumber them, and not to permit any lien other than that of Assignee to attach to them.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Assignor

Comment: The reference to payments such as refunds and equities in form 8.19-1 may apply if the obligor is a cooperative marketing association. Payments by cooperatives to members can be in a wide variety of forms, and the terminology used is intended to cover all common arrangements.

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§8.20 2. Form: Acceptance of Assignment

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8.20-1 Acceptance of crop assignment

ACCEPTANCE OF ASSIGNMENT
_ _[*AND SUBORDINATION AGREEMENT*]_ _

_ _[*Name of obligor*]_ _ **("Processor-Marketer") acknowledges receipt of a copy of this assignment, states that there is no other assignment of the same account on file, and agrees to be bound by the assignment**

[*Add one of the following alternatives*]

[*Alternative 1*]

subject to whatever sums Processor-Marketer may be entitled to withhold because of storage, processing, selling, or other costs to which Processor-Marketer may be entitled under contractual agreements with the Assignor in the assignment.

[*Alternative 2*]

and that any lien, claim, or indebtedness existing now or in the future in favor of Processor-Marketer against the Assignor or the crops is subordinated to this assignment to the extent that the Assignor is and becomes indebted to the Assignee.

[*Continue*]

Date: _ _ _ _ _ _ _ _[*NAME OF PROCESSOR-MARKETER*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: The acknowledgment of receipt of assignment in form 8.20-1 includes language specifying the processor's right to withhold various charges before remitting the funds or subordinating the processor's rights to those of the secured party.

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§8.21 F. Special Considerations for Dairy Cattle

Creditors taking security interests in dairy cattle should be aware of special considerations applicable to dairy herds. The nature of the debtor's interest should be carefully determined because dairy herds are sometimes leased, and the creditor should consider the possible impact of a dairy cattle supply lien (see §8.22).

NOTE: With respect to embryo transplants, the embryo and the resulting calf are sometimes owned by someone other than the owner of the cow. In such a situation, the cattle owner's creditor may not obtain a security interest in the calf. In *Fairview State Bank v Edwards* (Okla 1987) 739 P2d 994, the court held that a security interest in cows and their increase attached to the proceeds received from the sale of embryos for transfer to surrogate mother cows.

The holder of a security interest in the cattle may also wish to obtain (1) a security interest in the related milk and milk products and the debtor's rights under the California milk pooling plan (see §8.23), and (2) an assignment of the debtor's milk check (see §§8.24-8.26).

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§8.22 1. Dairy Cattle Supply Lien

The Dairy Cattle Supply Lien Act (Food & A C §§57401-57414) creates a statutory lien right for a person who provides feed or materials to aid in the raising or maintaining of dairy cattle. The lien created under this legislation may be filed at any time after the supplier begins feed deliveries. Among other conditions, the lien attaches only to the proceeds of the milk or milk products and it cannot exceed an amount equal to the reasonable or agreed charges for feed or materials provided within a 45-day period. Only two providers may have an enforceable lien at any time. Perfection of the lien requires the filing of a notice of claim of lien with the Secretary of State. A lien created under this law has priority in accordance with the time the notice is filed and has the same priority as a security interest perfected by the filing of a financing statement. The lien is subject to Commercial Code Division 9. The lien claimant must provide written notice to all senior secured parties that have a perfected security interest in the dairy cattle, milk, milk products, or proceeds thereof 30 days before enforcing the lien. The lien can be foreclosed on only in an action to recover the reasonable or agreed charges for feed and materials delivered. Although the lien has a major impact on the relationship between feed suppliers and dairy farmers, it has little if any impact on lenders.

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§8.23 2. Milk Pooling Plan Rights

The marketing of milk is subject to the California Department of Food and Agriculture, Milk Pooling Branch's California Pooling Plan for Market Milk, and the price obtained for milk is dependent on the debtor's rights under that plan. See generally Food & A C §§61801-62756. Therefore, it is important for the secured party to take a security interest in the debtor's rights. There is some question as to the extent of the secured party's rights because the Milk Pooling Branch does not acknowledge voluntary security interests in the absence of a court order. It will, however, notify a secured creditor who submits Form 210-080 (Authorization to Release Information) of an intended transfer of the debtor's rights under the pooling plan. Copies of this form may be obtained from the California Department of Food and Agriculture, Milk Pooling Branch, 1220 N Street, Sacramento, CA 95814-5621; (916) 341-5901; e-mail pooling@cdfa.ca.gov.

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§8.24 3. Milk-Check Assignment

A dairy farmer may deliver milk or cream to a processor under a contract that provides that the farmer will be paid periodically at certain times, *e.g.,* the first of each month. This right to payment can be assigned to secure a loan, and is commonly assigned in connection with loans secured by dairy cattle. (On assignment of proceeds, see §8.18). Such an assignment is commonly referred to as a milk-check assignment. For a form of milk-check assignment by the debtor, see §8.25. For a form of acceptance of milk-check assignment by the processor, see §8.26.

While a right to payment is an account (Com C §9102(a)(2)), the milk or milk products that give rise to it may be found to be products of the dairy cattle collateral or proceeds. Thus, it is advisable for the security agreement to include proceeds and products as well as accounts. The financing statement need not expressly mention proceeds, because proceeds are automatically covered by a perfected security interest in the collateral (see Com C §9315). The box indicating "products" of collateral, however, should be checked. See *In re Quaal* (Bankr D Minn 1984) 40 BR 619 (security interest in milk not perfected when financing statement covered farm livestock but products box not checked); *In re Weyland* (Bankr ED Wis 1986) 63 BR 854 (security interest in milk proceeds did not extend to dairy termination program payments when products box not checked). See also *U.S. v Hollie (In re Hollie)* (Bankr MD Ga 1984) 42 BR 111 (reference to farm products covered milk from dairy cattle; authorization to sell milk did not waive secured party's interest in milk diversion program payments).

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§8.25 a. Form: Milk-Check Assignment

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8.25-1 Milk-check assignment

ASSIGNMENT OF PROCEEDS OF SALE OF DAIRY PRODUCTS

For and in consideration of advances made or to be made by _ _[*name of lender*]_ _ ("Assignee"), the undersigned ("Assignors") transfer, sell, and assign to Assignee all sums of money, not exceeding, however, the sums set forth in this assignment, payable to Assignors on account of the sale or handling for Assignors' account of any milk, cream, butter, butterfats, and all dairy products of any kind or character delivered now or at any later time by Assignors to _ _[*name of processor*]_ _ ("Marketing Concern").

The sums assigned and times of payment are as follows:

_ _[*dollar amount*]_ _ **on** _ _[*date*]_ _

_ _[*dollar amount*]_ _ **on** _ _[*date*]_ _

_ _[*dollar amount*]_ _ **on** _ _[*date*]_ _

_ _[*dollar amount*]_ _ **on** _ _[*date*]_ _

_ _[*dollar amount*]_ _ **on** _ _[*date*]_ _

and a payment of _ _[*dollar amount*]_ _ on the _ _[*e.g., 15th*]_ _ day of each month thereafter until the total indebtedness of Assignors to Assignee has been paid in full and Assignee has given written notice of payment in full to Marketing Concern.

Assignors authorize and direct the payment to Assignee or its assigns of the sums payable to us as set forth above.

The terms and conditions of any security agreement executed by Assignors in favor of Assignee are incorporated in this assignment by reference.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Assignor

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§8.26 b. Form: Acceptance of Milk-Check Assignment

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8.26-1 Acceptance of milk-check assignment

ACCEPTANCE OF ASSIGNMENT

The undersigned accepts the above assignment which, according to the records of the undersigned, is the first assignment of those proceeds of sale by the named Assignors. The undersigned agrees to pay the Assignee the proceeds of sale of the dairy products delivered to the undersigned by those Assignors in the amounts set forth in the above assignment on the condition that there shall be available in the Assignors' account with the undersigned a sum sufficient to permit such payment and, if insufficient to pay in full, payment will be made to the extent of the sums available and the deficit will be paid when funds become available.

Date: _ _ _ _ _ _

_ _[*NAME OF MARKETING CONCERN*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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Source: Business Law/Secured Transactions in California Commercial Law Practice/8 Agricultural Financing/§8.27 G. Farm Equipment as Collateral

§8.27 G. Farm Equipment as Collateral

Equipment may be important as collateral for credit, either for purchase-money loans to buy the equipment, or for other credit secured by equipment already owned. Equipment is a category of goods. Com C §9102(a)(33). On perfecting a security interest in goods, see §3.30. On special rules regarding perfection of security interests in motor vehicles, see §§3.65, 3.72.

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§8.28 H. Subsidies and Other Government Payments

Farmers may be entitled to rights and payments under a number of government programs, and creditors may want to take security interests in these rights and payments. Because such programs are often short-lived and differ widely from one another, detailed discussion of individual programs is beyond the scope of this chapter.

To the extent that a lender's potential rights are not determined by federal law that preempts Division 9, state law applies. Com C §9109(c). Therefore, creditors and their attorneys should take into consideration and comply with both the federal statutes and regulations governing security interests under a particular program and the requirements of the Commercial Code. Counsel also should be aware of cases holding that U.S. Department of Agriculture regulations preclude creating security interests in commodities certificates (7 CFR §1401.4(b) (former 7 CFR §770.4(b)); *Adams Bank & Trust v McQuillan (In re Curry)* (D Neb 1990) 113 BR 546; *In re Lehl* (D Neb 1987) 79 BR 880), although there is contrary authority that the regulations do not preempt state commercial laws (see *Mercantile Bank v Norville (In re Norville)* (Bankr CD Ill 2000) 248 BR 127; *In re Selzer* (D Kan 1991) 135 BR 417; *In re George* (D Kan 1990) 119 BR 800; *In re Ferguson* (Bankr ND Tex 1990) 112 BR 820).

PRACTICE TIP: Reported cases dealing with security interests and the various government payment or diversion programs reach contrary conclusions as to the classification of the collateral. Practitioners should use descriptions covering all of the broad categories under the Commercial Code when documenting loans involving any such government programs.

Although government payments generally may be encumbered, some courts have held that neither diversion nor deficiency payments fall within the Commercial Code definition of "proceeds" and therefore are not proceeds of crops. See *Bank of N. Arkansas v Owens* (8th Cir 1989) 884 F2d 330; *In re Kingsley* (8th Cir 1989) 865 F2d 975. Rather, the rights to such payments are usually characterized as accounts or general intangibles. See *In re Schmaling* (7th Cir 1986) 783 F2d 680; *In re Sunberg* (8th Cir 1984) 729 F2d 561. However, in *Rainier Nat'l Bank v Bachmann* (Wash 1988) 757 P2d 979, the court held that a security interest in accounts, livestock, and proceeds included Dairy Termination Program payments. Another court concluded that payment-in-kind (PIK) payments are proceeds of a farmer's crop. *Farmers & Merchants Nat'l Bank v Sooner Coop., Inc.* (Okla 1988) 766 P2d 325, 7 UCC Rep Serv 2d 321. Raisin industry diversion payments also have been held to be proceeds of crops. *Dettman v Fresno-Madera Prod. Credit Ass'n (In re Dettman)* (BAP 9th Cir 1988) 84 BR 662. Note that the definition of "proceeds" under Division 9 is broader than under former Division 9 and the result in some cases may be different. See §1.12.

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III. NON-CODE RESTRICTIONS AND LIENS

§8.29 A. Marketing Order Restrictions

The marketing of agricultural products is regulated by both federal and state governments. When these products are the subject of secured transactions, all parties must comply with applicable regulations and marketing orders. If the collateral cannot be lawfully marketed, it is of little value for security purposes.

Federal laws affecting agricultural marketing include the Agricultural Marketing Agreement Act of 1937 (7 USC §§601-674), the Packers and Stockyards Act (7 USC §§181-229c), the Perishable Agricultural Commodities Act of 1930 (PACA) (7 USC §§499a-499s), and the Agricultural Adjustment Act of 1938 (7 USC §§1281-1393). California laws include the Marketing Act of 1937 (Food & A C §§58601-59293), the Milk Stabilization and Marketing Act (Food & A C §§61801-62403), and the Fruits, Nuts, and Vegetables Standardization Laws (Food & A C §§42501-48003).

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B. Statutory Liens

§8.30 1. Producer's Lien

The producer's lien is established by Food & A C §§55631-55653. The producer has a lien for the labor, care, and expense of growing and harvesting farm products sold to a processor, to the extent of the agreed price of the product or the value of the product as of the date of delivery if there is no agreed price. Food & A C §55631. Section 55631 provides that

> [e]very producer of any farm product that sells any product which is grown by him to any processor under contract… has a lien upon such product and upon all processed or manufactured forms of such farm product.

Food and Agricultural Code §55634 further provides that producer's liens cover "every farm product and any processed form of the farm product which is in the possession of the processor without segregation of the product."

A nonprofit cooperative association acting as a producer bargaining association may assert producer's lien rights for or on behalf of its members. Food & A C §55631.5.

The lien has priority over all other claims and liens, except for labor claims and warehouseman's liens. Food & A C §55633. Accordingly, the lien is prior to liens created by contract (*e.g.,* security interests) and by legal action (*e.g.,* levy of execution). All producers' claims are of equal standing, and payment is to be prorated, if necessary, among the claimants. Food & A C §55645. Special liens apply to suppliers of feed, seed, chemicals, and certain other materials used in production of farm products. See §§8.31-8.32.

NOTE: As a prior statutory lien, the producer's lien is not subject to avoidance in bankruptcy. *Saslow v Andrew (In re Loretto Winery, Ltd.)* (9th Cir 1990) 898 F2d 715; *S.N.A. Nut Co. v Tulare Nut Co. (In re S.N.A. Nut Co.)* (Bankr ND Ill 1996) 197 BR 642.

Food and Agricultural Code §55634 specifically limits the lien to farm products in the processor's possession (Food & A C §55634); the lien would therefore not be enforceable against a purchaser or other person who takes possession of the goods. But see *Frazier Nuts, Inc. v American Ag Credit* (2006) 141 CA4th 1263, 46 CR3d 869, discussed below. In *Richardson v Wells Fargo Bank (In re Churchill Nut Co.)* (Bankr ND Cal 2000) 251 BR 143, the court determined that a sheriff's lien did not necessarily interrupt possession when the sheriff was unable to hold an auction and the property was turned over to the bankruptcy estate. The duration of the lien is indefinite (Food & A C §55635), and the statute does not specify whether it extends to proceeds of the product (*e.g.,* cash or accounts receivable). In *In re California Pac. Rice Mill, Ltd.* (Bankr ED Cal 2001) 265 BR 237, the court interpreted Food & A C §§55631 and 55634 to provide that the producer's lien is limited to the product delivered by the producer and other similar products in the processor's possession if the product has been commingled.

California state courts and federal bankruptcy courts differ as to whether the lien attaches to proceeds from the sale of the processor's inventory. In *U.S. Bank v Deseret Farms, Inc. (In re Sargent Walnut Ranches, Inc.)* (Bankr ED Cal 1998) 219 BR 880, the court held that the producer's lien does not attach to the proceeds from the sale of the processor's inventory. The *Sargent* processor had sold all of its inventory. Although the grower had initiated the requisite action to foreclose on its producer's lien, it had not taken steps to prevent the sale of inventory. The producer's lien attaches to the inventory in the possession of the processor. Once the inventory is out of the processor's possession, there is no inventory to which the lien may attach. The court noted that Food & A C §§55631 and 55634 do not state or suggest that the lien would attach to the proceeds from the sale; therefore, it could not rule that the lien did attach. The court suggested that the appropriate course of action would have been for the grower to enjoin the sale of the inventory or to take similar legal action to prevent the inventory from leaving the processor's possession.

In *Frazier Nuts, Inc. v American Ag Credit* (2006) 141 CA4th 1263, 46 CR3d 869, the state court of appeal reached a different conclusion. Unlike the bankruptcy court in *Sargent,* the state court was free to interpret Food & A C §55638 without following Ninth Circuit precedent. 141 CA4th at 1274 n12. The court found that a producer's right to be paid

from the proceeds of the sale of farm products constitutes a lien on the proceeds. Food & A C §55638. The legislature clearly intended the proceeds from the sale of raw or processed farm products to be used to "satisfy obligations to producers," the *Frazier* court held, and a producer's lien, with only a few exceptions, is "a preferred lien prior in dignity to all other liens, claims, or encumbrances" under Food & A C §55633. 141 CA4th at 1277.

The *Frazier* holding appears to contradict the language in Food & A C §55634 that provides that the lien is limited to products in the processor's possession. It will be interesting to see how other courts interpret the statute, *Sargent,* and *Frazier*.

PRACTICE TIP: Lenders who lend against a processor's inventory of farm products should obtain a waiver or subordination of the lien from the producers or insist that their borrowers obtain a waiver or subordination in order to avoid potential problems with a producer's lien.

The only absolute protection against the lien is to ensure that all producers providing farm products to a processor have been fully paid. However, a waiver will be enforced if adequate information is provided to the producer. See *Silva v Wells Fargo Bank (In re GVF Cannery, Inc.)* (ND Cal 1996) 202 BR 140.

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§8.31 a. Poultry and Fish Supply Lien

The Poultry and Fish Supply Lien Act (Food & A C §§57501-57545) creates a statutory lien right for a person who provides feed or materials to aid the raising or maintaining of poultry or fish or for the production of eggs. The lien attaches to the proceeds of the sale of the eggs, poultry, fish, or other products derived from eggs, poultry, or fish. The lien is limited to the reasonable or agreed-on charges for feed or materials provided within a 45-day period. Food & A C §57510. The lien is perfected when a notice of claim is filed with the Secretary of State, and the priority of the lien is in accordance with the time the notice of claim of lien is filed and has the same priority as a security interest perfected by the filing of a financing statement as of the date the notice of claim of lien was filed. Food & A C §§57512, 57525.

No more than two liens are enforceable against any one lien debtor even if filed by different lien claimants. Food & A C §57700. The lien claimant must provide written notice to all senior secured parties that have a perfected security interest 30 days before enforcing the lien, and the lien claimant may foreclose on the lien only in an action to recover the reasonable or agreed-on charges for feed and materials provided. Food & A C §§57535-57536.

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§8.32 b. Agricultural Chemical and Seed Lien

The Agricultural Chemical and Seed Lien Act (Food & A C §§57551-57595) creates a statutory lien right for a person who provides agricultural chemicals or agricultural seed to aid in the production of a crop.

Before being entitled to the lien, the person who provides the agricultural chemicals or agricultural seed is required to send to the lien debtor, by certified mail, written notice. The notice must state in part that the payment of the reasonable or agreed-on charges is more than 30 days overdue and the amount of the charges that are overdue, and must give the lien debtor three alternatives (Food & A C §57561(a)):

- Allow the lien to be filed;
- Enter into a consensual security interest in the proceeds of the crop under the Commercial Code; or
- Pay the reasonable or agreed-on charges that are overdue.

One of the alternatives must be selected within 10 days of the receipt of the notice. If the person who provides the chemicals or seed has complied with the statute's notice requirements, and the lien debtor has not selected one of the alternatives, the provider is granted a lien on the proceeds of (1) the crops that existed at the time of the application on the land where the agricultural chemical is applied; (2) if the crops are not planted, the next production crop on that land following the last date on which the agricultural chemical was applied; or (3) the crops produced from the agricultural seed. Food & A C §57561(c).

The amount of the charges secured by the lien may not exceed an amount equal to the charges for chemicals furnished within a 60-day period or for agricultural seeds furnished within a 45-day period. Food & A C §57561(d).

The lien is perfected when a notice of claim is filed with the Secretary of State, and has the same priority as a security interest perfected by the filing of a financing statement as of the date the notice of claim of lien was filed. Food & A C §§57563, 57575. No more than two liens are enforceable against any one lien debtor even if filed by different lien claimants. Food & A C §57700. The lien claimant must provide written notice to secured parties at least 30 days before enforcement of the claim of lien, and the lien claimant may foreclose on the lien only in an action to recover the reasonable or agreed-on charges. Food & A C §§57585-57586.

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§8.33 2. Possessory Lien

Civil Code §3051 is a catchall possessory lien provision that essentially codifies the common law agister's lien. It lists many situations in which those who perform services on personal property may acquire liens, dependent on possession, to the extent of the value of the services performed. It includes a provision that veterinary proprietors and veterinary surgeons have a lien (dependent on possession) for their compensation for the care, boarding, feeding, and medical treatment of animals.

When a statute or rule of law gives a person such a lien on goods in his or her possession for services or materials furnished in the ordinary course of business, that lien takes priority over a perfected security interest in the goods, unless the lien is statutory and the statute expressly provides otherwise. Com C §9333.

NOTE: If the work is performed at the request of a person who does not hold legal title to the goods, the CC §3051 lien is limited to $300 unless actual notice is given to the holder of the legal title. CC §3051a.

Another limitation on this lien is that it does not apply to outstanding bills or to services rendered for goods that are no longer voluntarily in the possession of the lien claimant, unless a statute providing otherwise is in effect. CC §3051; *Belknap v Mitchell* (1933) 217 C 377, 380, 18 P2d 929; *Quist v Sandman* (1908) 154 C 748, 756, 99 P 204.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/8 Agricultural Financing/§8.34 3. Livestock Service Lien

§8.34 3. Livestock Service Lien

A livestock service lien secures payment for the grazing, feeding, and boarding of livestock, and other general care services provided to livestock. CC §§3080-3080.22. The lien extends to livestock in the possession of a livestock servicer as defined in CC §3080(b). The lien is a limited general lien in that it secures payment for services to livestock in the servicer's possession as well as payment for certain livestock services provided in connection with or as part of the same livestock service transaction. The lien takes priority over all other liens on, and security interests in, the livestock and arises as the charges for livestock services become due. CC §3080.01(b).

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§8.35 4. Harvester's Lien

An agricultural laborer's lien (called a harvester's lien) is provided by CC §§3061.5-3061.6. This lien protects employees who perform any work harvesting or transporting harvested crops or farm products (defined in Food & A C §55403) that are owned and grown or produced by a limited partnership (defined in Corp C §15501). CC §3061.5(a). The lien takes priority over all other claims, liens, or encumbrances and attaches to the severed crops or farm products, or to the proceeds of sale, from the date that the labor commenced. CC §3061.5(b).

The lien is limited in amount to the lesser of the value of the labor up to a maximum of two weeks' earnings, or 25 percent of the fair market value of the severed crops or farm products or their proceeds. CC §3061.5(c).

The duration of the lien is limited to 45 days after cessation of the labor, unless the claimant files a claim with the Labor Commissioner or brings suit to foreclose the lien. The Labor Commissioner must act on and finally determine all claims within 180 days of filing. CC §3061.6(a). If the Labor Commissioner determines that a lien is necessary to protect the claimant's interest, the Labor Commissioner must "file such lien" on the severed crops or farm products or proceeds and notify the owner and all persons who have filed financing statements covering the crops, farm products, or proceeds. CC §3061.6(b).

PRACTICE TIP: Although the statute does not state where the Labor Commissioner must "file such lien," the requirement of notice to competing claimants would indicate that the notice of lien should be filed where a financing statement would be properly filed to perfect an interest in crops or farm products under the Commercial Code. See §3.78.

The owner of the crops or farm products can avoid attachment of the lien by giving (or having the labor supplier give) the Labor Commissioner, before the harvest and for 45 days after harvest is completed, a bond covering payment of wages. CC §3061.5(d). A buyer in the ordinary course of business (defined in Com C §1201(b)(9)) takes free of the lien even though the lien is perfected and the buyer is aware of its existence. CC §3061.5(e). (On buyers in the ordinary course of business under the Commercial Code, see §§4.64-4.67.)

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§8.36 5. Thresher Worker's Lien

Civil Code §3061 gives a lien to laborers performing threshing services. The lien is against the threshing or crushing machine itself and extends for 10 days after the work is performed. Within that time, the lien claimant may bring an action to recover the amount of the claim. If several such judgments are obtained against the same machine, the proceeds are divided pro rata. CC §3061.

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6. Breeder's Lien

§8.37 a. Attachment and Perfection of Breeder's Lien

Civil Code §3062 gives a lien to those providing stallions, jacks, or bulls for breeding purposes. The lien attaches to the mare or cow and the resulting offspring.

A verified claim of lien must be recorded in the county where the mare or cow is kept within 90 days after the service is performed. CC §3063. The recorded claim is notice to subsequent purchasers or encumbrancers for one year after recording. CC §3063. A form of verified claim of lien is provided in §8.38.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/8 Agricultural Financing/§8.38 b. Form: Verified Claim for Propagating Service

§8.38 b. Form: Verified Claim for Propagating Service

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CLAIM OF LIEN

NOTICE IS GIVEN that I, _ _[*name*]_ _, am and was at all times mentioned in this claim the _ _[*owner/person in charge*]_ _ of a certain _ _[*stallion/jack/bull*]_ _, named, used for propagating purposes; that, on or about _ _[*date*]_ _, _ _[*name of owner or reputed owner*]_ _, the owner or reputed owner of a _ _[*mare/cow*]_ _, located in _ _ _ _ _ _ County, California, and described as follows: _ _[*insert description*]_ _, agreed to pay me for the propagating service of _ _[*name of stallion, jack, or bull*]_ _, the amount of _ _[*dollar amount*]_ _; that the service was performed at _ _[*location*]_ _, on or about _ _[*date*]_ _; that payment for this service has not been made; and that I claim a lien in the amount of _ _[*dollar amount*]_ _ on the _ _[*mare/cow*]_ _ for this service and on the offspring of this service.

Executed on _ _[*date*]_ _, at _ _ _ _ _ _, California.

I declare under penalty of perjury that the foregoing is true and correct.

__[*Signature of declarant*]__

Comment: This form is for a verified claim that must be recorded under CC §3063 within 90 days after the propagating service. See §8.37.

If the claim will be signed outside of California, the last sentence of the form should read "I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct," and the line showing the place of execution should be amended accordingly. See CCP §2015.5.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/8 Agricultural Financing/§8.39 C. State Department of Agriculture Liens

§8.39 C. State Department of Agriculture Liens

Many sections of the California Food and Agricultural Code are designed to control or eradicate diseases and pests that affect plants and domestic animals. See Food & A C §§9101-11305. An owner of infected livestock, for example, may be notified that animals are under a quarantine, that certain tests or treatment must be given to them, and (if the disease is too far advanced) that all or some of the infected animals must be destroyed. If the owner fails to take the required action within the period mentioned in the notice, the county commissioner of agriculture, acting through subordinates, usually takes whatever reasonable action is necessary to abate the nuisance. See Food & A C §§10384, 10385, 10492. The cost of labor and materials used for this purpose becomes a lien against the animals, which arises when the work is completed. Food & A C §10385. The lien is enforced in the manner prescribed in CC §3052.

NOTE: In *Adams v DMV* (1974) 11 C3d 146, 113 CR 145, the court declared a lien enforcement procedure similar to that contemplated by Food & A C §10385, which incorporates CC §3052, to be an unconstitutional violation of due process.

The owner's failure to take the directed action within the notice period is often a misdemeanor. See Food & A C §10384. Although the police power of the state permits it to destroy plants or livestock to prevent the spread of pests or disease (see *Patrick v Riley* (1930) 209 C 350, 287 P 455), California law in some circumstances allows for compensation for such losses. See Food & A C §§10067-10068.

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§8.40 D. Liens After Farmer Sells or Delivers Livestock

The federal Packers and Stockyards Act (7 USC §§181-229c) requires prompt payment (7 USC §228b) and imposes a "trust" on all livestock purchased by certain packers in cash sales, and all inventories, receivables, or proceeds from meat, meat food products, or livestock products derived from them, for the benefit of all unpaid cash sellers of livestock until full payment has been received. 7 USC §196.

A person who sells or delivers livestock to a meat packer also has a California lien on the livestock to secure payment of the purchase price, or the unpaid value of the livestock if no purchase price has been agreed on. Food & A C §§55701-55704.

The lien takes priority over all other liens or security interests in the livestock, commences on the date that the meat packer takes possession of the livestock, and extends to the livestock and to identifiable proceeds and products. Food & A C §55702(a). The lien protects only cash sellers (Food & A C §55702(d)) who must file a notice of lien with the Secretary of State within 21 days after the commencement of the lien to continue the lien in effect. Food & A C §55702(c). A buyer in the ordinary course of business, as defined in Com C §1201(9), takes free of the lien even though the buyer knows of the lien's existence. Food & A C §55702(b). (On buyers in the ordinary course of business under the Commercial Code, see §§4.64-4.67.)

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§8.41 E. PACA Trust Fund Rights

Under the Perishable Agricultural Commodities Act of 1930 (PACA) (7 USC §§499a-499s), the buyer of perishable agricultural commodities holds the produce and any related inventory and accounts receivable in trust for the benefit of all of the buyer's unpaid sellers, suppliers, and agents involved in the transaction. 7 USC §499e(c)(2); *Middle Mountain Land & Produce, Inc. v J.R. Simplot Co.* (9th Cir 2002) 307 F3d 1220 (recovery may include contractually due attorney fees and interest); *Cavendish Farms v Fleming Cos. (In re Fleming Cos.)* (D Del 2004) 316 BR 809; *JC Produce, Inc. v Paragon Steakhouse Restaurants, Inc.* (ED Cal 1999) 70 F Supp 2d 1119. The agricultural products must be perishable. Canned goods are not perishable goods under PACA. *Cavendish Farms v Fleming Cos. (In re Fleming Cos.)* (D Del 2004) 316 BR 809. In addition, attorney fees are included in amounts owing under PACA. *Cavendish Farms v. Fleming Cos. (In re Fleming Cos.)*, *supra*. Unpaid sellers, suppliers, and agents must provide notice of intent to preserve the benefit of the trust. See §8.42. The trust is imposed on all perishable commodities received by the merchant, dealer, or broker, all inventories of food or other products derived from such commodities, and any receivables or proceeds from the sale of such commodities or products. 7 USC §499e(c)(2). There is a presumption that all property of the buyer is subject to the trust. See §8.43. Freight charges by the railroad providing transportation services, however, are not included in the types of charges protected by PACA. *"R" Best Produce, Inc. v Shulman Robin Mkt. Corp.* (2nd Cir 2006) 467 F3d 238; *Pacific Int'l Mktg., Inc. v A & B Produce, Inc.* (3rd Cir 2006) 462 F3d 279.

The term "dealer" in 7 USC §499a(b)(6) is meant to be interpreted broadly. Excluded from the definition, however, are:

- Producers selling what they raised;
- Persons who buy solely for sale at retail, but only if the invoice costs of perishable goods purchased do not exceed $230,000 in a calendar year; and
- Certain canners or processors who buy and can or process within the same state as the produce is grown.

See *Royal Foods Co. v RJR Holdings Inc.* (9th Cir 2001) 252 F3d 1102, 1107 (restaurant is "dealer" subject to PACA); *Sysco Food Servs., Inc. v Country Harvest Buffet Restaurants, Inc. (In re Country Harvest Buffet Restaurants, Inc.)* (BAP 9th Cir 2000) 245 BR 650 (holding that restaurant was "dealer," subject to trust provisions of statute).

PRACTICE TIP: Not only must secured creditors anticipate disputes with PACA claimants regarding the priority of their competing claims against insolvent produce purchasers, but secured creditors also run the risk of having to disgorge payments received from debtors on preexisting loans. Careful monitoring of the loan transaction and purpose is a creditor's best protection.

Numerous cases have arisen in which a lender has been compelled to refund money received "out of trust." See §8.44. In some cases, personal liability has been imposed for claims against corporate purchasers. See §8.45.

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§8.42 1. Notice of Trust

Unpaid suppliers, sellers, or agents must give and file a written notice of intent to preserve the benefits of the trust within 30 days after default; if they do not do so, they lose those benefits. 7 USC §499e(c)(3).

Alternatively, suppliers, sellers, or agents may provide buyers with notice of their intent to preserve PACA trust rights by including the statutorily prescribed language on the face of their invoices. 7 USC §499e(c)(4). See *Idahoan Fresh v Advantage Produce, Inc.* (3d Cir 1998) 157 F3d 197; *G & G Sales Corp. v Kelly Food Prods., Inc. (In re Kelly Food Prods., Inc.)* (Bankr CD Ill 1997) 204 BR 18. Notice on the back of an invoice was not sufficient to preserve PACA trust rights in *Hintz & Reiman, Inc. v J&J Produce* (SD NY, Mar. 21, 2006, No. 05 Civ. 5739 LTS/KNF) 2006 WL 709106.

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§8.43 2. Presumption of Trust

There is a presumption that a PACA trust exists over everything an agricultural commodity purchaser owns during the life of its business, and the burden is on the party other than the trust beneficiary to establish which, if any, of its assets are acquired with funds other than proceeds derived from produce sales. *J.A. Besteman Co. v Carter's, Inc.* (WD Mich 2006) 439 F Supp 2d 774 (PACA trust extended to all real and personal property of debtor); *In re Atlantic Tropical Mkt. Corp.* (Bankr SD Fla 1990) 118 BR 139.

In *Tom Lange Co. v Kornblum & Co. (In re Kornblum & Co.)* (2d Cir 1996) 81 F3d 280, the court articulated a standard to determine whether assets of a merchant, lender, or broker, other than perishable agricultural commodities and their proceeds, are subject to the PACA trust. To prove that such assets were not acquired with the proceeds of trust assets, the other party must prove the existence of one of the following conditions:

- That no PACA trust existed (*i.e.*, there were no unpaid produce suppliers) at the time the purchaser acquired the asset;
- Even though a PACA trust existed at the time of acquisition, the asset was acquired with funds that were not trust assets; or
- Even though the PACA trust existed at the time of the acquisition and the asset was acquired with PACA trust funds, the purchaser had since paid all unpaid produce sellers, thereby terminating the PACA trust.

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§8.44 3. Disgorgement of Money Received Out of Trust

Secured lenders routinely are required to disgorge proceeds of produce to PACA trust beneficiaries when the lender obtained those proceeds by enforcing its security agreement or through a "forced transfer" of assets. See *Gargiulo v G.M. Sales, Inc.* (11th Cir 1997) 131 F3d 995; *Endico Potatoes, Inc. v CIT Group/Factoring, Inc*. (2d Cir 1995) 67 F3d 1063.

When the secured lender has received proceeds in the ordinary course of business, such as the receipt of regular interest or loan repayments from a borrower, courts have been more reluctant to require disgorgement if the lender can successfully argue that it was a bona fide purchaser for value, receiving those payments without notice of the borrower's breach of the PACA trust. See *Consumers Produce Co. v Volante Wholesale Produce, Inc.* (3d Cir 1994) 16 F3d 1374; *C.H. Robinson Co. v Trust Co. Bank* (11th Cir 1992) 952 F2d 1311; *Battle v Fresh Preps Distribution, Inc*. (ED Mich 1995) 873 F Supp 1062; *Merrill Farms Corp. v H. R. Hindle & Co. (In re H. R. Hindle & Co.)* (Bankr ED Pa 1993) 149 BR 775. See also *Albee Tomato, Inc. v A.B. Shalom Produce Corp.* (2d Cir 1998) 155 F3d 612. A trustee's deposit of funds into a checking account does not constitute a breach of a PACA trust if the funds remain unencumbered and freely available to PACA creditors. *E. Armata, Inc. v Korea Commercial Bank* (2d Cir, Mar. 4, 2004) 2004 US App Lexis 9637. Further, a PACA trustee's payment of "commercially reasonable" interest and fees to maintain trust assets as "freely available" to pay PACA creditors does not constitute a breach of trust under PACA. *E. Armata, Inc. v Korea Commercial Bank, supra*; *D.M. Rothman & Co. v Korea Commercial Bank* (2d Cir 2005) 411 F3d 90.

The Ninth Circuit has held that a "commercially reasonable sale of accounts for fair value" is consistent with a PACA trustee's duty. *Boulder Express Fruit & Heger Organic Farm Sales v Transportation Factoring, Inc.* (9th Cir 2001) 251 F3d 1268, 1271. However, the factoring agreement must represent a "true sale of accounts." In *Reaves Brokerage Co. v Sunbelt Fruit & Vegetable Co.* (5th Cir 2003) 336 F3d 410, 417, the Fifth Circuit determined that a factoring agreement was not a true sale of accounts but rather a secured lending arrangement and therefore did not qualify for the bona fide purchaser exception to the priority of the PACA trust. See also *Nickey Gregory, Co. v Agricap, LLC* (D SC 2008) 592 F Supp 2d 862. See §1.19 for discussion of distinguishing true sales from security transfers.

In *C.H. Robinson Co. v Trust Co. Bank* (11th Cir 1992) 952 F2d 1311, the court held that the defenses of bona fide purchaser and holder in due course were available to a bank that received proceeds from the sale of produce by a dealer. Under general trust principles, a bona fide purchaser receives trust property free of a trust even if the property was transferred in breach of trust. A bona fide purchaser is a person who takes for value and without notice of the breach of the trust. Money transferred in payment of a debt is for value. ("Notice" means "knows or should have known of the breach of trust.") The court held that the bank was a bona fide purchaser and was entitled to retain the payments.

In *Merrill Farms Corp. v H. R. Hindle & Co. (In re H. R. Hindle & Co.)* (Bankr ED Pa 1993) 149 BR 775, the court held that a lender that had effected a setoff before the produce dealer's bankruptcy must first prove that it neither knew nor had reason to know that the funds that it obtained were trust funds and that their seizure would be in violation of the PACA trust amendments. Also, the lender had the burden of proving that its seizure of the funds at issue were "for value."

The court may require disgorgement of payments received by secured lenders, however, when the lender should have known the payments consisted of PACA trust proceeds. See, *e.g., E. Armata, Inc. v Platinum Funding Corp.* (SD NY 1995) 887 F Supp 590; *Post & Taback, Inc. v Merrill Lynch Bus. Fin. Servs., Inc.* (SD NY 1994) 859 F Supp 757; *A & J Produce Corp. v CIT Group/Factoring, Inc*. (SD NY 1993) 829 F Supp 651; *Debruyn Produce Co. v Richmond Produce Co. (In re Richmond Produce Co.)* (Bankr ND Cal 1990) 112 BR 364. In *Richmond Produce*, a bank was required to refund money it received in connection with debtors' accounts receivable when the money received was trust money under PACA, the bank knew that the debtor was engaged in the sale of perishable agricultural commodities, and the money debtor was owed by the accounts receivable creditor resulted from the sale of such commodities.

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§8.45 4. Personal Liability for Breach of Trust

Individual shareholders, officers, or directors of a corporate debtor who are in a position to control PACA trust assets, and who breach their fiduciary duty by using trust assets for any purpose other than repaying produce suppliers, are personally liable under PACA for the corporate debt. *Sunkist Growers, Inc. v Fisher* (9th Cir 1997) 104 F3d 280; *Bronia, Inc. v Ho* (SD NY 1995) 873 F Supp 854; *Morris Okun, Inc. v Harry Zimmerman, Inc.* (SD NY 1993) 814 F Supp 346; *Mid-Valley Produce Corp. v 4-XXX Produce Corp*. (ED NY 1993) 819 F Supp 209. Personal liability arises from the trustee's breach of fiduciary duty in allowing the dissipation of trust assets, and the breach is considered a "defalcation." *Nuchief Sales, Inc. v Harper (In re Harper)* (Bankr ED Tenn 1993) 150 BR 416.

Some courts have expanded the purposes for which trust accounts may be used. See, *e.g., In re Bear Kodiak Produce, Inc.* (Bankr D Ariz 2002) 283 BR 577, 586 (payment of salaries and other ordinary business expenses). However, a trustee that allows trust assets to dissipate may be liable for breach of fiduciary duty, and the trustee's liability for breach is nondischargeable in bankruptcy. See *A.J. Rinella & Co. v Bartlett (In re Bartlett)* (Bankr WD Mass 2008) 397 BR 610; *Nuchief Sales, Inc. v Harper (In re Harper)* (Bankr ED Tenn 1993) 150 BR 416. But see *Cardile Bros. Mushroom Packaging, Inc. v McCue (In re McCue)* (Bankr MD Fla 2005) 324 BR 389 (no liability for defalcation while acting in fiduciary capacity because Perishable Agricultural Commodities Act of 1930 (PACA) trust res need not be segregated).

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§8.46 F. Plant Variety Protection Act and Federal Seed Act

The Plant Variety Protection Act (7 USC §§2321-2582) provides that it is an infringement of the rights of the owner of a protected variety of seed to perform certain acts without authority, including but not limited to selling or marketing the protected seed, transferring title or possession of it, importing or exporting it, or reproducing it. 7 USC §2541. A farmer who has obtained protected seed legally, however, is allowed to save seed produced from that seed for replanting on that farmer's farm. 7 USC §2543.

The Federal Seed Act (7 USC §§1551-1611) makes it illegal to sell seed protected by the Plant Variety Protection Act as undesignated seed in order to avoid paying royalties. 7 USC §1611.

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§8.47 G. Federal Farm Products Rule

The Food Security Act of 1985 (7 USC §1631) provides that, notwithstanding any other provision of federal, state, or local law, a buyer in the ordinary course of business who buys a farm product from a seller engaged in farming operations takes free of any security interest created by the seller, even if the security interest is perfected and the buyer knows that the security interest exists. 7 USC §1631(d).

These provisions also cover commission merchants and selling agents. 7 USC §1631(g). The debtor may be required to identify his or her buyers, commission merchants, and selling agents as part of the security agreement. 7 USC §1631(h).

Methods of protecting a security interest in farm products are discussed in §§8.48-8.50. The impact of the Food Security Act on California practice is discussed in §8.51.

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§8.48 1. Methods of Protecting Security Interest in Farm Products

The Food Security Act provides two methods for preventing farm products from being sold free and clear of a security interest. The first method is by direct notification. 7 USC §1631(e)(1). See §8.49.

The second method is by filing an effective financing statement or notice covering the farm products being sold if the state has established a central filing system. 7 USC §1631(e)(2)-(e)(3). See §8.50.

NOTE: California has not established a central filing system. As a result, the second method is not available in California.

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§8.49 a. Direct Notification Method

The direct notification method provides that a buyer of farm products will take subject to a security interest created by the seller if, during the year preceding the sale, the buyer receives proper written notice from a secured party or seller and fails to comply with payment instructions in the notice. 7 USC §1631(e)(1).

The notice must be an original or reproduced copy organized according to farm products that contains the following (7 USC §1631(e)(1)(A)(ii)):

- The name and address of the secured party;
- The name and address of the debtor;
- The Social Security number or tax identification number of the debtor; and
- A description of the farm products, including the amount of the farm products (when applicable), crop year, the name of each county or parish in which the farm products are produced or located.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/8 Agricultural Financing/§8.50 b. Central Filing System

§8.50 b. Central Filing System

In states that choose to implement a central filing system, a buyer of farm products takes subject to security interests if:

- The buyer has failed to register with the central filing system before purchase and the secured party has filed an effective financing statement or notice covering the farm products being sold (7 USC §1631(e)(2)); or
- The buyer has registered and receives written notice from the Secretary of State that the farm product being sold is subject to an effective financing statement or notice and does not secure a waiver or release of specified security interests by performing any payment obligation or otherwise (7 USC §1631(e)(3)).

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§8.51 2. Impact on California Practice

The Food Security Act does not have much impact on California practice. California law varies from the Uniform Commercial Code in that buyers of farm products in California always acquire the goods free and clear of security interests created by the seller. California law thus mirrors the result imposed by federal law in other states. See §8.47.

Typical practice in California is for the lender to obtain a direct assignment of the farmer's right to receive payment from the entity that purchases the farmer's crop. See §8.18. Assignments sometimes contain the type of information that would qualify the assignment as a direct notification under the Food Security Act (see §8.49), but the lack of such information is not usually significant. In most instances, the farmer holds a producer's lien against the purchaser and the farmer's lender has a security interest in the farmer's rights under the producer's lien law. Because the producer's lien has a higher priority than a Division 9 security interest, this assigned lien right is typically more valuable than being able to assert that the Division 9 security interest continues in the product that was sold. See §8.30.

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§8.52 H. Water Rights as Personal Property Collateral

An agricultural lender in California must consider whether rights to transfer water or contracts not to use water under the Reclamation Projects Authorization and Adjustment Act of 1992 (Pub L 102-575, §3405, 106 Stat 4600) and the Water Conservation Projects Act of 1985 (Wat C §§11950-11984) give rise to personal property interests that may be transferred free and clear of the secured party's liens unless properly perfected under the Uniform Commercial Code.

Although water rights are normally thought of as an interest in real property, the water itself and contracts to purchase or sell the water may instead be considered interests in personal property. For example, in *Mulberry-Fairplains Water Ass'n v Town of North Wilkesboro* (NC App 1992) 412 SE2d 910, the court held that a sale of water constituted a sale of goods under UCC Article 2. In so doing, the court had to decide that the water itself was personal property and thus covered by UCC Article 2.

Water held for sale is best characterized as inventory. An agreement not to use water (which would allow a water district to transfer the water to some other party) is similar to many of the property rights arising from the various government agricultural programs, such as payment-in-kind programs. The better-reasoned decisions have characterized these property rights as general intangibles. See §8.28.

PRACTICE TIP: No cases have been decided that provide any clear guidance on the classification of agreements not to use water. Until the courts have ruled, counsel should raise the issue and suggest that it be dealt with by the use of all-inclusive language in the security description or by describing the property rights in detail by reference to the types of agreements or arrangements sought to be covered.

In *Lake Region Credit Union v Crystal Pure Water, Inc.* (ND 1993) 502 NW2d 524, 21 UCC Rep Serv 2d 774, the court held that a state water permit was classified as a general intangible that could be subject to a valid security interest. The court noted that the provisions governing issuing, retaining, and transferring a state water permit are generally similar to those governing liquor licenses and other government-issued licenses and permits. Because there was no specific prohibition against the creation of a security interest in a water permit, the court concluded that a water permit is a general intangible under the North Dakota Commercial Code.

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9

Legal Opinions

Ellen A. Friedman
Hill Blackett, III ("Buzz")

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.1 I. INTRODUCTION

§9.1 I. INTRODUCTION

This chapter addresses legal opinion letters provided in connection with secured transactions. There are several types of opinions, the most common being an opinion delivered at the closing of a secured transaction. Closing opinions usually relate to the loan and the security interests granted in connection with the loan, and will be the main focus of this chapter. Reasoned opinions are also sometimes delivered in connection with secured transactions. They provide commentary or explanation regarding a question of law, such as whether a sale of accounts is a "true sale" or a secured transaction. (See §1.19 for a discussion of true sales.) Reasoned opinions are specific to the particular legal question being addressed, and the opinions furnished by different law firms often vary widely in content and organization. This chapter discusses reasoned opinions in secured transactions briefly (see §9.10), but does not address them in detail.

In general, the purpose of a legal opinion is to provide assurance, or "comfort," to the recipient that counsel for the opposing party (or sometimes the recipient's counsel) has taken the steps necessary to make the transaction valid and the agreements enforceable in accordance with the expectations of the parties. In particular, the issuance of a legal opinion by the opposing party's counsel provides comfort that the opposing party has the same view of the legal effect of the transaction and the relevant agreements as the party requesting the opinion. In that context, the legal opinion helps to "estop" the other party and its counsel from later attempting to disavow the transaction or dispute the rights of the party requesting the opinion.

In a typical closing, the borrower's counsel will provide the opinion based on the general or specific request of the secured creditor's counsel. When a formal legal opinion is requested, a new dynamic as well as a new party, the borrower's counsel, is added to the transaction. By providing an opinion to the secured creditor, the borrower's counsel has agreed that the secured creditor may rely on the statements in the opinion, and therefore, may be liable to the secured creditor with respect to the matters contained in the opinion. Because borrower's counsel has potential liability, legal opinions are normally crafted carefully, with numerous assumptions and exceptions that are often negotiated in detail. Custom and tradition also play a critical role in what legal opinions are given and what exceptions and assumptions are considered acceptable. Opinion practice is based on the "Golden Rule," that a lawyer requesting a legal opinion should not ask for an opinion that the requesting lawyer would be unwilling to provide. See §9.3. Because of all of these concerns, practitioners and their clients should understand that legal opinions can be difficult to negotiate and may cost a great deal of money. Before requesting a legal opinion, it is important to determine whether a legal opinion is necessary and worth the cost.

This chapter focuses on legal opinions relating to secured transactions under the California Commercial Code. Usually a legal opinion letter will contain several different opinions, including corporate transactional opinions such as the due organization of a party and its power and authority to enter into the transaction. For information regarding legal opinions on those topics, readers should consult:

- James F. Fotenos, "Legal Opinions," Drafting Business Contracts: Principles, Techniques, and Forms, chap 12 (Cal CEB 1994), updated October 2007 (the "Corporate Opinion Chapter");
- Corporations Committee, State Bar of California, Business Law Section, 2005 Report, Legal Opinions in Business Transactions (Excluding the Remedies Opinion) (May 2005, rev'd Sept. 2007) (Corporate Opinion Report), available from the Business Law Section on the State Bar's website at http://www.calbar.ca.gov; and
- State Bar of California, Business Law Section, Report on Third-Party Remedies Opinions (Sept. 2004, rev'd Sept. 2007) (Remedies Opinion Report), also available from the Business Law Section on the State Bar website at http://www.calbar.ca.gov.

Practitioners should also be aware that the UCC Committee of the Business Law Section of the California State Bar has also prepared a report regarding legal opinions in personal property secured transactions. This report is very useful in the discussion of all aspects of legal opinions relating to personal property collateral. See 2005 Report, Uniform Commercial Code Committee of the State Bar of California, Legal Opinions in Personal Property Secured Transactions

(June 2005) (UCC Opinion Report). In addition, for legal opinions relating to real property collateral, practitioners should review Legal Opinions in California Real Estate Transactions, contained in State Bar of California, Business Law Section, 2002 California Opinion Reports. Both reports are available online from the Business Law Section on the State Bar website at http://www.calbar.ca.gov. Finally, the Special Report of the TriBar Opinion Committee: UCC Security Interest Opinions-Revised Article 9, 58 Bus Law 1449 (2003) (TriBar Report-Security Interest Opinions) is an important resource on security interest opinions.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.2 II. PRELIMINARY CONSIDERATIONS

§9.2 II. PRELIMINARY CONSIDERATIONS

Before agreeing to render a legal opinion, the opinion giver and the recipient should consider several factors, including cost, timing customary practice, and the other matters discussed in §§9.3-9.14.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.3 A. Golden Rule

§9.3 A. Golden Rule

Lawyers should not routinely ask for a legal opinion from counsel to the other party in a transaction. Several issues must be considered in determining whether a legal opinion is appropriate and if so, what opinions should be delivered. As mentioned above, a lawyer requesting an opinion should first consider whether he or she (or their firm) would provide the opinion and should not request an opinion that the lawyer would not deliver. This is the "Golden Rule" of opinion practice. See Corporate Opinion Report, p 13; UCC Opinion Report, p 4. A corollary to this principle is that counsel should not request an opinion on a matter of substantial legal uncertainty.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.4 B. Cost

§9.4 B. Cost

A lawyer should consider the cost of the opinion as compared to the cost of the transaction. In small transactions, for example, furnishing an opinion is probably not cost-effective. The parties may rely instead on representations and warranties and indemnity clauses to provide assurance of regularity and to allocate risk. The nationwide uniformity of Revised Article 9 may further reduce the need for an opinion insofar as it has minimized legal uncertainties in multistate transactions. UCC insurance coverage for perfection and priority may also reduce the need for an opinion. See §§4.77-4.81 for a discussion of UCC insurance coverage.

PRACTICE TIP: Clients may assume incorrectly that a formal legal opinion is routine and easily given. Before agreeing to provide an opinion, the attorney should confirm that the client is aware of the potentially substantial legal fees involved in the research, preparation, and negotiation of the opinion.

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§9.5 C. Confidential Matters

Counsel should also consider whether providing the opinion would adversely affect the opinion giver's client and, if so, obtain the client's informed consent before rendering the opinion. For example, an opinion giver providing written confirmation concerning pending or threatened litigation may have to disclose claims that have not yet been publicly disclosed by the client. See Corporate Opinion Report, pp 11, 16.

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§9.6 D. Timing

If a legal opinion is appropriate, counsel should negotiate the form and substance of the requested opinion as early as possible in the transaction, preferably before the parties are committed to proceed with the transaction. A delay in resolving opinion matters may result in the issuance of an inappropriate opinion due to the superior bargaining power or coercion of one party or even a misunderstanding with the client. See Corporate Opinion Report, p 20.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.7 E. Customary Practice

§9.7 E. Customary Practice

The opinions in a third party opinion letter are expressions of professional judgment regarding the legal matters addressed, and not guaranties that a court will reach any particular decision. An opinion letter should be read in light of the customary practices of persons giving and receiving opinion letters. Customary practice is based on the practices of lawyers (and their clients) who are knowledgeable about legal opinions of the type being rendered and who regularly give and receive opinions. Customary practice may be varied by a specific understanding between the opinion giver and the party to whom the opinion letter is addressed. See Remedies Opinion Report, p 7 and App 8.

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§9.8 F. Reliance

The recipient of an opinion letter ordinarily may rely on the opinions expressed without taking any action to verify them. An opinion recipient has no right to rely on an opinion, however, if reliance is unreasonable under the circumstances or the opinion is known by the recipient to be false. See TriBar Report-Security Interest Opinions, p 1457 n 20. See also Ryan, Recipient Counsel Responsibilities and Concerns, 62 Bus Law 401 (2007).

It is often prudent for the opinion giver to limit the parties that may rely on the opinion by stating in the opinion that it is solely for the benefit of the addressee. The opinion giver should also limit the specific instances in which the opinion recipient may rely on the opinion. The opinion should therefore contain a statement that the recipient may rely on the opinion only in connection with the subject transaction. Typically, the opinion giver will also state that the opinion may not be provided to others without consent of the addressee. See sample opinion at §9.61. If a rating agency or another third party will need to review the opinion, the opinion recipient will need to negotiate this in advance. If the opinion giver agrees that the opinion may be provided to another entity, the opinion usually states to whom it may be provided.

NOTE: Legal opinions are not typically requested or given regarding title to assets, fraudulent transfers or other insolvency-related matters, the probable outcome of litigation, issues of significant legal uncertainty, or with respect to financial statements or economic valuations. See Corporate Opinion Report, pp 18 n 72, 93-94.

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§9.9 G. Liability for Opinion

Although a recipient of a legal opinion does not become a "client" of the opinion giver, the opinion giver undertakes a duty to the opinion recipient to use care in the preparation of the opinion. See Corporate Opinion Report, pp 7, 11. In addition, a recent decision held that an opinion giver suffered a "disabling conflict" in continuing to represent its client when the opinion recipient later sought indemnification from the opinion giver. *In re SonicBlue, Inc.* (Bankr ND Cal, March 26, 2007, No. 03-51775) 2007 Bankr Lexis 1057 (opinion giver firm disqualified as debtor's counsel in Chapter 11 case due to potential liability to bondholders based on enforceability opinion previously issued to trustee for bondholders and failure to disclose conflict on timely basis).

Reported decisions in cases brought by opinion recipients against opinion givers alleging a violation of due care, or negligence, in rendering a closing opinion are rare. See, *e.g., Reich Family L.P. v McDermott Will & Emery* (NY Sup Ct, Oct. 29, 2003, No. 101901-03) 230 NYLJ 20, discussed in Committee on Legal Opinions, ABA Section of Business Law, Annual Review of the Law on Legal Opinions, 60 Bus Law 1057, 1062 (2005) (Annual Review). More common are claims brought by an opinion recipient or a third party alleging that the opinion giver or counsel for a party to a transaction intentionally or negligently misrepresented material facts to the opinion recipient. See, *e.g., Vega v Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 17 CR 3d 26 (intentional misrepresentation); *Shafer v Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2003) 107 CA4th 54, 131 CR2d 777 (fraudulent misrepresentation); *Home Budget Loans, Inc. v Jacoby & Meyers Law Offices* (1989) 207 CA3d 1277, 255 CR 483 (intentional and negligent misrepresentation); *Roberts v Ball, Hunt, Hart, Brown & Baerwitz* (1976) 57 CA3d 104, 128 CR 901, discussed in Legal Opinions in Business Transactions n45 (negligent misrepresentation). See also the often-cited decision in *Dean Foods Co. v Pappathanasi* (Mass Super 2004) 18 Mass L Rptr 598, 2004 WL 3019442, discussed in Annual Review p 1061 (negligent misrepresentation in connection with a "no litigation" opinion).

Because the damages for rendering a negligent or misleading opinion can be substantial, it is prudent for the lawyer preparing a closing opinion to conduct the customary factual and legal due diligence necessary to enable the opinion giver to render the opinion called for by the pertinent agreement. Opinion preparers often prepare and maintain a documentary record of the investigations that they performed. To limit the opinion giver's exposure, opinion givers limit the persons who may rely on the opinion and the purpose for which it may be used. See sample opinion at §9.61.

It is generally understood that, regardless of compliance with other standards, and even if an opinion is technically correct, a lawyer should not render an opinion that the lawyer recognizes would be misleading to the opinion recipient. This principle is illustrated by the *Ball Hunt* decision, cited above. See Corporate Opinion Report, p 10.

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§9.10 H. Reasoned Opinions

A reasoned opinion is typically limited to one or two specific legal issues and summarizes the legal analysis supporting the opinion. It may be qualified or unqualified, but even if unqualified, the opinions cannot be separated from the discussion of the legal issues. A typical reasoned opinion relates to whether a transaction is a true sale or a loan. See §1.19 for a discussion of true sales. Practitioners providing a true sale opinion will analyze the entire transaction and provide a detailed legal analysis as to whether the various elements of the transaction appear to have characteristics that are generally attributable to a sale or a loan. Lawyers often argue over whether a "reasoned opinion" should conclude with the words "a court would hold" or "a court should hold." Some believe that the use of the word "would" expresses a stronger opinion. However, both terms convey no more than the opinion giver's informed professional judgment concerning the legal issues addressed based on existing legal precedents. See Corporate Opinion Report, p 19.

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§9.11 I. Factual Basis of Opinion

Closing opinions are based in large measure on facts not known personally to the opinion preparers but represented to them by persons or entities they have identified as being reliable sources. Unlike auditors, the opinion preparers have no obligation to conduct an investigation for the purpose of independently verifying facts represented to them by what they believe to be a reliable source. A person or entity that maintains factual information as a business record or public record is a reliable source for that information.

Opinion preparers typically rely on one or more officers' certificates to establish facts necessary to render the opinion. In this regard, Corp C §314 serves as an important aid. It states that bylaws or minutes of meetings of the board of directors or any committee of the board or resolutions adopted by the board or any committee, or by the shareholders, certified by the secretary or an assistant secretary of the corporation, is "prima facie evidence of the adoption of such bylaws or resolution or of the due holding of such meeting and of the matters stated therein." For a detailed discussion of officers' certificates, see Corporate Opinion Report, p 28.

Opinion preparers do not establish all the facts required to support the opinions expressed in an opinion letter; opinions are based on factual assumptions. Opinion letters do not recite every factual assumption. Many assumptions are understood to be implicit and are often not stated expressly, such as assumptions that apply to virtually all opinion letters (*e.g.,* that conformed copies furnished to the opinion preparer are identical to the originals and that signatures on documents are genuine) and assumptions concerning the opinion recipient (*e.g.,* its existence, its power to enter into the transaction, and the execution of the agreement by a duly authorized officer of the recipient).

Opinion preparers are not entitled to rely on factual information or assumptions that they recognize to be untrue or to have been furnished under circumstances that have led them to conclude that reliance is unwarranted. They also are not entitled to rely on a factual representation that in essence constitutes a legal conclusion (*e.g.,* that the company is not "doing business" in a specified state). Opinion preparers may, however, rely on legal conclusions contained in a certificate of a state official or in an opinion letter of other counsel they believe to be competent with regard to the subject matter of that letter.

Practice varies on the specificity with which opinion givers identify the documents on which they have relied in performing their factual due diligence. Some preface their opinion letters with a detailed list of the documents and certificates examined, together with either a statement that they have examined such other documents and have made such further legal and factual investigation as they consider necessary for purposes of rendering the opinions expressed or, alternatively, specifically disclaim the making of any other examination or factual investigation. See sample opinion at §9.28. Others prefer to deliver opinion letters that merely set forth a general description of the factual inquiry that they have conducted. See Corporate Opinion Report, p 25. Opinion recipients are entitled to assume that the opinion giver has followed customary practice in determining the facts required to support the opinions expressed and in establishing those facts, unless the opinion giver expressly states limitations on the scope of its factual investigation. See sample opinion at §9.36.

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§9.12 J. Qualifications; Knowledge Limitations

Opinion givers use qualifications to limit an opinion's scope. Qualifications include assumptions and exceptions. Typical qualifications include a limitation on the law considered by the opinion giver, *e.g.,* limited to California and federal law), laws not considered (such as tax, securities, antitrust, and local law), and assumptions about the recipient, such as that a lender qualifies as an exempt lender under California's usury law. See Corporate Opinion Report, pp 33-34. See also sample opinion at §§9.29-9.35, 9.49-9.61.

Qualifications may be expressed by the opinion giver or implied by customary practice. For example, an opinion delivered by a California lawyer should not be read to cover the substance or effect of the law of any other jurisdiction unless specifically stated otherwise in the opinion. See Corporate Opinion Report, pp 86-87; §9.13.

Factual confirmations, such as an opinion giver's litigation confirmation or negative assurance on the contents of a securities prospectus, are often limited by reference to the opinion giver's knowledge. Some common alternatives are to state that the factual confirmation is based only on the opinion giver's "current knowledge," "actual knowledge," or "best knowledge." Some attorneys qualify opinions by introducing them with language such as "after a review of limited scope, we do not know of" or "after a review of limited scope, nothing came to our attention that would…." These phrases all have the same practical effect: The opinion preparers' knowledge is limited to the actual knowledge of those persons working on the transaction. It sometimes is defined also to include those persons having primary responsibility for the legal representation of the client. Opinion givers frequently define the scope of their knowledge qualifier in the opinion itself. For an example, see Corporate Opinions Report, p 35.

The relationship between the opinion giver and its client can be a factor with regard to the question of what level of knowledge should reasonably be expected of the opinion giver. If the opinion giver has represented the client for many years, then the firm (limited to those persons mentioned above) can reasonably be expected to have more knowledge of the client's affairs than a law firm employed for the specific transaction. If the firm has been employed for the specific transaction, the opinion letter should say so. It should be noted, however, that identifying the opinion giver as "special counsel" does not limit the opinion giver's responsibility for the opinions rendered by it, nor the scope of the factual or legal due diligence that it should conduct to render the opinion in accordance with customary practice. Any such limitation should be expressly stated. See sample opinion at §9.28.

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§9.13 K. Law Covered

Unless otherwise stated, an opinion letter rendered by a California lawyer is understood to cover only the law of California and federal law and no other law. The laws covered are limited to those that a lawyer in California exercising customary professional diligence would recognize as being applicable to the entity, the transaction, or both. See Corporate Opinion Report, pp 86-87. An opinion letter by customary practice is understood not to cover specialized areas of the law, such as securities, tax, and insolvency laws. See Corporate Opinion Report, p 56, n 168. An opinion giver can expand or limit the scope of customary usage by an express statement to that effect. Because of ambiguities (in particular, concerning the laws not addressed), opinion givers often specify the laws that their opinion does not address. See sample opinion at §9.59.

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§9.14 L. Date of Opinion

Closing opinions are typically dated and delivered at the closing of the transaction. The opinion giver has no duty to update the opinion for facts or law that change after the date of the opinion. See sample opinion at §9.60.

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§9.15 III. DUE DILIGENCE

In order to provide an opinion, the opinion giver must perform ample due diligence. Even if the opinion giver will rely on exceptions or assumptions, some preliminary investigation will be required. The level of due diligence may depend on whether the opinion giver is special counsel with respect to the subject transaction only (but see §9.12), or if the opinion giver is the borrower's general counsel. In any case, for a secured transaction, the opinion giver will need to review copies of the transaction documents and financing statements. To the extent that opinions are being given regarding corporate status such as due authorization and good standing, the opinion giver will be required to review articles of incorporation, good standing certificates, board minutes relating to the transaction, and other documents. It is beyond the scope of this chapter to outline the extent of due diligence that a practitioner should perform before rendering a legal opinion. For a discussion of how to prepare to give a legal opinion, practitioners should review the Corporate Opinion Report and the Remedies Opinion Report.

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§9.16 IV. SPECIFIC OPINIONS WITH RESPECT TO SECURED TRANSACTIONS

The rest of this chapter reviews specific types of legal opinions relating to secured transactions. It discusses the difference between a remedies and security interest opinion (see §9.17), the scope and elements of a security interest opinion (see §9.18), opinions relating to attachment and specific methods of perfection (see §§9.19-9.24), priority opinions (see §9.25), and a remedies opinion in connection with secured transactions (see §9.26). A model opinion is included at §§9.27-9.61.

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§9.17 A. Security Interest and Remedies Opinions

Closing opinions in secured transactions typically contain two related but distinct opinions—the security interest opinion and the remedies opinion. The security interest opinion confirms that the security interest in the collateral is enforceable under the California Commercial Code with respect to the debtor and third parties. This opinion covers creation of the security interest, including attachment and perfection. See chap 3 for a discussion of attachment and perfection. The remedies opinion confirms that the security agreement is enforceable against the debtor. See UCC Opinion Report, pp 5-7; Remedies Opinion Report, p 3. Normally, secured lenders require both opinions because they want to confirm that they have an enforceable, perfected security interest and that their other rights and remedies under the security agreement are enforceable.

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§9.18 B. Scope and Elements of Security Interest Opinion

It is generally understood that a security interest opinion does not include:

- a remedies opinion;
- a choice of law opinion;
- an opinion that no default or breach is caused by the grant of the security interest;
- an opinion that the security interest will not terminate; or
- an opinion regarding the effect of equitable principles.

Accordingly, a separate disclaimer is not required to confirm that these matters are not covered by the security interest opinion. See UCC Opinion Report, pp 8-9. Although these opinions are not included in the security interest opinion, the opinion recipient may request that the closing opinion cover some of these issues, but only to the extent that it is customary to provide the type of opinion being requested. For instance, a remedies opinion is customarily provided, but an opinion regarding the effect of equitable principles is not. See §9.26 and the sample opinion at §§9.40, 9.41, and 9.49.

The security interest opinion combines an attachment opinion (*i.e.,* that the security interest is enforceable against the debtor) and a perfection opinion (*i.e.,* that the security interest is enforceable against third parties), and almost always includes a scope limitation. See UCC Opinion Report, pp 5-10. The scope limitation typically limits the security interest opinion to personal property that is subject to Division 9. See chap 1 for a discussion of what property is subject to Division 9. For example, because rights of tenants under real property leases are considered to be real property and therefore are not covered by Division 9, they would be excluded from the attachment and perfection opinions. The scope limitation provides that the security interest opinion:

- does not cover any collateral other than that subject to Division 9;
- only covers the laws of California; and
- only covers Division 9 of the Commercial Code.

See UCC Opinion Report, p 10. See sample opinion §§9.51 and 9.59.

If the opinion recipient wishes to obtain an opinion regarding collateral that is not covered by Division 9, that opinion should be requested early in the opinion process to enable the opinion giver to determine if he or she is willing to provide the opinion. If there is collateral not covered by Division 9 that will be included in the opinion, the security interest opinion will still have a general scope limitation and the additional collateral will be addressed in a separate opinion paragraph tailored to that type of collateral.

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§9.19 C. Attachment Portion of Security Interest Opinion

As discussed in Chapter 3, "attachment" refers to the creation of a security interest enforceable between the parties to an agreement. Attachment does not create rights against competing third parties, such as other secured parties with perfected security interests in the same collateral or a trustee in bankruptcy. Under Com C §9203(b)(3), a security interest attaches to personal property on the satisfaction of three preconditions:

- Either the debtor has authenticated a security agreement describing the collateral or the collateral is in the secured party's possession under an agreement (Com C §§9203(b)(3)(A)-(B));
- Value has been given (Com C §9203(b)(1)); and
- The debtor has rights in the collateral (Com C §9203(b)(2)).

The requirements for attachment are discussed in §§3.2-3.5. The attachment portion of the security interest opinion normally covers whether the first two factors required for attachment have occurred and does not cover the third factor, whether the debtor has rights in the collateral. See UCC Opinion Report, pp 11-20 for a discussion of attachment opinions in general. For the vast majority of transactions, the attachment opinion covers whether there is a security agreement and whether that security agreement sufficiently describes the collateral as required under Com C §9108. See §2.7 for a discussion of the sufficiency of the collateral description.

Commercial Code §9203(a) provides that a security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral, unless an agreement expressly postpones the time of attachment. Com C §9203(a). Unless expressly excluded or assumed, an attachment opinion by its very nature provides that there is no agreement that expressly postpones the time of attachment. Due diligence and carefully crafted exclusions and assumptions are important in addressing whether there has been or could be any postponement.

If there is after-acquired property (See section §2.12 for a discussion of after-acquired property), the attachment opinion will cover the after-acquired property including proceeds, unless the opinion giver includes a specific exception with respect to such after-acquired property.

The TriBar Report-Security Interest Opinions contends that it is a straightforward undertaking on the part of the opinion giver to ascertain whether value has been given. The opinion giver should be able to determine whether the borrower has received funds or a binding commitment to provide funds in the future. See TriBar Report-Security Interest Opinions, §3.3(b), at 1467. If the opinion giver is not comfortable opining whether value has been given, the opinion giver should take an exception or include an appropriate assumption. The TriBar Report-Security Interest Opinions suggests, however, that the opinion giver should be able to determine that value has been given and that it should not be necessary (except under specified circumstances) to take an exception or make an assumption regarding value.

Concerning the issue of whether the debtor has rights in the collateral, the UCC Opinion Report provides that an attachment opinion is not generally understood to cover whether the debtor has rights in the collateral because it is difficult for the opinion giver to determine, as a matter of fact, whether the debtor actually does have rights in the collateral. The lender or opinion recipient will generally need to rely on representations of the debtor in that regard. Many opinion givers will either take an exception or make an assumption regarding whether the debtor has rights in the collateral. It should be noted that that the UCC Opinion Report provides that no such exception or assumption is necessary. See UCC Opinion Report, p 16.

For an example of an attachment assumption see sample opinion at §§9.32-9.34.

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§9.20 D. Perfection Portion of Security Interest Opinion

Perfection relates to a creditor's rights with respect to third parties. Perfection of a security interest in collateral is the means by which a creditor may gain superior rights over other creditors. The requirements for perfection are discussed in §3.6 and throughout Chapter 3. A perfection opinion provides comfort that a security interest is enforceable against third parties with respect to the collateral identified in the opinion. For a discussion of perfection opinions in general, see UCC Opinion Report, pp 21-53. Because of the different methods of perfection permitted under the California Commercial Code for certain types of collateral, the perfection opinion must often address perfection by filing, perfection by possession, perfection by control, and perfection by notification. See chap 3 regarding perfection.

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§9.21 E. Perfection by Filing

An opinion regarding perfection by filing covers whether:

- the collateral is of a type that may be perfected by filing (see §3.13 for an introduction to different types of perfection and chap 3 generally);
- whether the financing statement itself is sufficient because it provides the name of the debtor, the name of the secured party, and describes the collateral sufficiently (See §§3.86-3.95); and
- the filing office is the appropriate place to file the financing statement (See §3.78).

As noted in chap 3, the requirements concerning the correct name of a registered organization are very specific. The requirements for individuals, trusts, and partnerships are more complicated.

A perfection-by-filing opinion does not generally cover the following (unless the opinion giver specifically so provides):

- perfection by other methods;
- whether the collateral may be perfected by other methods;
- the priority of the security interest; and
- the correctness, completeness, or accuracy of all information contained on the financing statement.

See UCC Opinion Report, p 26. A prudent opinion giver will review the financing statement and provide any comments regarding any deficiencies that he or she sees in the financing statement, and may also choose to take an exception providing that the opinion does not cover the accuracy or sufficiency of particular information contained in the financing statement.

See the sample opinion at §9.42 for an example of a perfection by filing opinion as well as some pertinent exceptions and assumptions.

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§9.22 F. Perfection by Possession

An opinion regarding perfection by possession provides comfort that specific collateral that may be perfected by possession (see §3.13 and chap 3 generally) has been or will be perfected. In order to be able to provide this opinion, the opinion giver must either conduct a factual review of whether the lender or an independent third party is actually in possession of the collateral or make some assumptions. See the sample opinion at §9.31 for sample assumptions.

The law governing perfection by possession is the law of the state where the collateral is located. Com C §9301(2). Therefore, the perfection-by-possession opinion should include an assumption regarding the location of the collateral. If the collateral is not located in California and the opinion giver is opining only under California law, an additional exception is often necessary. The UCC Opinion Report, however, provides that no location qualification is necessary because the opinion "is commonly understood to be only under the law covered by the opinion letter generally." UCC Opinion Report, p 37.

Typically, opinion givers include in the opinion a reminder styled as a qualification that the secured party must maintain possession of the collateral to maintain perfection of its security interest. The UCC Opinion Report indicates that this reminder is not necessary because the opinion does not cover events that occur after the date of the opinion. See UCC Opinion Report, pp 21-53, 37.

Practitioners should also be aware that by providing an opinion regarding perfection by possession, the practitioner will be opining that the perfection requirements of these provisions have been met. For perfection of certificated securities by a bailee, however, there are certain differences based on whether the bailee is a securities intermediary. The opinion giver is not expected to make a determination concerning whether the bailee is a securities intermediary. Again the UCC Opinion Report provides that an exception, assumption, or qualification is not required; however, many practitioners will take an exception. UCC Opinion Report, p 37.

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§9.23 G. Perfection by Control

As described in §§3.42, 3.44-3.45 and 3.52-3.57, several types of collateral may be perfected by control. The most common types of collateral that may be perfected by control are deposit accounts, investment property, securities entitlements, and securities accounts. In each instance, if the secured party is the bank or securities intermediary holding the deposit account or the securities entitlement, the opinion will relate to whether or not the secured party is holding the collateral. However, if control is being achieved through an agreement (see §§3.45 and 3.57 for model deposit account control agreements and investment property control account agreements), the opinion giver must review the control agreement and determine that the critical language relating to the control by the secured party is included in the applicable agreement. It should be noted that unless included in a separate remedies opinion, a perfection-by-control opinion does not customarily include an opinion that the control account agreement is enforceable. UCC Opinion Report, p 41, n 227.

Practitioners may need to take particular exceptions or make assumptions regarding the question of whether a "deposit account" is actually a deposit account or some other type of collateral that may not be perfected by control, such as a certificate of deposit. See §1.11A for a discussion of the definition of deposit account.

See sample opinion at §9.47 for an opinion regarding perfection by control for deposit accounts and §9.46 for an opinion regarding perfection by control for securities entitlements.

It is also possible to perfect letter of credit rights by control. That opinion will relate to the assignment by the borrower to the secured party of the letter of credit rights and the consent by the issuer to the assignment. Again, this means that the opinion giver must review both the assignment documents and the consent. The opinion giver, however, generally does not opine on the validity of the letter of credit itself. UCC Opinion Report, p 52.

NOTE: Letter of credit rights that constitute supporting obligations attach automatically and are perfected when the collateral that is being supported, such as an account, is perfected. Com C §§9203(f), 9308(d). Therefore, these types of letter of credit rights are not included in perfection by control opinions.

See sample opinion at §9.48 for an example of a perfection by control opinion regarding letter of credit rights

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§9.24 H. Perfection by Notice

As described in §3.47, California contains a non-uniform provision for the perfection of insurance policies through notice to the insurer. Com C §§9312(b)(4). An opinion regarding perfection by notice, should not contain an opinion regarding the sufficiency of the notice, and an exception should be taken, See UCC Opinion Report, p 53. See sample opinion at §9.43 for an example of an opinion regarding perfection by notice.

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§9.25 I. Priority Opinions

The authors believe that priority opinions should not be given because they are factual in nature and require too many qualifications, assumptions, or exceptions. The UCC Opinion Report outlines the difficulties of giving a priority opinion and suggests that parties to a transaction should act reasonably when requesting a priority opinion. The UCC Opinion Report further suggests that any priority opinion should be limited in scope to competing security interests that are capable of being granted under the UCC. The UCC Opinion Report also states that priority opinions should generally not be requested in light of the cost and limited purpose that they serve because of the qualifications required to provide one. See UCC Opinion Report, pp 54-55. The Corporate Opinion Chapter states that priority opinions should rarely be given outside of a securitization transaction. See Corporate Opinion Chapter, §12.36. As indicated above, secured lenders are able to obtain title insurance regarding priority if they do not believe that their own searches and the borrower's representations and warranties are sufficient.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.26 J. Remedies Opinions

§9.26 J. Remedies Opinions

The remedies opinion (also referred to as an "enforceability opinion") addresses the issue of whether, and subject to what limitations, an agreement is valid, binding, and enforceable. Historically the remedies opinion (and its limitations and exceptions) has been the subject of intense negotiation between counsel for opinion givers and opinion recipients because it concerns whether the recipient's contractual rights will be upheld if litigated. See Remedies Opinion Report, p 5.

An opinion that a contract is "legal, valid, binding, and enforceable" has the same meaning as an opinion that uses one or more but not all of those terms, although, at a minimum, the opinion should contain the word "binding" or "enforceable."

By customary usage, a remedies opinion expresses the opinion giver's professional judgment that (see Remedies Opinion Report, p 3):

- A contract has been formed;
- In the event of a material breach by the party identified in the opinion letter, a court would give effect to the obligations of that party (even if only through money damages); and
- Provisions calling for a particular remedy will be given effect unless expressly or implicitly excluded from the scope of the opinion.

A remedies opinion with respect to a secured transaction relates to pertinent loan documents. This could include a loan agreement, a security agreement, and a control agreement, depending on the transaction. The remedies opinion addresses whether the applicable agreement is binding and whether the covenants in the applicable agreement are binding against the borrower. See UCC Opinion Report, p 6. The opinion giver will need to review the loan agreement and security agreement. In addition, for an opinion concerning perfection by control, the opinion giver will opine on the enforceability of the control agreement, unless some type of exception or assumption is made.

The opinion giver needs to take exceptions to enforceability for provisions of the pertinent loan documents that may not be enforceable. For example, if the documents contain a jury trial waiver, an exception should be taken. See *Grafton Partners L.P. v Superior Court* (Cal. 2005) 36 C4th 944, 116 P3d 479, 32 CR3d 5. See sample opinion at §9.58.

In rendering the remedies opinion, the opinion giver needs to satisfy itself that the contract has been duly authorized, executed, and delivered by the party identified in the opinion; that adequate consideration has been furnished to that party as a matter of contract law; and that other requirements relating to the formation of a contract have been met. On contract formation requirements, see California Law of Contracts, chaps 2-4 (Cal CEB 2007). For specific opinions with respect to corporate issues, see the Corporate Opinion Chapter, §§12.18, 12.20, 12.22, 12.24.

A remedies opinion is subject to commonly recognized exceptions relating to bankruptcy, insolvency, and equitable principles that limit the enforcement of rights and remedies and that may lead a court not to give effect to the agreement as a whole or to a specific contractual provision in certain circumstances. See sample opinion at §9.49. Examples of such matters include inequitable conduct of the party seeking enforcement, the discretion that courts exercise in granting equitable remedies, the duty of good faith and fair dealing, limitations on the rights of creditors in acting on their collateral, rules limiting waivers of a contracting party's rights, and limitations on the enforceability of provisions exculpating or indemnifying a party for reckless or willful misconduct. See Remedies Opinions Report, p 9, Apps 10, 11. See generally California Law of Contracts (Cal CEB 2007).

In addition, security agreement remedies opinions are generally considered not to address the following issues:

- That the language granting the security interest is effective to create a security interest; and
- That the security interest has attached, is perfected, or has priority.

See UCC Opinion Report, pp 6-7. Opinion givers need to be careful to provide separate opinions regarding remedies under the operable contracts and the effectiveness of the security interest in order to avoid confusing the two types of

opinions and thereby expanding either the security interest opinion or the remedies opinion. It should also be noted that, although the TriBar Report and the UCC Opinion Report clearly state that the two types of opinions are separate (see UCC Opinion Report, pp 6-7; Tribar Report-Security Interest Opinions §2.2 pp 1460-1461), at least one court has found that the security interest opinion and the remedies opinion may be contained in the same opinion. See *Prudential Ins. Co. of Am v Dewey Ballantine, Bushby, Palmer & Wood* (NY 1992) 605 NE 2d 318.

With the increasing standardization of loan agreements, particularly for smaller loans (less than $10 million), and the lenders' preference to select New York law as the law governing the loan agreement, counsel for opinion givers should raise with counsel to opinion recipients the possibility of allocating responsibility for advising the lender concerning the enforceability of the agreement to lender's counsel rather than to borrower's counsel. Lender's counsel will have prepared the form of loan agreement and be thoroughly familiar with its terms under New York law. If this allocation of responsibility is acceptable to the opinion recipient, borrower's counsel would render either an "as-if" remedies opinion (as if the loan agreement were governed by California law) or an opinion only on the loan agreement's choice of law clause. For further discussion, see Corporate Opinion Report, p 88. On the enforceability of choice of law clauses, see California Law of Contracts chap 5 (Cal CEB 2007).

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V. MODEL OPINION LETTER FROM BORROWER'S COUNSEL FOR SECURED TRANSACTION

§9.27 A. Introduction

The form of opinion letter in §§9.28-9.62 is based on two sources: (1) the Corporate Opinions Chapter and (2) the UCC Opinion Report. The form is also based on the so-called "Golden Rule" of opinion practice—that a lawyer should not request an opinion that he or she would not give if the roles of counsel in the transaction were reversed. See §9.3. Finally, the form is based on the philosophy that legal opinions should be limited to issues of law, and should not extend to questions of fact.

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B. Model Opinion Letter from Borrower's Counsel for Secured Transaction

§9.28 1. Form: Capacity of Borrower's Counsel; Scope of Due Diligence

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§9.28-9.61.

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_ _[*Name of Lender or other Addressee*]_ _
_ _[*address*]_ _

Re: _ _[*Identification of Secured Transaction*]_ _

Ladies and Gentlemen:

We have acted as special counsel to _ _[*corporate name*]_ _**, a** _ _[*state*]_ _ _ _[*corporation/limited liability company/limited partnership*]_ _ **(the "Borrower") in connection with that certain** _ _[*title of loan agreement or security agreement*]_ _ **dated as of** _ _[*date*]_ _ **(the "Agreement") between Borrower and** _ _[*name of lender*]_ _ **(the "Lender").** _ _[*We have not previously represented the Borrower and have been retained solely to represent it in connection with the Agreement.*]_ _ **Capitalized terms used herein without definition shall have the respective meanings ascribed to such terms in the Agreement. This opinion letter is delivered to you at the request of Borrower pursuant to Section __ of the Agreement.**

In the preparation of this opinion letter, we have examined such agreements and documents, and originals or copies, certified to our satisfaction, of such certificates of public officials and officers and representatives of the Borrower as we have deemed relevant or necessary for the opinions set forth in this letter. In addition, we have made such inquiries of officers and representatives of the Borrower as we have deemed relevant or necessary for the opinions expressed in this letter. Without limiting the foregoing, we have reviewed the following: _ _[*list and describe other documents and materials on which attorney relied*]_ _**.**

Comment: The documents to be reviewed and listed should include the loan and security agreements, any stock pledge agreements, any intellectual property security agreements, all of the financing statements, any deposit account control agreements, any control agreements with respect to securities or securities accounts, any guaranties, and any good standing certificates.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.29 2. Form: Assumptions: Accuracy of Borrower's Representations, Legal Capacity of Signers, Genuineness of Signatures, Authenticity of Documents

§9.29 2. Form: Assumptions: Accuracy of Borrower's Representations, Legal Capacity of Signers, Genuineness of Signatures, Authenticity of Documents

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We have, with your consent, assumed the accuracy and completeness of the factual information contained in all of the Agreement (including schedules and exhibits thereto), documents, and certificates described above, and the accuracy of all representations of fact made by the Borrower in the Agreement. In addition, we have assumed and relied on the following:

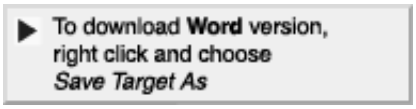
(A) the legal capacity of all natural persons executing the Agreement and all related documents (collectively, the "Loan Documents"), the genuineness of all signatures of persons signing the Loan Documents, and the authenticity of all documents submitted to us as originals or copies of such documents;

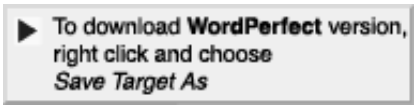
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.30 3. Form: Assumptions: Valid Existence, Good Standing, Qualification to Conduct Business, Authority, Due Execution

§9.30 3. Form: Assumptions: Valid Existence, Good Standing, Qualification to Conduct Business, Authority, Due Execution

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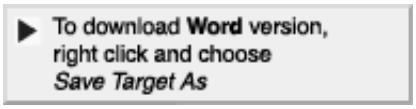
(B) all parties to the Agreement and the related documents, other than the Borrower, are validly existing and in good standing under the laws of their respective jurisdictions of organization, are qualified to conduct business under the laws of all jurisdictions where they are conducting business or required to be so qualified, have full power and authority to execute, deliver and perform under such documents, have duly authorized the execution and delivery of such documents, and have duly executed and delivered such documents;

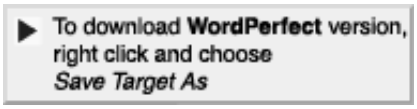
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.31 4. Form: Assumptions: Possession of Collateral

§9.31 4. Form: Assumptions: Possession of Collateral

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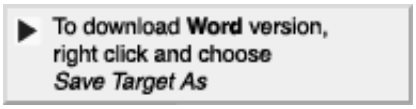
(C) all items of Collateral for which possession must be taken by a secured party to perfect its security interest under section 9312 of the Uniform Commercial Code of California (the "Code") are in the possession or constructive possession of the Lender and not in the possession of the Borrower or any of its affiliates;

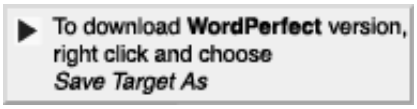
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.32 5. Form: Assumptions: Borrower's Rights in Collateral

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(D) the Borrower has good and sufficient title to each item of Collateral and has, or has the power to transfer, "rights in the [C]ollateral" within the meaning of section 9203 of the Code;

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§9.33 6. Form: Assumptions: Advance to Borrower Made

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(E) the _ _[*initial*]_ _ advance to or for the Borrower under the Agreement and related documents has been made;

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§9.34 7. Form: Assumptions: Collateral Existence, Description

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(F) the Collateral exists, and the description of the Collateral in the Loan Documents reasonably describes the property intended to be included in the Collateral.

Comment: The UCC Opinion Report states that the attachment-related assumptions in paragraphs D, E, and F are understood and not necessary to include in an opinion letter. UCC Opinion Report, pp 15-16. If those assumptions are omitted, the authors recommend that the opinion letter add a statement that incorporates the assumptions and customary practices noted in the UCC Opinion Report.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.35 8. Form: Assumptions: Loan Documents Valid, Binding, Enforceable

§9.35 8. Form: Assumptions: Loan Documents Valid, Binding, Enforceable

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(G) each Loan Document executed by any party other than the Borrower constitutes the valid and binding obligation of such party, enforceable against such party in accordance with its terms;

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.36 9. Form: Scope of Counsel's Knowledge

§9.36 9. Form: Scope of Counsel's Knowledge

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Whenever our opinion regarding factual information is expressly based on our knowledge or awareness, we are referring to the actual, present knowledge of the particular attorney or attorneys representing the Borrower in connection with the Loan Documents. Unless expressly stated, we have not undertaken any independent investigation to determine such factual information.

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§9.37 10. Form: If Borrower Organized Outside California

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In connection with our opinions in paragraphs ____ regarding perfection, we note that the _ _[*articles/certificate*]_ _ of _ _[*incorporation/organization*]_ _ of the Borrower indicates that it is a _ _[*state*]_ _ _ _[*corporation/limited liability company/limited partnership*]_ _, and that the Borrower is therefore a "registered organization," located for purposes of sections 9301 and 9307 of the Code in _ _[*state*]_ _. Under section 9301 of the Code, perfection and the effect of perfection or nonperfection of nonpossessory security interests in the Collateral will be governed by _ _[*state*]_ _ law. To the extent that _ _[*state*]_ _ law applies to such perfection matters, we have, with your consent, relied solely on our review of Article 9 of the Uniform Commercial Code as enacted in _ _[*state*]_ _ and set forth in the CCH Secured Transactions Guide available to us and updated through _ _[*date*]_ _ (the "_ _[*state*]_ _ Code"), without any investigation of other statutes or common law in effect in _ _[*state*]_ _ that may affect the perfection and the effect of perfection under _ _[*state*]_ _ law.

Comment: The preceding paragraph should be included if the Borrower is incorporated or organized outside of California. Because of the nation-wide uniformity of the Uniform Commercial Code and the location filing rules for debtors that are registered organizations, counsel for borrowers are often expected to provide limited perfection opinions under the relevant provisions of the Uniform Commercial Code as adopted in the state where the borrower is incorporated or registered. In such instances, counsel for the borrower is permitted to base the perfection opinions only on the statutory text of the relevant Uniform Commercial Code, and is not expected to provide any comfort with respect to other laws in that State.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.38 11. Form: Opinion: Borrower's Valid Existence, Good Standing, Power, and Authority

§9.38 11. Form: Opinion: Borrower's Valid Existence, Good Standing, Power, and Authority

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Based upon the foregoing and subject to the qualifications, limitations and comments herein, we are of the opinion that:

1. The Borrower is validly existing and in good standing under the laws of the State of _ _[*California/state*]**_ _. _ _**[*The exact legal name of the Borrower is* **_____**.]**_ _ The Borrower has the corporate power and corporate authority to enter into and perform the Agreement and the other Loan Documents to which it is a party, to carry on its business as to our knowledge it is currently being conducted, and to execute and deliver each of the Loan Documents to which it is a party.**

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.39 12. Form: Opinion: Borrower's Qualification as Foreign Entity

§9.39 12. Form: Opinion: Borrower's Qualification as Foreign Entity

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2. Based solely on our review of recent good standing certificates, the Company has qualified to do business and is in good standing as a foreign _ _[*corporation/limited liability company/limited partnership*]**_ _ in the state(s) of _ _**[*list*]**_ _.**

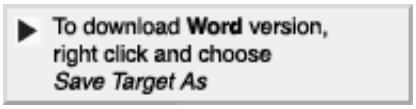
Comment: Although the borrower may be required to provide a representation identifying all the jurisdictions in which it does business, an opinion should be limited to good standing in the jurisdiction in which the borrower is incorporated and specified jurisdictions in which the borrower does business, because of the complex factual issues involved in determining where any business enterprise must be registered.

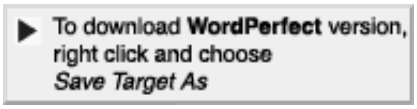
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.40 13. Form: Opinion: Execution, Delivery, Performance of Loan Documents; Enforceability of Loan Documents

§9.40 13. Form: Opinion: Execution, Delivery, Performance of Loan Documents; Enforceability of Loan Documents

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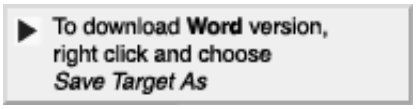
3. The execution, delivery and performance of the Agreement and each of the other Loan Documents to which the Borrower is a party have been duly authorized by all necessary _ _[*corporate*]_ _ action on the part of the Company, and each of the Agreement and such Loan Documents constitutes the valid and binding obligation of the Borrower, enforceable against the Borrower in accordance with its terms.

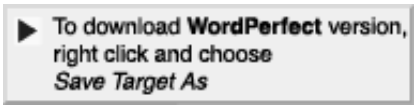
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.41 14. Form: Opinion: No Violation, No Default, No Lien Created, No Governmental Consent or Approval Required

§9.41 14. Form: Opinion: No Violation, No Default, No Lien Created, No Governmental Consent or Approval Required

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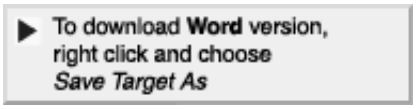


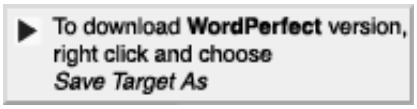
4. Assuming all advances by the Lender are used by the Borrower for the purposes set forth in the Agreement, the execution and delivery of the Agreement and the other Loan Documents, and the performance by the Borrower of its obligations thereunder, do not: (a) violate the Borrower's _ _[*articles of incorporation/operating agreement/limited partnership agreement or bylaws*]_ _**; (b) constitute a default under or a** _ _[*material*]_ _ **breach of, any of the following agreements to which the Borrower is a party** _ _[*list specific agreements that were reviewed*]_ _ _ _[*, but excluding in any such case financial covenants requiring the analysis of financial information or cross-defaults under any other agreement*]_ _**; (c) result in the creation or imposition of any lien on any of the property of the Borrower under any agreement listed in clause (b) above; (d) require any consent, approval, authorization, or order of, or filing, registration, and qualification by, the Company with any federal or California regulatory authority or governmental body required for the execution, delivery, and performance of the Agreement, except for those, if any, that have been made or obtained; or (e) violate any federal or California law, rule, or regulation that in our experience is typically applicable to transactions of the nature contemplated by the Agreement or generally applicable to companies engaged in the same line of business as the Borrower.**

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§9.42 15. Form: Opinion: Security Interest Created, Collateral Description Sufficient, Security Interest Perfected

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§9.28-9.61.





5. The provisions of the Agreement are sufficient to create in the Lender's favor as security for the payment of the _ _[*Secured Obligations*]_ _ (as defined therein) a security interest in all right title and interest of the Borrower in those items and types of Collateral described therein in which a security interest may be created under Division 9 of the Code (the "_ _[*Division/Article*]_ _ 9 Collateral"). The description of the _ _[*Division/Article*]_ _ 9 Collateral set forth in the Financing Statement _ _[*to be*]_ _ filed with the _ _[*Secretary of State*]_ _ of _ _[*state*]_ _ _ _[*is/will when filed be*]_ _ sufficient to perfect a security interest in the items and types of Collateral in which a security interest may be perfected by the filing of a financing statement under the _ _[*state*]_ _ Code. Assuming the Financing Statement has been properly filed with the _ _[*Secretary of State*]_ _ of _ _[*state*]_ _, the Lender's security interest in the _ _[*Division/Article*]_ _ 9 Collateral has been perfected to the extent a security interest in such portion of the _ _[*Division/Article*]_ _ 9 Collateral may be perfected under the _ _[*state*]_ _ Code by the filing of the Financing Statement.

Comment: If the Borrower is an organization registered in California or is otherwise located in California, perfection and the effect of perfection will be governed by the Code and the relevant collateral should be described as the "Division 9 Collateral." If the Borrower is registered or otherwise located in another state, the relevant collateral should be described as the "Article 9 Collateral."

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§9.43 16. Form: Opinion: Perfection of Security Interest in Insurance Policy Rights

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§9.28-9.61.

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6. The security interest of the Lender in the portion of the _ _[*Division/Article*]_ _ 9 Collateral consisting of rights under the policies of insurance listed in _ _[*Schedule* ___]_ _ of the Agreement will be perfected upon the delivery to the insurers listed on such _ _[*Schedule*]_ _ of written notice of such security interest.

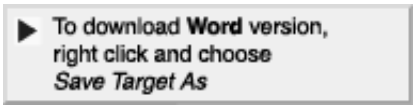
Comment: California has a non-uniform requirement of written notice to an insurer to perfect a security interest in debtor's rights under an insurance policy. See Com C §9312(b)(4). Because Division 9 provides no guidance as to the form of notice that is required, who may give the notice, or even whether the notice can be provided to a broker for the underwriter, the authors believe that no opinion should be given regarding the sufficiency of a particular form of notice. Note that perfection by notice does not extend to health care insurance receivables. See UCC Opinion Report, p 53.

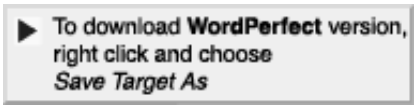
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.44 17. Form: Opinion: Perfection of Security Interest in Certificated Securities

§9.44 17. Form: Opinion: Perfection of Security Interest in Certificated Securities

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§9.28-9.61.





7. Assuming that the Lender has taken and is retaining possession of the stock certificates owned by the Borrower evidencing the shares of stock described in the Agreement (the "Pledged Certificated Stock") in the State of _ _[*state*]_ _ in registered form accompanied by undated stock powers with respect thereto duly endorsed in blank by an effective endorsement, and that the Lender has taken the Pledged Certificated Stock in good faith without actual or constructive notice of any adverse claim within the meaning of the Code, the Lender has been granted a perfected security interest in the Pledged Stock to the extent a security interest may be perfected by possession under the Code.

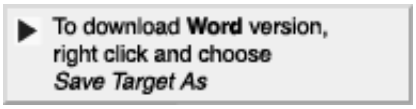
Comment: The foregoing paragraph should be added if certificated securities owned and held by the Borrower are included in the Collateral.

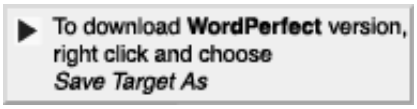
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.45 18. Form: Opinion: Perfection of Security Interest in Uncertificated Securities

§9.45 18. Form: Opinion: Perfection of Security Interest in Uncertificated Securities

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§9.28-9.61.





8. The Lender _ _[*has/will have*]_ _ a perfected security interest in the uncertificated securities owned by the Borrower evidencing the shares of stock described in the Agreement (the "Pledged Uncertificated Stock") when the issuer of the Pledged Uncertificated Stock has agreed that it will comply with the instructions of the Lender with respect thereto without further consent of the Borrower.

Comment: The foregoing paragraph should be added if uncertificated securities owned and held by the Borrower are included in the Collateral.

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§9.46 19. Form: Opinion: Perfection of Security Interest in Securities Held by Securities Intermediary

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9. The Lender will have a perfected security interest in the investment property owned by the Borrower and described in the Agreement (the "Pledged Investment Property") and held by _ _[*name*]_ _ as a securities intermediary ("Securities Intermediary") upon

[*Alternative 1:*]

the execution and delivery by the Securities Intermediary, the Borrower, and the Lender of a securities account control agreement that includes the agreement of the Securities Intermediary that it will comply with entitlement orders originated by the Lender with respect to such Pledged Investment Property without further consent by the Borrower.

[*Alternative 2:*]

the Securities Intermediary indicating by book entry that such Pledged Investment Property has been credited to a securities account with the Securities Intermediary maintained by the Lender.

[*Alternative 3:*]

the Lender, in its capacity as the Securities Intermediary, indicating by book entry that such Pledged Investment Property has been credited to a securities account maintained by the Securities Intermediary in its own name.

Comment: The foregoing paragraph should be added if certificated or uncertificated securities owned by the Borrower and held by a securities intermediary are included in the collateral. The three perfection alternatives for securities held by a third party cover the complicated, market-oriented perfection provisions in Com C §§8301, 9106, 9313(a) and 9314. The most common situation is Alternative 1, in which there is an investment property control agreement among the Borrower, the Lender, and the Securities Intermediary. See §3.57 for a form investment account control agreement.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.47 20. Form: Opinion: Perfection of Security Interest in Deposit Accounts

§9.47 20. Form: Opinion: Perfection of Security Interest in Deposit Accounts

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10. The security interest of the Lender in the Borrower's deposit accounts and the amounts on deposit in such deposit accounts _ _[is/will become]**_ _ a perfected security interest upon**

[*Alternative 1:*]

the execution and delivery by the bank maintaining such deposit accounts, the Borrower, and the Lender of a deposit account control agreement that includes the agreement of such bank to comply with instructions originated by the Lender directing disposition of the funds in such deposit accounts without further instruction by the Borrower.

[*Alternative 2:*]

the Lender becoming the customer of such bank with respect to such deposit accounts.

[*Alternative 3*:]

the Lender being the bank maintaining such deposit accounts.

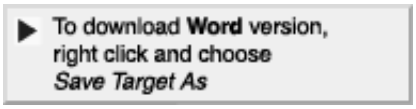
Comment: The foregoing paragraph should be added if deposit accounts are included in the collateral. The three perfection alternatives for securities held by a third party cover the various methods by which a secured lender may obtain control. The opinion giver should pick the alternative that matches the perfection method for the subject transaction.

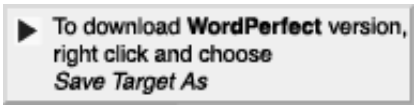
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.48 21. Form: Opinion: Perfection of Security Interest in Letter of Credit Rights

§9.48 21. Form: Opinion: Perfection of Security Interest in Letter of Credit Rights

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§9.28-9.61.





11. The security interest of the Lender in the Borrower's letter of credit rights under the letter[s] of credit listed above and described in the Agreement will be perfected upon the execution and delivery by the Issuer, the Borrower, and the Lender of a letter of credit rights control agreement that includes the agreement of the Issuer that it will comply with draw requests originated by the Lender with respect to such letter[s] of credit without further consent by the Borrower.

Comment: The foregoing paragraph should be added if letter of credit rights are included in the collateral.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.49 22. Form: Qualifications: Bankruptcy, Equitable Principles, Etc.

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The opinions expressed in this letter are subject to the following qualifications, limitations, and comments:

(a) the enforceability of the Loan Documents and the obligations of the Borrower thereunder and the availability of certain rights and remedial provisions provided for in the Loan Documents are subject to (i) the effect of bankruptcy, fraudulent conveyance or transfer, insolvency, reorganization, arrangement, composition, liquidation, conservatorship, and moratorium laws and are subject to limitations imposed by other laws and judicial decisions relating to or affecting the rights of secured or unsecured creditors generally, and (ii) general principles of equity (including the possible unavailability of specific performance or injunctive relief), whether enforceability is considered in a proceeding at equity or at law;

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.50 23. Form: Qualifications: Local Law, Antitrust, Securities, Tax, Etc.

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(b) we express no opinion on (i) local or municipal law, antitrust, environmental, land use, securities, tax, pension, employee benefit, or margin laws or regulations, or (ii) any law, rule or regulation that as a matter of customary practice is understood to be covered only when an opinion refers to it expressly;

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.51 24. Form: Qualifications: Fixtures

§9.51 24. Form: Qualifications: Fixtures

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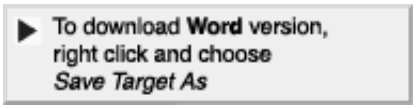
(c) we express no opinion as to any Collateral as to which the creation and perfection of security interests therein are not governed solely by _ _[*Division/Article*]_ _ 9 of the Code or any Collateral consisting of goods that are or may become fixtures on any premises;

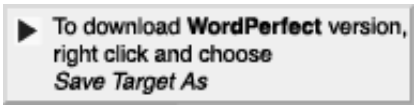
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.52 25. Form: Qualifications: Illegality, Copyrights, Negative Pledges, Governmental Obligations, Commercial Tort Claims.

§9.52 25. Form: Qualifications: Illegality, Copyrights, Negative Pledges, Governmental Obligations, Commercial Tort Claims.

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(d) we express no opinion with respect to the creation, perfection or enforceability of security interests in (i) property in which it is illegal or a violation of governmental rules or regulations to grant a security interest, (ii) "general intangibles" (as defined in the Code) that consist of registered copyrights or that terminate or become terminable, pursuant to the terms of an agreement, if a security interest is granted by the Borrower therein, (iii) property subject to a negative pledge clause applicable to the Borrower of which the Lender is aware, (iv) any "accounts," "chattel paper," "documents," "instruments," or "general intangibles" (each as defined in the Code) with respect to which the account debtor or obligor is the United States of America, any state, county, city, municipality or other governmental body, or any department, agency or instrumentality thereof, unless the same has been assigned to the Lender in accordance with the Assignment of Claims Act of 1940, as amended, or any similar law or regulation relating to the assignment of pledge thereof; or (v) "commercial tort claims" (as defined in the Code);

Comment: The common denominator in the exclusions in paragraph (d) above is that they involve legal or factual complications that would make a security interest opinion or a perfection opinion more difficult or expensive to provide. With respect to commercial tort claims, there is always a factual issue as to whether the description of a particular claim is sufficient under §9108(e) of the Commercial Code.

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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.53 26. Form: Qualifications: Proceeds

§9.53 26. Form: Qualifications: Proceeds

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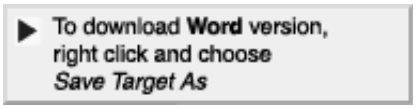
(e) we express no opinion with respect to the perfection of a security interest in any "proceeds" (as defined in the Code) of Collateral to the extent either such perfection is limited under section 9315 of the Code, or under the circumstances described in sections 9320 or 9330 of the Code purchasers may take such proceeds or Collateral free of a perfected security interest;

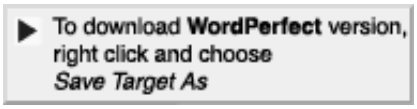
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.54 27. Form: Qualifications: Title to or Location of Collateral

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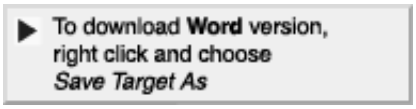


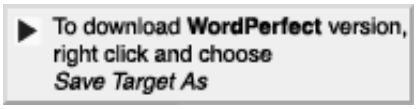
(f) we have not undertaken any investigation of the state of title to the Collateral or the location thereof and we express no opinion with respect to such title or location, or the priority of the security interests granted or purported to be granted under the Loan Documents;

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§9.55 28. Form: Qualifications: Notice Periods, Notice Waivers

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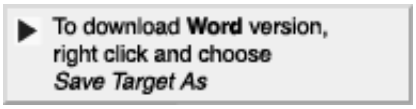
(g) we express no opinion regarding the enforceability of provisions in the Agreement establishing periods for the delivery of notice to the Company or the waiving any rights to notice, to the extent such provisions are subject to sections 9610 through 9614 or sections 9620, 9621, or 9624 of the Code;

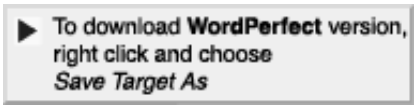
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.56 29. Form: Qualifications: Waivers, Releases, Disclaimers

§9.56 29. Form: Qualifications: Waivers, Releases, Disclaimers

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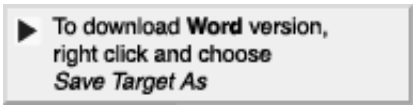
(h) we express no opinion regarding the enforceability of any purported waiver, release, or disclaimer by the Company under the Agreement of any rights or claims of the Company to the extent such waiver, release, or disclaimer is limited by sections 1102(3), 9207, or 9602 of the Code;

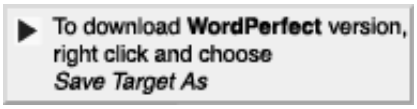
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.57 30. Form: Qualifications: Accessions, Commingled Goods

§9.57 30. Form: Qualifications: Accessions, Commingled Goods

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(i) we express no opinion with respect to any goods included in the Collateral that are accessions to, or commingled with, other goods to the extent that the Lender's security interest in such goods is limited by sections 9335 or 9336 of the Code; and

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§9.58 31. Form: Qualifications: Choice of Forum, Arbitration, Jury Trial Waiver

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(j) we express no opinion with respect to provisions in the Agreement in which the Borrower either consents to the jurisdiction of any court, the designation of any court as the appropriate venue for any purpose, or any arbitration or other alternative dispute resolution procedure, or waives any right to trial by jury.

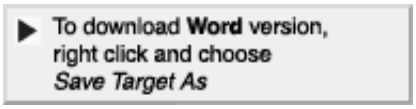
Comment: As noted in §9.26, California law regarding jury trial waivers and consents to arbitration or judicial reference is complex and uncertain. Absent unusual circumstances, an exception is appropriate.

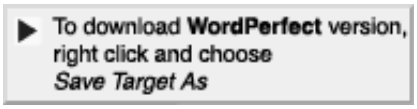
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Source: Business Law/Secured Transactions in California Commercial Law Practice/9 Legal Opinions/§9.59 32. Form: Qualifications: Limited to California and Federal Law

§9.59 32. Form: Qualifications: Limited to California and Federal Law

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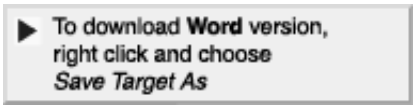
(k) we are not admitted to practice in any state other than the state of California, and _ _[*, except with respect to (i) the (General Corporation Law) of the State of _ _*[*state*]*_ _ with respect to our opinions in paragraph 1, and (ii) the _ _*[*state*]*_ _ Code as described above in connection with our opinions in paragraphs [5,] [7]*, *[8]*, *[9]*, *[10]*, *[11,] [and 12,]*]*_ _* **this opinion does not address the effect or application of any law other than California and federal law.**

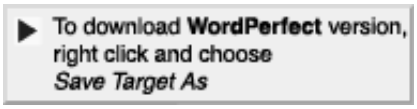
Comment: If the Borrower is incorporated or registered in a state other than California, provision of the "validly existing" and "good standing" opinions in paragraph 1 requires expertise with respect to the corporate, limited liability company, or limited partnership laws of that state. Although law firms in California often maintain such expertise with respect to Delaware corporate law, it is unusual for California firms to provide such opinions for companies incorporated or registered in other states or foreign countries.

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§9.60 33. Form: Qualifications: No Obligation to Update

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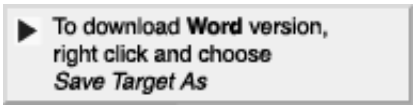
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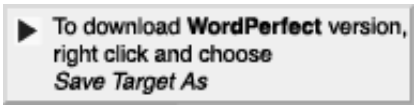
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§9.61 34. Form: Qualifications: No Reliance by Third Parties

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