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# JOURNAL

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By Patricia L. Pelino and Wayne Robinson

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### ***Lease Financing Transactions and In re Commercial Money Center Inc.***

By Benjamin R. Norris

Should the ability to prevent fraud in lease financing transactions be trumped by a perceived need to preserve flexibility in such transactions? This article discusses problems raised by a 2006 bankruptcy decision and suggests ways in which creditors may obtain some limited protection.

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### ***Learning From the Leaders: Why a Select Few Leasing Companies Consistently Outperform Their Peers***

By Scott A. Thacker

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# Lease Financing Transactions and In re Commercial Money Center Inc.

By Benjamin R. Norris

Should the ability to prevent fraud in lease financing transactions be trumped by a perceived need to preserve flexibility in such transactions, specifically the ability to separate (and take separate security interests in) chattel paper leases and the payment streams generated thereby?

This article begins by addressing the facts and issues raised in the decision of the Bankruptcy Appellate Panel for the Ninth Circuit (BAP)<sup>1</sup> in *In re Commercial Money Center Inc.*,<sup>2</sup> which held that the Uniform Commercial Code (UCC) protects flexibility in lease financing transactions at the expense of allowing a form of fraud that ultimately cannot be protected against.

This article then (a) concludes that the BAP was wrong to emphasize flexibility at the expense of preserving integrity in lease financing transactions, discussing some of the problems raised by the BAP's decision, (b) explains how the BAP could (and should) have read the UCC to both protect the integrity of lease financing while preserving the ability to fractionalize lease-derived forms of collateral; and (c) suggests some practical steps that may give at least partial protection against the problems created by the BAP's decision.

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## THE FACTS OF *IN RE COMMERCIAL MONEY CENTER INC.*<sup>3</sup>

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Commercial Money Center (CMC) was an equipment lessor that packaged and assigned its rights to Net.Bank Inc., FSB (NetBank).<sup>4</sup> NetBank paid over \$47 million to CMC for rights in seven lease pools, and CMC granted NetBank a security interest in the payment streams generated by the underlying leases.<sup>5</sup>

CMC also purchased surety bonds guaranteeing the payments due from the underlying leases and assigned its rights in these bonds to NetBank.<sup>6</sup> Documentation typically included a sale and servicing agreement (between CMC, Net-

Bank, and the surety); the surety bond, issued by the surety to CMC; and an agreement by CMC to indemnify the surety.<sup>7</sup>

Under the sale and servicing agreements, the surety was the “servicer,” but CMC was made “sub-servicer” and given all duties associated with servicing the leases—without compensation for its services.<sup>8</sup> CMC had to pay to NetBank a fixed “monthly base distribution amount” and additional amounts designated “interest” and “principal” (and also had to pay all taxes and insurance on the leased equipment) regardless of whether CMC received payments due from the underlying leases.<sup>9</sup> CMC was required to file UCC-1 financing statements on behalf of NetBank, but—significantly, as we shall see—failed to do so.<sup>10</sup>

The parties' documentation also stated that the transactions were intended as sales, not loans, and all of the underlying leases were to be stamped to show NetBank as owner.<sup>11</sup> However, the parties' documentation also characterized the transactions as loans for tax purposes. Other provisions used both sale and loan terminology.<sup>12</sup>

Subsequently, CMC ran into financial trouble, and the surety brought an action and obtained an order removing CMC as sub-servicer.<sup>13</sup> CMC filed a Chapter 11 bankruptcy, later converted to Chapter 7.<sup>14</sup> CMC's Chapter 7 trustee then brought a complaint seeking avoidance of NetBank's security interest in the payment streams, arguing that NetBank had failed to perfect its security interest in the payment streams.<sup>15</sup>

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## THE ISSUES ON APPEAL

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Before the bankruptcy court, NetBank argued that (a) the payment streams were “payment intangibles”<sup>16</sup> that had been “stripped” by the parties' documentation from the underlying chattel paper leases, in which perfection occurred automatically when they were sold to NetBank,

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On the issue of whether the payment streams were chattel paper or payment intangibles, the Bankruptcy Appellate Panel reversed the bankruptcy court, holding that the payment streams were payment intangibles separate from the underlying leases.

not “chattel paper”<sup>17</sup> that would require perfection by recording a financing statement or taking possession of the underlying leases, and (b) the CMC-NetBank transactions were sales and not loans. NetBank had to prevail on both issues in order to keep its rights in the payment streams, because under UCC 9-309(3), only when payment intangibles are sold (and not when they are security for a loan) does perfection occur automatically—i.e., without recording a financing statement or taking possession of the underlying chattel paper leases.

The bankruptcy court found on cross-motions for summary judgment that (a) the payment streams constituted chattel paper, not payment intangibles, and therefore (because NetBank failed to file a financing statement or take possession of the leases), NetBank was unsecured; and (b) the CMC-NetBank transactions constituted loans secured by the payment streams, not sales of the payment streams.<sup>18</sup>

On appeal, the BAP stated that it would consider three issues:

- A. Are the payment streams “chattel paper” within the meaning of Revised UCC Article 9?
- B. Alternatively, were the transactions at issue loans, rather than sales?
- C. If the answer to either question is affirmative, is there a genuine issue of material fact whether NetBank perfected its interest in the payment streams, or regarding NetBank’s alleged equitable defenses?<sup>19</sup>

#### **The BAP finds the payment streams were payment intangibles.**

On the issue of whether the payment streams were chattel paper or payment intangibles, the BAP reversed the bankruptcy court, holding that the payment streams were payment intangibles separate from the underlying leases—so far, so good for NetBank.<sup>20</sup> The BAP’s reasoning was that chattel paper consists of the records that evidence the underlying monetary obligation, not the monetary obligation itself, such as the payment streams at issue here.<sup>21</sup> The BAP determined that the payment streams could not

be “accounts” because the definition of account excludes “rights to payment evidenced by chattel paper,” so that the payment streams necessarily “fall within the payment intangible subset of the catch-all definition of general intangibles.”<sup>22</sup>

In so holding, the BAP relied on its earlier decision in *In re Wiersma*<sup>23</sup> to support its conclusion that once a right to payment comes into existence, it is a “payment intangible” separate from the “chattel paper” that gave rise to it.

The BAP rejected the bankruptcy court’s reliance on *In re Commercial Management Service Inc.*,<sup>24</sup> noting that the creditor in that case had taken possession of the leases, whereas in CMC possession remains a disputed issue.<sup>25</sup> However, the BAP did agree with the reasoning in *Commercial Management Service* that if the creditor does take possession of the chattel paper, it necessarily perfects an interest in the underlying payment streams even if the UCC does not expressly so provide, because otherwise perfection by taking possession of the chattel paper would be meaningless.<sup>26</sup>

The BAP reached this conclusion notwithstanding UCC 9-313(a), which does not include payment intangibles among the collateral in which a security interest can be perfected by possession, and Official Comment 2 thereto, which states that “[a] security interest in accounts and payment intangibles—property not ordinarily represented by any writing whose delivery operates to transfer the right to payment—may under this Article be perfected only by filing.” In this respect, the BAP accepted NetBank’s reasoning; NetBank had argued that a sale of chattel paper transfers all rights that arise thereunder, but a sale of payment streams does not automatically transfer ownership rights in the chattel paper evidencing them.<sup>27</sup>

The trustee argued that the BAP’s interpretation would “lead to endless debates over whether particular assignments are actually sales or secured loans,” and that allowing purchases of payment streams to be automatically perfected would “wreak havoc on the financing market.”<sup>28</sup> The BAP rejected this argument, noting that the first creditor to perfect will generally be the first

in priority, presuming that the creditor takes an interest in both the chattel paper and the associated payment streams.<sup>29</sup>

The BAP agreed that problems may arise if the creditor purchases an interest in the chattel paper after the debtor already has sold the underlying payment streams to someone else, but concluded that this is a problem for the state legislatures, not the courts.<sup>30</sup> The BAP also rejected the bankruptcy court's reasoning that finding the payment streams to be payment intangibles deletes the monetary obligation requirement from the definition of chattel paper.<sup>31</sup>

**The BAP finds the transactions were loans, not sales.**

While the BAP ruled for NetBank and against CMC's trustee in holding that the payments streams were payment intangibles, the BAP ruled in favor of the trustee and against NetBank in holding that the CMC-NetBank transactions were loans and not sales.<sup>32</sup> This was fatal to NetBank because the key criteria for automatic perfection (i.e., perfection without filing a financing statement or taking possession) under UCC 9-309(3)—the actual sale of the payment intangible(s) in question—was not satisfied.<sup>33</sup>

Although agreeing that the transactions contained some characteristics of sales, the BAP concluded that “the transactions bear far more hallmarks of a loan than a sale.”<sup>34</sup> The BAP concluded notwithstanding the parties' stated intent that their transactions were sales and not loans, “NetBank (1) has none of the potential benefits of ownership and (2) is contractually allocated none of the risk of loss. These are strong indicia of a loan rather than a sale.”<sup>35</sup> The BAP placed particular emphasis on the fact that CMC, not NetBank, bore the risk of loss in the event of a default on any one of the underlying leases.<sup>36</sup>

NetBank argued that the transactions were sales, not loans because: (a) NetBank received no right of recourse or guarantee from CMC; (b) the surety guaranteed the performance of the lessees, not of CMC; and (c) NetBank had no knowledge of and was not a party to CMC's agreement to indemnify the surety.<sup>37</sup> The BAP found that NetBank's first two points were inadequate to

reverse its conclusion that the transactions were loans and not sales, and declined to address NetBank's third point on grounds that NetBank had not raised it below.<sup>38</sup>

At least in theory, this leaves open the possibility that the ignorance by a creditor of an agreement to indemnify a surety might make a transaction a sale and not a loan, but this seems unlikely given that (a) this would not have shifted the risk of loss from CMC to NetBank, and (b) a surety generally has a right of indemnity as a matter of law, so the creditor would have the burden of proving that the surety had no right to indemnification and could not presume otherwise.<sup>39</sup>

**The BAP finds a genuine issue of material fact whether NetBank perfected its interest in the payment streams, and remands.**

In a final twist, the BAP concluded that a genuine issue of material fact remained regarding whether NetBank perfected its interest in the payment streams through an agent of NetBank taking possession of the underlying leases.<sup>40</sup> The BAP rejected NetBank's argument that CMC could have taken possession of the leases in a capacity as agent for NetBank, citing UCC 9-313(c) and (h), as well as Official Comment 3 to UCC Section 9-313.<sup>41</sup> However, the BAP found there was an issue of fact as to whether the surety had taken possession of the leases as agent for NetBank, and remanded to the bankruptcy court.<sup>42</sup>

**THE LESSONS OF THE CMC-NETBANK LITIGATION**

**Problems Created by the BAP's Ruling**

Although NetBank would have prevailed on the facts presented in *CMC* had it filed financing statements and/or taken possession of the leases, this would not solve the problem raised by the BAP's reasoning: What if an unscrupulous (or sloppy) debtor first sells the payment stream/ payment intangible outright (so that the buyer's interest is perfected under UCC 9-309[3]), and subsequently grants a security interest in or sells the underlying lease to a party that believes it is thereby obtaining rights in the payment

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streams?<sup>43</sup> As the BAP admits, its ruling leaves such a subsequent buyer of rights in the lease unable to determine if it really has acquired an interest in the related payment streams.<sup>44</sup>

In a letter to the Permanent Editorial Board for the UCC (California Bar Letter), the UCC Committee of the Business Law Section of the State Bar of California identifies other specific problems that arise from the BAP's reasoning.<sup>45</sup> Additional inconsistencies and problematical situations pointed out by the California Bar include the following:

- If a first buyer of the lessor's rights in a lease buys all such rights together and fails to perfect by recording a UCC-1 or taking possession of the lease, the first buyer may lose all its rights to a subsequent buyer that properly perfects, but if the first buyer acquires the right to the payment stream "separately" from its acquisition of the other rights in the lease, then the first buyer will be deemed secured as to the payment stream even if it does nothing more.
- A second creditor that perfects an interest in a lease by filing but that has knowledge of a prior unperfected security interest has a second priority lien (because of its actual knowledge of the first creditor's unperfected first lien), and also is ahead of a third creditor that takes possession of the lease (because the third creditor would be on notice of the second creditor's UCC filing); however, the third creditor (so long as it has no knowledge of the first creditor's unperfected lien) has priority over the first creditor, creating an irresolvable conflict in priority claims among the creditors.

As the foregoing fact patterns show, the BAP's decision in *CMC* undermines the essential purpose of the UCC, and Article 9 in particular—to create a clear, uniform set of rules that preserves the integrity of secured transactions while encouraging flexibility in fractionalizing and dealing separately with all the forms of collateral created thereby. The BAP erred in placing flexibility ahead of preserving the integrity of secured transactions. Preservation of flexibility

is an important goal of the UCC, but it necessarily is secondary to the code's first purpose of preserving the transparency and integrity of the transactions it governs.

**The BAP could (and should) have adopted an interpretation of the UCC that would have protected the integrity of lease financing transactions while preserving the flexibility in such transactions.**

As a remedy for the problems it identifies, the California Bar suggests amending the UCC.<sup>46</sup> However, this approach begs the question of whether revising the UCC is really necessary, if the UCC is instead read more expansively. If the BAP can find that a secured party taking possession of chattel paper necessarily perfects an interest in the underlying payment streams even if the UCC does not expressly so provide—as the BAP in fact did—then why isn't the right answer that the granting of a security interest in payment streams arising from leases must be perfected as if the collateral were the underlying chattel paper, i.e., either by filing a financing statement or by taking possession of the leases?

This course of action would not eliminate the ability of parties to "strip" payment streams from leases (and thus would not impinge on the flexibility that the UCC is intended to support). All this would do would be to require a party taking an interest in the payment streams to either give notice (through the filing of a financing statement) or to take possession of the underlying leases to prevent any rights therein from being transferred to others.

Incidentally, this approach would have produced exactly the same result in *CMC*: NetBank would be left unsecured, except to the extent it can show it took possession of the leases.

Furthermore, UCC 9-309(3) (providing perfection in a payment intangible upon attachment) could be harmonized by reading it to be effective where the *only* collateral is a payment intangible; i.e., the payment intangible is not associated with underlying chattel paper in which an interest might be taken.

Requiring that the granting of a security interest in payment streams arising from chattel paper must be perfected as if the collateral were the underlying lease is compatible with the UCC's express goal of "simplify[ing], clarify[ing], and moderniz[ing] the law governing commercial transactions."<sup>47</sup> This proposed rule also would be analogous to other existing UCC practices not required by the literal language of the code.

For example, where the proper place for filing is uncertain because the characterization of the collateral is uncertain, the best procedure is to record in both places, and wise secured parties have been doing so for years (see, e.g., *In re Stevens*).<sup>48</sup> Similarly, the UCC approach to classifying collateral is empirical, depending on the parties' actual use of the collateral, not on the "normal use" of the collateral (see, e.g., *In re Gilder*).<sup>49</sup> The same pragmatism applies in determining the debtor's "place of business" for filing purposes.<sup>50</sup>

In particular, pragmatism has been injected into the lien priority provisions of the UCC in other circumstances (see *McFarland v. Brier*) ("Although not expressly stated, the [UCC] clearly implies that a secured party with a perfected security interest is entitled to priority over a creditor who has obtained a later lien on the collateral by attachment, garnishment, levy, or the like"; citation omitted).<sup>51</sup>

In summary, the rule suggested by this article can be stated as follows: Where a particular means of perfection in a first kind of collateral would leave open the possibility of fraud with regard to related collateral, then perfection in the first kind of collateral must be accomplished by means that would prevent such fraud. The burden would be on the creditor to perfect in such a way as to prevent any fraud.

**SOME PRACTICAL STEPS THAT MAY PROVIDE SOME LIMITED PROTECTION**

Although there is no way under the BAP's reasoning in *CMC* that a creditor seeking a security interest in all collateral generated by a lease transaction can protect itself absolutely against a prior, secret sale of the income stream generated

by the lease, there are certain practical steps that can be taken to minimize such risks.

On the facts presented in *CMC*, NetBank should have (a) made sure that financing statements were filed, (b) taken possession of the leases, or (c) done both. A financing statement would have perfected NetBank's security interest in both the payment streams and the leases. Although a financing statement cannot directly perfect an interest in payment intangibles, it does perfect a security interest in chattel paper (under UCC 9-312[a]) and under the BAP's reasoning in *CMC*, in the payment intangibles generated thereby.

A secured creditor can file a financing statement without the debtor's signature, so there is no reason to delegate filing to the debtor as NetBank did.<sup>52</sup> Alternatively, NetBank could have perfected by taking possession of (and thereby perfecting its interest in, under UCC 9-313[a]) the underlying chattel paper leases. The secured party should take possession itself, rather than through a third party that may or may not be found to be the secured party's agent for such purposes. In *CMC*, NetBank was reduced to arguing that the surety or *CMC* itself had taken possession of the leases on its behalf. Had NetBank itself taken possession of the leases, the litigation would have resolved in NetBank's favor.

Other steps that a creditor can take include: (a) conducting thorough due diligence on all parties, including specifically the originator of the lease, its principals, and any broker involved in the transaction; (b) including specific representations in the transaction documents by the lease originator, its principals and any guarantors of the obligations being secured (likely the principals of the loan originator) that no prior sale of the payment streams has occurred; and (c) performing a UCC search of the lease originator, and checking all security agreements to make sure there is no prior grant of a security interest that might be read to reach the payment stream generated by the lease, especially where the lease originator may not have performed such an analysis itself.

Where the proper place for filing is uncertain because the characterization of the collateral is uncertain, the best procedure is to record in both places, and wise secured parties have been doing so for years.

## Endnotes

1. Appeals from bankruptcy courts in the Ninth Circuit are automatically assigned to the BAP, but if a party objects, the district court hears the appeal in place of the BAP. See 28 U.S.C. §158(a), (b) and (c), and Bankruptcy Rule 8001(a). Decisions of the Ninth Circuit BAP are appealable to the Ninth Circuit. 28 U.S.C. Sec. 158(d).
2. 350 B.R. 465 (9th Cir. BAP 2006).
3. The facts are at *CMC*, 350 B.R. 469-72 and 482-83, and also in the Bankruptcy Court's decision that was appealed to the BAP, *In re Commercial Money Center Inc.*, 56 UCC Rep.Serv.2d 54, 2005 WL 1365055 (Bkrtcy. S.D. Cal. 1/27/2005).
4. *CMC* at 350 B.R. 469.
5. *Id.* Typical *CMC*/NetBank contract documentation described the collateral as "(i) All contract rights under each Lease to receive all Scheduled Payments commencing with such payments due ... (ii) all funds on deposit from time to time in the Collection Account; (iii) all rights under the Surety Bonds; and (iv) any and all proceeds of the foregoing." *CMC* at 56 UCC Rep. Serv.2d 54, 2005 WL 1365055, \*2, n. 2.
6. *Id.* at 350 B.R. 469.
7. *Id.*
8. *Id.* at 350 B.R. 471.
9. *Id.*
10. *Id.* at 350 B.R. 470.
11. *Id.* at 350 B.R. 469-70.
12. *Id.* at 350 B.R. 470.
13. *Id.* at 350 B.R. 472.
14. *Id.*
15. *Id.*
16. See UCC 9-102(a)(61) (defining "payment intangible" as a type of "general intangible") and UCC 9-102(a)(42) (defining "general intangible").
17. See UCC 9-102(a)(11) (defining "chattel paper") and UCC 9-102(a)(42) (excluding "chattel paper" from the definition of "general intangible").
18. *CMC*, 56 UCC Rep.Serv.2d 54, 2005 WL 1365055 (Bkrtcy. S.D. Cal. 1/27/2005).
19. *CMC* at 350 B.R. 473.
20. *Id.* at 350 B.R. 475-81.
21. *Id.* at 350 B.R. 475-76.
22. *Id.* at 350 B.R. 476; see also UCC 9-102(a)(2); UCC 9-102(a)(42); and UCC 9-102(a)(61).
23. 324 B.R. 92, 106-07 (9th Cir. BAP 2005) ("payment intangible" includes assignment of payment right under settlement agreement); the BAP also cited Barkley Clark and Barbara Clark, *The Law of Secured Transactions Under the UCC*, para. 10.08[8][V]. Perhaps not surprisingly, the Clarks largely agree with the BAP's reasoning. See 09-06 Clarks' Secured Transactions Monthly 1, Ninth Circuit BAP Holds That Payment Intangibles May Be "Stripped Out" Of Equipment Leases (2006).
24. 127 B.R. 296 (Bkrtcy. Mass. 1991).
25. *CMC* at 350 B.R. 477-78.
26. *CMC* at 350 B.R. 477-78. In *In re Commercial Management Service*, the court refused to treat the payment streams separate from the leases themselves, where the creditor had perfected by taking possession of the leases: "Although the Code does not specifically provide [that a security interest in the payment stream generated by a lease can be perfected by taking possession of the lease], [t]aking possession of the collateral, the chattel paper itself, would be meaningless unless the paper represented the underlying rights where were transferred by a transfer of the paper." *Id.* at 127 B.R. 302-05, quoting from Boss, "Lease Chattel Paper: Unitary Treatment of a 'Special Kind of Commercial Specialty,'" 1983 *Duke L.J.* 69, 92-94 (1983).
27. *CMC* at 350 B.R. 478.
28. *Id.* at 350 B.R. 478-79.
29. *Id.* at 350 B.R. 479.
30. *Id.* at 350 B.R. 479-80.
31. *Id.* at 350 B.R. 476-77.
32. *Id.* at 350 B.R. 481-86.
33. See *id.* at 350 B.R. 485.
34. *Id.* at 350 B.R. 483-84.
35. *Id.* at 350 B.R. 484.
36. See *id.* at 350 B.R. 483-84.
37. *Id.* at 350 B.R. 484-85.
38. *Id.* at 350 B.R. 484-85.
39. See *id.* at 350 B.R. 485.
40. *Id.* at 350 B.R. 485-88.
41. *Id.* at 350 B.R. 486-87.
42. *Id.* at 350 B.R. 487-88.

43. Fortunately for NetBank, there was no claim that CMC had transferred its interests in the payment streams to a third party prior to entering into its transactions with NetBank.

44. It is odd that CMC was used as a vehicle for holding that flexibility trumps fraud prevention. Although NetBank argued that the parties' agreements stripped the payment streams from the leases (as it had to, since it had not perfected an interest in the chattel paper leases), it is *not* clear from that parties' contract language that the parties intended to do so. See footnote 5, *supra*. Given that there was not clear intent by the parties to utilize the flexibility that the BAP put ahead of preventing fraud, the BAP's using of CMC to establish this principle is questionable.

45. The California Bar Letter is at [www.calbar.ca.gov/calbar/pdfs/sections/buslaw/ucc/ucc-letter-to-peb.pdf](http://www.calbar.ca.gov/calbar/pdfs/sections/buslaw/ucc/ucc-letter-to-peb.pdf). Similar points are raised in Stern, *Structuring and Drafting Commercial Loan Agreements*, A.S. Pratt & Sons, para. 3.11[4].

46. See California Bar Letter, pp. 7-9.

47. See UCC 1-103(A)(1).

48. 307 B.R. 124, 132 (Bkrcty. E.D. Ark. 2004).

49. 225 B.R. 439, 447 (Bkrcty. E.D. Mo. 1998).

50. *Id.* at 225 B.R. 447, n. 9.

51. 850 A.2d 965, 977 (S.Ct. R.I. 2004).

52. See UCC 9-509, and Official Comments 2 and 4 thereto. To be fair, the transactions in CMC predated the 2001 revisions to the UCC. See CMC at 350 B.R. 469. Of course, NetBank still should have enforced its right to make sure that CMC was filing the financing statements.



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