

**DISPATCHES FROM THE TRENCHES**

**What's all This About Payment Intangibles? The CMC Case May Place the  
Syndication Market in a State of Disarray**

By Kenneth P. Weinberg

This edition of **Dispatches From the Trenches** discusses the *Commercial Money Center, Inc.* case, and the decision, which determined that payment intangibles are separate from the lease itself. The results of this case offer some recommendations funders may want to consider until the impact of this case is completely clear within the industry. Originators and brokers should also read this article in order to better understand funders' concerns.

The U.S. Bankruptcy Appellate Panel of the Ninth Circuit recently ruled in the case, *In re Commercial Money Center, Inc.*, 2006 WL 2505205, that it is possible for an originator to strip off and sell the right to receive payments under any equipment lease, that this "payment intangible" is separate and distinct from an assignment of the lease itself and that the purchaser of the rent payment stream is immediately perfected without the necessity of taking an interest in the underlying lease. This means that the assignee of a lease can perfect its interests and still, in some circumstances, find itself without a right to receive rental payments.

**Background**

Commercial Money Center, Inc. (CMC) originated equipment lease transactions and assigned the payment streams to NetBank. As part of the transaction, CMC also granted NetBank a security interest in the leases. NetBank failed to take possession of the original counterparts of the leases, which were chattel paper, or to file a Uniform Commercial Code (UCC) financing statement against CMC, which covered the payment streams, the leases or the underlying

equipment. When CMC filed for bankruptcy protection, the bankruptcy trustee sought to avoid NetBank's interest as an unperfected security interest.

Because NetBank failed to perfect by taking possession of the leases or filing a financing statement, its only chance of beating the bankruptcy trustee was to succeed on an argument that the assignment of the rent stream by CMC to NetBank constituted an outright sale of a "payment intangible." Such a holding would protect NetBank if it purchased the rent streams outright since §9-309(3) of the UCC provides that a purchaser's interest in payment intangibles is automatically perfected and that no UCC-1 filing or possession of the lease is required when buying a payment intangible.

The trustee successfully argued at trial that the rent payment stream was merely part of the chattel paper (the lease) and that NetBank could not perfect its rights without taking possession of the original counterpart of the lease or filing a UCC financing statement against CMC.

The appeals court, however, overruled the trial court and held that the rent payment stream could be stripped from the lease itself and that, once it was detached from the lease, the payment stream constituted a payment intangible. This holding did not save NetBank, however, because the appellate court also held that the transaction between NetBank and CMC constituted a loan and not an outright sale of the rent stream. As such, the automatic perfection provided by §9-309 (which operates only for the benefit of outright sales) did not apply. The case has been remanded for further determinations of fact since there is some possibility that NetBank actually took possession of the chattel paper through an agency arrangement.

Although the *NetBank/CMC* case only involves a battle between a secured party and a bankruptcy trustee, the appellate court holding raises several issues regarding whether a purchaser who is automatically perfected upon the purchase of a payment intangible takes priority over a subsequent assignee that later perfects an interest in the chattel paper (lease).

It should be noted that the appellate court left open *some* possibility that the super-priority-possession rules of §9-330 *may* grant an assignee whom perfects an interest in the chattel paper by possession priority over a purchaser who is automatically perfected upon the purchase of a payment intangible (emphasis added). However, significant issues of statutory interpretation need to be resolved before a court could make such a holding. Since this particular case only involves a battle with the bankruptcy trustee, the issue is merely one of whether NetBank is perfected or not. As such, the appellate court will not end up addressing priority issues in this case and we will have to wait for another case or legislative action to know for certain who

owns when an outright purchaser of only the rent stream battles a funder who takes possession of the sole original of the lease.

In any event, it is safe to say that the appeal court's ruling has left the lease syndication/funding market in something of a state of disarray.

### **What All This Means**

While other courts outside the Ninth Circuit (which includes only California, Oregon, Washington, Arizona, Montana, Nevada, Alaska, Hawaii and certain U.S. possessions) are not bound to follow the *CMC* ruling, the Ninth Circuit is highly respected and the logic behind its ruling is, technically, supportable. As such, cautious funders may want to proceed on the assumption that other courts will follow that court decision. If they do, funders should assume the following:

- The originator of a lease may sell the right to rent payments separately from assigning the lease.
- A purchaser of the rent payments is immediately perfected in the payments. Such automatic perfection means that, upon closing the purchase, the purchaser has the first priority right to receive rent payments without making any UCC filings or taking any other action, which may leave a trail that can be discovered by a subsequent assignee of the lease.
- An assignee of the lease, even if it takes possession of the sole original counterpart and thus perfects its rights in the lease as chattel paper, does not necessarily have first rights to the rent stream. If the rent stream has already been sold to another party, the assignee of the chattel paper may have no right to receive rent.

### **Recommendations to Consider**

There will undoubtedly be much written about this case and there will be both legislative and judicial response. The UCC Committee of the Business Law Section of the State Bar of California has written to the Permanent Editorial Board for the UCC to ask for clarification. Unfortunately, this clarification will probably require legislative action in each of the states and may take months or years.

For the present, funders should consider the following precautions (many of which were good practice prior to the *CMC* holding):

- *Know your broker/originator.* Given this state of affairs, it is very important that a funder trust its originators. There is more than ample opportunity for fraud if the originator sells the rent stream to one financier and assigns the lease to another. It goes without saying that none of the defensive measures suggested here are completely necessary if the originator is reputable, reliable and solvent. On the other hand, no amount of precautions will protect against the bad actors we all know are out there.
- *Add an originator representation.* The originator should represent that it has not sold the payment intangible, or granted any interest in the rent stream to any third party. This should go without saying and should be covered by implication in most good assignment documents. However, for purposes of supporting a fraud claim and, if nothing else to put the originator on notice that it is responsible for avoiding the *CMC* situation, it is prudent to make sure the assignment agreement has proper representations. It is hard to imagine a circumstance in which an originator could innocently sell off a rent stream to another funder, but loose language in existing agreements such as warehouse lines and other fundings could result in a sale of payment intangibles, at least in theory.
- *Consider conducting a UCC search against the originator.* It may be worth conducting a UCC search to see whether filings against the originator indicate prior assignments of payment intangibles. Even if you trust your originator, there is some risk that language in warehouse lines and other standing loan agreements provide for an assignment of payment intangibles. Consider, for example, the following language: "Borrower grants a security interest in all leases and sells and assigns to bank all of borrower's right, title and interest in all rents under the leases as security for" This risk is increased since this category of collateral is new, commentary in the UCC provides no examples of what payment streams fall into this category and drafters of assignment documents are therefore more like to "throw in" a reference to payment intangibles in a variety of loan and assignment agreements. Remember that a loan secured by payment intangibles is not a problem but that a sale of payment intangibles is.
- *Avoid blind assignments.* There is always increased risk with "blind assignments" where the lessee is unaware that the originator has sold the payment stream and/or assigned a lease to a funder. This is, however, a very common practice, particularly where reputable originators

want to maintain their good lessee relationships or vendors want to keep their private label program hidden from their customers. Again, the originator's good reputation is the key here, but there is a better chance of a funder's avoiding payment intangibles issues if the funder asks the lessee to sign a Notice and Acknowledgment. Similarly, fiscal agency arrangements under which the originator collects rent are far safer if the lessee signs an acknowledgement recognizing that the payment stream has been assigned and agreeing that, on notice, it will tender payment to the assignee. Of course, there is still some risk in both cases since there is always a possibility that a lessee did not know about a prior sale of the payment intangible.

Kenneth P. Weinberg is a founding partner of Marks & Weinberg, PC. He and co-founder, Barry Marks, have significant experience in dealing with virtually every type of equipment and facility lease financing, have participated in leasing financings for more than a billion dollars of equipment and are recognized throughout the industry. Weinberg has written *Dispatches from the Trenches* since 2002, routinely writes articles in a variety of equipment leasing and financing journals, and has participated in numerous seminars on equipment leasing issues. If you would like more cases or articles on leasing, or have any questions or comments about this column or other leasing issues, please visit [www.lease lawyer.com](http://www.lease lawyer.com) or contact Weinberg at 205-251-8307.



**Article appeared in the March/April, 2007 issue of the *Monitor*.**

**For more articles/news regarding the equipment leasing and finance industry, visit**

**<http://www.monitordaily.com/>**