#39.160 9/30/77

Memorandum 77-67

Subject: Study 39.160 - Attachment (Property Subject to Security Interest)

We have received some more comments on the Tentative Recommendation Relating to Attachment of Property Subject to Security Interest. Letters we received earlier are discussed in Memorandum 77-53 which will be considered with this memorandum.

Exhibit 1 is a reply by Professor Stefan A. Riesenfeld to the comments made by Mr. Thomas E. Shardlow in a letter attached as Exhibit 2 to Memorandum 77-53. These materials and the discussion on page 2 of Memorandum 77-53 should be self-explanatory. As stated in the earlier memorandum, we do not believe any change is required in the recommendation with respect to the relation between attachment liens and floating liens on accounts receivable securing future advances.

Exhibit 3 is a letter from Mr. Alvin G. Buchignani, raising the same point concerning notice of levy to the account debtor that was raised by Mr. Harold Marsh (see Exhibit 1 to Memorandum 77-53) and is discussed on pages 1 and 2 of Memorandum 77-53.

Exhibit 2 is a letter from Mr. Del Fuller which states the views of the UCC Section of the Business Law Committee of the State Bar. This letter makes several points:

(1) The letter points out that, under the tentative recommendation, the determination of the proper manner of levy and the consequences of an attachment are made to depend upon whether the security interest is perfected. As a practical matter, however, perfection is frequently a matter of dispute. Accordingly, the UCC Section recommends that, where an account debtor is making payments to a secured party, he should continue to do so without having to determine whether the security interest is in fact perfected. (See Exhibit 2, p.2.) If the Commission approves this policy, then we will have to devise a procedure whereby the attaching plaintiff may assert that the attachment lien is superior to the security interest or, in other words, that the security interest was unperfected at the time of the levy of attachment.

(2) The UCC Section is also concerned with the problem of how the attaching creditor will be able to obtain the information necessary to

determine whether the security interest is perfected. (See Exhibit 2, p.2, last complete paragraph.) Two alternatives are suggested. The parties could be left to their own devices or provision could be made for some sort of written demand for information, enforced by a penalty. The Commission has briefly discussed this general informational problem at an earlier meeting. The staff favors leaving this matter to the ingenuity of counsel for attaching creditors.

(3) The UCC Section suggests that the Commission defer action on the proposals to provide for the attachment of pledged securities and securities in the hands of third persons generally until the Section has the opportunity to consider the matter further. The Section plans to meet on October 12 and has invited members of the Commission's staff to attend, which we plan to do. The Section also suggests that this subject be treated as a separate matter. The staff anticipates that the input of the Section will be valuable on this subject and so recommends that we defer consideration until we have received the Section's response. We note, in addition, that the National Conference of Commissioners on Uniform State Laws has just approved some proposed amendments to the UCC, one of which would amend UCC Section 8-317 to deal with the problem of levying upon securities. (See Exhibit 3 to Memorandum 77-53 for a copy of existing Section 8317 and a proposed revision, some form of which was recently approved by the Uniform Commissioners.)

Respectfully submitted,

Stan G. Ulrich
Staff Counsel

Memorandum 77-67 #39.160

EXHIBIT 1

Washington, August 22, 1977

To: California Law Revision Commission

From: Stephan A. Riesenfeld, Consultant

Subject: Comment by Mr. Thomas M. Shardlow, July 20, 1977, on Tentative Recommendation Relative to Levy on Property Subject to Security Interest

Mr. Shardlow's letter, in essence, raises two issues relating to the rights of a levying creditor if the accounts levied upon are subject to security interests created by agreements including cross-collateralization clauses:

1. The status of future advances made after the levy on existing accounts;

2. The effect of the levy on accounts which come into existence after the levy.

The first issue is controlled by Cal. U.C.C. §§ 9-301(4) and 9-312(7), as amended in 1974. It would seem that Mr. Shardlow has overlooked these amendments. Their purpose and effect is explained by the Official Reasons for 1972 Change, given by the Permanent Editorial Board (see West 1977 Pamphlet 72, supplementing 3 U.C.C. (Uniform Laws Ann.)):

> Different but related problems exist with reference to the status of subsequent advances when the intervening party is a judgment creditor. He is not directly a part of the Code's system of priorities. It seems unfair to make it possible for a debtor and secured party with knowledge of the judgment lien to squeeze out a judgment creditor who has successfully levied on a valuable equity subject to a security interest, by permitting later enlargement of the security interest by an additional advance, unless that advance was committed in advance without such knowledge. Proposed Section 9-301(4) provides that a lien creditor does not take subject to a subsequent advance unless it is given or committed without knowledge, but there is an exception protecting future advances within 45 days regardless of knowledge.

Hence future advances, even if optional, given within 45 days with knowledge will squeeze out the levying creditor. This may seem unfair, but it is the system adopted by the California Legislature in conformity with the revision of the U.C.C. in 1972.

The second issue raises the issue of the possibility of a levy on after-acquired assets. Generally speaking levies, even if in the form of a garnishment, create liens only on property rights of the debtor existing at that time. The new system changes this rule with respect to attachment levies on inventory by filing. I would hesitate to recommend a change of the general rule with respect to future accounts subject to an anticipatory security interest, although some argument could be made for such a narrow extension. At any rate, § 488.440 (as revised in the light of my previous memo) would render it clear that an unused percentage of existing accounts could not be returned to the debtor.

EXHIBIT 2

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September 7, 1977

Professor John H. DeMoully
California Law Revision Commission
Stanford, California 94305

Dear Professor DeMoully:

This letter is for the purpose of summarizing certain of the matters which I discussed with you and Stan Ulrich last Friday, September 2.

As I advised, the UCC Section of the Business Law Committee of the State Bar of California reviewed the Commission's Tentative Recommendation of June 10, 1977 relating to Attachment of Property Subject to Security Interest at its meeting on August 31. As I indicated to you, the section had not had as much time to review the recommendation as it would have liked but did feel there were certain matters which should be promptly brought to the Commission's attention.

First, I believe the section felt that the subject of the proposed recommendation was one worthy of the Commission's attention.

Second, aside from the matter of clarifying the area of the law which there is uncertainty, it appeared to us that one of the Commission's objectives was to eliminate the necessity for secured parties filing third party claims in every instance where there is an attachment upon property in which there is security interest, an objective which we believe to be a worthwhile endeavor.

However, the Section did have some reservations about the particular course of action adopted, (ie) whether the particular cure might not present as many or more difficultes than the problem sought to be cured. A basic problem which concerned virtually all Section Members was the fact that the party to whom money would be paid (i.e., either the

levying officer or the secured party) would depend initially on the existence of a "perfected" security interest. All Section members are experienced UCC counsel and were only too aware of the arguments that can arise with respect to whether a security interest is perfected (e.g., is there a Security Agreement, is the Financing Statement complete and properly filed). In addition, it is not clear as to who is to make the determination; the Levying officer is not equipped to do so and the account debtor might have his own reasons for taking the position he cannot tell and hence ceasing payment). In short, the disputes about the existence of a "perfected" security interest - even if it is assumed that all the information necessary for this determination is available - is likely to precipitate difficulty at the very outset.

The Section concluded that it would perhaps be better to provide that the money shall flow to the secured party if it has been so flowing theretofore; if, on the otherhand, it has been flowing to the defendant, it would be paid to the Levying officer. It should be recognized, however, that this would only be an interim arrangement. If the secured party wished to do so, it could file a third party claim. Simiarly, an arrangment would have to be made so that the attaching creditor who felt that a secured party did not have a perfected security interest could make an appropriate claim against the secured party. It would be our expectation that in many cases the money would continue to flow as it had without dispute by the other party, hence relieving the courts and party of the burden.

A collateral matter that should be considered is how the attaching creditor would get information as to the existence of a perfected security interest for the purpose of evaluating whether he should file a claim. The Section did not discuss this matter in detail but there was some consensus that it should not be necessary to involve the courts in what is a preliminary form of discovery. One group felt that it might simply be left to the self-interest of the parties in avoiding litigation to work out their own arrangements by which secured parties furnish copies of the papers evidencing their perfected position to the attaching party; an alternative would be to provide that failure of the secured party to deliver appropriate papers for examination within a specified time period after written subjected the secured party to some penalty.

The whole effort would be to avoid disputes as "perfection" in the first instance and to resolve them

subsequently, keeping the money flowing from the account debtors to one party or another. Obviously the secured party who received money but was later held not entitled to because he did not have a perfected security interest as established in a subsequent proceeding by the attaching creditor would have to hand the money over to the levying officer.

The Section also felt that it was desirable to deal in greater detail with the fact that the secured party would not have any obligation to make any collection once its debt was satisfied, a matter which we believe has also been covered by your correspondence with Mr. Marsh.

The Section also discussed briefly the proposal to equate attachment of the paper representing leases as effecting a lien as to the equipment itself. Our conversation last Friday revealed that that arrangement was not meant to exclude the possibility of an attaching party leving on the equipment subject to lease but as a supplement thereto. That fact was not clear from the Commission's recommendation and should be clarified.

In reviewing the materials which you furnished to me at our meeting, I note that the Committee's consultant, Professor Reesenfelt, has concurred with Mr. Marsh's suggestion for a revision of UCC Section 8311. Our Section has not considered that matter and would hope that any action on that subject might be deferred until our Section meets again. I would suggest that the Commission treat that matter as a separate subject for consideration.

As I indicated in our conversation, we would be glad to have a staff member of the Commission attend any later meeting on attachment and to consult further as may be desirable.

Very truly yours,

Maurice D. L. Fuller, Jr.

cc: Stan G. Ulrich, Esq.

Memorandum 77-67 #39.160

EXHIBIT 3

ALVIN G. BUCHIGNANI
ATTORNEY AT LAW

ASSOCIATED WITH
KNIGHT, BOLAND & RIORDAN

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(415) 362-0664

September 1, 1977

California Law Revision Commission
Stanford Law School
Stanford, California 94305

Re: Tentative Recommendation
Relating to Attachment of
Properties Subject to
Security Interest

Gentlemen:

I apologize for not submitting this letter by August 15, 1977. My only comment concerns the problem faced by the attaching creditor when (as proposed in the case of a levy on an account receivable) levy is made by serving a copy of the writ and notice on the secured party only. Thereafter, the account debtor may be advised by the secured party that the secured party has been paid in full, in which event the account debtor would pay any balance to the defendant, without protection of the interest of the attaching creditor.

The recommendation seems to assume that the secured party will receive all payments from the account debtor, including those in excess of the amount owing to the secured party, but this will not always be the case.

Very truly yours,

Alvin G. Buchignani

AGB/eg