#39.160 4/1/77

Memorandum 77-25

Subject: Study 39.160 - Attachment (Levy on Chattel Paper, Accounts Receivable, Choses in Action, Negotiable Instruments, and Judgments)

Attached hereto is a copy of Professor Stefan A. Riesenfeld's background memorandum concerning certain problems with the method of levy of a writ of attachment on accounts receivable, choses in action, chattel paper, negotiable instruments, and judgments which are subject to perfected security interests of third parties. We will present drafts of amendments needed to deal with these problems at the meeting.

Respectfully submitted,

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EXHIBIT 1

Memorandum

Relating to Calif. Code Civ. Procedure §§ 488.370, 488.380, 488.400 and 488.420

California C.C.P. §§ 488.370, 488.380, 488.400 and 488.420 in conjunction with § 488.540 are bound to raise serious practical difficulties as to the proper method of levy in cases where accounts receivable, choses in action, chattel paper, negotiable instruments, or judgments are subject to perfected security interests of third parties because they a) either identify the "account debtor" (as defined in § 481.020) rather than the secured party as the person on whom the writ and notice of attachment should be served (§§ 488.370 and 488.420) or b) ignore the prior rights of the secured party to direct payment from the account debtor or obligors and to other types of resort to the collateral, (§ 488.330 (c), § 488.380 (c) and § 488.400 (c)). Moreover, in the case of chattel paper consisting of leases it is not clear whether the interests levied upon pursuant to § 488.380 includes the property interest of the lessor in the leased goods or only the interest in rental payments.

These are very serious defects which unfortunately are not easily remedied.

Perhaps the best method of approach is to start with a discussion of the former state of the law which, standing by itself, also was far from being clear, and to follow that discussion with a recommendation of the system to be adopted.

1. Levy on "pledged" choses in action (in the old sense)

(a) The leading case dealing with this type of problem is Axe v. Commercial Credit Corp., 227 C.A.2d 216, 38 Cal. Rptr. 746 (1964).

In that case the attaching creditor attached accounts receivable which had been "pledged" to a bank under a factoring arrangement by garnishing the bank. The bank had taken over the collection of the factored accounts and had collected more than enough to cover the amount of its loan to the attachment defendant. It released the uncollected accounts to the attachment defendant and also paid over to it the surplus collected from the accounts. The court held that the garnishee was liable to the garnishor under § 544 (the forerunner of C.C.P. § 488.550) because of its disregard of the garnishment lien and that the attachment of pledged accounts receivable was properly made by garnishing the pledgee. The court cited Crow v. Yosemite Creek Co., 149 C.A.2d 188, 308 P.2d 421, and Deering & Co. v. Richardson-Kimball Co., 109 Cal. 73, 41 Pac. 801, as authority. It distinguished cases where an assignment is made merely to an agent for collection. In such cases, according to the opinion, the account debtor would be a proper garnishee, citing inter alia, Smith v. Crocker First Nat'l Bank, 152 C.A.2d 832, 314 P.2d 237 (1957). In the Crow case the Crocker First Nat'l Bank had loaned to the judgment debtor a certain amount, of which $21,000 remained unpaid, taking canned figs stored in a warehouse as collateral. Smith, a creditor of the pledgor, garnished the pledgee (not the warehouse operator) and the court held that the garnishment of the pledgee was the proper way to proceed. In the companion case, Smith v. Crocker First Nat'l Bank, cit supra, the same garnishor claimed that the garnishement had reached also certain drafts delivered to the bank for collection. The court held that the garnishment did not create a lien on the drafts which were not yet accepted at the time of the service of the writ. The court actually rested its decision on the rationale that unaccepted drafts cannot be reached by garnishment, rather

than on the fact that the garnishee bank was merely a collection agent as intimated in Axe. If it had so held it might have disregarded C.C.P. 542 (6) as it was in force at that time. This point came up in Puissegur v. Yarbrough, 29 C.2d 409, 175 P.2d 830 (1964). In Puissegur the asset tried to be reached by two competing creditors was a note payable in installments, secured by a deed of trust. The makers of the note were the Yarbroughs, who had executed the note to Mrs. Wood, the payee. The note was held by a bank for collection. One creditor (Hovey) sought to attach the note by garnishment of the makers, the other creditor (Puissegur), garnished the bank and the makers, both garnishments were subsequent to Hovey's attachment. Hovey recovered judgment and he again attempted a levy by garnishing the Yarbroughs. The bank honored the garnishment under the execution upon the Puissegur judgment and delivered the note to the sheriff. The sheriff sold the note on execution to Puissegur. Puissegur then tried to collect the note from the Yarbroughs who pleaded payment to Hovey and invalidity of Puissegur's garnishment. The court held that Puissegur's garnishment of the notes held by the bank for collection by garnishing the bank was valid and that Hovey's levy by garnishing the Yarbroughs had lapsed, if it ever was valid. The court stressed twice the fact that the validity of Hovey's attachment was questionable although that question was immaterial for the outcome of the litigation. Unfortunately, the court did not discuss whether the note was negotiable or nonnegotiable. It would seem, however, that the better rule is that liabilities on negotiable instruments require either seizure of the note or garnishment of the holder and can never be accomplished by garnishment of the maker or endorser, although there is language in some cases which leaves the question open.

(b) It would seem therefore that the pledgor's interest in pledged negotiable instruments, pledged accounts receivable, pledged choses in action or pledged judgments can only be reached by garnishing the secured party and not by garnishing the account debtor or obligor. The account debtor or obligor remains liable for payment to the secured party in the full amount of the collateral and it is the garnishee who must pay over any excess to the sheriff. Any other rule would violate the rule against splitting causes of action and cause hardship to the account debtor or obligor. Most of all, to deprive a pledgee of the pledgee's right to direct payment from an account debtor or obligor and the pledgee's right to sell pledged collateral in case of default is subject to serious doubts on the wisdom or legality of such rule. A different result is only defensible in the special case where the debtor remains entitled to collection (so-called non-notification assignment) U.C.C. § 9-205.

If a negotiable document is subject to a security interest which is perfected by filing, U.C.C. § 9-304 (1), the proper method of levy should be by seizure, if the document is in the hands of the debtor who is the attachment defendant, in order to prevent negotiation to a holder in due course, U.C.C. §§ 9-309 and 7-502. The secured party in such case must assert the security interest under § 488.090.

It is recommended to insert a new section qualifying the rules of the listed sections in the cases of perfected security interests in accounts receivable, choses in action and judgment and in cases of negotiable instruments in the possession of secured parties.

So far as negotiable documents are concerned, service of the writ on a person obligated under the document (i.e., the bailee who has issued the negotiable instrument) is a useless step in view of U.C.C. § 7-403

and the requirement of such service in § 488.400 (c) should be deleted.

A comment or amendment of § 488.330, however, should indicate that if a party claims a security interest in goods which is perfected by an issuance of a non-negotiable instrument, U.C.C. § 9-304, a proper levy on the debtor's right in the collateral is made by garnishment on the secured party and notice should be given to the debtor within 45 days.

2. Particular difficulties exist with respect to chattel paper resulting from true leases of goods.

a) In the first place if the chattel paper is subject to a security interest which is perfected by possession of the secured party the attachment of the attachment debtors rights in the collateral (U.C.C. § 9-311) should be by service of the writ on the secured party and the lessees should continue to make payments to the secured party, if the arrangement is a "direct collection" arrangement, see Official Comment to § 9-308, No. 1.

b) Even greater difficulties exist with respect to the status of the chattel paper's holder's rights in the lessor's property interests in the leased goods. While the Code has made it clear that a secured party holding a security interest in chattel paper resulting from a sale has a right in the debtor's security interest in the goods sold (which security interest must be perfected by filing), see Official Comments to § 9-105 "Chattel paper" and to § 9-308, the Code has left the matters not expressly resolved with respect to chattel paper resulting from true leases. In In re Leasing Consultants, 486 F.2d 367 (1973) the 2nd Circuit Court held that a perfected security interest in chattel paper resulting from true leases did not result in a perfected security interest in the "reversionary interest" of the lessor in the goods, if the security interest in the chattel paper was perfected by possession. The logic of that decision

would result in the conclusion that a creditor of the lessor who has received and pledged to a secured party chattel paper obtains by garnishment of the pledgee of the chattel paper merely a lien on surplus rentals and that he must garnish each lessee to obtain a lien on the goods subject to the lessee's right to possession for the period of the lease. In re Leasing has been severely criticized by a Comment in 84 Yale L.J. 1722. It is recommended to clarify the situation with respect to attachment or execution liens by providing that a levy under a writ of attachment on chattel paper creates an attachment lien also on the lessor's interest in the goods leased, provided that the lessee was properly notified of the levy on the chattel paper. By virtue of the lien the leased goods shall be delivered to the sheriff at the end of the lease, unless a secured party with a prior perfected security interest in the goods is entitled to possession of the goods, whether on default of the leasee or expiration of the lease. An exception to that rule may be provided where the attaching creditor has attached the inventory pursuant to § 488.360 (c), in order to facilitate continuation of the business. In such case the leased equipment may be returned to the lessor for releasing.