Rights In Payment Intangibles: Collateral or Red Herring?

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Jeffrey Wurst of Ruskin Moscou Faltischek, P.C discusses the emergence of payment intangibles, which were created when Article 9 was revised and became effective in 2001.

In this very difficult lending environment it is understandable that lenders keep seeking and identifying additional types of collateral to lend upon or to rely upon as backup collateral to secure a loan. Patents and trademarks, which were once afterthoughts or boot collateral, have developed into valuable collateral which many lenders now include in a borrowing base. Transportation and construction receivables have found their borrowing niche. New and interesting collateral-based loans continue to appear, sometimes ending up being less than initially envisioned. The purpose of this article is to discuss the emergence of payment intangibles – created when Article 9 was fully revised and became effective in 2001.

The Uniform Commercial Code defines a ***payment intangible*** as “a general intangible under which the account debtor’s principal obligation is a monetary obligation.” A ***general intangible*** “means any personal property, including things in action, *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.” The drafters of Revised Article 9 specifically considered “intellectual property and the right to payment of a loan of funds not evidenced by chattel paper or an instrument” as payment intangibles, as indicated in Official Comment 5(d).

Official Comment 5(d) also provides: “Payment intangible is a subset of the definition of ‘general intangible.’ The sale of a payment intangible is subject to this Article. See Section 9-109(a)(3). Virtually any intangible right could give rise to a right to payment once one hypothesizes, for example, that the account debtor is in breach of its obligations. The term “payment intangible”, however, embraces only those general intangibles under which the account debtor’s principal obligation is a monetary obligation."

Several courts have applied this doctrine as envisioned by the drafters, recognizing the sale of loan participations as payment intangibles having automatic perfection (no requirement to file a financing statement). This was a significant issue during the drafting of this new concept as banks became concerned that, without "automatic perfection", sales of loan participations would become complicated and impractical. Several decisions have come down to addressing automatic perfection of loan participations, where the courts determined the participations were actually *disguised* loans not *true sales*, serving as a warning that it is prudent to perfect by filing a UCC financing statement, especially when the participation is obtained from a lead lender that may itself be a financial risk. Notwithstanding, it is unlikely that filing by perfection will be permitted when purchasing a participation from a major financial institution.

The leading case affecting payment intangibles is *in re Commercial Money Center, Inc.,* a decision from the Bankruptcy Appellate Panel of the Ninth Circuit. Commercial Money Center was an equipment lessor that packaged and sold pools of leases, assigning both the payment streams and the leases as separate interests. The purchasers of these pools did not file financing statements, relying, instead, upon the automatic perfection of the payment intangibles. When Commercial Money Center became the subject of a Chapter 7 proceeding, the trustee sought to avoid the transfers, alleging, in part, that the automatic perfection provisions did not apply and that the purchasers failed to perfect their interest. The bankruptcy court agreed with the trustee, concluding that the payment streams were chattel paper, which needed a filing in order to be perfected. The BAP reversed, holding that the payment streams were payment intangibles that would be subject to automatic perfection if the payment streams had been sold. However, the court went on to determine that the transfers of the payment streams were not sales, but, instead, secured, nonrecourse loans and, thus, concluded that the interests were not automatically perfected. Again, a prophylactic filing would have come in handy in this situation.

In the 14 years since the effective date of revised Article 9, there has not been an abundance of litigation defining the extent of payment intangibles. Litigations to date have considered public policy concerning the sale or pledge of payment streams under structured settlements and similar annuities, tort claims, judgments and others. Most have focused on the necessity to perfect by filing, as opposed to automatic perfection.

Consider this situation. Lender makes advances to borrower to be used as cash deposits for borrower's purchases under a needs contract with seller. The cash deposits are placed with a financial intermediary, who, together with the borrower and seller, execute a deposit account control agreement (DACA). Pursuant to the needs contract when the borrower's needs drop, the amount of the deposits will be reduced and the DACA provided a mechanism for the return to the borrower of excess deposits. It had a perfected security interest in all assets specifically, including payment intangibles. To the extent the deposits were used to pay for borrower's purchases under the needs contract, those purchases evolved into accounts, which were subject to the lender's security interests with account debtors on notice to only pay the lender. Lender, understandably, desired a security interest in the deposits, in part, because it provided the funding for them.

In order to protect against the excess deposits falling into the hands of the borrower, lender wrote to the financial intermediary and the seller advising them of its interest in the payment intangibles and notified them, pursuant to 9-406, to make payment on all payment intangibles (the excess deposits to be returned to the borrower) only to the lender. The financial intermediary ignored or neglected the notification and paid the excess deposits to the borrower, who failed to turn them over to the lender.

Litigation pursued and the financial intermediary claimed that the returned excess deposits were not payment intangibles and that, even if they were, the notification was ineffective. These facts are presently before the Fourth Circuit Court of Appeals. Unlike many other cases involving payment intangibles, perfection is not an issue and the lender properly filed its financing statement on all assets, including the *usual string*, which included payment intangibles. Should the lender prevail, this will open the door for similar situations, where a lender is seeking a subordinate interest in funds held in a deposit account, but the financial intermediary will not authorize the subordinate interest. To the extent the funds remain in the account, they are clearly the collateral of the secured party-beneficiary of the deposit account. However, the argument goes that, once the funds are to be released to the debtor, they evolve into a monetary obligation – a payment intangible – subject to the interest of the secured party holding an interest in the payment intangible.

The Commercial Finance Association has submitted an *amicus* brief in the case. Stay tuned for further developments. **TSL**

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