

# BIG money



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## INSECURE *Secured Lenders*

By Timothy A. Lambirth and Regina Ashkinadze

Secured creditors, don't relax any time soon. If you think that nothing can touch a secured creditor: wrong! In a recent decision, by the First Appellate District, Court of Appeal, *Orix Financial Services v. Mike Kovacs*, LADJ Oct. 2008, the Court held that an unsecured judgment creditor is a "transferee" as contemplated by the California Uniform Commercial Code (CUCC) Sec. 933-2(b) if that creditor satisfies the judgment from the debtor's deposit account funds, and can levy funds from the account, even though the account is security for another's debt.

Orix Financial Services (Orix) was a secured creditor of ADA Machine Company (ADA). ADA defaulted on financial obligations to Orix, which were secured by all of ADA's goods, chattels, and property. ADA's outstanding balance was \$1.5 million.

9-332, which overrode Orix's customarily superior standing.

The CUCC 933-2 "affords broad protection to transferees who take funds from a deposit account and to those who take money." However, the kind of transactions envisioned by section 9-332 apply to transfers of funds from deposit accounts by check, fund transfer, or by debiting the debtor's deposit account while crediting another depositor's account. Notably, this definition suggests that such transfers are voluntary transfers by the debtor, rather than a levy or seizure. That suggestion is supported by CUCC section 9-306, comment 2(c), on which the CUCC is based.

The comment to that section states that, "Where cash proceeds are converted into the debtor's checking account and paid out in the operation of the debtor's business, recipients of the funds of course take free of any claim which the secured

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In an unrelated matter, Mike Kovacs (Kovacs) obtained a judgment against ADA for \$157,468.11, and executed a writ against ADA's deposit account. All of the funds in that deposit account were derived from the sale of ADA's inventory and collection of its accounts receivable and arguably secured by ORIX's prior perfected security agreement. Thereafter, Orix sued Kovacs to recover the levied funds.

Orix, as a secured creditor, should have had a superior interest to Kovacs's position as an unsecured creditor. However, under CUCC 9-332, Kovacs was converted from an unsecured creditor, with an inferior interest, to a transferee within section

party may have in them as proceeds." The comment further refers to payments in the ordinary course of business. Words such as "transfer of funds" and "paid out" generally accompany a voluntary act. Obviously, a post judgment levy of funds by the sheriff is not the same thing as a debtor paying bills in the ordinary course of business. However, in *Orix*, the Court did not see it this way.

The Court emphasized the importance of excluding "any judicial efforts to trace (as 'identifiable' secured 'proceeds') money paid out [of a commingled account] in the [ordinary course of] operation of the debtor's business." Given the need

to trace funds under Code of Civil Procedure, Sec. 720.110's third party claims procedure is curious. Why would the Court not look to a judicial effort to trace funds?

The Court was concerned with the prospect that if section 9-332 is defined too narrowly, a debtor may not be able to pay its regular expenses from a bank account because another secured creditor has an interest in its proceeds. Consequently, the Court found that scenario too ominous to allow for a limited construction of the meaning of "transferee" under Sec. 9-332.

To that end, the Court explained the meaning of "ordinary course of business." The determinative factors in that evaluation are:

- (1) The extent to which the payment was made in the routine operation of the debtor's business, and
- (2) The extent to which the recipient was aware that it was acting to the prejudice of the secured party"

The routine factor is measured by a debtor's "size, frequency of payments, whether the debtor received merchandise or services in return, and whether the payment was on an obligation overdue, due or not yet due."

Accordingly, Orix's argument that a secured creditor's rights cannot be comprised by a junior creditor was not well taken. A transferee protected by Sec. 9-332 need not be a creditor at all, and could have been paid and yet provided no services in return, or could have been paid by mistake. Because a transferee's creditor status is irrelevant, the Court held that there is no requirement that the debtor act voluntarily, or involuntarily,

in making a payment to the transferee.

Orix's argument, indicating that payment to a lien creditor is involuntary, was therefore unpersuasive. The court held that this conclusion was supported by Sec. 9-332 in the legislature's use of the word "transferee" instead of "payee." The Court used the same reasoning to refute Orix's argument that Sec. 9-332 protects only "complete transactions," rather than unilateral acts. It determined that the use of the word "transfer" did not necessitate a bilateral act.

Secured creditors should be alarmed and take action to protect their collateral. This case is troublesome for many reasons and will have far-reaching consequences. This case generates many unresolved questions:

How was ADA's judgment levied?

- Was the third party claim procedure set forth in Code of Civil Procedure Sec. 720.110 utilized?
- If so, to what effect?
- How can some one acting as a judgment creditor, who is having the sheriff seize funds from another's secured account via a levy, be deemed a "transferee" in the ordinary course of business?

This case will turn lending on its head and could cost lenders BIG MONEY.

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