

Legal Opinions in Sale-Leaseback Transactions

by TERI SHUGART ERICKSON



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In a typical "middle tier" equipment leasing transaction, a lessor and a lessee enter into a lease agreement under which the lessor agrees to make available a certain amount of money, usually \$1 million to \$5 million, for the purchase of equipment. The lessee orders the equipment it wishes to lease directly from an equipment manufacturer or supplier, the equipment is delivered to and accepted by the lessee, and, after the lessor receives notification from the lessee of the lessee's acceptance of the equipment, the lessor pays the equipment manufacturer or supplier directly for the equipment.

Many times, however, a lessee already will have purchased equipment that both the lessor and the lessee intend to have the lessor own and lease to the lessee. In that event, the lessor and lessee enter into a sale-leaseback arrangement under which, after complying with certain provisions of the California Civil Code, the lessee sells the equipment to the lessor and the lessor then leases the equipment back to the lessee. It is the opinions requested from lessee's counsel in these sale leaseback transactions that are the subject of this article.

Compliance With CC §3440.1(h)

Under CC §3440, a transfer of personal property made by a party having possession of the property, that

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is not accompanied by an immediate delivery followed by an actual and continued change of possession of the property (which is the factual scenario of a sale leaseback), is void as against the transferor's (lessee's) creditors. However, CC §3440.1(h) contains an exception to this rule. Section 3440 will not apply if the following CC §3440.1(h) requirements are satisfied:

- Before the transfer, a financing statement on Form UCC-1 is filed with the Secretary of State. There are no specific requirements for this filing, other than the standard requirements for any financing statement being filed with the Secretary of State. Typically the only changes made to the UCC-1 are to strike out the words *Secured Party* and *Debtor* and substitute the words *Transferor* and *Transferee*. In the space designated for the description of the transferred property, some practitioners merely describe the property, while others repeat verbatim the information contained in the notice described below.
- A notice is published in a newspaper "of general circulation published in the judicial district in which the personal property is located," which publication must be completed at least ten days before the transfer. Practitioners typically use a legal publication service to publish the notice as well as to determine the appropriate (as to location and type) newspaper for publication. If a practitioner elects to do the pub-

lication herself, she should ensure that the main offices of the selected newspaper (any general city paper will suffice) are in the correct judicial district, a task complicated by Govt C §71042.5, which provides that "[n]otwithstanding any other provision of law, upon consolidation of judicial districts, the territory embraced within the respective prior component judicial districts shall be separate judicial districts for purpose of publication within a judicial district." If there is no such newspaper in the appropriate judicial district, the practitioner may use a newspaper in the county embracing that judicial district. The notice must contain the following information:

- (1) The names and addresses of the transferor (lessee) and transferee (lessor);
- (2) A "general statement of the character" of the property being transferred;
- (3) The location of the property; and
- (4) The date on or after which the transfer is to be made.

A sample notice is contained in Document 1 in the Appendix following this article.

The Future Effect of CC §3440.1(k)

As an aside, it should be noted that the issue arises of whether the importance of CC §3440.1(h) will be significantly reduced when new CC §3440.1(k) takes effect on January 1, 1990. The new statute, complementing new Division 10 of the Uniform Commercial Code, which takes effect on the same date, provides an additional exception to the general rule that a transfer without a change of possession is fraudulent as to creditors by excluding from the scope of the rule "[a] transfer of personal property in connection with a transaction in which the property is immediately thereafter leased by the transferor from the transferee provided the transferee purchased the property for value and in good faith (subdivision (3) of Section 10308 of the Commercial Code.)"

The reference to the Commercial Code refers to a substantively identical provision in new Article 10 of the Uniform Commercial Code, also effective January 1, 1990.

At first glance, new CC §3440.1(k) would often appear to eliminate the need to rely on CC §3440.1(h), but there is enough room for doubt about this conclusion that it seems unlikely that attorneys for lessors will be willing to give up the more objective protec-

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tion of CC §3440.1(h). Reliance solely on CC §3440.1(k) leaves the lessor open to later contentions that the transaction involves a security interest rather than a lease under Com C §1201(37), or that the purchase was not for value and in good faith.

Opinion Request

In these leasing transactions, it has become fairly common for lessor's counsel to ask that lessee's counsel provide various opinions regarding the sale and leaseback of the equipment, including an opinion that the transaction is not void under CC §3440 and/or that all filings and publications required by §3440.1(h) have been duly and properly made.

Counsel should resist giving this opinion, because compliance with §3440.1(h) is primarily a factual issue. Lessor's counsel should rely on the representations and warranties of the lessee as well as its own review of the filings and publications rather than asking lessee's counsel to be an additional warrantor of facts. However, if client relations demand that the opinion be given, lessee's counsel may do so, but only if (1) appropriate assumptions are made and disclosed in the opinion, and (2) lessee's counsel (rather than the lessor or lessor's counsel) handles the publication and filing responsibilities.

Stating Assumptions

As a practical matter, lessee's counsel must make various assumptions in order to give an opinion. Thus, lessee's counsel must usually rely on information provided by the lessee regarding the location and description of the property. Further, lessee's counsel usually must rely on (1) a file-stamped copy of the financing statement on Form UCC-1 provided by the Secretary of State (via a filing service in Sacramento), and (2) proof of publication provided by the newspaper in which the notice was published. Lessee's counsel must also assume that (1) the names and addresses of the lessee and lessor are correct, (2) CC §3440.3, which protects a "buyer in the ordinary course of business" who purchases personal property in the seller's

possession, is not applicable to the transaction, (3) the transfer takes place on or after the date specified in the notice (provided the date is at least ten days after publication occurs), (4) the property description is sufficient, (5) the property is located as described in the notice, and (6) the publishing newspaper is a newspaper of general circulation published in the judicial district in which the property is located.

Counsel must be careful to recognize and carefully disclose these assumptions when rendering an opinion. If this is adequately done, counsel can give the opinion that the transfer of the equipment by the lessee to the lessor is not void under CC §3440 and/or that all filings and publications required by CC §3440.1(h) have been duly and properly made *provided* lessee's counsel has handled the filing responsibilities. Document 2 in the Appendix is a form of such an opinion.

Handling Filing Responsibilities

However, if, as is often the case, lessor's counsel has handled the filing and publication responsibilities for the transaction, lessee's counsel should not give the opinion. In this event, lessee's counsel is merely reviewing the work of lessor's counsel and would need to assume the accuracy of that work, *i.e.*, all relevant facts would have to be assumed. The result would be an opinion that would state, although disguised more eloquently, that "[a]ll filings and publications required by §3440.1(h) have been duly and properly made, but we have assumed for the purpose of this opinion that all filings and publications required by §3440.1(h) have been duly and properly made." Such an opinion would serve no purpose other than to increase the number of people who could potentially be liable to the lessor in the event the transaction turns sour.

Opinions Regarding Outstanding Liens or Encumbrances

A second opinion that is often requested by lessor's counsel in a sale-leaseback transaction is an opinion that there are no outstanding liens or encumbrances against the equipment being transferred from the lessee to the lessor. Such a request is merely a disguised attempt to get an opinion regarding whether the lessee has good and marketable title to the equipment. According to the Committee on Corporations of the Business Law Section of the State Bar of California (the Corporations Committee), lawyers should avoid rendering such an opinion. Report of the Committee on Corporations Regarding Legal Opinions in Busi-

ness Transactions, p 54 (1982), reprinted at 14 Pac LJ 1001, 1058 (1983), hereinafter cited as "1982 Report." There are many types of liens that could exist against the equipment that are undiscoverable due to such things as economic unfeasibility (*e.g.*, tax liens), liens that would not come to light even after investigation (*e.g.*, misindexed UCC-1s), or valid liens that exist without the necessity of a filing.

The Corporations Committee offers an alternative, suggesting that the opinion be given with the stated assumptions that it is made solely in reliance on a certificate of the Secretary of State listing outstanding filed financing statements and that the opinion is limited to the date of such certificate. 1982 Report p 54, 14 Pac LJ at 1059 (1983).

**"All the opinion really says is
'I compared the two lists and there
were no match-ups.' "**

The author disagrees with this approach on two counts. First, this "limited" opinion assumes that the lawyer will be able to ascertain whether any of the filed financing statements apply to the equipment that is being sold to the lessor. The description for the same piece of property can vary; in fact, some descriptions of property in financing statements merely reference a purchase order or a contract. Second, limiting the opinion to reliance on a certificate may not relieve lessee's counsel of its due diligence obligations, and it certainly will not allow lessee's counsel to turn a blind eye to liens or encumbrances of which it is aware but which are not disclosed by a search of filed financing statements. The real risk to lessee's counsel is the possible existence of liens of which lessee's counsel should have known. The "solely in reliance" language in the opinion may not absolve lessee's counsel of that risk.

A barely palatable alternative opinion that can be given by lessee's counsel is an opinion that states, after making the assumptions described below, that lessee's counsel has no knowledge of any filed financing statements covering the property to be transferred. The opinion is essentially a factual warranty by lessee's counsel, but, as with §3440.1(h) opinions, can be given when client relations demand it, as the risk to lessee's counsel is low. To give the opinion, lessee's counsel obtains copies of the financing statements on file with the Secretary of State as well as a lessee-provided list

of the equipment to be transferred from the lessee to the lessor, and then compares the two lists. The opinion that lessee's counsel gives, after extensive assumptions and exclusions, states that lessee's counsel is unaware of any financing statements on file with the California Secretary of State covering the equipment that list the lessee as debtor, lessee, or transferor. Due to the assumptions and exclusions that make this statement possible, all the opinion really says is "I compared the two lists and there were no match-ups." Document 3 in the Appendix is a form of such an opinion. Giving the opinion poses a risk similar to the risk posed by the limited opinion described above in that descriptions of the same piece of property can vary. Therefore, lessee's counsel must assume that the descriptions are identical.

However, even stating this assumption does not completely eliminate the problem. Even though the opinion will state that the description of the equipment and the name of the lessee are assumed to be identical to any information contained in any filed financing statements, lessee's counsel will be under some obligation if it finds similarly but not identically described equipment or if it finds a list of similarly or identically described equipment for a company with a corporate name similar but not identical to that of the lessee. At a minimum, lessee's counsel will be under an obligation to investigate if such similarities are discovered.

Lessor's counsel will occasionally ask for an expansion of the above opinion to include the statement that

"to our knowledge, and without any independent investigation thereof, we are unaware of any other financing statements that conflict with the opinion expressed herein." Lessee's counsel should resist giving this opinion for two reasons. First, it is not an opinion, but rather merely a guaranty by lessee's counsel that it is not hiding any facts from the lessor. Second, and most important, this statement runs into the same problems as the "no-liens-or-encumbrances" opinion described above. As the assumptions in the opinion limit it to a review of a specified set of financing statements, the additional statement appears to lie outside of those assumptions, leaving lessee's counsel open for a "should-have-known" attack. This is an especially dangerous opinion when lessee's counsel represents the lessee in a wide range of corporate activities.

Conclusion

A legal opinion should be given in only one instance: to advise one's client (or the client's designated recipient) of the application of the law to a given set of facts. A lawyer should not be an additional verifier of facts nor should she be the guarantor for the outcome of the transaction. The above-described opinions could be characterized as forcing lessee's counsel into those two roles and, therefore, counsel should not give those opinions. However, if lessee's counsel elects to give an opinion in a sale-leaseback transaction, the following examples provide possible alternatives.

Appendix

Document 1.
*Notice of Sale and
Leaseback*

NOTICE OF SALE AND LEASEBACK

Section 3440.1(h) of the California Civil Code

Notice is hereby given that Cortlandt Electronics, transferor, whose principal business address is 15 Glover Street, City of Sunnyvale, County of Santa Clara, State of California, that a sale and leaseback is about to be made to Montgomery Enterprises, transferee, whose principal business address is 430 Lassen Street, City of Palo Alto, County of Santa Clara, State of California.

The property to be transferred is located at 15 Glover Street, Sunnyvale, California. The property is described in general as manufacturing, computer, test, and production equipment.

The sale and leaseback will be consummated on or after the 20th day of March, 1989, at 15 Glover Street, Sunnyvale, California.

Dated: March 5, 1989

Travis Montgomery, President
Montgomery Enterprises,
Transferee

Document 2.

*Opinion on Compliance With
CC §3440.1(h)*

**Montgomery Enterprises
420 Lassen Street
Palo Alto, California 94306
March 20, 1989**

Re: Cortlandt Electronics Sale-Leaseback Transaction

Ladies and Gentlemen:

Reference is made to the Master Equipment Lease (the Lease) dated February 1, 1989, between Montgomery Enterprises (Montgomery) and Cortlandt Electronics, a California corporation (the Company). This opinion is being given to you solely in connection with the sale of equipment listed on Exhibit A attached hereto (the Equipment)¹ from the Company to you (the Transaction).

We are counsel to the Company and have acted as such in connection with the filing and publication requirements of Section 3440.1(h) of the California Civil Code (the Civil Code) as they relate to the Transaction. In our examination of the documents referred to below, we have assumed the genuineness of all signatures and official markings of governmental agencies on original documents, the conformity to original documents of all copies submitted to us, and the due execution and delivery by parties other than the Company of all documents in which due execution and delivery are a prerequisite to the effectiveness thereof.

The opinion hereinafter expressed is subject to the following qualifications and assumptions:

(1) We express no opinion as to the effect of applicable bankruptcy and other similar laws affecting the rights of creditors generally.

(2) We have assumed that the addresses set forth in the Lease for the Company and Montgomery are correct.

(3) We have relied solely on a certificate of an officer of the Company that the equipment is of a general character described on the "Notice of Sale and Leaseback" which is attached hereto.

(4) We have assumed that the equipment, at all times relevant to Section 3440.1(h) of the Civil Code, has been located at the address shown in the attached "Notice of Sale and Leaseback," and that the date of sale is on or after the date stated in the notice.

(5) As to the actual filing of the financing statement on Form UCC-1 with the California Secretary of State, as required by Section 3440.1(h)(1) of the Civil Code, we have relied solely on a file-stamped carbon copy of a financing statement on Form UCC-1 provided to us by ABC Filing Service, a copy of which is attached hereto.²

(6) As to the actual publication of the notice required by Section 3440.1(h)(2) of the Civil Code, we have relied solely on a Proof of Publication from the Sunnyvale Tribune, a copy of which is attached hereto.³

(7) We have assumed that Section 3440.3 of the Civil Code is not applicable to this transaction.

Based on and subject to the foregoing, and subject to the qualifications contained herein, we are of the opinion that all filings and publications required by Section 3440.1(h) of the Civil Code have been duly and properly made covering the transfer of the Equipment by the Company to Montgomery and that the sale of the Equipment by the Company to Montgomery is not void under Section 3440 of the Civil Code.

This opinion is intended solely for your use and is not to be made available to or relied on by other persons or entities without our prior written consent.

Sincerely,

Tyler, Sloane & Baldwin

¹ This exhibit would be a lessee-prepared list of equipment.

² This is a necessary assumption. Time will not permit obtaining a certificate from the Secretary of State confirming the filing.

³ This refers to a proof of publication executed by the clerk of the publication under CCP §2015.5, which certifies that the newspaper is of general circulation in the correct judicial district and establishes the date of publication.

Document 3.
*Opinion Regarding Liens
and Encumbrances*

Montgomery Enterprises
420 Lassen Street
Palo Alto, California 94306
March 20, 1989

Re: Cortlandt Electronics Sale-Leaseback Transaction

Ladies and Gentlemen:

Reference is made to the Master Equipment Lease dated as of February 1, 1989 between Montgomery Enterprises (Montgomery) and Cortlandt Electronics, a California corporation (the Company). This opinion is being given to you solely in connection with the sale of equipment listed on Exhibit A attached hereto (the Equipment)¹ from the Company to you (the Transaction).

We are counsel to the Company and have acted as such in connection with the review of financing statements filed with the California Secretary of State as they relate to the Equipment and the Transaction. In our examination of the documents referred to below, we have assumed the genuineness of all signatures and official markings of governmental agencies on original documents, the conformity to original documents of all copies submitted to us, and the due execution and delivery of all documents in which due execution and delivery are a prerequisite to the effectiveness thereof.

The opinion hereinafter expressed is subject to the following qualifications and assumptions:

(1) Except as set forth below, we express no opinion as to the title of the Equipment or as to the perfection or priority of any security interest on the part of Montgomery with respect to the Equipment or the taking of any required action on the part of the Company or Montgomery to accomplish the same.

(2) We have assumed that, if a financing statement covering the Equipment was on file with the California Secretary of State, the description of the Equipment would be identical to the description contained on Exhibit A attached hereto.

(3) We have relied solely on a review of the copies of the financing statements attached hereto as Exhibit B, which copies were provided to us by ABC Filing Service.²

(4) We express no opinion regarding any security interests or liens covering the Equipment except as set forth below. Such exclusion includes, but is not limited to, the following matters:

(a) Any security interest or lien that exists on the Equipment but is not disclosed on the financing statements attached hereto as Exhibit B;

(b) Any security interest or lien that exists on the Equipment that is covered by a financing statement on file with the California Secretary of State but is not included on Exhibit B due to a security interest or lien that (i) is held by an individual or entity other than the Company, (ii) is not disclosed on a financing statement attached hereto as Exhibit B due to misindexed or misfiled statements at the California Secretary of State's office or due to the failure of ABC Filing Service to provide us with a true and complete copy as of March 15, 1989, or (iii) is outstanding against the Company but is listed under a name other than "Cortlandt Electronics";

(c) Any security interest or lien (i) perfected or filed in a jurisdiction other than California, or (ii) evidenced by virtue of a method other than filing a financing statement with the California Secretary of State.³

Based on and subject to the foregoing and subject to the qualifications contained herein, as of March 15, 1989, we are unaware of any financing statements on Form UCC-1 on file with the California Secretary of State covering the Equipment or any part thereof that also list Cortlandt Electronics as "Debtor" or "Lessee."

This opinion is intended solely for your use and is not to be made available to or relied on by other persons or entities without our prior written consent.

Sincerely,

Tyler, Sloane & Baldwin

1 This exhibit would be a lessee-prepared list of equipment.

2 Normally there will not be time to obtain certified copies of the financing statements from the Secretary of State.

3 These disclaimers and assumptions may seem repetitive; however, they help to forestall the argument that the lessor did not understand the limited nature of the opinion. The argument against having an extensive list is the contention that the specific listing implies that there are no assumptions about matters not listed.