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Kenneth M. Johnson

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By Kenneth M. Johnson*

IN CONSIDERING the developments of the decade just past, this article differs somewhat from the time honored character of the usual law review article and is intended to be an analysis of current and developing business practices and an excursion into preventive law.

Business Reasons for Increased Assignments

During the past ten years it has been obvious to the most casual observer that California has experienced a tremendous increase in population and a broad expansion of commerce and industry in every direction. This has resulted in the assignment of contracts or the assignment of contract proceeds in many areas, and such assignments are usually in one way or another related to financing. No one who buys an automobile under a conditional sale contract anticipates that the contract will remain with the dealer. The buyer expects that the contract will be assigned to a bank or finance company. The reason for this is, of course, obvious. With any reasonable volume, it soon becomes impossible for a dealer to retain his own paper. Assume that there are 260 business days in a year and that a dealer averages the sale of one car per day with an average deferred selling price of 3,000 dollars payable over a period of from twenty-four to thirty-six months. This means that within a year the dealer will have approximately 700,000 dollars outstanding. Also the abilities of a particular finance company will be strained to accommodate all of those desiring to sell conditional sale contracts to it and the finance company itself will be compelled either to resell the contracts to a bank or a larger finance company, or to borrow on the security of the same. In either case there is an assignment of contractual rights involved. While in the example there has been a reference to motor vehicles, conditional sale contracts are common in many other fields such as the sale of refrigerators, stoves, television sets, etc. Nor is the conditional sale contract limited to the consumer field. It has a place also in the sale of nonconsumer equipment.

* B.A. 1925, Stanford University; J.D. 1928, Stanford University, School of Law; Vice-President and Counsel, Bank of America National Trust & Savings Association; member, California and American Bar Associations.

As business increases and expands, so develops the need for additional financing by way of the sale or hypothecation of accounts receivable. Basically an account receivable represents the proceeds arising out of a performed contract of sale. Here again problems of assignment are involved.

The last ten years have seen the development of certain business methods which are entirely new. One relating to the problem of assignments is the conviction of many manufacturers and processors that it is more economical to rent machines and equipment rather than to invest capital therein. As a result, leasing corporations have arisen and they in turn obtain their financing through an assignment of the lease and its rentals, or of the proceeds thereof to a financing institution. Quite often the conditional sale contract and the lease are combined. A manufacturer will sell a large press to a leasing company under a conditional sale contract. A bank will purchase the conditional sale contract by way of assignment and may also take an assignment of the lease rentals when the press is leased to the actual user. Ordinarily in this situation the financing agency looks primarily to the credit of the user and his ability to pay the lease rentals rather than to the credit position of the leasing company itself.

California during the past ten years has certainly had its share of defense production. This has meant that in many cases the proceeds of government contracts and of subcontracts have been assigned.

Another area in which assignments of contracts or of contractual rights develop is when a going business is sold as a whole. The purchaser in one way or another will succeed to the benefits and the burdens of the various contractual relationships to which the seller is subject.

The purpose of this article is to explore certain of the problems in these areas to ascertain what if anything the California courts and legislature have had to say, and to suggest certain precautionary measures.

Applicable Law

California is a state in which rights of assignment are fully recognized both in statutes and in the decisions of the courts.[1] In fact there is probably a certain amount of duplication in the California statutes. For example, section 1458 of the Civil Code provides that "... [A] right arising out of an obligation is the property of the person to whom it is due and may be transferred as such." The following

[1] See, *e.g.*, Communale v. Traders & General Ins. Co., 50 Cal. 2d 654, 328 P.2d 198 (1958), (assignment of a chose in action); Farmland Irr. Co. v. Dopplmaier, 48 Cal. 2d 208, 308 P.2d 732 (1957), (assignment of license rights).

section provides that non-negotiable written contracts for the payment of money may be transferred by endorsement in like manner with negotiable instruments.[2] This whole section is at least in part duplicated by the provisions of Civil Code section 955 and section 955.1. The first section refers to the transfer of a contract of conditional sale or an obligation represented by a chattel mortgage or trust receipt, an obligation represented by a lease of personal property or a non-negotiable instrument which is a note, bill of exchange or acceptance. The second section appears to be more or less of a blanket section covering anything that may have been omitted under section 955 and which does not constitute an account receivable as defined in section 3017 of the Civil Code.[3] Section 3017 rather broadly defines accounts receivable and has a good many specific exceptions.[4] Anyone contemplating the assignment of contract rights or of moneys due or to become due under a contract should carefully evaluate all of these sections since, to perfect an assignment of an account receivable as against third party creditors, there must be a filing of a notice as provided in Civil Code sections 3018 and 3019. Recent decisions under the statutes have held that accounts receivable to arise in the future

[2] CAL. CIV. CODE § 1459.

[3] CAL. CIV. CODE § 955.1 provides: "Except as provided in Section 955, and subject to compliance with any applicable statute requiring recording or filing, the transfer of any right to payment, not constituting an account as defined in Section 3017 of this code and not constituting a negotiable instrument, shall be deemed perfected as against third persons upon their being executed and delivered to the transferee an assignment thereof in writing; provided, however, that as between bona fide assignees of the same right for value without notice, the assignee first giving notice thereof to the obligor in writing shall have priority; but such assignment shall not be, of itself, notice to the obligor so as to invalidate any payments made by him to the transferor."

[4] CAL. CIV. CODE § 3017 provides: "In this chapter: (1) 'Account' means a debt, due or to become due, arising out of the sale, storage, transportation, care, repair, processing, manufacture or other improvement of tangible personal property, or arising out of a contract therefor, or arising out of the rendition of personal services which in the regular course of business will result in an open book account; provided, however, that 'account' does not include:

(a) Any debt evidenced by or arising under a judgment, note, bill of exchange, acceptance, chattel mortgage, trust receipt, lease, or contract of conditional sale (meaning a deferred payment contract reserving title in the seller);

(b) Any debt which arises from the sale of tangible personal property or from the sale or assignment of the rents, issues, profits, products, proceeds or increase of tangible personal property, if at the time of the assignment of such debt the assignee is the owner of an encumbrance or a lien, other than a lender's lien pursuant to Section 3031 of the Civil Code, upon the said personal property, which lien or encumbrance has been duly perfected against third persons pursuant to any applicable state or federal law or is so perfected within 10 days after the assignment of such debt;

(c) Any debt arising under a contract for a work of improvement to real property as defined in Section 1182 of the Code of Civil Procedure or a public work of improvement as defined in Section 4200 of the Government Code. . . ."

and moneys to become due in the future are freely assignable.[5]

Waiver of Defenses

In view of the relatively satisfactory condition of California statutes and cases one may well ask where are the areas of difficulty? One area not entirely clear is the attempt to provide that if the contract is assigned, then the assignee may take the contract free and clear of certain defenses which the other party may have against the assignor. In other words, what is the effect of attempts by way of agreement to give a non-negotiable contract the qualities of a negotiable instrument? In general an assignee stands in the shoes of his assignor; however when financing is involved the assignee may desire to be placed in the position of a holder in due course of a negotiable instrument and thus have rights superior to those of his assignor. Questions have also arisen where the contract itself contains specific provisions against assignment. Section 1589 of the Civil Code has given rise to decisions that are difficult to reconcile. Assignment of the proceeds of government contracts presents certain problems not found in other situations. Occasionally problems in the assignment field have developed out of the use of imprecise language by the parties.

While the practice in California is not uniform, certain conditional sale contracts provide that if the contract is assigned, then the person obligated to pay will pay the assignee regardless of any defenses he may have against the assignor and will look only to the assignor as to his claim. In other jurisdictions the cases have gone both ways as to the validity of such clauses. Some have held them completely invalid as being contrary to public policy. The one reported case in California which bears on this matter is *Commercial Credit Corp. v. Orange County Mach. Works.*[6] In this case certain equipment had been sold and a conditional sale contract taken. Also evidencing the obligation to pay the balance of the purchase price were promissory notes. The notes were sold by the original seller of the equipment to the plaintiff. In an action for a deficiency after repossession and sale, the defendant was allowed to introduce defenses which he normally would not have been permitted to introduce in an action by a holder in due course of the notes.[7] The court seemed to base its decision on the general overall intimacy of the plaintiff to the transaction.

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[5] *E.g.*, H. S. Mann Corp. v. Moody, 144 Cal. App. 2d 310, 301 P.2d 28 (1956).

[6] 34 Cal. 2d 766, 214 P.2d 819 (1950).

[7] The facts in the case indicated that plaintiff was a holder in due course as defined in CAL. CIV. CODE § 3133, who normally would be free from the defenses available to prior parties between themselves by virtue of CAL. CIV. CODE § 3138. Sections 3133 and 3138 are codifications of UNIFORM NEGOTIABLE INSTRUMENTS LAW §§ 52 and 57.

The only other case in this area in California is *United States v. Klatt.*[8] This case involved an F.H.A. Title I loan in which a promissory note was given to a contractor performing certain work and the note was assigned to a bank and subsequently to the United States of America. A completion certificate was required upon completion of the work. This apparently was forged, and the work was not completed satisfactorily. The United States government maintained that it had the rights of a holder in due course under the shelter doctrine since the bank was a holder in due course. The court rejected this argument, stating that the bank had supplied the forms and ". . . that the relationship between the payee named in the instrument in suit and the bank, as to the entire transaction giving rise to the instrument, was such that the bank must be considered in effect a party to the original transaction between the named-payee dealer and the defendant; and the bank could not therefore, in any event, be deemed a holder in due course of any negotiable instrument executed as a part of the transaction."[9]

It might be noted that the above language does not appear to be completely supported by the analysis of the facts in the case. However, it must be recognized that both the *Orange County Machine Works* case and the *Klatt* case evidence a feeling on the part of the California courts not to give conditional sale contracts the quality of negotiable instruments even though the device of promissory notes be utilized. If this is so, the courts could well look with disfavor upon contractual provisions in conditional sale contracts which waive defenses as against an assignee of the contract and its proceeds. Certainly on the consumer level it can be anticipated that this could well be the attitude of the courts.

As a matter of fact in California it has not been the universal practice (as in some states) to insert waiver of defense clauses in conditional sale contracts. This fact may explain the lack of decided cases on this point in California. On the other hand where personal property leases are involved it is more or less universal practice to have such provisions in the lease itself or in the acknowledgment of the assignment by the lessee. A typical provision taken from a printed form currently in use for motor vehicle transactions in California is as follows:

> • 12. ASSIGNMENT: Lessee will not, without the prior written consent of Lessor and Lienholder, assign this Lease or sublet any vehicle leased hereunder. Lessor may assign and

[8] 135 F. Supp. 648 (S.D. Cal. 1955).
[9] *Id.* at 650.

> pledge to Lienholder all rentals due and becoming due hereunder and pursuant to any and all Lease Schedules hereto and all other sums payable by Lessee to Lessor, and in such event Lessee agrees that: (a) Lienholder's right to receive such rentals and other sums shall be free from all defenses, setoffs, counterclaims and other claims and demands which Lessee may be entitled to assert against Lessor, and no breach or default of any agreement, including this Lease, between Lessor and Lessee, and whether pertaining to the maintenance, service, repair or warranty of any vehicle leased hereunder, or otherwise, shall excuse, diminish, modify or amend Lessee's obligation to pay Lienholder; and (b) Lienholder does not assume and shall not be obligated to perform any obligation or covenant of Lessee hereunder or pursuant to any Lease Schedule hereto, or otherwise; except to account for any Deposit made by Lessee or Pre-Termination Rental Adjustment Credit coming into Lienholder's possession.

Where the transaction is on a nonconsumer level it appears that there can be no serious objection to such provisions on the basis of public policy. Considering the overall transaction, the lessee has obtained the property he desires and the lending institution has provided the necessary financing. Certainly the financing institution should have a fair degree of assurance that its advances will be repaid. The financing institution of course does look to the lessor who has assigned the proceeds of the lease and usually has signed a promissory note; however, from the overall credit viewpoint the financing institution is looking to the lessee rather than to the lessor because the lessor's obligations soon become quite excessive in relation to its assets.

This consumer-nonconsumer distinction is the solution adopted by Uniform Commercial Code section 9-206, reading in part as follows:

> Subject to any statute or decision which establishes a different rule for buyers of consumer goods, an agreement by a buyer that he will not assert against an assignee any claim or defense which he may have against the seller is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Commercial Paper (Article 3). A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement.

California has adopted in part such legislation prohibiting to a large extent such waivers in conditional sale contracts in what are termed retail transactions.[10]

In summary, certain doubt exists in California as to the enforceability of such waivers of defenses. However, it would appear that they probably will and should be valid except on the consumer level.

Prohibitions Against Assignment

Contracts containing prohibitions both as to the assignment of contract rights and of the proceeds thereunder are frequently found in current commercial practice in California. A typical example would be a contract between the suppliers of certain particular parts or equipment and a large airframe manufacturer. The airframe manufacturer simply does not want to be bothered with any possibility of dealing with others than the actual contractor, nor does the manufacturer care to place itself in a position where it might not be able to offset against amounts due the contractor. As a result large numbers of such contracts contain provisions prohibiting not only an assignment of the contract, but also of the proceeds.

In the first place it seems clear that as between the parties such provisions are completely effective and that regardless of the general policy of the California law as to freedom of assignment, there is no reason why parties cannot agree that there will be no assignment, even as to proceeds.[11]

A rather peculiar problem develops when the contractor desires financial assistance and obtains this by assigning to a financing institution the proceeds of a contract containing a prohibition against such an assignment. Such proceeds, of course, constitute accounts receivable and a security interest in such accounts receivable may be perfected by the filing of notice and without actual notification given to the person who owes the account receivable.[12] In *Bass v. Aetna Factors Co.*[13] the court had before it a case where such an assignment had been made, and notice filed by the assignee. The dispute thereafter arose when the contractor went into bankruptcy. Certain proceeds of assigned contracts were paid to the trustee in bankruptcy, and the obvious conflict arose between the trustee and the assignee financing institution. The final determination was that the financing institution was entitled to these funds rather than the trustee in bankruptcy.

In connection with the above, there remains one situation where there are no California cases. Suppose, for example, in a contract case of this nature the person obligated to pay the account receivable does

[10] CAL. CIV. CODE §§ 1804.1, 1804.2.

[11] Parkinson v. Caldwell, 126 Cal. App. 2d 548, 272 P.2d 934 (1954).

[12] CAL. CIV. CODE §§ 3017, 3029.

[13] 272 F.2d 707 (9th Cir. 1959).

not so pay, and an action is brought by the assignee financing institution. What the result would be is not certain at the present time.

Generally speaking, contracts containing prohibitions against assignment of proceeds use language something similar to "this contract and the proceeds thereunder shall not be subject to assignment." Query, would the result of the *Bass* case be different if the language was stronger and declared that any assignment of proceeds is void and shall be invalid and of no force and effect whatever?[14]

There may also be cases where, because of somewhat ambiguous language, a contract may be interpreted as prohibiting assignment. A recent case of this nature is *Ott v. Home Sav. & Loan Ass'n.*[15] In this case a savings and loan association forwarded to *S* a document reading in part as:[16]

> This letter is to serve as a binding commitment for a period of three years from date hereof, upon [the] Savings and Loan Association to make to you or your nominee the following loans:
> . . . [a specified amount of "G.I." guaranteed loans].
> In addition, the association agrees to purchase from you or your nominee . . . [a specified amount of "G.I." loans].

Just prior to the end of the three year period *S* appointed *O* as his nominee under the commitment and assigned to *O* all rights arising under the commitment. *O* communicated with the Association informing it of *O's* nomination by *S* and actually tendered a certain amount of loans which were accepted. Apparently the Association dealth with *O* for approximately a month and then informed *O* that it would no longer purchase loans. *O* filed an action against the Association and the court held that *O* could not recover. The court reasoned that the letter to *S* was not a contract, but was merely an offer; however, apparently the real basis of the decision was that even though a contract had been created, nevertheless it was nonassignable. The court decided that the phrase "or your nominee" was used to indicate the contract's nonassignability because the term "nominee" designated a person who would take in a representative capacity rather than as owner. Probably the real import of this case is its indication of the continuing necessity of giving careful attention to precise phrasing in contract transactions.

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[14] For cases which upheld the provision against assignment when the provision was that any assignment shall be *"void"* see Allhusen v. Caristo Const. Co., 303 N.Y. 446, 103 N.E.2d 891 (1952) and Sacks v. Neptune Meter Co., 238 App. Div. 82, 263 N.Y. Supp. 462 (1933), 21 FORDHAM L. REV. 178 (1952), distinguishing a provision that an assignment shall be void from a covenant not to assign.

[15] 265 F.2d 643 (9th Cir. 1958).

[16] *Id.* at 644.

Effect of Civil Code Section 1589

California Civil Code section 1589 reads as follows: "A voluntary acceptance of the benefit of a transaction is equivalent to a consent to all the obligations arising from it, so far as the facts are known, or ought to be known, to the person accepting."

During the past ten years there has been a certain division of authority as to the interpretation of this section. One view, and this is certainly the majority view, is that the section applies only where the person accepting the benefit was a party to the original transaction. This is the position taken in the fairly recent cases of *King v. Curtis*,[17] and *Fruitvale Canning Co. v. Cotton*.[18]

In the *Fruitvale* case the canning company advanced money to the first defendant who operated a saw mill. It was agreed that the loan would be repaid by the delivery of shook to the cannery. Prior to the performance of this contract the first defendant sold his business to a second defendant, and the second defendant performed for a while under the original contract and then ceased. The court held that the second defendant was not liable on the ground that although in a sense he had accepted the benefits, he was not a party to the original transaction.

Another case which indicates a somewhat contrary line of thinking, and which again involved the sale of a business, is *Gregers v. Peterson Ice Cream Co.*[19] In this case plaintiff and the first defendant entered into a contract whereby plaintiff was given a certain territory in which to sell defendant's products. Later the first defendant sold its business to the second defendant who continued to supply the plaintiff for a period of time. The court held that the second defendant was obligated under the original contract to continue to supply the plaintiff, finding that under the circumstances the second defendant intended to assume the obligations of the original contract. The court specifically cited section 1589 of the Civil Code. These two cases indicate again the necessity of specific language manifesting the intent of the parties.

Assignment of Proceeds of Government Contracts

Originally contract claims against the United States government were not subject to assignment; however, in 1940 the Assignment of Claims Act[20] was passed, permitting assignment to banks, trust companies and other financing institutions. This was specifically done to

[17] 133 Cal. App. 2d Supp. 806, 284 P.2d 983 (1955).
[18] 115 Cal. App. 2d 622, 252 P.2d 953 (1953).
[19] 158 Cal. App. 2d 746, 323 P.2d 572 (1958).
[20] 54 Stat. 1029 (1940), as amended, 31 U.S.C. § 203 (1958).

provide financial assistance for government contractors. Conflicts have arisen because most governmental contracts require a performance and a payment bond, and the bonding company generally takes an assignment of the contract proceeds even though the assignment is one not permitted under the federal statute. In passing it should be noted that the federal government may waive its right of offset where contract proceeds are assigned if a national emergency exists. As of the time this article was written, the Department of Justice has indicated that the national emergency proclaimed by President Truman on December 16, 1950, has not been terminated.

To take a fairly typical situation, suppose that a contractor under a government contract has provided the required payment and performance bonds under the terms of the Miller Act.[21] As part of the process of obtaining the bond the contractor assigns the contract proceeds to the surety company. Subsequently the contractor again assigns the proceeds to a financing institution, and there is full compliance at this stage with the Assignment of Claims Act. After all of this has occurred, the contractor defaults and the surety is required to perform the uncompleted part of the contract and to satisfy the claims of labor and materialmen. At the time of default, the government will be holding funds which represent earned progress payments not yet disbursed and retained percentages of progress payments already paid. Certainly upon default any progress payments earned thereafter are payable to the surety because it is the party that is actually performing the contract. The financing institution usually finds itself in a position where it needs the retained percentages and the earned but unpaid progress payments in order to satisfy the loans it has made to the contractor. Throughout the United States there has been a considerable amount of litigation in this situation. Under most factual situations, at least as to the earned progress payments, the financing institution has prevailed in contests with the surety.[22] A leading case to the contrary is *National Sur. Corp. v. U.S.*[23] In so far as the Ninth Circuit is concerned, the court of appeal has indicated that the financing institution would prevail at least as to payments already paid to the lender.[24] This result seems sound although the court mentioned in this case that the bank did not have notice of the prior assignment.[25] This distinction would appear immaterial if the assignment to the

[21] 49 Stat. 793 (1935), as amended, 40 U.S.C. § 270(a) (1958).

[22] See, *e.g.*, American Sur. Co. v. Hinds, 260 F.2d 366 (10th Cir. 1958); General Cas. Co. v. Second Nat'l Bank, 178 F.2d 679 (5th Cir. 1950).

[23] 133 F. Supp. 381 (Ct. Cl. 1955), cert. denied 350 U.S. 902 (1956).

[24] Bank of Arizona v. National Sur. Co., 237 F.2d 90 (9th Cir. 1956).

[25] *Id.* at 96.

bank was permitted and perfected according to law while the assignment to the surety was not recognized and could not be perfected.

The various possibilities in this area have not been fully explored in the Ninth Circuit, and as a result it must be recognized that the law is somewhat unsettled in so far as this circuit is concerned. Neither is there any comprehensive determination by the United States Supreme Court.

Conclusion

In conclusion, it is recognized that this article may have raised more questions than it has settled. However, as indicated at the outset, the primary purpose was to trace the business developments of the past ten years and to indicate some of the shoals and bars that have been discovered as commerce explores new areas.