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The Vendor's Lender: Secured Creditor's Rights in Receivables Are Paramount

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In this article, the author explains that once an account debtor is notified to pay the secured creditor, not remitting payment on a receivable directly to the lender can mean that the account debtor pays twice.

Accounts receivable serve as an important source of collateral – indeed, receivables and other rights to payment represent the lifeblood of asset-based lending, securitizations and factoring arrangements. Article 9 of the Uniform Commercial Code (the UCC) applies to any transaction, regardless of its form, that creates a security interest in personal property as well as to a sale of accounts and other instruments evidencing a monetary obligation.[1] The scheme embodied in Article 9 contains a comprehensive set of important rules that address these forms of intangible property.

A number of courts have misinterpreted Article 9 to preclude a secured party from commencing suit against its debtor's customers to collect amounts owed to the debtor.[2] The premise behind this rationale is rooted in the language of the statute and the nature of the various relationships: "to hold that an account debtor is obligated to pay the secured creditor and not the debtor would be tantamount to creating a duty owed by the account debtor to the secured creditor that was separate and distinct from the duty it owed to the debtor."[3] These decisions threaten the foundation of receivables financing and undermine the certainty envisioned by the drafters of Article 9.

A recent decision by the highest court in New York ruled in favor of the secured creditor and correctly found that a holder of a presently exercisable security interest in a debtor's receivables is entitled to receive and collect payment directly from the account debtor after furnishing the customer notice of its interest. The court in *Worthy Lending LLC v. New Style Contractors, Inc.*, reversed the dismissal of a complaint filed by the secured creditor against a customer of the debtor and the finding that Article 9 of the UCC did not authorize a direct cause of action.[4]

RULES FOR COLLECTION AND ENFORCEMENT

Other than cash and securities, collateral consisting of rights to payment

represent the most liquid asset of a debtor's business. This form of asset may, unlike inventory and equipment for example, be collected without interruption of the debtor's operations. Further, rights to payment do not present valuation and other complexities that are often attendant realization on tangible personal property. Section 9-607 of the UCC permits a secured creditor at any time, if so agreed, and, in any event after a default, to notify account debtors[5] and others that are obligated to the debtor to make payment directly to the secured party.[6] Additionally, that statute grants the secured creditor the right to enforce the obligations of the account debtor, exercise the rights of the debtor and enforce claims of the debtor against account debtors and other parties.[7] Section 9-607's primary aim is to address the rights of the secured creditor in relation to its debtor to collect a specified payment right. The statute does not, however, itself determine whether an account debtor owes a duty to a secured party.[8]

Section 9-406 of the UCC addresses accounts and a different relationship. That statute addresses the rights of the secured party in relation to the account debtor to collect a specified payment right. Section 9-406, unlike other provisions of Article 9, uses terminology that references “assignor,” “assignee” and “assignment” and not “debtor,” “secured party” and “security interest.”[9]

The statute makes no mention of secured parties. It provides that an account debtor may discharge the obligation it owes by paying the assignor (i.e., the borrower) until, but not after, the account debtor receives required notification that the amount due has been “assigned” and that payment is to be made to the “assignee.” “After receipt of the notification, the account debtor may discharge its obligation by paying the assignee and may not discharge the obligation by paying the assignor.”[10]

Section 9-406 addresses the requirements of notice and permits the account debtor to request reasonable proof that an “assignment” has been made (i.e., that an interest in the right to payment has been conveyed).[11] The statute also makes legal restrictions contained in contracts between the debtor and its customer/account debtor that prohibit or restrict assignment to be ineffective.[12]

The courts in *Worthy Lending LLC v. New Style Contractors, Inc.* were called upon to determine whether the terms used in the statute – assignor, assignee, assignment – allow the holder of a presently exercisable security interest to commence suit against an account debtor to collect payment constituting collateral. The decision required resolution by the highest court in the State of New York, which reversed the lower courts and answered the question in the affirmative.

BACKGROUND

The facts in *Worthy Lending* are relatively unremarkable in commercial finance. The borrower needed capital and entered into an arrangement with its lender to borrower up to $3 million. The borrower granted the lender a security interest in its assets to secure all obligations, including accounts receivable. The security agreement granted the lender the right

to notify and instruct account debtors (i.e., the debtor's customers) to remit payment directly to the lender.

The secured creditor perfected its security interest by filing a UCC-1 financing statement with the applicable office of the Secretary of State. The lender later sent New Style Contractors, Inc. (New Style) a notice of its security interest and directed the account debtor to remit all amounts owed by New Style to the debtor only to the lender.[13] New Style, despite receiving notice directing it to pay the lender instead of its vendor, the debtor, failed to make payment as instructed. Instead, it paid the debtor the amounts it owed.

The debtor, after defaulting on its obligations, filed for bankruptcy. The secured creditor commenced a lawsuit against New Style seeking to recover over $1.4 million, the amount of the accounts receivable owed to the debtor at the time the lender provided notice. The cause of action was based on UCC § 9-607 and was an action to collect proceeds owed to the debtor and to enforce the rights of the debtor with respect to New Style.

New Style moved to dismiss the suit, since the lender only had a security interest in accounts receivable and did not obtain an actual, valid assignment as required by the express terms of Section 9-406 of the UCC. As such, the account debtor argued that lender's rights were not the same as those of an assignee under the UCC. Absent an actual assignment, the secured creditor should be limited to its standing as such and those rights are governed by UCC § 9-607. That section of the UCC does not, by itself, create any direct obligation by an account debtor to a secured party.

New Style also argued that it had already paid the account pursuant to instructions it received from its vendor, the debtor, and discharged all amounts owed. New Style had no direct contractual privity with the lender who, from New Style's perspective, was a stranger to the business relationship between New Style and its vendor.

LOWER COURT PROHIBITS DIRECT ACTION

The lower court granted New Style's motion to dismiss the secured creditor's complaint. The court found that a security interest was not equivalent to an assignment and such an outright conveyance of property is necessary to trigger the application of Section 9-406. Absent an actual assignment, the secured creditor was not an assignee of accounts as required by the statue and has no independent basis for a cause of action.

The court also noted that the existence of an underlying dispute between the secured creditor and the debtor, such as the collection action involved in this case, bars the lender from bringing a cause of action against the account debtor under Section 9-607. The court found that the secured creditor cannot be said to be exercising the rights of the debtor with respect to the payment obligation of the account debtor in the face of an ongoing dispute between the lender and its debtor. A contrary result would, according to the lower court, be tantamount to creating a duty owed by an account debtor to the secured creditor that is separate and distinct

from that owed to the debtor.

HIGH COURT FINDS SECURITY INTERESTS ARE ASSIGNMENTS

Section 9-406(a) provides that "an account debtor . . . may discharge its obligation by paying the *assignor* until, but not after, the account debtor receives a notification . . . that the amount due or to become due has been *assigned* and that payment is to be made to the *assignee*. . . ."[14] The statute contains a clear payment direction provision designed to facilitate sales and other transfers of an interest in receivables. New York State's highest court split from the U.S. Courts of Appeals for the Fourth and Eleventh Circuits and reversed the lower courts by holding that a security interest is also an assignment of accounts receivable.

In a unanimous opinion, the court found that the language of UCC §§ 9-607 and 9-406, together with the "clear commentary" by the drafters with respect to those sections, make no distinction between a security interest and an assignment and the definition section of the UCC contains no separate definition of "assignment," "assignor" or "assignee." In fact, the commentary states that an assignment "'refers to both an outright transfer of ownership and a transfer of interest to secure an obligation.'"[15] Treating assignments and security interests identically promotes efficient business dealings and commerce.[16] No parsing of contractual language by parties and the courts is necessary to determine whether an interest is an assignment or a security interest. The duty of the account debtor to pay upon receipt of notice to do so is required by law.

The court responded to the concerns of the lower courts with respect to the fact that the account debtor, typically a stranger the borrower-lender relationship, may end up paying twice. The customer in this case already paid the debtor. The court found "[t]hat is the statutory consequence of failing to pay a secured party who has notified the account debtor to pay the secured party directly."[17] The burden of double payment therefore falls on the account debtor under the circumstances.[18]

CONCLUSION

The UCC has been appropriately referred to as "the backbone of American commerce." The statutes provide a comprehensive set of uniform laws designed to promote commercial certainty in business transactions in the United States. The high court's decision in *Worthy Lending LLC v. New Style Contractors, Inc.* furthers that end. It is now clear, at least in New York, that secured creditors who are granted the right by their debtors (or upon default possess the right) to demand payment directly from account debtors and may enforce that right under the UCC notwithstanding any claimed dispute between the secured creditor and the debtor.

The lower court decisions make clear that a number of courts is confused by the use of the undefined terms "assignment," "assignee" and "assignor" in Article 9. The language of the statutes, particularly when read in the context of policy and applicable PEB commentary, makes clear that terminology used and defined, such as "security interest" and "debtor," is drafting intended to encompass sale transactions as well as security

interests in accounts.19 And for purposes of Section 9-406, the rights of an "assignee" of accounts against an account debtor inures to the benefit of both an absolute owner and a lender holding a security interest in accounts receivable.

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[1] UCC § 9-109(a)(1) & (3).

[2] See, e.g., Durham Commer. Capital Corp. v. Ocwen Loan Servicing, LLC, 77 Fed. Appx. 952 (11th Cir. 2019) (concluding that Article 9 did not give the lender, as a secured creditor that was not an assignee within the meaning of the statute, a private right of action against an account debtor); Forest Capital v. Blackrock, Inc., 658 Fed 576 (4th Cir. 2016).

[3] Worthy Lending LLC v. New Style Contrs., 196 A.D.3d 422 (N.Y. App. Div. 2021), rev'd, 2022 LEXIS 2384 (Ct. App. N.Y. Nov. 22, 2022).

[4] 2022 LEXIS 2384 (Ct. App. N.Y. Nov. 22, 2022).

[5] An "account debtor" is a person obligated on a right to payment of a monetary obligation (i.e., a customer of the lender's borrower). UCC § 9-102(a)(3).

[6] UCC § 9-607(a). This section permits the secured creditor to collect and enforce obligations that are part of its collateral in its capacity as a secured party. It is not necessary that the secured creditor become the absolute owner of the collateral first, whether by foreclosure or otherwise, in order to have enforcement rights. Id. cmt. 6.

[7] Id. § 9-607(a)(3). Section 9-607 is broader than former law and applies to all persons obligated on the collateral and "explicitly provides for the secured party's enforcement of the debtor's rights in respect of the account debtor's (and other third parties') obligations . . . which include the right to enforce claims that the debtor may enjoy against others." Id. cmt. 3. The statute permits the secured party to obtain property constituting its collateral directly from an account debtor.

[8] Id. § 9-607(e).

[9] See id. § 1-201(b)(35) (defining "security interest" to include "any interest of a . . . buyer of accounts, chattel paper, a payment intangible or a promissory note in a transaction that is subject to Article 9"); id. § 9-102(a)(73) (defining "secured party" to include a "person in whosefavor a security interest is created or provided for under a security agreement" as well as a "person to which accounts, chattel paper, payment intangibles or promissory notes have been sold"). Accord id. § 9-102(a)(28) (defining "debtor").

[10] Id. § 9-406(a).

[11] Id. § 9-406(c).

[12] Id. § 9-406(d). Accord id. § 9-406(f).

[13] The lender's notice also provided as follows: “Pursuant to Section 9-406 of the Uniform Commercial Code, payments of accounts made by New Stile to [the debtor] or to any other than [the lender] will not discharge any of New Styles obligations . . . and notwithstanding any such payments, New Style shall remain liable to [the lender] for the full amount of [the receivable owed].”

[14] UCC § 9-406(a) (emphasis added).

[15] Worthy Lending LLC v. New Style Constrs., Inc., 2022 N.Y. LEXIS 2384 *3 (Ct. App. N.Y. Nov. 22, 2022) (quoting PEB Commentary No. 21 at 4).

[16] Id. at *7.

[17] Id. at *10.

[18] It is significant to point out that neither the existence of a lender's security interest or the receipt of notification from a secured party under the UCC will change the amount owed, the terms of the payment obligation or any defenses the account debtor may have to payment. See UCC § 9-404.

[19] See generally, UCC § 9-109 cmt. 5.

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