WARNING: DON'T IGNORE YOUR CUSTOMERS' SECURED LENDERS, YOU COULD BE REQUIRED TO PAY TWICE!

Hodgson Russ Banking & Finance Alert
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New York State's highest court recently dealt a big win for secured lenders holding accounts receivable as collateral. In *Worthy Lending LLC v. New Style Contractors, Inc.*, the Court of Appeals of New York held that, pursuant to Article 9 of the Uniform Commercial Code (the "UCC"), a secured party may directly collect on the proceeds of accounts receivable owed to the borrower from third parties (so called "account debtors" in UCC parlance), *even if an event of default has not occurred.* In so holding, the Court concluded that Section 9-406 of the UCC (which governs the discharge of an account debtor's liability) applies to secured lending transactions, notwithstanding the provision's use of the term "assignment", which the Court determined to be synonymous with a security interest.

Furthermore, the Court determined that a secured lender has an independent cause of action against any account debtor that ignores such lender's request for direct payment and any account debtor that does not follow such direction will be liable to the lender even if it has already paid its vendor (resulting in double payment).

Case Background:

The Court of Appeals held: "Under UCC 9-406, a security interest is an assignment and the UCC is purposefully structured to permit a debtor to grant creditors security interests in a debtor's receivables so that the secured creditor can direct account debtors to pay it directly."

Checkmate Communications LLC and Worthy Lending LLC entered into a Note and Security Agreement whereby Checkmate could borrow up to $3 million from Worthy. As collateral for the loan, Checkmate granted Worthy a security interest in substantially all of its assets including "all right title and interest of [Checkmate] in and to its (a) accounts…" "Accounts", as defined under the UCC, include accounts receivable arising from invoices issued by Checkmate to its customers such as New Style Contractors, Inc. Additionally, the Note and Security Agreement provided Worthy the right to "notify and instruct account debtors" to remit payment directly to Worthy including before any event of default had occurred.

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Worthy perfected its security interest by filing a UCC-1 Financing Statement and subsequently notified New Style of its security interest and the collateral assignment of the accounts receivable of New Style. In its notice to New Style, Worthy instructed New Style to remit all payments to Worthy directly instead of to Checkmate. Citing Section 9-406 of the UCC, Worthy also notified New Style that payments made to any party other than Worthy would not discharge New Style's obligations and liabilities with respect to its accounts receivable.

Following Checkmate's default on the loan, Worthy accelerated the debt under the Note and demanded repayment. Checkmate filed for bankruptcy protection and Worthy commenced a lawsuit against New Style to collect the receivables owed it to Checkmate.

New Style sought to defend the claim by asserting that Section 9-607 of the UCC applies only to assignments of accounts and not to security interests in accounts. The Court rejected this argument based on a plain reading of the statute and commentary thereto, and found that Section 9-607(a)(3) expressly states that a secured party may obtain collateral directly from an account debtor and the parties may contractually agree that the secured party may do so without regard to an event of default.

The Court further rejected New Style's attempt to distinguish a "security interest" from an "assignment" under the UCC citing the definition of security interest in Section 1-201(b)(35) and noting that the definition does not distinguish between the two terms.

Addressing New Style's concern about potential double payment, the Court indicated that is the consequence imposed by the UCC for failure to heed the notice and request for payment provided by a secured party.

Lessons for Account Debtors:

The ruling in *Worthy Lending* creates a conundrum for account debtors. If the account debtor ignores a notice from the secured lender and pays its vendor/the borrower instead, such account debtor may nevertheless be liable to the secured lender even if it causes them to pay double. As stated by the NY Court of Appeals—"[t]hat is the statutory consequence of failing to pay a secured party." However, if the account debtor obliges the secured lender, there is a strong chance that the vendor/borrower will no longer provide goods or services to such account debtor since the vendor/borrower did not directly receive payment for the goods or services it delivered.

If you have received a notice from a purported secured creditor, we suggest that you contact counsel who can assist you to determine whether or not the secured creditor has a perfected lien on your vendor's receivables and how to respond to such notice. As noted by the Court, an account debtor has certain rights under the UCC to request proof from the secured lender that it possesses a valid assignment and to withhold payment in the interim. Legal counsel can assist you to assert your rights to reduce and discharge your liabilities.

Lessons for Borrowers

The Court determined that Section 9-607(a)(3) of the UCC establishes the baseline rights of a secured party *vis-à-vis* the borrower and permits the "the secured party to enforce and collect [from an account debtor] after default ***or earlier if so agreed***." If you have leverage with your lender and do not want your lender to directly collect from your customers, make

sure your security agreements do not give away this right unless an event of default has occurred. If you are planning to take out a loan, you should contact a legal professional to help you navigate the terms and conditions of the loan documents and help you negotiate the best terms with your lender.

If you have any questions about the courts decision or other issues concerning the UCC, please contact **Christofer Fattey**, **James Thoman**, **Jessica Chue**, or any member of the Hodgson Russ **Banking and Finance Practice**.