

NY Court of Appeals' Ruling Results in Account Debtor Owing Its Counterparty's Debts Under UCC Article 9

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In *Worthy Lending LLC v. New Style Contractors, Inc.*, the New York Court of Appeals held that a security interest includes a lender's right to force the borrower's account debtors to remit payments directly to the lender, regardless of whether an event of default exists. Further, the court clarified that the Uniform Commercial Code (UCC) does not provide a distinction between a security interest and an assignment. As a practical result, the account debtor in this case was obligated to pay the lender an amount equal to the amount of payments paid to the borrower instead of the lender, causing the account debtor to ultimately pay double the amount that the account debtor owed.

Background

In 2019, Worthy Lending LLC and Checkmate Communications LLC entered into a promissory note and security agreement (the "agreement") whereby Checkmate could borrow up to \$3,000,000 (subject to increase) from Worthy. To secure the loan, Checkmate granted Worthy a continuing security interest in, and a lien on, all of Checkmate's assets. Checkmate's assets included all right, title, and interest in its accounts receivable. Worthy perfected its security interest by filing a UCC-1 financing statement with the New Jersey secretary of state upon the closing of the loan facility.

Checkmate's accounts receivable included receivables from Checkmate's invoices issued to its customers, including New Style Contractors, Inc., that had previously engaged Checkmate as a subcontractor. The agreement allowed Worthy the right to "notify and instruct account debtors ... to remit payment of Accounts and other Collateral directly to Lender (Worthy)" before any default under the agreement by Checkmate.

Shortly following the closing of the loan facility, Worthy sent a notice and collateral assignment to New Style, directing New Style to remit all payments due under the accounts receivable directly to Worthy instead of Checkmate. Worthy's notice also referred to UCC Section 9-406 in boldface type to inform New Style that any payments New Style made to Checkmate would not relieve New Style of its obligations to Worthy:

"Pursuant to Section 9-406 of the Uniform Commercial Code, payments of accounts made by New Style to Checkmate or to anyone other than Worthy Lending will not discharge any of New Style's obligations with respect to such Accounts, and notwithstanding any such payments, New Style shall remain liable to Worthy Lending for the full amount of such Accounts."

Despite receiving this notification, New Style continued to remit payments to Checkmate. Subsequently, Checkmate defaulted on the loan, and Worthy demanded immediate repayment. Checkmate was unable to pay the principal and accrued interest under the loan and filed for bankruptcy.

Following Checkmate's bankruptcy declaration, Worthy sued New Style. Worthy alleged that New Style, which ignored Worthy's payment notice, was obligated to pay Worthy an amount equal to all amounts payable to Checkmate after New Style's receipt of Worthy's notice, regardless of whether those amounts were previously paid to Checkmate.

The New York Supreme Court held that New Style did not owe a duty to Worthy under the UCC on the basis that the rules cited by Worthy only applied to assignments and not security interests. The Appellate Division affirmed on similar grounds. Worthy "did not have an independent cause of action against [New Style] pursuant to UCC 9-607? because Section 9-607(e) does not authorize a secured creditor, as distinct from an assignee, to recover from a nonparty debtor like New Style even though Worthy had directed New Style to pay Worthy instead of Checkmate."

Outcome

The New York Court of Appeals reversed the decisions of both lower courts. The Court of Appeals held that (1) a secured creditor may, regardless of whether an event of default exists, assert its rights to receive payments due under any secured collateral directly from a borrower's account debtor if permitted under the loan documentation, and (2) the UCC does not provide a distinction between a security interest and an assignment. Section 9-607 of the UCC states:

"If so agreed, and in any event after default, a secured party ... may enforce the obligations of an account debtor or other person obligated on collateral and exercise the rights of the debtor with respect to the obligation of the account debtor or other person obligated on collateral to make payment or otherwise render performance to the debtor, and with respect to any property that secures the obligations of the account debtor or other person obligated on the collateral."

The court interpreted the phrase "If so agreed" as a mechanism that allows parties to contractually determine the extent of a creditor's rights in the borrower's accounts receivable prior to a default. Any prohibition of this right would render Section 9-607 meaningless because the secured creditor already has statutory rights to step into the shoes of the borrower and collect on any obligations owed to the borrower by an account debtor after a default.

The court then analyzed whether the definition of "security interest" in the UCC distinguishes between a security interest and an assignment. The court referred to the language of the statute and the UCC Permanent Editorial Board (PEB) Commentary No. 21 issued in 2020 on the use of the term "assignment" in Article 9 of the UCC. The court found that under Sections 9-406 and 9-607, "an account debtor who receives a secured creditor's notice asserting its right to receive payment directly can pay the secured creditor and receive a complete discharge (UCC § 9-406(a)) or, if in doubt, can seek proof from the secured creditor that it possesses a valid assignment and withhold payment in the interim (UCC § 9-406(c))." In pointing to this language, the court concluded that there was no distinction between the two concepts. Further, the lack of distinction was a useful tool, the court argued, to promote efficiency in contracting.

While New Style may now be forced to pay double, the court strongly stated that this outcome is “the statutory consequence of failing to pay a secured party who has notified the account debtor to pay the secured party directly.”

Significance for Borrowers and Debtors of Borrowers

For borrowers, this case highlights the significance of understanding the breadth of rights that can be granted to a secured lender and negotiating provisions that are problematic. Borrowers seeking to maintain good relations with key customers should alert their customers about provisions that grant borrowers’ lenders broad collection rights in the borrowers’ receivables. Even more importantly, the case presents a clear shot across the bow to account debtors of borrowers to take notices from their counterparty’s lenders seriously or else risk being on the hook for all, or part of, the debt owed by their counterparty. Any entity that receives a notice from their counterparty’s lenders should consult counsel immediately or else risk double payment.

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