Account Debtor Litigation – Please Get It Right!

If a debtor fails to pay the secured party, it seems obvious that the factor should be able to file a claim and win in court. However Steven Kurtz points out that the lawsuit must be correctly structured, especially when trying to claim protection under UCC §9-406. Two recent cases illustrate this point.

The factoring industry is grounded in the ability to purchase accounts, notice the account debtors to pay the factor, get repaid from the account debtors, and be secure in the knowledge that the UCC will protect the factor if the account debtor pays over notice. Indeed, the UCC offers a broad array of provisions that protect the factor from the debtor's paying over notice.

Included within the vast spectrum of statutory protections in the UCC, is §9-406. This section requires the account debtor to pay the secured party after the account debtor receives a notice of assignment (a redirection notice) from the factor. Failure to honor the redirection notice does not discharge the account debtor's payment obligation to the secured party and the account debtor is not relieved of its obligation to pay the factor if it disregards it.

While §9-406 is clear about the consequences if the account debtor pays over the factor's notice, courts often have trouble requiring an otherwise honest person, who is also likely a victim of the factor client's fraud, to pay twice on the same bill. There has been a troubling recent trend in account debtor litigation, where the factor only pleads a claim for payment over notice, as provided for in §9-406 and completely ignores all of the other statutory protections set forth in the UCC, as well as general contract and common law which, when properly put before a court in conjunction with a payment over notice claim, should result in a victory for the factor. There are now two diverging lines of cases dealing with payments over notice. One recognizes a claim for payment over notice, and the other line of cases state that there is no direct claim under §9-406.

Durham v. Ocwen

On May 29, 2019, the U.S. Court of Appeals for the 11th Circuit, in *Durham Commercial Capital v. Ocwen Loan Servicing* (No. 17-15572) struck a blow to the entire lending industry when it issued a written opinion which denied the private right of action by the secured party against the account debtor for payment over notice when the claim is brought solely under §9-406.

The facts in *Durham* are straightforward. Durham Commercial Capital factored the accounts of a law firm which specialized in mortgage foreclosure cases. Durham purchased the accounts in a non-recourse factoring arrangement and sent a redirection notice to the defendant/account debtor, Ocwen Loan Servicing. Ocwen failed to honor the redirection notice and, instead, paid the law firm directly.

The law firm, of course, kept the funds and later filed for bankruptcy. In the U.S. District Court action, Durham sued Ocwen, alleging only a single cause of action for a *Breach of the Statutory Duty to Pay Accounts* based on the alleged violation of New York's adoption of §9-406. The case proceeded to

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trial on that single claim. The only theory of liability upon which the district court instructed the jury was §9-406(a). Durham based proposed jury instructions solely on this basis. Ocwen objected to the complaint by filing a combination motion to dismiss and for judgment as a matter of law. It filed a renewal motion after it rested its case and filed several post-trial motions — all of which argued that, as a matter of law, there is no private right of action under §9-406. The district court ruled against Ocwen on its pre-trial and post-trial motions for judgment as a matter of law and entered judgment in favor of Durham. Ocwen appealed the decision.

Reversal in Court of Appeals

The 11th Circuit Court of Appeals in *Durham* reversed the district court's ruling. However, this ruling should be applied narrowly given the limited issues and facts raised in that case. There, the only UCC provisions cited were §9-406 and §1-305 (which provide for affirmative claims when there are violations of rights contained in the UCC). Moreover, at oral argument, Durham's counsel conceded that it failed to introduce any evidence of its assignment of the accounts but instead argued that the security interest it received via the factoring agreement was sufficient to enable it to qualify as an "assignee" thereby giving rise to the statutory duty under §9-406 to pay Durham. Durham further failed to present the vast body of contract and common law which, when taken together with multiple other sections of the UCC, protect the factor.

In addressing Durham's arguments, the court of appeals found that §9-406 makes no specific reference to a secured party, so a claim under §9-406 must be an implied claim. The *Durham* Court went on to examine the purpose of §9-406. It found the law was drafted to benefit the account debtor because it clarifies how it can discharge its debts by providing who it can pay before it receives a redirection notice and the account debtor's duties after it receives the redirection notice.

Factor Fails to Structure Proper Claim

It held that Durham, the secured party, is not an intended beneficiary under §9-406. Accordingly, the *Durham* court did not think that the statute provided for an implied private right of action. The *Durham* Court did note that UCC §9-607, which discusses the secured party's rights to directly collect accounts after default, or if agreed to in the contract, does give the secured party a right of action. However, because the factor only plead a

single claim for relief under §9-406 and failed to offer any other theories or evidence to support its claims, the 11th Circuit Court reversed the trial court, and the factor lost. While I disagree with the court's analysis of §9-406 not benefiting the secured party, who is in fact the assignee referenced in §9-406, the factor did not do itself any favors in structuring the claim.

Reading v. Suffolk

The contrary line of authority and what may be the best case for the factoring industry is *Reading Co-Operative Bank v. Suffolk Construction*., 464 Mass 543 (2013). In *Reading*, the factor closed a line of credit with its borrower. When the line was increased to finance the borrower's HVAC installation project, the bank decided to collect directly on the borrower's accounts and sent a notice of assignment to the defendant account debtor, which was acknowledged by a high-level person.

The account debtor's high ranking person neglected to notify the payable department about the redirection notice. The account debtor paid $3,822,500.49 over notice to the borrower, who of course failed to remit the payments to the bank. The borrower defaulted on the loan and owed the bank $1,499,149.42. Before filing suit, the bank recovered monies from a different party, which brought the claim down to $533,348.62.

The bank subsequently sued the account debtor for the entire amount paid over notice, and in addition to the UCC specific claims for "breach of statutory duty to pay", the bank sued the account debtor on the various contract claims which constituted a part of bank's collateral. The trial case was presented as the bank enforcing the borrower's contract claim because of the bank's standing as a secured party with a perfected lien against accounts. The trial court also had a payment over notice claim on the theory that the bank had the right to collect the accounts under §9-607, and that the account debtor failed to discharge the debt because it paid over the redirection notice, with liability for the payment over notice set by §9-406. After trial, the jury awarded the bank $533,348.49 which was the contractual amount owed when the lawsuit was filed. The judge, however, awarded the bank $3,015,000.49 for the breach of statutory duty to pay, and, in doing so, gave the account debtor credit for a guaranty the bank held against a guarantor. Both sides appealed (the bank probably filed a cross-appeal, after the account debtor appealed).

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Supreme Court Reversal

The Massachusetts Supreme Court reversed the trial court and awarded the bank the full amount that the account debtor paid over notice — $3,822,500.49. In rendering its decision, the Massachusetts Supreme Court gives the reader a nice guided tour through the relevant portions of the UCC, and provides a solid analysis of the payment over notice rules. The *Reading* Court recognized the bank's right to collect accounts under §9-607. The court then went through a detailed analysis of §9-406. The court recognized that the damages for a payment over notice are for *all* monies paid over notice. The *Reading* Court was clear that §9-406 does not allow a court to reduce the award if the bank is owed less than the amount paid over notice. The account debtor's duty, after receiving a proper notice, is to pay according to the notice, or suffer the consequences. The *Reading* Court then discussed what expenses the secured party is allowed to assert in collecting accounts. The court then went on to discuss how funds are disbursed when there is a surplus, with the ultimate surplus funds going back to the debtor/borrower. The *Reading* Court held the account debtor holds a remedy against the borrower and is able to assert a claim to the surplus as part of its claim against the borrower.

These two cases illustrate that appellate courts can only decide a case based upon the record before it. However, depending upon the status of the record, radical and horrible results can and do occur. The appellate court record consists of what the parties plead in their claims, answers, various motions and admissible evidence put before the trial court. The difference between these two cases, both decided by high level and

distinguished courts, lies in the presentations made to the trial court. The *Durham* plaintiff *only plead a claim under §9-406 and offered nothing more*. The *Reading* plaintiff basically gave the court a tour of the UCC and presented both the borrower's contract claims and the UCC specific claims as a complete *package*. A defective presentation will result in a bad decision and unfortunately, the bad decisions results in bad consequences for the lending and factoring industries.

Successfully Processing a Claim

To collect upon your account collateral, you must plead the underlying claim that your factor client has, based upon its agreement with the account debtor and the relevant facts. Typically, one would start with a claim for breach of contract, as there was an underlying agreement to perform services or sell goods. If there is a written agreement, then one must plead breach of the written agreement and satisfy the rules of pleading a written contract. This usually means attaching the contract and alleging a proper claim. If there is no written agreement, then there is likely a breach of an oral agreement, which requires pleading the essential terms of the oral agreement. It's not hard to say "my factor client sold goods to the account debtor on terms, the goods were delivered, accepted, and now the buyer has a duty to pay for the goods."

This hypothetical sale of goods claim will also require the plaintiff to be cognizant of the rules in UCC Article 2, which governs sale of goods and is often your best friend when litigating this type of claim. There are also likely common law type claims relating to selling goods or providing services on an open account as well as claims for a declaration of your rights. When you are unsure as to what has been paid over notice, or believe that may have happened, then you have the right to allege an accounting claim, which puts at issue the entire transaction and what was paid, if anything, and to whom. Finally, careful attention must be paid to the fact that you, as the secured party, under the UCC and your agreement, are the assignee of the right to payment.

As a secured creditor with a security interest in accounts, general intangibles, and proceeds, and presumably a reasonably well written agreement, you have the right to collect upon your account and payment intangible collateral (a payment intangible is an obligation to pay money only and is a sub-set of general intangibles). Indeed, your automatic right to proceeds of collateral, includes certain litigation claims. Now it's time to provide the court and the other side with a basic understanding of your rights under the UCC. You can start with §9-109, which provides that Article 9 applies to the sale of accounts. A reference to §9-201 is helpful as it establishes that the terms of your security agreement (which for most of you will be contained in your factoring agreement), is binding upon your debtor and all of its creditors (which includes the account debtor in a payment over notice claim). Reference to §9-318 is warranted because upon purchase of an account, the debtor/factor client no longer has an ownership interest in the purchased account because you own it. Next comes a reference to §9-607 and its official comments, which give you the right to collect upon the accounts directly when so agreed, which is what your factoring agreement says, and gives you a claim to enforce the payment rights against the account debtor. You may want to state that collateral proceeds includes litigation claims to collect as provided for in the definition section in 9-102. A reference to §1-305 is required, which gives you the right to assert claims for breaches of various rights contained under the UCC. And, finally, you now reference §9-406, which governs that upon receipt of a proper redirection notice, the account debtor only discharges its obligation upon payment to the assignor (you, as the factor). These UCC sections provide you with a good claim for breach of a statutory duty to pay.

Hopefully it's clear that if you just plead a case under §9-406, you will lose. You will lose because a naked claim under §9-406 will invoke judicial sympathy because the account debtor is often a victim of fraud. You will also lose because the naked §9-406 claim is devoid of any real analysis. The UCC is one of the best-drafted pieces of law. At the risk of being a labeled a nerd, it's a work of art, worthy of being studied. Taken together, the UCC provides a framework for pleading a case to enforce your collection rights in accounts or payment tangibles, and sets you up to deal with many of the possible defenses. In addition to the *Durham* Case, there are some other bad decisions, resulting from a naked §9-406 claim, one of which the IFA is writing an amicus brief.

We don't want this problem to get any worse. Therefore, as a service to the commercial finance industry, we are going to provide samples of complaints against account debtors, which will be available at the IFA website. We ask, in return, that upon downloading the samples, that you make a donation to the American Factoring Association, which is the lobbying arm of the industry representing your interest. Alternatively, please make a donation to the charity of your choice. Better yet, do both. Thanks for reading and apologies for exceeding my usual allotted length. Next up, I'll take you through a stroll of the UCC as it relates to protecting your rights to collect accounts. •