When Your Vendor's Lender Demands You Pay It Instead of Your Vendor

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A commercial lender's favorite collateral is often a borrower's accounts receivable. This collateral is the building block of countless revolving lines of credit that provide borrowers with working capital and flexibility. Lenders prefer accounts receivable as collateral because it is similar to cash, unlike collateral that must be fed and liquidated (assets that must be insured, stored, marketed and sold). Additionally, the Uniform Commercial Code ("UCC") permits lenders to collect accounts receivable directly from the borrower's customers without using judicial process, thus saving time and money.[1]

After a loan agreement "goes bad" and the lender declares a default, the lender's options for collection of accounts receivable collateral include giving notice to persons whose accounts owed to a borrower were pledged by that borrower to the lender (the borrower's customer is a "payor"),[2] that is, accounts receivable in which the lender has a UCC Article 9 Security interest.[3] The primary operative provision is UCC 9-406, which states in part:

- Subject to subsections (b) through (i), an account debtor on an account, chattel paper, or a payment intangible may discharge its obligation by paying the assignor [borrower] until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee that the amount due or to become due has been assigned and that payment is to be made to the assignee. **After receipt of the notification, the account debtor [payor] may discharge its obligation by paying the assignee [Lender] and may not discharge the obligation by paying the assignor [Borrower]**.
- Subject to subsection (h), notification is ineffective under subsection (a):
  (1) if it does not reasonably identify the rights assigned;
  (2) . . . [a limitation applicable to payment intangibles that are

not accounts receivable, for example insurance settlements]; or

(3) at the option of an account debtor, if the notification notifies the account debtor to make less than the full amount of any installment or other periodic payment to the assignee, even if: (A) only a portion of the account, chattel paper, or payment intangible has been assigned to that assignee; (B) a portion has been assigned to another assignee; or (C) the account debtor knows that the assignment to that assignee is limited.[4]

- Subject to subsection (h), **if requested by the account debtor [payor], an assignee [lender] shall seasonably furnish reasonable proof that the assignment has been made**. Unless the assignee complies, the account debtor may discharge its obligation by paying the assignor, even if the account debtor has received a notification under subsection (a).

(Emphases added.) Ordinarily, the above-quoted statute means that, after a borrower defaults, the lender can give a "notification" to its borrower's customers (payors)[5] and demand that amounts owed to the borrower instead be paid to the lender if the lender has a perfected security interest in its borrower's receivables.

There are a few common concerns faced by our payor clients who receive notifications from their secured vendor's secured lenders.

The first thing a payor must understand is that neither (a) the borrower's granting of a security interest in its accounts receivable, nor (b) a lender's notification under UCC 9-406, will change the amount owed, the terms of the account debt, or the payor's rights such as a discount for returned merchandise or prompt payment. A payor who receives a lender's notification should, therefore, take a deep breath and determine exactly what is owed to the vendor that granted the security interest to the lender.

In my experience, payors who receive a lender's notification nearly always choose to alert their vendor (the lender's borrower) of the notification. The statute neither permits nor prohibits such action. Typically, the payor's communication is, in part, an effort by the payor to (i) alert its vendor that a payment may not be coming, (ii) assess the vendor's stability so the payor can determine if it needs to find a new source for the goods and services supplied by the vendor, and (iii) to seek information on whether the lender's notification is real and appropriate.

Contacting the vendor is understandable. It is natural for a payor to seek information from the party with whom it regularly does business rather than a probable stranger, the lender. Vendor-provided information, however, comes with a caveat: If the vendor asserts that the lender's notice to the payor is in error and should be ignored, the payor accepts that advice at its own risk. The UCC provision quoted above clearly states that a payor who has received an appropriate lender's notification cannot discharge its debt to the vendor by paying the vendor instead of the lender.

Rather, or in addition to, contacting the vendor, a payor can choose to contact the lender and request evidence that payment to the lender is appropriate. In this event, the UCC requires the lender to provide "reasonable proof that the assignment was made." This usually means evidence that the vendor granted a security interest to the lender and that the accounts receivable created by the payor's debt to the vendor is covered by that security interest. A payor should take advantage of this opportunity to communicate with the lender and request "proof," if either (a) the vendor asserts that the lender's notice to payor is wrongful, or (b) the lender's "notification" seems inadequate. This is a proper response to payor's concerns.[6]

In my experience, lenders often ignore a payor's request for "proof" following a lender's "notification." There are many possible reasons for this inaction by the lender.[7] Whatever the rationale, however, the result is the same. According to UCC 9-406 comment 4:

[e]ven if the proof is not forthcoming, the notification of assignment would remain effective, so that, in the absence of reasonable proof of the assignment, the account debtor could discharge the obligation by paying either the assignee or the assignor. **Of course, if the assignee [lender] did not in fact receive an assignment, the account debtor [payor] cannot**

discharge its obligation by paying a putative assignee who is a stranger [a fraudster].

(Emphasis added). Given the last sentence in this comment, the only safe action by payor is payment to the vendor, not the lender, if the lender failed to respond to payor's request for "proof."

As noted above, the lender's notification to payor does not alter the terms of the payor's obligations to the vendor. For example, if a payor has received a notification from a lender and has requested reasonable proof of the assignment, payor may discharge its obligation by paying the assignor at the time when payment is due, even if the account debtor has not yet received a response to its request for proof. This is a warning for lenders to think about their borrower's collection cycle when sending notifications to payors.

If a payor deals with a large vendor or one with diverse operations, the vendor may have more than one secured lender. Vendors can have two or more secured creditors each with a security interest in the vendor's accounts payable.[8] Sophisticated payors will often discover this fact when they do an online search with the appropriate Secretary of State's office. Unfortunately, the UCC's official commentary is silent on the payor's duties in this situation. See, however, comment 7 to UCC 9-406:

For example, an assignor [vendor] might assign the same receivable to multiple assignees [. . . .] Or, the assignor could assign the receivable to assignee-1, which then might re-assign it to assignee-2, and so forth. The rights and duties of an account debtor in the face of multiple assignments and in other circumstances not resolved in the statutory text are left to the common-law rules. See, e.g., Restatement (2d), Contracts Sections 338(3), 339.

When faced with this problem, counsel must determine which state's common law applies and find the non-UCC answer from applicable law.

Finally, clients often ask whether a particular lender notification is an appropriate and effective "authenticated" notification. The answer depends on the circumstances of the notification. Fortunately, there are plenty of court decisions that can provide guidance on this question. One example is *Swift Energy Operating, LLC v. Plemco-South Inc.*, 157 So.3d 1154 (La. Ct. App. 2015), where a borrower did business with an account receivable factor, the secured party. The borrower and factor sent an email to the payor which was the alleged lender notification under Louisiana's version of UCC 9-406. In response to that email, the payor's employee directed the lender to contact the payor's appropriate office. The payor's employee, however, did not sign and return the acknowledgment that payor received the lender's notification. The lender subsequently failed to contact the payor's accounts payable office as directed and the payor paid its obligation to the vendor rather than the lender/account receivable factor. Litigation was initiated in an effort to determine if payor was nonetheless liable to the lender for failure to follow the lender's notification.

The Louisiana Court of Appeals held that the email was not an "authenticated" notification in compliance with the statute. The court reasonably held that the required notice must be directed to the appropriate payor department or employee when the lender has notice of that department. The court ruled:

> [W]e find that the notice required by La.R.S. 10:9-406(a) was not effected prior to Swift Energy's payment to Plemco–South. Given the size of its operation, we find that Swift Energy maintained reasonable routines for communicating significant information through its departmentalization policy, and both Factor King and Plemco–South were timely made aware of the proper department for delivery of the required notice. Had either Ms. Gleberman or Mr. Stigall followed Ms. Keo's instruction, notice would have been effected to the appropriate department well before the payment to Plemco–South at issue.

Id. at 1164.

The UCC's provision for nonjudicial collection of accounts receivable collateral is important and valuable to lenders. Unfortunately, it regularly raises questions and concerns for recipients of lender notifications. Experienced counsel can help their payor clients resolve concerns, determine who to pay, and possibly smooth any tensions between the payor and its vendor by demonstrating that the payor exercised every opportunity to protect the vendor before paying the lender.

For more information, please contact Vince Mauer or any attorney in Frost Brown Todd's Financial Services industry team.

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[1] This post does not address a lender's efforts to control accounts receivable collateral while the lending relationship is intact, such as use of a lockbox to receive payments and control over the borrower's bank accounts into which the accounts receivable payments are deposited by the borrower (whether by check or wire transfer).

[2] For purposes of this blog post, I will use the term "Payor" for the borrower's customer who owes money to the borrower and whose debt to borrower is subject to a security interest in favor of the lender. This blog post is written from a Payor's perspective.

[3] A warning for lenders: According to the Ohio Supreme Court, this remedy is not fully available against the collateral of a borrower whose customer, the Payor, is a government entity. *See MP Star Financial Inc. v. Cleveland State Univ.*, 837 N.E.2d 758 (Ohio 2005) ("provision of UCC making an account debtor liable to an assignee of accounts receivable, for payments made to assignor after receiving notice of assignment, does not apply to payments made by an account debtor that is a governmental unit.").

[4] Under subsection (b)(3), an account debtor that is notified to pay an assignee less than the full amount of any installment or other periodic payment has the option to treat the notification as ineffective, ignore the notice, and discharge the assigned obligation by paying the assignor [vendor]. This is a convenience for Payors and a warning to lenders.

[5] For the typical recipient of this notice (a Payor), the borrower whose account was assigned is a vendor, a business that sells goods or services to you and grants its lender a security interest in the account receivable generated by that sale.

[6] Comment 3 to UCC 9-406 states: "[i]f an account debtor [Payor] has doubt as to the adequacy of a notification, it may not be safe [for the Payor] in disregarding the notification unless it [Payor] notifies the assignee [lender] with reasonable promptness as to the respects in which the account debtor considers the notification defective." So, a Payor with concerns may be better off to seek information from the lender rather than making its own decision concerning the adequacy of the notification.

[7] I have occasionally counseled lender clients to ignore a Payor's request for "proof." The reasons for this advice are beyond the scope of this blog post.

[8] Hopefully, there is an Intercreditor Agreement addressing lien priorities and which lender(s) can send a lender notification.