IS A LENDER "WORTHY" OF DIRECT PAYMENT ON ACCOUNTS RECEIVABLE OWING TO ITS DEBTOR? THE NEW YORK COURT OF APPEALS SETTLES THIS QUESTION

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US Finance Judicial Opinion Summary

A recent New York Court of Appeals case, *Worthy Lending LLC v. New Style Contractors, Inc.*,[1] highlights the importance of maintaining best practices in transactions where the lender takes a security interest in the borrower's accounts receivable or contracts.

WHAT DOES THE *WORTHY* CASE SAY?

In Worthy, the New York Court of Appeals held that Worthy, a lender with a security interest in the accounts of a borrower, Checkmate Communications (Borrower), was entitled to payment on Borrower's pledged accounts regardless of whether or not an event of default existed. In 2019, Borrower executed a promissory note and security agreement in favor of Worthy, granting Worthy a lien on all of its assets, including its accounts receivables. Worthy properly filed a UCC-1 financing statement to perfect its security interest and sent a notice of its interest to Borrower's account debtors along with a statement that any subsequent payments made by such account debtor to Borrower would no longer discharge its obligations. However, one such account debtor continued to remit payments to Borrower (hereinafter, the Rogue Debtor). Shortly after entering into this transaction, Borrower defaulted and Worthy properly accelerated repayment of the note. At that time, Worthy also pursued a debt collection action against the Rogue Debtor on the ground that its security interest in Rogue Debtor's account owing to Borrower gave it a lien on any payments made under the account.

Ultimately, the crux of the issue was whether the statute governing security interests in accounts receivable is N.Y. U.C.C. LAW § 9-406 or N.Y. U.C.C. LAW § 9-607. The former, by its terms, only applies to assignments of accounts while the latter governs pledges of accounts receivable but does not determine whether the account debtor owes a duty to the pledgee before a default occurs vis-à-vis the pledgor and pledgee.

First, the Court of Appeals held that § 9-406 governs security interests in accounts receivable because, for purposes of that section, an “assignee” includes the holder of a presently exercisable security interest in accounts receivable and an “assignor” includes a pledger of receivables.[2] Thus, under § 9-406, an account debtor with notice of the security interest may discharge its obligation only by paying the secured party.[3]

Second, the Court of Appeals held that while § 9-607 does not establish a duty on the part of an account debtor to pay the pledgee of accounts receivable owed by it before a default occurs, such a duty may be established by contract and clearly was so established here.[4] The Court of Appeals went a step further in its analysis of § 9-607(a), finding that it applies regardless of whether there is a dispute as to the amount owed on the account.[5]

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In light of the *Worthy* case, secured lenders should take steps to mitigate potential problems with any finance transaction by conducting careful due diligence, preparing clear documentation, and sending timely notices to any account debtors of their secured interest.

WHAT ARE SOME BEST PRACTICES FOR LENDERS IN LIGHT OF WORTHY?

Lenders, as part of their due diligence process on the borrower prior to funding, generally require the borrower to disclose contracts material to the borrower's business, especially customer or vendor contracts whose financial value comprise a significant portion of the borrower's revenue and that may generate material accounts receivables. Lenders should review those contracts and pay close attention to the duration of the contract, payment mechanics, and contact information.

In connection with the closing of a loan secured by accounts receivable, secured lenders should ensure that the security grant in the loan documentation includes “all right, title and interest of [the borrower] in and to its … accounts,” which includes “any accounts receivable arising from invoices the borrower issued to its customers.”[6] Additionally, the loan documentation should grant the secured lender the right to notify any person owing funds to the borrower of the lender's security interest in such funds, verify the amount owed and instruct account debtors “to remit payment of accounts and other collateral directly to the lender.”[7]

At closing, the lender should file a completed UCC1 financing statement in the state where the borrower is organized.[8] This will perfect the lenders' security interest in the accounts receivable under the Uniform Commercial Code. A lender would be well advised to also take a collateral assignment of any material contracts to strengthen their secured position.

Finally, either at closing or shortly thereafter, the lenders should notify any account debtors of the lenders' secured interest in the accounts payable by those account debtors. The notice should inform the account debtor that the borrower has pledged to the lender any amounts payable by the account debtor to borrower as described and conditioned upon the terms of the relevant agreements. Lenders should also specify where to remit payments of amounts payable and include the lenders contact information for any questions.

WHAT ABOUT ACCOUNT DEBTORS?

For an account debtor that is alerted by a lender of its security interest in their accounts payable, the debtor should ask for proof of the security interest and, upon receipt of such proof, pay the secured lender amounts that are due. If the account debtor fails to do this, then it risks being forced to pay an outstanding obligation twice over. However, because *Worthy* is a New York state court ruling under the New York Uniform Commercial Code, an account debtor who receives notice to direct payment to a secured lender should consult their attorney to determine whether the secured lender has taken all of the steps required by the applicable governing jurisdiction to be entitled to the payment.

FOOTNOTES

[1] 201 N.E.3d 783 (N.Y. 2022), https://www.nycourts.gov/ctapps/Decisions/2022/Nov22/86opn22-Decision.pdf.

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[2] *Id*. at 788.

[3] *Id*.

[4] *Id*. at 786.

[5] *Id*. at 786.

[6] *Id*. at 785.

[7] *Id*. At 786.

[8] N.Y. U.C.C. LAW § 9-307(e).

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