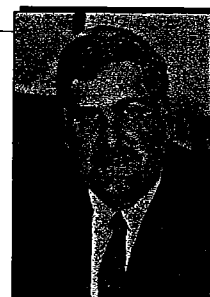


Collecting and Enforcing Accounts Receivable Collateral:

A Secured Lender's Rights and Duties

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Revised Article 9 of the Uniform Commercial Code allows a lender to take a security interest in some or all of its borrower's accounts receivable (commonly referred to as either "accounts" or "receivables") and the proceeds thereof. Each account will evidence the borrower's right to receive payment from an account debtor, commonly but not invariably for goods, property or services that the borrower has sold, leased or rendered to it. *Rev. U.C.C. §9-102(a)(2)*. In those loans secured by a borrower's accounts, the lender will have the rights and duties of a secured party and assignee under Revised Article 9 and the borrower those of a debtor, assignor and obligor. *Rev. U.C.C. §9-102(a)(28), (59) and (72)*.

Before the borrower's default, the lender's rights will not include, unless otherwise agreed to between them, those to collect and enforce accounts collateral or to control their proceeds. *Rev. U.C.C. §9-607(a)*. After a default and whether or not agreed to by the borrower, the lender will have the right under Revised Article 9 to liquidate accounts collateral by assuming control of their collection and enforcement, as well as the right to apply the accounts' proceeds (net of expenses) in reduction of the defaulted loan. *Id.* The lender ordinarily may but need

not enforce those rights at the same time it forecloses upon other available collateral and enforces payment by the borrower and any guarantors. *Rev. U.C.C. §9-601(a) and (c)*.

A lender's success in collecting and enforcing accounts collateral following its borrower's default will vary from loan to loan depending upon the particular circumstances of each liquidation, including the extent to which the accounts are past their due date, payable by solvent account debtors and subject to dilution for any of various reasons, including disputes. In all such liquidations, however, the lender will be subject to many if not all of the Revised Article 9 rights and duties discussed in this article. Its adherence to Revised Article 9 not only will allow the lender to realize upon accounts collateral to the extent that they are enforceable against the account debtors, but will preserve the lender's contractual entitlement to recover any remaining loan balance from the borrower and any guarantors. (The reader should be aware that many of the rights and duties mentioned below may be either varied by other controlling law when the account debtor is a consumer or inapplicable to some accounts, most notably health-care-insurance-receivables.)

NOTIFICATION AND COLLECTION

Following its borrower's default in a loan secured by accounts, the lender is entitled to collect the accounts by notifying the account debtors to pay it. *Rev. U.C.C. §9-607(a)(1)*. (Before its borrower's default, the lender may so notify account debtors only if agreed to by the borrower. *Id.*) Upon receiving an effective notification as to an assigned account, the account debtor may discharge its obligation under that account only by paying the lender. *Rev. U.C.C. §406(a)*.

An effective notification under Revised Article 9 requires that the notice sent (1) be authenticated by either the account's assignee or assignor (i.e., the lender or borrower); (2) advise the account debtor "that the amount due or to become due" under the account "has been assigned and that payment is to be made to the assignee"; and (3) "reasonably identify the rights assigned". *Rev. U.C.C. §9-406(a) and (b)(1)*. "Authentication" of the notice may be accomplished in any one of several ways, including having it signed by the notifying party, or sent either

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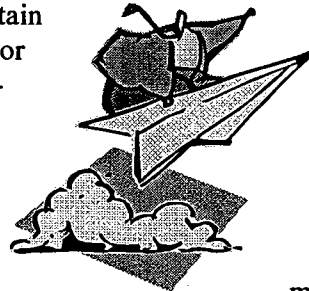
on the notifying party's letterhead or on a form on which the notifying party's name appears. *Rev. U.C.C. §§9-102(a)(7) and 9-406, cmt. 2.* The detail necessary to "reasonably identify the rights assigned" is not described in Revised Article 9, but the Official Comments advise both that the notification "need not identify the right to payment with specificity" and that the adequacy of the identification is "not left to the arbitrary decision of the account debtor". *Rev. U.C.C. §9-406, cmt. 3.*

An account debtor who receives an effective notification has the right to request that the lender "seasonably furnish reasonable proof of the account's assignment". *Rev. U.C.C. §9-406(c).* If the lender fails to furnish the requested proof, the account debtor will be discharged if it pays the borrower. *Id.* The Official Comments suggest that after such a request is made of the lender but before a "seasonable response" is due, the account debtor may discharge the account by paying the borrower so as to avoid a default thereunder. *Rev. U.C.C. §9-406, cmt. 4.*

It is usually advisable that the lender electing to notify account debtors do so promptly after a default to prevent the account debtors from discharging their obligation under the accounts by paying the borrower. *Rev. U.C.C. §9-406(a).* Unless it has been receiving timely information from the borrower, such as receivable agings and copies of invoices, the lender may not know the account debtors to be notified. If the borrower after a default resists the lender's request for the identification of account debtors, the lender may fear that any accounts' proceeds collected by the borrower will be dissipated or secreted. In such situation, the lender may seek to have a court: (a) enjoin the borrower's continued collection of

the accounts; (b) order the borrower to segregate and hold for the lender's benefit any accounts' proceeds received by it; and (c) order the borrower to provide the information necessary for the lender to notify the account debtors.

The lender, after notifying the account debtors under Revised Article 9, usually will need the borrower's books and records supporting the accounts. Without them, the lender may be unable to establish the enforceability of those accounts questioned or disputed by an account debtor. It is for this reason that the lender often requires a security interest in the borrower's books and records, thereby entitling the lender to obtain an order of seizure or replevin under applicable state law when the borrower withholds such collateral. *Rev. U.C.C. §9-609(b)(1).*



ENFORCEMENT

It is not at all uncommon for a notified account debtor to dispute, for reasons genuine or feigned, its obligation under the account or to simply ignore the lender's notice. Revised Article 9 therefore authorizes the lender to exercise its borrower's right to enforce an account's payment by the account debtor. *Rev. U.C.C. §9-607(a)(3).* In enforcing the account, the lender will be subject to certain rights that the account debtor may have against the borrower to the extent provided for in Revised Article 9. The account debtor's liability under the account, however, is left to controlling law outside of Revised Article 9.

The lender enforcing an account will be subject to all terms of the agreement between the borrower and the account debtor as to the account. *Rev.*

U.C.C. §9-404(a)(1). Any terms of that agreement, however, that prohibits or restricts the assignment of a security interest in the account generally will be ineffective as to the lender. *Rev. U.C.C. §9-406(d).* The lender may also be bound by any good faith modification of an agreement that was entered into before either (a) the borrower's right to payment was fully earned or (b) the account debtor was notified to pay the lender. *Rev. U.C.C. §9-405.*

In some instances, an account debtor and borrower may have agreed that the account debtor will waive or otherwise not assert any defenses or claims to the account's enforcement by the borrower's assignee. The lender is entitled to enforce that agreement if it took the security interest in the account for value, in good faith, and without notice both of conflicting claims to the account or of a defense thereto of the type that may be asserted to the enforcement of a negotiable instrument under Uniform Commercial Code section 3-305(a). *Rev. U.C.C. §9-403(b).* An enforceable waiver insulates the lender from all defenses except those of the type that may be asserted against a holder in due course under section 3-305(b) (commonly referred to as "real defenses"). *Rev. U.C.C. §9-403(c).* Notwithstanding that an account debtor's waiver may be unenforceable under Revised Article 9, the lender will be entitled to enforce that waiver to the extent permitted by other controlling law. *Rev. U.C.C. §9-403(f) and cmt. 6.*

In the absence of the account debtor's enforceable waiver, the lender's enforcement of an account is subject to "any defenses or claims in recoupment arising from the transaction that gave rise to the contract". *Rev. U.C.C. §9-404(a)(1).* The account debtor also will be entitled to raise any other defenses or claims that it may

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have against the borrower, provided that such a claim or defense "accrued" before the account debtor was notified of the account's assignment. *Rev. U.C.C. §9-404(a)(2)*. Any affirmative claims against the borrower that the account debtor may successfully assert against the account's enforcement will reduce the lender's recovery under the account but cannot result in an affirmative recovery against it. *Rev. U.C.C. §9-404(b)*.

While it permits the lender to exercise the borrower's right to enforce an account against the account debtor, Revised Article 9 will not control as to whether or not that account is an enforceable obligation of the account debtor. That issue, as well as the particular defenses or claims to the account's enforcement, is left to other controlling law. *Rev. U.C.C. §9-607(e)* and cmt. 6. Thus, if the account evidences a payment obligation for goods sold by the borrower to the account debtor, the lender may need to establish the account debtor's obligation to make payment under Article 2 of the Uniform Commercial Code or under a theory of account stated. The account debtor, to the extent permitted under Revised Article 9, will be entitled to raise any defenses or claims that may exist under Article 2 or other applicable law.

PROCEEDS

The lender is required to apply the proceeds received from the accounts' collection and enforcement in accordance with Revised Article 9. *Rev. U.C.C. §9-608(a)*. Any non-cash proceeds, however, need not be applied

until they are reduced to cash, unless the failure to apply them earlier would be commercially reasonable. *Rev. U.C.C. §9-608(a)(3)* and cmt. 4. An account debtor's promissory note delivered to the lender to discharge an account would constitute non-cash proceeds.

Before applying the accounts' proceeds against the secured loan, the lender is entitled to deduct therefrom both its (a) reasonable expenses of collection and enforcement and (b) reasonable attorneys' fees and legal expenses to the extent agreed to by the borrower and not prohibited by law. *Rev. U.C.C. §9-608(a)(1)(A)* and (B). Absent the borrower's enforceable agreement covering attorney's fees, the lender nonetheless may deduct as an expense any reasonable attorneys' fees and legal expenses it incurred in collecting and enforcing the accounts. *Rev. U.C.C. §9-607(d)* and cmt. 10.

Accounts liquidated by a lender in some instances may also secure the payment of a subordinate security interest or lien. If the accounts' proceeds are sufficient to satisfy the lender's expenses and loan in full, the lender in certain circumstances may have to remit all or some of any remaining proceeds (i.e., surplus proceeds) to the holder of the subordinate security interest or lien. *Rev. U.C.C. §9-608(a)(1)(C)*.

After applying the proceeds in accordance with Revised Article 9, the lender typically will be required to account to and pay the borrower any surplus proceeds or entitled to recover from the borrower and other obligors any deficiency. *Rev. U.C.C. §9-608(a)(4)*. The borrower's entitlement to a surplus or an obligor's liability for a deficiency, however, will be subject to the terms of their agreement with the lender. *Rev. U.C.C. §9-608*, cmt. 3. Moreover, the

lender's right to a deficiency (or liability for an unrealized surplus) may depend upon whether or not the lender's collection and enforcement efforts were "commercially reasonable".

COMMERCIAL REASONABLENESS

Where it has the right either to charge back uncollected accounts or to recover a deficiency from any obligors, the lender's collection and enforcement of accounts (including their settlement and compromise) must "proceed in a commercially reasonable manner". *Rev. U.C.C. §9-607(c)* and cmt. 9. This duty is intended "to protect the [borrower and guarantors] from an avoidable deficiency judgment or the squandering of a possible surplus through the [lender's] inaction". *Federal Deposit Ins. Corp. v. Fort Worth Aviation*, 806 F.2d 575, 577 (5th Cir. 1986). It thus assures that the lender who assumes control of the accounts' collection and enforcement will "act with the same degree of prudence which the [borrower] would exercise". *Financial, Inc. v. Ross*, 301 S.E. 2d 262, 264 (Ga. 1983).

What is or is not commercially reasonable in the context of the collection or enforcement of accounts is not specifically defined in Revised Article 9 (nor was it in section 9-502 of the former Article 9). Revised Article 9 does instruct, however, that a lender's manner of liquidating accounts may not be deemed to have been commercially unreasonable solely because the lender could have realized more from the accounts' liquidation had it proceeded in a different manner. *Rev. U.C.C. §9-627(a)*. It also allows a lender to obtain advance approval by a court or on behalf of the borrower's other creditors as to the commercial reasonableness of its proposed manner of liquidation. *Rev. U.C.C. §9-627(c)*, (d) and cmt. 3. Presumably, the lender then is required to adhere to the approved manner of liquidation. In addition, a borrower and lender



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are free to determine by their agreement the "standards measuring the fulfillment" of commercial reasonableness, provided that the agreed standards are not "manifestly unreasonable". *Rev. U.C.C. §9-603*. They may not, however, agree "to waive or vary" the lender's duty of commercial reasonableness. *Rev. U.C.C. §9-602(c)*.

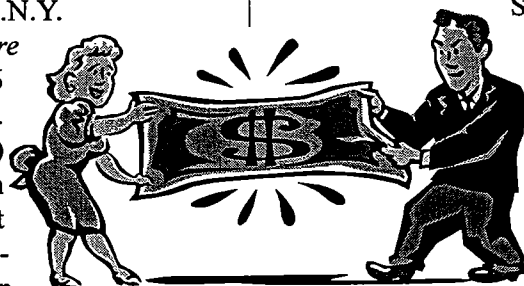
Absent such an agreement or advance approval, the lender's commercial reasonableness in the collection or enforcement of accounts will "hing[e] on the totality of circumstances, including the good faith efforts of the" lender. *Federal Deposit Ins. Corp. v. Wrapwell Corp.*, 46 UCC Rep. Serv. 2d 885, 897 (S.D.N.Y.

2002); see also *In re Nicsinger*, 136 B.R. 228 (Bank. W.D. Mo. 1992) (lender's good faith efforts to collect accounts were commercially reasonable). (Good faith under Revised Article 9 requires the lender's "honesty in fact and the observance of reasonable commercial standards of fair dealing". *Rev. U.C.C. §9-102(a)(43)*.) Comparing the lender's liquidation "with reasonable commercial practices among others collecting [and enforcing] receivables [will] establish that a collection [or enforcement] was done in a commercially reasonable manner". *Matter of Braten Apparel Corp.*, 68 B.R. 955 (Bank. S.D.N.Y. 1987).

In some liquidations, the account debtors involved may number in the hundreds and be located throughout (and even outside) the country. Commercial reasonableness may require that the lender who lacks the expertise and resources necessary to effectively pursue the accounts' collection or enforcement either retain an experienced

and reputable company capable of liquidating the accounts or, if practical, utilize its borrower's employees familiar with the accounts to assist in their liquidation. The lender should monitor their progress because it ultimately will be responsible for the "commercial reasonableness" of their efforts.

In any liquidation, at least some if not substantially more of the accounts may be both uncollectible and unenforceable through no fault of the lender's attempts to collect or enforce them. Courts ordinarily do not construe commercial reasonableness as requiring the lender "to turn vinegar into wine". *In re Emergency Beacon Corp.*, 49 B.R. 341, 349 (Bank. S.D.N.Y. 1985).



The lender, however, must realize that accounts "do not improve with age" (*id.*) and that courts expect a lender to make at least some timely and

cost-efficient attempts at their collection. See *In re Wells*, 51 B.R. 563, 568 (Bank. D. Colo. 1985) ("[w]hile it may not be cost-efficient to commence a suit against the account debtors, certainly a demand letter could have been sent"); *DeLay First Nat'l Bank And Trust Co. v. Jacobson Appliance Co.*, 243 N.W. 2d 745, 751 (Neb. 1976) ("the record indicates that bank made little or no effort to realize on accounts receivables").

At the very least, the lender in all liquidations will be required to account as to the ultimate result of its collection efforts. "If the requirement of commercial reasonableness as applied to the liquidation of accounts receivable means anything, it must mean at a minimum that [the lender] was obligated to account to the [borrower] as to the (accounts') final disposition." *Fedders*

Corp. v. Taylor, 473 F.Supp. 961, 977 (D. Minn. 1979).

If the lender who undertakes the account's liquidation fails to proceed in a commercially reasonable manner, the borrower or another aggrieved party may request a court to order or restrain the lender's liquidation. *Rev. U.C.C. §9-625(a)*. Moreover, the lender's failure to liquidate accounts in a commercially reasonable manner may render it liable in damages to the borrower or another aggrieved party for the loss of a potential surplus. *Rev. U.C.C. §9-625(b)*.

REBUTTABLE PRESUMPTION

When it seeks to recover a deficiency judgment, the lender's compliance with its post-default duties under Revised Article 9 will be subject to the rebuttable presumption rule. *Rev. U.C.C. §9-626(a)*. Under that rule (which may not apply in consumer transactions), the lender need not prove that its post-default collection and enforcement of accounts complied with Revised Article 9, including the duty of commercial reasonableness, unless the adverse party places the lender's compliance at issue. *Rev. U.C.C. §9-626(a)(1)* and (2). If the lender then fails to demonstrate its compliance, any entitlement that the lender otherwise may have to a deficiency judgment will be presumed to have been eliminated unless it can establish that the collection and enforcement of the accounts in accordance with Revised Article 9 would have realized an amount less than the loan. *Rev. U.C.C. §9-626(a)(3)*. Such lesser amount will then be subtracted from the loan to arrive at the deficiency judgment that can be recovered by the lender. *Rev. U.C.C. §9-626(a)(4)*.

The rebuttable presumption rule also applies when the amount of a surplus is at issue, although it would appear that the party claiming the loss of an unrealized surplus will have the burden of proving that loss after the lender fails to establish its compliance with Revised Article 9. *Rev.*

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U.C.C. §9-626(a). In consumer transactions, courts are free to adopt the rebuttable presumption rule or another "established" rule to determine an entitlement for a deficiency or surplus. *Rev. U.C.C. §9-626(b)*.

CONCLUSION

A lender's post-default liquidation of accounts collateral may as to some accounts require no more than a letter, while as to others demand that the lender litigate the accounts' enforceability. Complying with Revised Article 9's dictates should allow every lender to protect and enforce its rights against account debtors and the loan's obligors, as well as enhance the extent to which it may ultimately recover from them.