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NINTH CIRCUIT IMPAIRS SECURED CREDITOR'S RIGHT TO COLLECT FROM ACCOUNT DEBTOR

In an unfortunate decision, the Ninth Circuit has cast doubt on a secured creditor's ability to collect from an account debtor after the account debtor has improperly paid the debtor. *Ta Chong Bank Ltd. v. Hitachi High Technologies America, Inc.*, 610 F.3d 1063 (9th Cir. 2010).

The facts. In 2005, Hitachi High Technologies purchased a large number of DVD players from Cyberhome Entertainment, for \$1.2 million. Cyberhome assigned the resulting account (along with other accounts) to Ta Chong Bank, which failed to file a financing statement. The bank and Cyberhome promptly instructed Hitachi in writing to make payment to the bank, but despite this instruction Hitachi paid Cyberhome. If these were the only relevant facts, the result would be clear. Under UCC 9-406(a), Hitachi's payment to Cyberhome would not have discharged its obligation. Hitachi would remain liable to the bank and, upon paying the bank, could seek restitution from

Cyberhome. The bank's failure to perfect its interest would not be material to the analysis.

However, eight months after Hitachi paid Cyberhome, Cyberhome filed for Chapter 7 bankruptcy protection. The bank filed a secured claim for \$83 million but the trustee avoided the bank's unperfected security interest in Cyberhome's accounts. The bank then sued Hitachi in federal district court for the \$1.2 million that Hitachi was supposed to have paid to the bank. The district court dismissed the case for failure to state a claim, concluding that the bank was attempting an end-run around the bankruptcy court's avoidance order. The bank appealed.

The bank claimed that Cyberhome's bankruptcy estate could have no conceivable property interest in either the invoices or the bank's claim against Hitachi because Cyberhome had received payment in full prior to filing bankruptcy. Moreover, the bank argued, avoidance of its security interest was also irrelevant because avoidance applies only to property in which the debtor has an interest, and Cyberhome had no interest in Hitachi's liability to the bank.

The Ninth Circuit decision. The Ninth Circuit rejected these arguments. It agreed with the conclusion of the lower courts that Cyberhome's accounts receivable were part of the bankruptcy estate. While UCC 9-406(a) might require Hitachi to pay twice, "the second payment would be for the same obligation which Hitachi failed to discharge through its payment to Cyberhome." The court then cited UCC 9-318(b), which provides that as long as an account buyer's security interest is unperfected, "the debtor is deemed to have rights and title to the account...identical to those the debtor sold." The court also concluded that its decision was consistent with bankruptcy policy:

A finding that Hitachi is liable to the Bank may well affect the bankruptcy proceedings because Hitachi would likely then seek repayment of its \$1.2 million from CyberHome. Accordingly, a ruling on the Bank's claims here could potentially reorder the preference in which the creditors, including the Bank, are paid.

Some thoughts about the decision. Superficially, the court's decision seems sound. Hitachi's payment did not

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discharge its obligation, so the account must still exist. Because the bank's security interest was avoided, the account remained part of Cyberhome's bankruptcy estate. Accordingly, the bank's efforts to obtain payment from Hitachi would indeed be an end-run around the bankruptcy process and the bankruptcy court's rulings.

Nevertheless, the decision is definitely unsettling and seems flawed. Let's start at the end with the court's policy argument, which is particularly off the point. The court is correct that if Hitachi now pays, Hitachi will have a claim for reimbursement against the debtor. But that would not cause a drain on the estate because the bank's claim would be reduced by the same amount. In other words, the bankruptcy estate owes either the bank or Hitachi, but not both (and not neither). So, it does not matter to the bankruptcy proceeding whether Hitachi pays the bank or not.

The court's main analysis is premised on an almost metaphysical conclusion: that an account continues to exist after the account debtor pays the wrong person and thereby does not discharge the obligation. Admittedly, UCC 9-406(a) can be read to support that conclusion. But such an interpretation would also suggest that the debtor could continue to collateralize the account despite having been paid in full. Consider this scenario:

Debtor borrows against accounts, granting a security interest to Lender One, who fails to perfect. Debtor and Lender One instruct Account Debtor to pay Lender One. Account Debtor pays Debtor. Debtor then assigns the non-discharged obligation of Account Debtor to Lender Two. The court's analysis implies that Lender Two gets a valid security interest in the obligation of Account Debtor. Yet, once Debtor has received payment in full on the account, Debtor does not have any rights in the account to transfer.

Indeed, by concluding that Cyberhome retained a property interest in Hitachi's obligation, and treating the account as part of the estate, the court's analysis implicitly assumes that the trustee could enforce the account obligation by forcing Hitachi to pay a second time. But that can't be correct. After all, Hitachi would have a restitution claim for the full amount of any second payment; it would also have either setoff or recoupment rights that would allow it to net the two obligations against each other and thereby avoid making a second payment to the estate.

The court's reading of UCC 9-318(b) is also problematic. Although that provision says that the debtor "is deemed to have rights" in an assigned account if the assignee has failed to perfect, that language is there "[f]or the purposes of determining the rights of" creditors of the debtor and purchasers of the account. In other words, the debtor does not actually retain rights, but merely has the power to convey rights to someone else. (In a similar vein, UCC 9-203(b)

(2) provides that attachment of a security interest requires that the debtor have rights in the collateral or the power to convey rights in the collateral).

Bottom line. The Ninth Circuit decision is probably wrong. Fortunately, it should have little impact on account financing. The bank would not have suffered a loss had it properly perfected its interest. The case therefore presents one more reason – albeit an unfortunate one – for factors to make sure they file financing statements.

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