

What Constitutes Sufficient Notification of a Security Interest to Cut Off Trade Creditors' Setoff Rights?

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When a trade creditor's customer fails to pay its debts, the creditor must consider its options and quickly exercise its rights. One such right is a creditor's right of setoff, which allows a creditor to net out debt the customer owes to the creditor against the debt the creditor owes to its customer. Setoff rights ensure that a creditor is not obligated to pay its customer for a debt the creditor owes while there are still amounts owing to the creditor.

However, in certain circumstances, notification of a lender's security interest in its customer's accounts receivable cuts off a trade creditor's rights to setoff its outstanding indebtedness owing to the customer. Uniform Commercial Code ("UCC") Section 9-404 states a lender's security interest in accounts receivable takes precedence over a trade creditor's setoff rights that arose after the creditor had received a notification of the assignment.

An unresolved question is whether a trade creditor has received sufficient notification of a security interest to cut off its setoff rights when the creditor had previously received a Dun and Bradstreet ("D&B") report that discloses the security interest. Or is more required, such as the creditor's customer or its lender providing a manually or electronically signed notification of the security interest to the trade creditor?

In 2015, the United States District Court for the District of Maine, in *Wheeling & Lake Erie Ry. Co. v. Maine Northern Ry. Co.*, held that the creditors' receipt of D&B reports, which contained information about a lender's security interest in the creditors' customer's accounts receivable, were not a sufficient notification under the UCC to cut off the creditors' setoff rights. In so holding, the court disagreed with a 2003 decision of the United States Bankruptcy Court for the District of Delaware, in the *Communication Dynamics* case, that a creditor's receipt of a D&B report disclosing a lender's security interest was sufficient to cut off the creditor's setoff rights under the UCC. Interestingly, however, the *Communication Dynamics* court ultimately held that the creditor could rely on its right of recoupment—which is similar to, yet distinct from, setoff rights—to reduce the amount the creditor owed to its customer, regardless of the fact that the creditor's setoff rights were wiped out when the creditor had received notification of the lender's security interest.

In light of the inconsistency among the courts regarding what entails sufficient notification under UCC Section 9-404, trade creditors weighing their options against a delinquent customer should be aware of the circumstances under which a secured lender might challenge the creditors' setoff rights. Creditors should also be cognizant of whether they have

recoupment rights which would not be defeated by notification of a competing security interest.

Overview of a Creditor's Setoff Rights

Setoff rights are significant state and federal law rights that a creditor can use to reduce its exposure on amounts it owes to a financially distressed customer. A creditor can assert a setoff when the creditor and its customer sell goods or provide services to each other by netting out the amount its customer owes to the creditor against the amount the creditor owes to its customer. For example, if ABC owes XYZ \$1,000 and XYZ also owes ABC \$800, then XYZ can net out, or setoff, the amounts owed so that ABC only pays XYZ the net amount of \$200. XYZ's setoff rights are easily understandable and efficient – they excuse ABC from having to pay XYZ \$1,000 and then requiring XYZ to immediately pay \$800 back to ABC.

A creditor's setoff rights are especially valuable if its customer files for bankruptcy. The creditor can assert its right of setoff to avoid paying the full amount of its indebtedness to its customer when the creditor faces the real risk of the customer's delayed payment of only a fraction of, or nonpayment of, the creditor's offsetting claim.

Section 553 of the Bankruptcy Code recognizes a creditor's setoff rights that already exist under applicable federal or state law. However, the Bankruptcy Code imposes restrictions on a creditor's setoff rights. Setoff requires that the debtor's and creditor's obligations are mutual (they are owed between the same legal entities) and both arose either before or after the bankruptcy filing. A creditor must also first obtain from the bankruptcy court relief from the automatic stay that arises under Section 362 of the Bankruptcy Code to exercise its setoff rights following a debtor's bankruptcy filing. Other provisions of Section 553 limit setoff rights that arose within 90 days of the bankruptcy filing or any setoff during that 90-day period that improved the creditor's recovery.

Overview of a Creditor's Recoupment Rights

A creditor's right of recoupment has the same effect as setoff—allowing the creditor to net out the debt its customer owes against the creditor's obligations—but it differs from setoff in significant ways. Recoupment is narrower than setoff in that recoupment is available only where the mutual debts between the creditor and customer arose out of the same transaction. Courts have defined "transaction" either broadly or narrowly. Some courts have applied a flexible broad approach to allow recoupment where the debts are logically related. According to this view, recoupment is permissible

if the debts are sufficiently interconnected that it would be unfair to insist that one party fulfill its obligation but not require the same of the other party. Other courts, however, narrowly interpret “transaction” and recoupment rights to require that the mutual debts arose from the same contract or even a single transaction under the contract.

Recoupment has several advantages over setoff, especially once a creditor’s customer has filed for bankruptcy. First, unlike setoff, a creditor usually does not need to obtain relief from the automatic stay to exercise its right of recoupment. Second, Section 553’s limits on setoff rights do not apply to recoupment. Many courts have held that a creditor can recoup its pre-petition claim against its post-petition obligations and vice versa. Third, as discussed next, UCC Section 9-404 protects a creditor’s recoupment rights, even when the creditor has received notification of a competing security interest.

UCC Section 9-404

According to UCC Section 9-404(a)(2), a lender’s blanket security interest in its borrower’s accounts receivable is subject to any defense or claim, including setoff, of the account debtor (the party owing the account receivable) against the lender’s borrower “which accrues before the account debtor receives a notification of the assignment authenticated by the [borrower] or the [lender].” The term “authenticate” means to manually sign or, in the case of an electronic document or other non-written media, to electronically sign by attaching an electronic sound, symbol or process. However, according to UCC Section 9-404(a)(1), a secured lender’s rights are subject to “all terms of the agreement between the account debtor and [lender’s borrower] and any defense or claim in recoupment”. Therefore, while a notification of a lender’s prior security interest cuts off a trade creditor’s setoff rights, it does not cut off a trade creditor’s recoupment rights.

The Wheeling & Lake Erie Railway Case

In *Wheeling & Lake Erie Ry. Co. v. Maine Northern Ry. Co.*, Maine Northern Railway Company and New Brunswick Southern Railway Company Limited (together, the “Defendants”) owed money to Maine & Atlantic Railway, Ltd., and its affiliates (“MMA”) based on services MMA had provided to the Defendants. In 2009, Wheeling & Lake Erie Railway Company (“Wheeling”) provided MMA with a line of credit. As part of the loan transaction, MMA granted Wheeling a security interest in MMA’s accounts receivable.

On August 7, 2013, MMA filed a Chapter 11 bankruptcy petition and the bankruptcy court granted Wheeling relief from the automatic stay to pursue collection of MMA’s accounts receivable. Wheeling then sued the Defendants to collect the accounts receivable they owed to MMA. The Defendants asserted their setoff rights, based on the amounts that MMA owed to the Defendants for services the Defendants had provided to MMA, as a defense to the lawsuit.

There was no dispute that the Defendants had received D&B reports prior to the inception of Defendants’ setoff

rights. The D&B reports disclosed Wheeling’s security interest in MMA’s accounts receivable. However, Wheeling and the Defendants disagreed over whether the Defendants’ receipt of the D&B reports was sufficient notice under Maine’s version of UCC Section 9-404. The parties each filed motions asking the court for a determination of their rights.

The District Court’s Decision

The district court ruled that the Defendants’ setoffs rights had priority over Wheeling’s security interest and, therefore, the Defendants could setoff the accounts receivable they owed to MMA against amounts MMA owed to them. The district court agreed with the Defendants that their receipt of a D&B report disclosing Wheeling’s security interest was not sufficient notice under UCC Section 9-404 to cut off the Defendants’ setoff rights. The court reasoned that Section 9-404 required either MMA or Wheeling to have provided an authenticated notification of Wheeling’s security interest to the Defendants. Neither MMA nor Wheeling prepared, signed—electronically or otherwise—or circulated the D&B reports to the Defendants. D&B prepared, issued and provided its reports directly to the Defendants.

The Communication Dynamics Case

On September 23, 2002, Communication Dynamics, Inc. (the “Debtor”) and its affiliates filed their Chapter 11 cases in the United States Bankruptcy Court for the District of Delaware. More than a year before the bankruptcy filing, the Debtor had entered into an agreement with Thomas & Betts Corporation (“T&B”) through which the Debtor had agreed to distribute communication equipment for T&B. The agreement established standard prices at which the Debtor would purchase T&B’s equipment. The Debtor would then resell the equipment to end-users. According to the agreement, if T&B authorized the Debtor to sell the equipment to end-users at prices lower than the standard prices, which the Debtor frequently did, T&B would give the Debtor a credit for the difference between the standard price and the lower sale price.

Shortly after entering into the distribution agreement with T&B, the Debtor entered into a credit agreement with a group of lenders (the “Lenders”) through which the Debtor granted the Lenders a security interest on all of its assets, including accounts receivable. At the time of the bankruptcy filing, the Debtor owed the Lenders more than \$120 million.

Following the bankruptcy filing, T&B filed a motion for relief from the automatic stay to setoff or recoup \$232,477 in credits that were generated prior to the bankruptcy filing when the Debtor had sold equipment, for which the Debtor had already paid T&B, below the standard price. T&B sought to setoff these credits against amounts the Debtor owed T&B for other equipment the Debtor had purchased under the distribution agreement. The Debtor argued that T&B was not entitled to recoup or setoff the credits and that, consequently, T&B was required to pay the credits to the Debtor and was only entitled to a general unsecured claim for the amounts the Debtor owed T&B (for which the prospect for recovery was uncertain).

T&B's Right of Setoff

The bankruptcy court first considered whether the Lenders' security interest cut off T&B's setoff rights. T&B claimed that its setoff rights were not subordinate to the Lenders' security interest because neither the Debtor nor the Lenders had provided T&B with a notification of the security interest. The Debtor countered that T&B received notice of the Lenders' security interest when T&B's director of credit downloaded a credit report of the Debtor from D&B, which included a statement that the Lenders had a security interest in all of the Debtor's accounts receivable. The bankruptcy court agreed that T&B had received sufficient notification of the Lenders' security interest under UCC Section 9-404. It upheld the sufficiency of the unsigned D&B report, which T&B admitted to often rely upon for confirming the existence of security interests, and further noted that a signed formal notice of the Lenders' security interest sent to T&B was not required. For these reasons, the bankruptcy court held that T&B's right of setoff did not have priority over, and was cut off by, the Lenders' security interest.

The district court in the *Wheeling and Lake Erie Ry. Co.* case rejected the bankruptcy court's holding in the *Communication Dynamics* case that a lender's or its borrower's delivery of an authenticated notification of the lender's security interest to the creditor is not necessary to cut off the creditor's setoff rights. The district court concluded that the *Communication Dynamics* court had failed to take into account UCC Section 9-404(a)(2)'s clear requirement that either Wheeling or MMA had to provide an authenticated notification of Wheeling's prior security interest to wipe out the Defendants' setoff rights. This requirement ensures that account debtors, such as the Defendants, are made aware of a secured creditor's prior rights in the account receivable that the account debtor owes the secured creditor's borrower, and can then act accordingly to protect the account debtors' rights.

T&B's Right of Recoupment

T&B next argued that even if the Lenders' prior security interest cut off T&B's setoff rights, T&B was still entitled to recoup the credits it owed the Debtor to reduce T&B's claim against the Debtor because the debts T&B and the Debtors owed each other both arose from the sale of equipment under the distribution agreement. It did not matter that the Lenders' prior security interest in the Debtor's accounts receivable cut off T&B's setoff rights.

The Debtor countered that the credits (which T&B owed the Debtor)—generated in connection with equipment for which the Debtors had already paid T&B—were unrelated to the equipment purchases giving rise to T&B's claim (against the Debtor). As a result, T&B was not entitled to a right of recoupment and, at most, had setoff rights that were cut off when T&B had received the D&B report that disclosed the Lenders' security interest.

The Bankruptcy Court's Decision

The bankruptcy court upheld T&B's recoupment rights and granted T&B's motion for relief from the automatic stay so that T&B could recoup the credits against the amounts the Debtor owed T&B. The court broadly interpreted recoupment

rights to hold that recoupment arises when both debts arose out of a single integrated transaction such that it would be unfair to allow the debtor to enjoy the benefits of the transaction without also meeting its obligations under the transaction. The credits and equipment purchases were both part of a single integrated transaction. Indeed, the distribution agreement contemplated T&B's sale of multiple pieces of equipment to the Debtor and the parties certainly intended for the credits to be applied to all of the Debtor's purchases of equipment from T&B. Moreover, the credits were generated only after the Debtor had sold the equipment to an end-user below the standard price, which typically occurred long after the Debtor had paid T&B for the equipment.

Conclusion

In dealing with a delinquent customer, a trade creditor should be aware of and weigh its options, including whether it can exercise setoff rights. The *Wheeling & Lake Erie Ry. Co. v. Maine Northern Ry. Co.* decision is certainly a positive development for trade creditors to the extent it limits a secured lender's ability to cut off trade creditors' setoff rights. However, in light of the contrary holding of the *Communication Dynamics* court, a trade creditor receiving D&B reports or other information that disclose a security interest in its customer's accounts receivable should be aware that the creditor's customer's secured lender might challenge the creditor's setoff rights. The creditor can avoid this unfavorable outcome if it can prove that either its setoff rights arose prior to its receipt of notification of the lender's security interest or the creditor has recoupment rights.

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Bruce S. Nathan, Partner in the firm's Bankruptcy, Financial Reorganization & Creditors' Rights Department, has more than 30 years experience in the bankruptcy and insolvency field, and is a recognized national expert on trade creditor rights and the representation of trade creditors in bankruptcy and other legal matters. Bruce has represented trade and other unsecured creditors, unsecured creditors' committees, secured creditors, and other interested parties in many of the larger Chapter 11 cases that have been filed, and is currently representing the liquidating trust and previously represented the creditors' committee in the Borders Group Inc. Chapter 11 case. Bruce also negotiates and prepares letters of credit, guarantees, security, consignment, bailment, tolling, and other agreements for the credit departments of institutional clients.

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