New York Law Journal
Corporate Update
WWW.NYLJ.COM
An ALM Publication
VOLUME 256—NO. 105
THURSDAY, DECEMBER 1, 2016

SECURED TRANSACTIONS

Forest Capital: Is It a Case Of UCC Article 8 Versus Article 9?

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Institutions that maintain and manage securities accounts for businesses and other customers perform a critical function for the securities and lending industries. These intermediaries, consisting primarily of investment managers, broker-dealers and banks, manage more than $62 trillion in assets for both individual and institutional clients.[1] In so doing, they enable customers to hold and borrow against investment property.

UCC Article 8 provides what has been described as the "modern legal structure" for the system of holding securities through intermediaries.[2] And through the interaction of Articles 8 and 9, the UCC both governs and facilitates the use of securities as collateral for obtaining credit.

For the system to function smoothly, securities intermediaries[3] and their customers need clarity as to their mutual obligations. These obligations are usually spelled out in agreements between the securities intermediary and their customer, but they are also subject to Articles 8 and 9. However, these articles have not always meshed seamlessly when it comes to the duties of securities intermediaries.

This tension between UCC Articles 8 and 9 was the subject of a recent case in the Fourth Circuit. In *Forest Capital v. Blackrock*,[4] the plaintiff, Forest Capital, a lender to People's Power & Gas (PP&G), and defendant Blackstone, PP&G's investment firm and securities intermediary, disagreed about whether Forest could assert claims against Blackstone for violating certain provisions of Article 9. In so doing, they attracted the attention and involvement of the leading trade associations for the securities markets (Securities Industry and Financial Markets Association (SIFMA)) and the commercial lending industry (Commercial Finance Association (CFA)), each of which weighed in on opposite sides through amicus briefs. And the resulting decision of the appellate court may be at least as notable for what it didn't decide as for what it did.

The Court Decisions

In the *Forest Capital* case, Forest, the plaintiff-appellant, had entered into a factoring agreement with PP&G, an energy service company. Under that agreement, Forest bought certain of PP&G's accounts receivables. To secure its obligations to Forest, PP&G granted Forest a security interest in substantially all of its assets (excluding certain prepayments).

PP&G also had a line of credit with ISO New England (ISO), an energy supplier. As collateral for this line of credit, PP&G maintained a securities account with Blackrock, which account was subject to a control agreement among PP&G, Blackrock and ISO.

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In December 2013, PP&G defaulted under its factoring agreement with Forest. In an effort to induce Forest not to pursue default remedies, PP&G directed Blackrock to remit to Forest monies payable from time to time by Blackrock to PP&G.

Blackrock complied, and made one payment to Forest. PP&G then rescinded its original instructions, and Blackrock remitted subsequent

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payments to PP&G, totaling about $1,000,000. Shortly thereafter, PP&G filed for bankruptcy. Forest filed suit against Blackrock in Federal District Court in Maryland, maintaining it was owed the subsequent payments that were made to PP&G and asserting conversion of property and violations of UCC §§9-406 and 9-607.[5]

The District Court ruled in favor of Blackrock on its motion to dismiss.[6] It characterized the payments by Blackstone as "prepayments" and concluded that the rights to those payments were therefore excluded from the Forest Capital security interest, and further that Blackrock, by sending funds to PP&G, was simply complying with its control agreement with PP&G and ISO. In addition, it held that the "alleged" notice from Forest to Blackrock was inadequate under 9-406 and 9-607 to obligate Blackrock to pay Forest in that it was not countersigned by or copied to Forest (neither of which is required under 9-406), was vague and did not "reasonably identify the rights assigned."

On appeal, the Fourth Circuit Court in a de novo review addressed the claims of conversion and violation of the UCC but examined none of the grounds relied upon by the District Court in dismissing Forest's claims. Instead, it focused solely on whether, as claimed by Forest, UCC §§9-406 and 9-607 provided a private right of action to an assignee (Forest) against a securities intermediary (Blackrock) who, after receiving notice that its debt has been assigned, pays the assignor (PP&G) rather than the assignee.

Drawing on case history, the court stated that legislative intent was the key to an implied right of action, and then applied a three-part test, namely, whether the plaintiff is an intended beneficiary of the statute, whether there is indication of legislative intent to create or deny a remedy and whether implying a remedy is consistent with the legislative scheme. The court then found that §9-406(a) was intended to grant rights to an "account debtor"[7] rather than an assignee, found no evidence of legislative intent to provide such a right of action to an assignee, and found that a right of action for an assignee would be inconsistent with the purpose of the statute—clarifying an account debtor's payment obligation when its debt is assigned. Thus, the court declined to find such a private right of action under UCC §9-406, noting that "creating a private right of action … could … [create] rights out of nothing more than a notification and [submit] account debtors to obligations they never agreed to take on."[8]

The court found "even less reason to think that UCC §9-607(a) provided Forest a private right of action."[9] The court pointed to UCC commentary, noting that the section "establishes only the baseline rights of the secured party vis-à-vis the debtor [i.e., PP&G]—the secured party is entitled to enforce and collect after default or earlier if so agreed."[10]

Having found no private right of action implied in either of the UCC sections analyzed, the court affirmed the lower court's dismissal of Forest's claims.

Analysis

While private rights of action do exist under the UCC,[11] few cases have addressed the question of implied private rights of action under UCC Article 9 and so there is little precedent to draw on.[12] However, it is not the court's reliance on the three-prong test but rather its application of this test in the context of 9-406 that raises some questions.

First, in determining that account debtors rather than assignees are the intended beneficiaries of §9-406(a), the court cites comment 2 to 9-406. This comment confirms that under §9-406(a) the account debtor can pay the assignor until it receives appropriate notification to the contrary. Notably, the court does not cite nor distinguish the next sentence, which states that "once the account debtor receives that notification, it cannot discharge its obligation by paying the assignor."[13] This second sentence would seem to suggest a contrary conclusion.

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In addition, the court's holding that a private right of action would be inconsistent with the purpose of 9-406 relies on a District Court decision in *Platinum Funding Services v. Petco Insulation*.[14] However, the court in the *Platinum* case rejected a private right of action on the grounds that the assignee had not in fact been assigned the payments that it was seeking to recover. Such was not the case in *Forest Capital*.

At least as interesting are the issues left unaddressed by the Fourth Circuit, namely whether a securities intermediary is an account debtor for purposes of §9-406, and perhaps to a lesser extent, the

question of adequacy of notices under 9-406 discussed by the District Court.

In its amicus brief, SIFMA stated its concern that including a securities intermediary within the definition of "account debtor" under Article 9 would have "troubling implications for the legal framework set out in Article 8 of the UCC." In SIFMA's view, this could "permit complete strangers to unilaterally impose duties upon securities custodians" and create liability for securities intermediaries to either their customers or third parties whenever the intermediaries were caught in the middle of conflicting claims. Ministerial tasks critical for the smooth functioning of the market would become laborious and time-consuming, requiring investigations and assessments of the strength of competing claims. Aside from affecting obligations already agreed-upon between securities intermediaries and their customers, SIFMA argued that it would also impair financial liquidity, particularly in times of financial stress.

Perhaps, given the alarming statements made by SIFMA, the court felt more comfortable tackling the question of whether a private remedy exists than whether a securities intermediary fits within the definition of "account debtor." However, that still leaves open the question of exactly what remedy *is* available to an assignee if an account debtor ignores a proper notification under 9-406. The court alludes to the possible availability of a breach-of-contract claim against Blackrock. But Forest's attempt to assert such a claim is neatly sidestepped by the court (allowing it to avoid the account debtor question) when it rejects such assertion as "belated."

The other interesting issue untouched by the appellate court is the sufficiency of the notice to Blackrock under 9-406(a), which unfortunately is beyond the scope of this article. However, while the lower court decision appears questionable in many of its conclusions (e.g., the requirements for notices under 9-406, its apparent view of the effect of anti-assignment provisions in the underlying DACA and the characterization of Blackstone's payment obligations), it does serve as a useful reminder to financiers that 9-406(a) imposes specific requirements on the notices to account debtors, and failing to conform to those requirements could be fatal to a claimant's rights.

Conclusion

Forest Capital is believed to be first opinion at appellate level to hold that UCC §§9-406(a) and 9-607(a) do not create a private right of action for an assignee of a security interest. The specter raised by the securities industry of the potential conflict between Articles 8 and 9 in regard to duties of securities intermediaries remains unaddressed and a potential warning sign for debtors, account custodians and secured parties alike. But an important question now also remains as to the remedy for breach of an instruction properly given under 9-406, and whether and in what circumstances a contractual claim would be available to a secured party against an account debtor. The practical result of the Forest Capital decision may be that secured parties increasingly insist on an account debtor's consent or agreement to redirect payment, rather than rely on notice, notwithstanding the express provisions of 9-406.

1. See Amicus Brief of the Securities Industry and Financial Markets Association, *Forest Capital v. Blackrock*, No. 15-1551 (4th Cir. Sept. 21, 2015), at 1 (ECF No. 28-1).

2. UCC §8-102(a)(14) defines a "securities intermediary" as a clearing corporation or a "person … that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity." U.C.C. §8-102.

3. Id.

4. *Forest Capital v. BlackRock*, No. 15-1551, 2016 WL 4207911 (4th Cir. Aug. 10, 2016).

5. UCC §9-406(a) provides that "an account debtor on an account, chattel paper, or a payment intangible may discharge its obligations by paying the assignor 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 … may not discharge the obligation by paying the assignor." UCC §9-607(a) provides that a secured party "may notify an account debtor or other person obligated on collateral to make payment" to the secured party and may enforce the obligations of an account debtor.

6. See *Forest Capital v. Blackrock*, No. 14-01530, (D. Md. Feb. 26, 2015) ECF No. 41.

7. UCC §9-102(a)(3) defines an "account debtor" as a "person obligated on an account, chattel paper, or general intangible" but excludes a person obligated on a "negotiable instrument."

8. *Forest Capital*, 2016 WL 4207911 at *5.

9. Id at *6

10. Id at *6.

11. See, e.g. UCC §9-625(b), which provides that a secured party is liable for damages caused by a failure to comply with Article 9.

12. See, e.g., *Mercantile Capital Partners v. Agenzia Sports*, No. 04 C 5571, 2005 WL 351926, at *7 (N.D. Ill. Feb. 10, 2005), noting that UCC section 9-509(d)(1) provides no right of action by a third party who is not a debtor or obligor with an interest in the subject property; *Novartis Animal Health US v. Earle Palmer Brown*, 424 F. Supp. 2d 1358, 1363 (N.D. Ga. 2006), discussing a number of cases that have held UCC §9-318 does not create an affirmative right of action by an account debtor against an assignee.

13. *Forest Capital*, 2016 WL 4207911 at *4.

14. See *Platinum Funding Servs. v. Petco Insulation*, No. 3:09CV1133 (MRK), 2011 WL 1743417, at *1 (D. Conn. May 2, 2011).

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