



# CLIENT ALERT

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Recent UCC Case Affecting Receivables Financings  
*MP Star Financial v. Cleveland State University*, 837 N.E.2d 758 (Ohio 2005)

For your information, the Supreme Court of Ohio recently issued an opinion that could affect purchasers of, and lenders relying on, receivables owing from state governmental entities. Ohio has adopted a non-uniform version of UCC Section 9-109 which was a critical element of this decision. Under Ohio's version of UCC Section 9-109(d)(14), an assignee of accounts receivable from a governmental entity could not force the governmental entity to pay the assignee directly. Because at least 20 other states have adopted a version of UCC Section 9-109(d) similar to Ohio<sup>1</sup> this decision could also be important outside of Ohio.

In the Ohio case, an employment services company was retained by Cleveland State University (the "University") to provide temporary employment services. The employment services company subsequently assigned its accounts receivable in a factoring transaction<sup>2</sup> to an assignee, MP Star Financial, and then notified its account debtors (including the University) of such assignment and instructed such account debtors to pay MP Star Financial. The University continued to pay the employment services company, the assignor, instead of MP Star Financial, the assignee. MP Star Financial, in asserting rights to the University's accounts receivable, asserted that UCC Section 9-109(d)(14) should not be applicable to the assignment because the University was not acting as a borrower or seller assigning a security interest in its own accounts receivable.<sup>3</sup>

The Ohio Supreme Court, however, held that "transfer" in Section 9-109(d)(14) is not limited to a security interest or sale by the University as a borrower or seller, but also applies to payments transferred or to be transferred by the University to third parties such as the employment services company. Accordingly, the court concluded that the University was not required to pay an assignee after receiving notice of the assignment.<sup>4</sup>

While the Ohio case involved a factoring arrangement, its holding could also apply to lenders in traditional loan transactions secured by receivables owing from a state governmental obligor. Such a lender would, similar to an assignee in a factoring transaction, typically rely on its ability to obtain payment directly from its borrower's account debtor by providing notice of assignment to the account debtor.<sup>5</sup> However, given the court's holding in the Ohio case that "transfer" includes payments transferred or to be transferred by a governmental obligor to a third party (and thus outside the scope of UCC Article 9), an Ohio governmental obligor whose payment obligations are collateral for a loan may not be required to honor a notice of assignment from a traditional lender any more than the governmental obligor in the Ohio case was required to honor a notice of assignment from an assignee in a factoring or sale transaction.

The Ohio case could also apply to certain Ohio public finance transactions, including COPs, revenue bond or other transactions secured by a municipal lease. In such transactions, a corporation acting "on behalf of" a municipality will often lease equipment, vehicles or other personal property to a municipality as lessee and assign its right to the lease and rentals to a trustee on behalf of holders of COPs or bonds. Absent either the consent of the municipal obligor or non-UCC law requiring the municipal obligor to honor the assignment of its payment obligation, such municipality may not be obligated to honor a notice of assignment or make lease payments to the trustee.

It is unclear whether the Ohio Supreme Court’s decision will be followed in other jurisdictions. If a factoring, loan or public finance transaction involves collateral consisting of accounts receivable owing from state governmental obligors, it may be prudent to consider obtaining the prior written consent of such governmental obligors to the assignment. Alternatively, while not free from risk, the factor, lender or trustee in a public finance transaction could consider establishing a lockbox account within the control of the factor, lender or trustee into which all payments by all obligors will be made and obtaining an irrevocable power of attorney from the seller or borrower, as the case may be, to cash and otherwise dispose of checks and all related funds in a manner consistent with the related financing documents.<sup>6</sup>

Last, based on the Ohio case, providers of legal opinions on perfection matters in transactions governed by Ohio law (and, absent controlling precedent to the contrary, potentially in other jurisdictions with a version of Section 9-109(d) similar to Ohio) with collateral consisting of receivables owing from a governmental obligor should consider adding an exception to the opinion to the effect that no opinion is given on any collateral consisting of receivables owing from a governmental obligor.

**(Endnotes)**

<sup>1</sup> While a review of an applicable state’s UCC may be necessary in connection with particular transaction, based on Uniform Commercial Code (U.L.A.) § 9-109 (West 2005), it appears the following states have enacted a version of UCC Section 9-109(d) similar to Ohio: Alaska, Arizona, Arkansas, California, Florida, Illinois, Kansas, Kentucky, Michigan, Mississippi, Montana, Nevada, New Jersey, New Mexico, North Dakota, South Carolina, Vermont, Washington, West Virginia and Wyoming.

<sup>2</sup> In a typical “factoring” transaction, receivables are sold to a buyer at a discount and obligors on such receivables are notified of such assignment and instructed to make payments directly to the buyer. The seller in factoring transactions will in some cases remain obligated to pay the buyer for either all or a portion of receivables that are unpaid.

<sup>3</sup> Absent the application of Section 9-109(d)(14), Ohio UCC Section 9-406(a) would, generally speaking, require account debtors to pay an assignee after receipt of notice that its accounts have been assigned.

<sup>4</sup> In so holding, the court declined to consider Official Comment 5 to former UCC Section 9-104(e), the predecessor to current Ohio UCC Section 9-109(d)(14). This Comment, in referencing “collateral” in which a security interest is granted in “governmental borrowings,” appears to reflect an intent of the UCC drafters that Section 9-104(e) apply only to circumstances in which the governmental entity is the borrower or seller. Similarly, the legislative analysis prepared by the Ohio Senate in connection with the enactment of revised Article 9 references “[s]ecurity interests created by governmental debtors” as being within the scope of the uniform version of Section 9-109. This reference arguably reflects the Ohio legislature’s intent in enacting Section 9-109(d)(14) to exclude from the Ohio UCC only transfers by a governmental entity acting as borrower or seller.

<sup>5</sup> Section 9-607(a), for example, permits a secured party to notify an account debtor to make payment to the secured party either if agreed between the borrower and the secured party or after a default.

<sup>6</sup> The Ohio case involved the assignment of receivables owing from a *state* government obligor. Assignments of receivables owing from *federal* government obligors involve additional issues independent of the Ohio decision, including the limitations provided by, and the need to comply with, federal laws applicable to the assignment of claims against the federal government (including the Assignment of Claims Act of 1940, 31 U.S.C. Section 3727, 41 U.S.C. Section 15).

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