Ta Chong Bank Ltd. vs. Hitachi High Technologies America, Inc.—An Expensive Lesson On What Not To Do

As factoring companies seek to expand their horizons and enter into transactions outside their customary place of business, the factor who is not mindful of the laws and the practice where their factor client is located and who, at the same time, fails to follow the basics, runs the risk of a catastrophic loss. **BY STEVEN N. KURTZ, ESQ**

As factoring companies seek to expand their horizons and enter into transactions outside their customary place of business, the factor who is not mindful of the laws and the practice where their factor client is located and who, at the same time, fails to follow the basics, runs the risk of a catastrophic loss. The recent case of Ta Chong Bank Ltd. vs. Hitachi High Technologies America, Inc., 610 F.3d 1063 (9th Cir., 2010), decided in July 2010, illustrates how things can go terribly wrong when a factor is careless. In this instance, Ta Chong Bank Ltd.'s ("Ta Chong") total exposure may be as high as $83,000,000.

Ta Chong is a banking institution with its principal place of business in Taiwan. It entered into a series of financing arrangements, including several factoring agreements with CyberHome Entertainment, Inc. ("CyberHome"), which is incorporated in California. The documents which Ta Chong provided to the bankruptcy court to support its proof of claim indicate that the loan documents were written in Chinese, and were entered into several years before CyberHome filed for Chapter 7 bankruptcy on September 5, 2006. Although Ta Chong had substantial lending and factoring activities in place for several years, it failed to timely perfect its lien on all assets and recorded its UCC-1 financing statement in California less than three months before CyberHome's bankruptcy filing.

As part of the factoring arrangement, Ta Chong purchased an account of CyberHome's, in the amount of $1,200,000. The account debtor was Hitachi High Technologies America, Inc ("Hitachi"). Before that account was purchased, Hitachi received a properly worded notice of assignment which stated, to the effect, that CyberHome was factoring with Ta Chong and that payment on all obligations owed to CyberHome should be paid to Ta Chong, in care of CIT, who was handling the collections for Ta Chong. Despite receiving a properly worded notice of assignment, Hitachi failed to honor the notice and paid CyberHome directly. CyberHome failed to remit the Hitachi payment to Ta Chong and kept the $1,200,000, getting paid twice on the same invoice. Eight months later, CyberHome filed its Chapter 7 bankruptcy case.

Ta Chong filed a proof of claim in CyberHome's bankruptcy case in the amount of $83,000,000, claiming that it was a secured creditor. Ta Chong attached versions of its agreements in Chinese with English translations along with its UCC-1 financing statement filed within three months of the bankruptcy filing. Not surprisingly, the bankruptcy Trustee for CyberHome sought to challenge Ta Chong's status as a secured creditor on the basis that the UCC-1 financing statement was filed within 90 days of the bankruptcy filing, and not within 30 days after entering into the various agreements with CyberHome. The Trustee filed a preference lawsuit against Ta Chong which sought to invalidate the recorded UCC-1 financing statement and also sought an order which would give the Trustee the exclusive right to collect CyberHome's accounts receivable. The basis of the preference claim was that Ta Chong improved its position as an unsecured creditor to a secured creditor within 90 days of the bankruptcy filing coupled with Ta Chong failing to perfect its security interest within 30 days after it attached. Ta Chong filed counter claims against CyberHome, which were of no practical use since the company was no longer in business.

The bankruptcy Trustee prevailed in its action. The Trustee obtained an order which set aside Ta Chong's preferential transfer and rendered Ta Chong an unsecured creditor—a position just like any other trade creditor, and not where a bank and factor who is owed $83,000,000

wants to be. The Trustee also received an order from the bankruptcy court giving the Trustee the exclusive right to collect the accounts receivable. Ta Chong did not seek an appeal of the bankruptcy court order and therefore that order became final and not subject to appeal.

After losing in the bankruptcy court, Ta Chong then sued Hitachi in the state court to seek recovery on its purchased account, which Hitachi paid over notice. Hitachi removed the case from the state court to the federal court on the basis of diversity jurisdiction. (Parties can do this if they are citizens of different states arguing over more than $75,000.) Hitachi then asked the federal court to grant judgment in its favor based upon the bankruptcy court's ruling against Ta Chong. The federal court granted judgment in favor of Hitachi and against Ta Chong. Ta Chong then appealed to the Ninth Circuit Court of Appeals (the "Ninth Circuit").

Ta Chong contended, on appeal, that the bankruptcy court's ruling setting aside the lien had no bearing on Ta Chong's rights against Hitachi for its failure to pay over notice. Ta Chong stated what most factors would say: (i) that it sent a properly worded notice of assignment to Hitachi; and (ii) that Hitachi failed to honor the notice of assignment by paying CyberHome, and therefore, Hitachi's obligation to pay on that account was not discharged because it failed to pay Ta Chong pursuant to the notice—a standard argument in a double jeopardy case.

The Ninth Circuit, which does not see many factoring and Uniform Commercial Code ("UCC") cases, did a good job analyzing the matter. The Ninth Circuit correctly noted that, when determining the effect of perfection, lack of perfection, and priority between parties, you start with the law of the debtor's jurisdiction, which in this case was California since CyberHome was incorporated in that state. The Ninth Circuit correctly analyzed the "double jeopardy" statute, UCC § 9406(a), and noted that Hitachi did not discharge its obligation to pay the account when it failed to pay Ta Chong. The Ninth Circuit then analyzed UCC § 9318(b), which states: "for purposes of determining the rights of creditors of, and purchasers for value of an account or chattel paper from a debtor that has sold an account or chattel paper while the buyer's security interest is unperfected, the debtor is deemed to have rights and title to the account or chattel paper identical to those the debtor sold." UCC § 9318(a) is the section that factors use to establish their right when an account is sold, that the debtor (the seller) no longer has rights to the account and that the account is the sole property of the factor now that it has been purchased.

The Ninth Circuit indicated that because Ta Chong was an unsecured creditor at the time of purchase, and at all relevant times during the Hitachi transaction, the Debtor, CyberHome, had rights to the Hitachi account. The Ninth Circuit further discussed that these rights were in existence at the time when CyberHome filed its chapter 7 case and therefore belonged to the Trustee at the time of the bankruptcy filing. The Ninth Circuit then went on to hold that because the Trustee challenged Ta Chong's proof of claim, which included details on the Hitachi account, the Hitachi account was litigated in and determined by the bankruptcy court. The Ninth Circuit held that the trial court was correct in holding for Hitachi and that Ta Chong did not have the right to collect upon the account which Hitachi paid to CyberHome over notice, because it was unperfected when all the events with Hitachi transpired, and the bankruptcy court set aside Ta Chong's security interest.

While arguably the Ninth Circuit could have found in favor of Ta Chong by holding the line on the fact that the account was properly assigned to Ta Chong and Hitachi failed to honor the notice, the fact that Ta Chong was sloppy in its dealings in how it handled the situation did not invoke the court's sympathies. Judges often look for ways out of making an account debtor pay twice on an assigned account when a payment is made over notice. In this case, Ta Chong was careless and lackadaisical and the Ninth Circuit was not about to find a way to fashion a remedy under these facts.

The Ta Chong case is an expensive lesson and illustrates how important it is to follow the basics when signing up a new factor client and in administering the transaction.

The first lesson is that when you are financing a factor client in a different country, make sure that you have followed the rules in that other country. Here, Ta Chong had documents drafted under the laws of Taiwan and were written in Chinese, which is fine. However, since Ta Chong was factoring and financing a California entity, it needed to properly obtain its security interest and perfect its lien under California law, as the law of the debtor's jurisdiction governs perfection, the effects of lack of perfection and priority among creditors.

The second lesion is to follow the basics. Do not fund your deals unless and until your transaction documents are executed, your UCC-1 is filed in the proper jurisdiction, you have taken steps to perfect your collateral which is not governed by the UCC-1 (such as deposit accounts, where a control agreement is required), and your guaranties are signed. For those of you who have been attending IFA conferences, it probably has been drilled into your head that you need to document your transaction with a properly prepared factoring agreement and that you file your financing statement in the exact name of your factor client in the jurisdiction where it is registered (or, if an individual, with the person's exact name where the person resides—or, better yet, make the person incorporate or form an LLC and follow the outlined steps). Once you file your financing statement, obtain a search using the factor client's exact name through the official UCC search logic and procedures in the state where you filed. If your financing statement comes up, you're perfected. If it does not show, you are not perfected and you need to re-file correctly. The latest you can file your financing statement is 30 days after the factoring or security agreement is executed or you face the risk of it being set aside as a preference if the factor client files bankruptcy within 90 days after you file. The better practice is to obtain authority to file the UCC-1 financing statement in your term sheet or proposed letter and file it before funding.

In this case, the bank learned a very expensive lesson—one that all of you can avoid by having a checklist in place before you fund any deal and make sure that everything on the checklist is accomplished. Let's hope that we can all learn from the bank's mistakes. •

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