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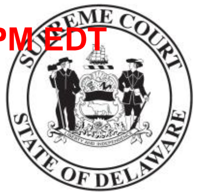

IN THE SUPREME COURT OF THE STATE OF DELAWARE

OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF MOTORS LIQUIDATION COMPANY,	:	**No. 325, 2014**
Plaintiff-Appellant,	:	Certification of Question of Law from the United States Court of Appeals for the Second Circuit C.A. No. 13-2187-bk
v.	:	
JPMORGAN CHASE BANK, N.A., individually and as Administrative Agent for various lenders party to the Term Loan Agreement described herein,	:	
Defendant-Appellee.	:	

AMICUS CURIAE BRIEF OF THE COMMERCIAL FINANCE ASSOCIATION ON CERTIFIED QUESTION, AND SUPPORTING AFFIRMANCE OF BANKRUPTCY COURT ORDER AND APPELLEE'S POSITION

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STATEMENT OF IDENTITY, INTEREST AND AUTHORITY OF AMICUS CURIAE

This *amicus curiae* brief is filed by Commercial Finance Association ("CFA") to provide the asset-based lending industry's perspective on the question certified to this Court (the "Certified Question") by the United States Court of Appeals for the Second Circuit (the "Second Circuit") in an appeal from a decision by the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court").

CFA is the principal U.S. trade association for financial institutions that provide asset-based financing and factoring services to commercial borrowers. Its nearly 300 members (including JPMorgan Chase Bank, N.A.) include substantially all of the major money-center banks, regional banks and other large and small commercial lenders engaged in asset-based lending. Financing by CFA members comprises a substantial portion of the U.S. credit market, approaching $620 billion in outstanding loans. Much of this financing goes to U.S. small- and medium-sized businesses that are the backbone of the U.S. economy, providing them with vital working capital to run their businesses, create jobs and grow. For many of these borrowers, asset-based lending is the only form of financing available to them.[1]

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[1] Additional information about CFA may be found at www.cfa.com.

In an asset-based loan, a lender extends credit to a borrower based on the value of, and secured by, the borrower's assets, principally receivables and inventory. Although asset-based lending exists to some extent in countries other than the U.S., it thrives in the U.S. because the U.S. has a legal regime, embodied in Article 9 of the Uniform Commercial Code (the "UCC"), that allows for the efficient creation of security interests in receivables, inventory and other personal property.

One of the key features of Article 9 is that, once a security interest is properly created in accordance with the requirements of Article 9 and perfected by the filing of a financing statement, the lender is protected against an unauthorized termination of the financing statement (whether willful or inadvertent) by the borrower or any other person. As a result, a lender can rest assured that the financing statement perfecting the security interest upon which it has based its loan will remain effective until the lender authorizes its termination or the financing statement has lapsed.

The Official Committee of Unsecured Creditors of Motors Liquidation Company (the "Committee") seeks to topple this pillar of secured finance, arguing instead, as a purported matter of practicality and policy, that the nature of Article 9 as a notice statute should be ignored, and that lenders holding security interests in personal property should bear the risk of unauthorized or inadvertent terminations

of their financing statements. This position is not only patently contrary to the provisions of Article 9 and therefore wrong as a matter of law, but would, if adopted, dramatically increase the risk to lenders who underwrite asset-based loans and extend other forms of secured credit by requiring them to constantly check their filings across multiple jurisdictions to make sure that there have not been any subsequent unauthorized filings of termination statements. This would, in turn, drive up the cost of secured credit to borrowers, and reduce the availability of credit at a time when small- and medium-sized businesses in the U.S. can least afford it. Such endless, ongoing due diligence is neither practical, nor efficient, nor economical.

As the principal U.S. trade association for asset-based lenders, CFA is uniquely situated to address the issues presented by the Certified Question, and the impact a decision of this Court could have on secured lending in the U.S. Therefore, CFA respectfully submits that its views on the Certified Question will assist this Court in rendering its decision.[2] Specifically, CFA asks this Court to answer the Certified Question as follows:

> In order for a UCC-3 filing to be effective to terminate a security interest, the secured lender holding such interest must intend to terminate the particular security interest that is listed on the UCC-3. It is not sufficient that the lender review and knowingly approve for filing a UCC-3 purporting

[2] This is the only aspect of the Certified Question that CFA seeks to address. Thus, CFA does not seek to address the issue of whether JPMorgan Chase authorized the filing of the termination statement.

> to extinguish a perfected security interest, if, due to a clerical error or otherwise, the UCC-3 listed a security interest that the lender did not intend to terminate.

Because UCC filings put lenders and others on inquiry notice of a possible security interest, the rule as set forth above will make clear precisely what inquiry a new lender or other entity should make to ascertain whether a UCC-3 filing was intended to terminate the specific security interest.

ARGUMENT

The Committee makes its practicality and policy argument at pages 25 to 29 of its brief, which may be summarized by the following assertion by the Committee on page 27:

> Conditioning the effectiveness of a termination statement on the intent of a secured party to achieve particular legal consequences is both impractical and contrary to the overarching public policy that potential creditors are entitled to rely on properly filed records maintained under the UCC system.

That assertion is incorrect, and is flatly contradicted at Footnote 7 of the Committee's brief before this Court, where the Committee concedes that "the mere presence of a filed record in the UCC filing system does not ensure its effectiveness, and searchers of UCC records bear the risks involved in taking those filed records at face value." Committee's Brief at Footnote 7 (emphasis supplied). Moreover, the Committee is wrong when it asserts that the Bankruptcy Court's view is impractical and inconsistent with public policy. To the contrary, the

position adopted by the Official Comment to Article 9 on the issue of unauthorized terminations of financing statements is by far the most practical approach to that issue. Official Comment 2 to UCC § 9-502 states that the "notice itself indicates merely that a person may have a security interest in the collateral indicated. Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs." This makes complete sense from a policy standpoint and resolves the issue in a way that preserves the integrity of the UCC filing system and promotes credit by placing the risks and protections of the filing system where they properly belong – the risks are allocated to the subsequent filer (the party who has not yet extended credit) and the protections are in place for the benefit of the first filer (the party who has already extended credit).

To illustrate why this is so, take the following situation: Lender A makes revolving loans to Borrower secured by a security interest in Borrower's receivables and inventory. The security interest is perfected by the filing of a financing statement. A year later, Borrower surreptitiously files a termination statement purporting to terminate the effectiveness of Lender A's financing statement without Lender A's knowledge, and then applies to Lender B for additional credit.

As part of its due diligence, Lender B conducts a search of the filing office records. Because Article 9 provides that the filing of a termination statement does

not expunge the original financing statement from the records of the filing office, Lender B's search reveals both Lender A's original financing statement and the termination statement.

Under the UCC, a termination statement is effective only if its filing is "authorized" by the secured party of record. UCC § 9-509(d). However, Article 9 does not require or allow the filing officer to request, or the terminating party to file, any evidence of that authorization.[3] Thus, a new lender has no way of knowing whether a termination statement it finds in its search was authorized unless it obtains confirmation from the prior lender. How should the law address this situation? Should Lender B be entitled to assume that the termination statement was authorized and that Lender A's original financing statement is no longer effective?

Article 9 resolves this policy issue by protecting the existing lender, on the ground that, as between Lender A and Lender B in the above example, Lender B is in a better position to protect itself. The only way that Lender A could protect

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[3] Under what is often referred to as the "open drawer" policy, filing officers have very limited discretion regarding the acceptance of records for filing and are obligated to accept them regardless of other indicators. *See United States v. Florida UCC, Inc.*, No. 4:09-cv-15 (RH)(WCS), 2009 WL 1956269, at * 4-5 (N.D. Fla. July 2, 2009) (2001 revisions to the Florida UCC, which is identical to the Delaware UCC, created no obligation for the filing office to "make a substantive review of a filing to determine whether an alleged debtor did or did not authorize the filing to be made"); *see also* Wallis N. Boggus, Revised UCC Article 9 Filing System: The Next Generation, STATE BAR OF TEXAS LAW SEMINAR, Ch. 3, p. 7 (Oct. 2, 2003); UCC § 9-502 cmt; UCC § 9-502(a).

itself against an unauthorized termination of its financing statement would be to conduct frequent searches of the filing office records, an exercise that could be quite costly over time (and because costs of searches are typically passed along to the borrower, could significantly increase the cost of credit to the borrower). Moreover, even that costly exercise would not protect Lender A with respect to loans already made to Borrower. On the other hand, Lender B, faced with the knowledge that a termination statement has been filed, could easily (and inexpensively) contact Lender A before it extends credit, to inquire and verify that the termination statement was authorized. Shifting the risk of an unauthorized termination statement to Lender A (the approach advocated by the Committee) results in the loss of Lender A's entire security for credit it has already extended, while shifting the risk to Lender B (the result adopted by Article 9) imposes upon Lender B nothing more than the burden of a one-time follow-up communication such as a phone call or e-mail, which is how the industry regularly operates.

Indeed, Official Comment 2 to UCC § 9-502, in addressing the sufficiency of a financing statement, explicitly states that the notice of the financing statement only indicates that a person may have a security interest in collateral and that "[f]urther inquiry from the parties concerned will be necessary to disclose the complete state of affairs." As the Bankruptcy Court correctly found, that comment applies equally to UCC-3 termination statements. *See, Official Comm. v.*

JPMorgan Chase Bank, NA (In re Motors Liquidation Co.), 486 B.R. 596, 644, (Bankr. S.D.N.Y. 2013). *See also*, UCC § 9-102 (39) (termination statement is a record "relating to the initial financing statement" and as such, is part of a "financing statement" as defined by the UCC."). Thus, the duty for prospective lenders to investigate is, and always has been, part of the lender's duties under the UCC. *See, e.g., SEC v. Credit Bancorp, Ltd.*, 386 F.3d 438, 454 (2d Cir. 2004); *Md. Nat'l Bank v. Porter-Way Mfg. Col.*, 300 A.2d 8, 10 (Del. 1972) ("The Delaware Uniform Commercial Code's financing statement is designed to give public notice of the existence of a security agreement and to give enough information as to permit interested persons to make inquiries to the parties of the secured transaction to ascertain details regarding the debtor's encumbered assets").

As a practical matter, Article 9 requires a new lender confronted with a filed termination statement to engage in a cost-benefit analysis to decide if it wants to invest in some level of diligence to check into authorization.[4] If the new lender is very familiar with the borrower, it may well take the risk, and often does.

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[4] *See e.g.,* Fred H. Miller & William H. Henning, *The Danger of Dictum*, 45 UCC Law Letter 1, 3 (Mar. 2011) ("... the burden that the true state of affairs might be other than as indicated in the filing-office records falls on the searcher, which can inquire further and thereby determine the true state of affairs."); Harry C. Sigman, *The Filing System Under Revised Article 9*, 73 AM. BANKR. L. J. 61, 78 n.110 (1999); Charles Cheatam, *Changes In Filing Procedures Under Revised Article 9*, 25 OKLA. CITY U. L. REV. 235, 253 (2000); John J. Eikenburg, Jr., *Filing Provisions of Revised Article 9*, 52 SMU L. REV. 1627, 1643 (2000).

Although the example above deals with a willful termination of a financing statement, the same analysis applies in the case of a negligent or inadvertent termination by a Borrower, a third party without the secured party of record's authorization, or, as in the case at hand, a UCC-3 termination statement that, due to a clerical error on the part of all parties, listed the wrong financing statement. In all cases, the risk is (and should be) borne by the new lender who has not yet extended credit and is in the best position to protect itself. This position does not favor old lenders over new lenders, because at some point every lender is a "searching" party. JPMorgan Chase (the lender benefitting from the UCC's rule in this case) was itself in the shoes of a new lender at the time it extended credit to General Motors.

As formulated by the Second Circuit, the Certified Question implicitly recognizes that a new lender who wishes to have a first priority secured interest must make an inquiry as recognized by this Court in *Md. Nat'l Bank, supra*. The issue is the scope of that inquiry. The better policy, and the practice designed to achieve the correct result, and the industry standard, is one which asks for confirmation that the secured lender intended to terminate the particular security interest listed on the UCC-3. That is the current industry practice and can take the form of a call, email or payoff letter on which the new lender may rely.

The policy decision reflected in Article 9 has a direct and powerful bearing on the cost and availability of credit. Requiring a lender to constantly check the filing office records and verify its priority liens would dramatically increase the cost of asset-based lending and, in some cases, eliminate business access to this vital form of credit. As noted above, it is customary for the costs associated with loans to be borne by the borrower, either directly (in the form of cost reimbursements) or indirectly (by being factored into the interest rate). If a lender were required to constantly search the filing office records to confirm that its UCC financing statement had not been wrongfully terminated, the costs associated with those searches (both in terms of search fees and the time and overhead spent conducting the searches) would typically be passed on to the borrower, thus increasing the cost of credit. Moreover, the added uncertainty for lenders generated by the rule advocated by the Committee would reduce the ability of lenders to rely on their security interests, increasing the interest rates lenders charge to reflect this added risk and making lenders more reluctant to extend credit to borrowers who lack an established credit history. Thus, the approach adopted by Article 9 is not only logical in terms of its allocation of risk to the lender best able to protect itself, but also has a positive impact upon the cost and availability of credit. This is a clear benefit to not only the wide-range of small, medium-sized

and large lenders who are members of the CFA, but to their small, medium-sized and large borrowers as well.

The Committee concludes its brief by asserting that "a decision that secured parties must authorize the legal consequences of a filing in order for the filed record to be effective will undermine the public notice system that is central to the UCC, introducing uncertainty and disruption to the secured lending markets by requiring bottomless inquiries into the intentions that lie behind those records." This assertion is simply not true. To the contrary, the Bankruptcy Court's decision is perfectly consistent with the functioning of the filing system as envisioned by the UCC, and will reinforce the protection afforded to secured creditors afforded by that system by giving them the comfort that their properly perfected security interests are safe from willful or negligent attack.

Far from a "bottomless inquiry," the solution is the straightforward inquiry to the prior lender envisioned by the UCC, which can be answered "yes" or "no": "Did you intend to release your blanket lien on X Company's assets"?

CONCLUSION

For the foregoing reasons, the CFA respectfully requests that this Court answer the Certified Question as follows: In order for a UCC-3 filing to be effective to terminate a security interest, the secured lender holding such interest must intend to terminate the particular security interest that is listed on the UCC-3.

It is not sufficient that the lender review and knowingly approve for filing a UCC-3 purporting to extinguish a perfected security interest if, due to a clerical error or otherwise, the UCC-3 listed a security interest that the lender did not intend to terminate.

Dated: September 23, 2014

Respectfully submitted,

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