LEGAL EFFECT OF ERRONEOUS FILING OF A UNIFORM COMMERCIAL CODE TERMINATION FINANCING STATEMENT

Two cases, one recently decided and one pending, address the question of whether unauthorized Uniform Commercial Code ("UCC") termination statements are effective. *Roswell Capital Partners LLC v. Alternative Construction Technologies*, No. 08 Civ. 10647 (DLC), 2010 WL 3452378 (S.D.N.Y. Sept. 1, 2010) (the "Roswell case") supports the notion that an unauthorized termination statement is fully effective in destroying the perfected status of a security interest. The effect of the decision, if followed, would be to impose a burden on the secured party of record to monitor the public financing statement records for unauthorized or erroneous filings, regardless of whether such filings are within its control.

Perfection[1] occurs when a security interest has attached and the necessary steps have been taken to perfect that interest.[2] Article 9 of the UCC promotes filing a financing statement as the primary method of perfection.[3] A filed financing statement, however, does not establish the existence of a security interest; rather, it merely puts third parties on notice to inquire about the existence of a security interest. In general, a financing statement remains in effect until terminated by law (usually five years after the filing, unless the filing is continued by the timely filing of a continuation statement) or by the filing of a termination statement. A secured party of record can terminate a financing statement or authorize another party to terminate the financing statement, before the financing statement would otherwise lapse, by filing a termination statement.[4] Sometimes there are unauthorized filings of termination statements. The UCC does not define the term "authorize."

In *dicta* in the Roswell case, Judge Cote stated that a termination statement filed by the debtor with respect to the lender's financing statement was effective even if not authorized by the lender. The relevant facts of the case are as follows.

> In 2005, JMB Associates ("JMB") provided $630,000 in financing to Alternative Construction Technologies ("ACT"), represented by two convertible promissory notes (the "Notes"), secured by certain personal property, and perfected by a properly filed financing statement. The Notes provided that (i) JMB could at its option convert the loan obligation into equity in ACT, (ii) JMB could unwind the conversion and convert the equity back into debt if the price of ACT's stock fell below $2.00 a share, and (iii) "[ACT] shall be required to seek the endorsement of [JMB] prior to the removal of the UCC-1 upon payment."

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[1] Perfection provides priority over a trustee in bankruptcy.

[2] *See* UCC § 9-308(a), (b).

[3] *See* UCC § 9-310.

[4] *See* UCC § 9-513(d).

> In 2006, in connection with a public offering, JMB elected to convert the Notes to equity interests in ACT and subsequently, in 2007 and 2008, Roswell Capital Partners, LLC ("Roswell"), as collateral agent for a group of lenders, provided ACT with two rounds of funding totaling over $6 million, secured by substantially all of ACT's assets. On July 2, 2007, ACT filed termination statements against JMB's financing statements. On July 5, 2007, Roswell filed a UCC-1 financing statement to perfect its security interest. In July 2008, JMB tendered 315,000 shares of its stock to ACT to unwind the prior conversion and reconvert the equity to debt because ACT's stock had fallen below $2.00 per share.
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> Subsequently, ACT defaulted in paying the Roswell loan. Roswell instituted a suit to foreclose on the collateral that was the subject of its financing statement. JMB joined the suit to dispute the seniority of Roswell's security interest. JMB disputed the validity of the UCC-3 termination statement because ACT did not comply with the conditions of the Notes, which specifically required that the debtor "seek the endorsement of" JMB prior to the removal of the UCC-1 financing statement upon payment. JMB and Roswell agreed that Roswell's security interest was perfected, but Roswell challenged both the attachment and the perfection of JMB's security interest. Roswell moved for summary judgment and the court granted its request. It held that Roswell, rather than JMB, had a first priority perfected security interest in ACT's assets.

The court stated, in *dicta*, that "[e]ven if the termination statement was not authorized by [the secured party of record], it nonetheless extinguished any perfected security interest [the secured party] had in the Collateral." In Judge Cote's view, potential creditors must be able to rely on termination statements filed in the public record, even if such termination statements were filed in error and without authorization. In other words, even if the termination statement was not authorized by JMB, it nonetheless extinguished any perfected security interest JMB had in the collateral.[5]

The court rejected JMB's counsel's argument that the UCC adopted a "notice filing" system that contemplates further inquiry into the scope of the security agreement,[6] and therefore the UCC requires subsequent secured parties to investigate the filing of the UCC termination statement.

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[5] UCC Section 9-510(a) provides that a filed record is effective only to the extent that it was filed by someone authorized to do so under UCC Section 9-509. UCC Section 9-509, in turn, requires the debtor's authorization for an initial financing statement to be filed and a secured party's authorization for a termination statement to be filed (except in certain circumstances not applicable to this case). The intention was to prevent arbitrary and unauthorized filings. This is particularly important when the unauthorized filing is a termination, as terminating a perfected interest has significant consequences.

[6] Official Comment 2 to UCC Section 9-502 provides that the Article 9 filing system is merely a "notice" system: "What is required to be filed is not . . . the security agreement itself, but only a simple record providing a limited amount of information (financing statement). . . . 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. Section 9-210 provides a statutory procedure under which the secured party, at the debtor's request, may be required to make disclosure. However, in many cases, information may be forthcoming without the need to resort to the formalities of that section."

The court stated that it had based its reasoning on the fact that Article 9 refers only to "financing statements" and not to termination statements.[7]

The court reasoned that "[p]otential creditors must be able to rely on termination statements filed in the public record, even if they were filed in error or without authorization" and that "the UCC *. . . places the burden of monitoring for potentially erroneous UCC-3 filings on existing creditors* [emphasis added], who are aware of the true state of affairs as to their security interests, rather than potential creditors who will not be in a position to know whether a termination statement was authorized or not."[8]

This case supports the notion that an unauthorized termination statement is fully effective to terminate the perfection of a security interest. It imposes a burden on the secured party of record to monitor the public financing statement records for unauthorized or erroneous filings, even if such filings are not within its control.

Interestingly, the recent revisions proposed by the National Conference of Commissioners on Uniform State Laws and the American Law Institute to Article 9 of the UCC and to the Official Comments to the UCC[9] (the "Proposed Revisions") include the following addition to Official Comment 2 to UCC Section 9-518, which addresses the point made by Judge Cote regarding whether subsequent creditors or the initial creditor bears the risk of an unauthorized filing: "Just as searchers bear the burden of determining whether the filing of [sic] initial financing statement was authorized, searchers bear the burden of determining whether the filing of every subsequent record was authorized. Inasmuch as the filing of an information statement has no legal effect, this section does not provide a mechanism by which a secured party can correct an error that it discovers in its own financing statement."

In light of the *Roswell* decision, secured creditors might consider monitoring the UCC financing statement records to discover unauthorized or erroneous termination statement filings. If such a filing is discovered, then the secured party can file a new financing statement as a precautionary measure and continue to file against the existing UCC financing statement of record, and, in addition, upon the effectiveness of the Proposed Revisions, file a UCC-5 "Information Statement" publicizing the correction of the public record as well as the existence of possible priority disputes. Note, however, that if the unauthorized termination statement is effective to terminate the initial financing statement, there will be a preference risk associated with any purported perfection that occurs by the filing of the new initial financing statement. In addition, if the unauthorized termination statement is effective, the lender should examine its loan

[7] UCC Section 9-102(a)(39) defines a financing statement as "a record or records composed of the initial financing statement and any filed record relating to the initial financing statement." Thus, the term "financing statement" includes the initial UCC-1 and all subsequently filed records, including termination statements. The term "initial financing statement" is used when the intent is to limit the application to the initial UCC-1 filing.

[8] While Article 9 does contain some provisions that require a secured party to "monitor" the debtor, such as knowing when the debtor changes its name or location, there is nothing in Article 9 that creates an obligation for an existing secured party to monitor its filed financing statements.

[9] It is contemplated that the Proposed Revisions will be submitted to state legislatures for consideration with the intent that they will become adopted and effective on or about July 1, 2013.

documents to determine whether the failure of the security interest to be perfected is a default and consider what action should be taken under the circumstances. Such action could theoretically include discontinuance of additional funding or acceleration of the maturity of outstanding loans.

Secured creditors should keep in mind that a financing statement does not tell searchers that the secured party of record has a security interest; rather, it merely gives notice that it may have one. A searcher should always follow up on any filed records to determine the legal effectiveness of a financing statement, and a searcher should never assume that authority exists merely because a financing statement was filed in the UCC records. A financing statement could be filed in error or without authorization by someone with no claim to any rights in the listed collateral.

A party filing an unauthorized UCC record can be liable both to the debtor and to other secured parties for losses resulting from the filing. The UCC provides tools to deal with such filings. First, UCC Section 9-210 provides that a debtor may make three types of requests for information from a secured party: (i) a request for an accounting; (ii) a request for a list of collateral; and (iii) a request for a statement of account. A secured party receiving such a request from its debtor generally must comply with the request within 14 days of receipt. The secured party is required to respond to such a request from the debtor only, so other interested persons need to work through the debtor to obtain such information.

Second, Section 9-518, entitled "Claim Concerning Inaccurate or Wrongfully Filed Record," provides a nonjudicial means for a debtor to give notice that a UCC financing statement is inaccurate or wrongfully filed. The UCC-5 is the form for taking action under this section, and it is currently known as a "Correction Statement" and can be filed only by the debtor; however after the Proposed Revisions take effect, it will be known as an "Information Statement" and will be able to be filed by either the secured party or the debtor. It is important to note that filing a UCC-5 form has no legal effect; it is merely a method for providing additional information to searchers.

Third, the secured party can seek to recover damages from the party making the unauthorized filing pursuant to UCC Section 9-625, entitled "Remedies for Secured Party's Failure to Comply with Article," which sets forth penalties for noncompliance with Article 9. UCC Sections 9-625(b) and 9-625(e) cover the fraudulent or mistaken filing of UCC financing statements.

Section 9-625(b) provides: ". . . a person is liable for damages in the amount of any loss caused by failure to comply with this article. Loss caused by failure to comply may include loss resulting from the debtor's inability to obtain, or increased costs of, alternative financing." Section 9-625(c)(1) provides that a debtor, an obligor, or person that holds ". . . a security interest in or other lien on the collateral may recover damages under subsection (b) for its loss." Section 9-625(e) provides in part that "[i]n addition to any damages recoverable under subsection (b), the debtor . . . may recover $500 in each case from a person that . . . files a record that the person is not entitled to file under section 9-509(a)."

In some cases, the parties may dispute whether the filing of a termination statement was authorized or, alternatively, whether the filing was a mistake (*e.g.*, it was authorized but inadvertently released the wrong collateral or terminated the wrong UCC-1 financing statement). This dispute is at the heart of litigation pending in *Official Committee of Unsecured Creditors of General Motors Corp. v. JPMorgan Chase Bank, N.A. (In re Motor Liquidation Co.)*, Nos. 09-50026 (REG), Adv. 09-00504 (REG) (Bankr. S.D.N.Y. filed June 1, 2009).

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