13-2187-bk

United States Court of Appeals
for the
Second Circuit

IN RE: MOTORS LIQUIDATION COMPANY, *et al.*,

Debtor.

OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF
MOTORS LIQUIDATION COMPANY,

Plaintiff-Appellant,

– v. –

JP MORGAN CHASE BANK, N.A., individually and as Administrative Agent
for various lenders party to the Term Loan Agreement described herein,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

AMICUS CURIAE BRIEF OF COMMERCIAL FINANCE ASSOCIATION IN SUPPORT OF DEFENDANT-APPELLEE JPMORGAN CHASE BANK, N.A.

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CORPORATE DISCLOSURE

Pursuant to Rule 26.1(a) of the Federal Rules of Appellate Procedure, Commercial Finance Association certifies that it is a tax exempt organization that has no parent corporation and that there is no publicly traded corporation that owns ten percent (10%) or more of its stock.

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STATEMENT OF IDENTITY, INTEREST AND AUTHORITY OF AMICUS CURIAE[1]

This *amicus curiae* brief is filed by Commercial Finance Association ("CFA") in support of Defendant-Appellee JPMorgan Chase Bank, N.A., individually and as Administrative Agent for various lenders party to a Term Loan Agreement ("JPMorgan").

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 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 United States 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

[1] As required by Second Circuit Local Rule 29.1, it is hereby confirmed that (i) no party's counsel has authored this brief in whole or in part; (ii) no party or party's counsel contributed money that was intended to fund the preparation or submission of this brief; and (iii) no person or entity, other than the Commercial Finance Association, as *amicus curiae*, made a monetary contribution to the preparation or submission of this brief. JPMorgan Chase Bank, N.A. is a member of the Commercial Finance Association.

their businesses, create jobs and grow. For many of these borrowers, asset-based lending is the only form of financing available to them.[2]

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 United States, 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 party. 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.

In its brief, the Official Committee of Unsecured Creditors of Motors Liquidation Corp. ("Committee") seeks to topple this pillar of secured finance,

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

arguing instead, as a matter of practicality and policy, that the express provisions of Article 9 should be ignored, and that lenders holding security interests in personal property should bear the risk of unauthorized 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, thereby driving up the cost of secured credit to borrowers, and reducing the availability of credit at a time when small- and medium-sized businesses in the United States can least afford it.

As the principal U.S. trade association for asset-based lenders, CFA is well-positioned to address the impact a decision of this Court could have on secured lending in the United States. Therefore, CFA respectfully submits that its views on this appeal will assist the Court in rendering its decision.[3]

ARGUMENT

The Committee makes its practicality and policy argument on page 60 of its brief with the following assertion:

[3] This is the only this aspect of the Committee's Brief that CFA seeks to address. Thus, CFA does not seek to address the issue of whether the Bankruptcy Court was correct in finding that JPMorgan did not authorize the filing of the termination statement. Although CFA strongly believes that the Bankruptcy Court was correct, CFA is not in a position to provide an industry-based perspective on that issue, which is largely a matter of agency law.

> According to the Bankruptcy Court, the 2001 revisions to Article 9 of the UCC, which allowed termination statements to be filed by authorized persons on behalf of secured parties of record, require potential creditors to investigate the facts and circumstances surrounding the filing of UCC termination statements to confirm that any prior security interests against a borrower were terminated at the direction of secured creditors fully cognizant of the legal consequences of their actions (SPA70). The Bankruptcy Court's view is *impractical* and, in addition to being in direct conflict with the conclusions reached by other courts about the operation of the UCC's public filing system, it is *contrary to the overarching public policy* that potential creditors are entitled to rely on properly filed records maintained under the UCC system. (emphasis added)

Notably, the Committee never contends that the view expressed by the Bankruptcy Court is contrary to law. In fact, the Bankruptcy Court's view accurately expresses the law.[4] 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 Article 9 on the issue of unauthorized terminations of financing statements is by far the most practical approach to that issue and makes complete sense from a policy standpoint as well, resolving the issue in a way that preserves the integrity of the UCC filing system and promotes 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

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[4] *See* Special Appendix ("SPA") 70-71.

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.[5] However, Article 9 does not require or allow the filing officer to request, or the terminating party to file, any evidence of that authorization.[6] Thus, a new lender has no way of knowing whether the

[5] UCC § 9-509(d).

[6] 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 3, 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. 3; UCC § 9-520(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.[7] The only way that Lender A could protect 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

[7] 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* SPA 71. *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 lenders to investigate is, and always has been, part of a 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. Co.*, 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.").

the borrower, could significantly increase the cost of credit to the 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, 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.

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.[8] If the new lender is very familiar with the borrower, it may well take the risk, and often does.

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

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[8] *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).

termination by a Borrower, or a third party without the secured party of record's authorization. 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.

The policy decision reflected in Article 9 has a direct and powerful bearing on the cost and availability of credit. Indeed, if a lender were required to constantly check the filing office records and verify its priority liens, it would dramatically increase the cost of asset-based lending and, in some cases, eliminate business access to this 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) will typically be passed on to the borrower, thus increasing the cost of credit. Moreover, the added uncertainty for lenders generated by this rule will cause lenders to reduce their ability to rely on their security interests, making lenders more reluctant to make loans 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.

The part of the *Roswell*[9] case cited by the Committee in support of its statement quoted above, was *dicta* and was wrong. *Roswell* said that an unauthorized termination statement should be effective because the UCC "places the burden of monitoring for potentially erroneous UCC-3 filings [termination statements] on existing creditors, 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."[10] This pronouncement, enthusiastically embraced by the Committee, actually is precisely the opposite of what the UCC provides. Accordingly, *Roswell* has been criticized by legal authorities and courts.[11]

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[9] *Roswell Capital Partners LLC v. Alt. Constr. Techs.*, No. 08 Civ. 10647 (DLC), 2010 WL 3452378 at *7 (S.D.N.Y. Sept. 1, 2010), *aff'd by summary order on other grounds*, 436 F. App'x 34 (2d Cir. 2011) ("*Roswell*").

[10] *Id.* at *7.

[11] *See* SPA 66-73; *See also AEG Liquidation Trust v. Toobro N.Y. LLC*, 32 Misc.3d 1202(A), No. 650680/10, 2011 WL 2535035, at *9 n. 1 (N.Y. Sup. Ct. Jun. 24, 2011) (criticizing *Roswell* because unauthorized termination statement could not terminate a secured party's security interest); *Lange v. Mut. Of Omaha Bank (In re Negus-Sons, Inc.)*, 460 B.R. 754, 757 n. 10 (B.A.P. 8th Cir. 2011), *aff'd*, 701 F.3d 534 (8th Cir. 2012) ("*Roswell's* holding appears to be contrary to the plain language of the Uniform Commercial Code"); 9B Hawkland's Uniform Commercial Code Series §9-510:2 [Rev] at n. 1.50 (finding *Roswell* "troubling"); Fred H. Miller & William H. Henning, The Danger of Dictum, 45 UCC Law Letter 1, 3 (Mar. 2011) (the *Roswell* court "had it exactly backwards").

The Committee concludes its brief by asserting that "the Bankruptcy Court's decision, if upheld, will undermine the public notice system that is central to the UCC and there by introduce uncertainty and disruption to the secured lending markets." This assertion is simply not true. On 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.

CONCLUSION

For the foregoing reasons, the CFA respectfully requests that the Court reject the practicability and policy argument of the Committee in deciding whether to affirm the decision of the Bankruptcy Court.

Dated: December 16, 2013

Respectfully submitted,

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