ASSET BASED LENDING ALERT
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Ineffective UCC Termination Statements Pose a Danger to Lenders

The Problem Scenario: A prospective secured lender obtains a UCC search showing a filed financing statement and a subsequent termination statement. Can the lender safely assume that the collateral covered by the financing statement is now free and clear? Without knowing more, the answer is "no."

The Rule: Under Article 9 of the UCC, a termination statement is effective only if an authorized person files it. The only persons who are permitted to file a termination statement are the secured party of record or the debtor if (i) it has been authorized by the secured party, or (ii) the secured party fails to terminate after payoff and a notice from the debtor. If an unauthorized person files a termination, or if the debtor fails to check the box on the form to identify itself as the filer, then the financing statement to which it refers will remain effective.

Does a filed termination statement indicate whether it has been properly authorized? No. Nothing on the face of a termination statement will indicate its filing was properly authorized. In fact, all that is required on a termination statement is the applicable financing statement's file number and a check mark in the termination box. Even if the debtor has checked the box to identify itself as the filer, there is still no proof that the debtor is an authorized filer.

What kind of due diligence should the new lender perform? An incoming lender must prepare itself against unauthorized and ineffective termination statements, whether from dishonest borrowers filing unauthorized termination statements to fraudulently clear the record, or by someone who simply filed the termination statements in error by typing the wrong financing statement file number onto the form. The best practice would be for the new lender to request from the debtor evidence that each "terminated" secured party of record actually authorized the applicable termination filing (typically set forth in a payoff letter). Alternatively, the new lender can attempt to make its own inquiries with prior secured parties. Unfortunately, the people with access to the appropriate records may be difficult to locate, or may not cooperate in response to a cold call from a new lender.

So, what do you do? A new lender may want to identify and probe only those situations that appear high risk, such as a termination statement for a blanket UCC filing for a supposed working capital facility, where no replacement secured party has filed a financing statement. (As opposed, for example, to the termination of a filing against a few specific pieces of equipment.) Another good idea is for the lender to require the borrower to purchase Article 9 title insurance. But, if the title company encounters difficulty in establishing proper authorization for a filed termination, the policy's coverage will likely be inadequate.

What happens with mistaken but seemingly authorized terminations? Under current law, it is unclear whether a secured party that mistakenly terminates its own financing statement can fix the error, but it appears that this issue may soon be addressed. In a recent bankruptcy filing, In re Heller Ehrman LLP, the secured party apparently admitted to having filed a termination statement against itself "in error and as a result of a clerical

HERRICK

New York Office
2 Park Avenue
New York, New York 10016
Phone: (212) 592-1400
Fax: (212) 592-1500

Princeton Office
210 Carnegie Center
Princeton, New Jersey 08540
Phone: (609) 452-3800
Fax: (609) 520-9095

Newark Office
One Gateway Center
Newark, New Jersey 07102
Phone: (973) 274-2000
Fax: (973) 274-2500

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error." It then filed a "correction statement" seeking to retract the termination within the 90 day preference period prior to the debtor's bankruptcy filing. In cases like this, if a law firm or service company actually submitted the termination statement, the secured party may argue that what was done was outside the scope of the agent's authority and, therefore, an unauthorized, ineffective termination—even though it appears on the surface to have been filed by the secured party of record. The law on this issue is unresolved, but it seems unlikely that an incoming lender who advanced new money based on a clear UCC search could be forced to suffer a major loss over what seems like a fine point of agency law, where a former secured party filed (or caused to be filed) the termination statement in question. If the secured party actually filed the mistaken termination itself, there might not be any remedy other than filing a new financing statement.

What should the secured party of record do if it discovers that someone filed an unauthorized termination statement? The secured party might not need to do anything to preserve the effectiveness of its filed financing statement if it knows that the debtor or another third party who was not acting as the secured party's agent must have filed an unauthorized termination statement. However, secured parties may want to act on such a discovery, and some have opted to file a correction statement to indicate that the termination was wrongfully filed. The UCC authorizes only debtors to file a correction statement under Article 9; but since a correction statement does not bear upon the effectiveness of a financing statement, many practitioners believe that there is no harm in a secured party making a correction filing, thus putting others on notice that something is wrong and that further inquiry should be made.

The secured party could also request that the debtor file the correction statement or, if the security agreement contains a suitable power of attorney clause, file one itself in the secured party's capacity as the debtor's attorney-in-fact. Of course, the secured party can always file a new financing statement and indicate in the collateral description box that the prior financing statement was terminated without authorization. Note that the American Law Institute's Joint Review Committee for UCC Article 9 met in February 2009 and decided not to make any changes regarding correction statements, but it did consider allowing secured parties to file something other than a correction statement to address unauthorized termination statements. This might result in a new section to Article 9.

For more information please contact Stephen D. Brodie at **(212) 592-1452** or sbrodie@herrick.com, Bruce Levine at **(212) 592-1488** or blevine@herrick.com, or Paul Rubin at **(212) 592-1448** or prubin@herrick.com**.**

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