

UCC Terminations and the Diligent Searcher

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Would an attorney or lender want to close a deal in reliance on the results of an incomplete UCC search? The answer, of course, is no. A complete and accurate UCC search is essential for reducing the risk in commercial transactions. Nevertheless, many are relying on insufficient search results without realizing it.

The reason is that some UCC searchers mistakenly believe it is safe to exclude terminated financing statements from the search results. They assume terminated records are no longer effective so no review is necessary. Thus, searchers may think they save time and money by omitting terminated records from their search.

This practice reflects a fundamental misunderstanding about the effect of a termination. It's also risky business. The filing of a termination statement does not mean the financing statement is not effective.

There are a variety of circumstances that can cause a "terminated" financing statement to remain effective. Regardless of the reason, these records remain in the filing office index for searchers to discover. The diligent searcher has a responsibility both to identify these records and determine the effect of each. Failure to do so can substantially increase the risks for the party that relies on the search results.

Ineffective Terminations

The reason searchers need to pay attention is that an unauthorized termination is not effective.¹ This is far from a hypothetical problem. Filing offices around the country receive thousands of unauthorized terminations every month. Many find their way into the UCC index. The odds are good that a searcher will come across one sooner or later.

There are many reasons why a termination may be unauthorized. Most are filed unintentionally, the result of data entry errors. The simplicity of the termination form accounts for much of the problem. A termination statement requires just two pieces of information, the initial financing statement file number and a check mark in the termination box.²

The most important piece of information is the initial file number. This is usually the only link to the initial financing statement in a central filing office.³

It is very easy for filers to make an error in the initial financing statement file number. We're all human. Typos happen, either during preparation of the termination record, or even long before, when someone entered the filing information into a UCC tracking system.

A typo is just one event that can result in an unauthorized termination. Sometimes the original filing acknowledgment is difficult to read. Threes and eights can look a lot alike if the number isn't clearly stamped on the document. Readability only gets worse when the filer works from scans

¹ U.C.C. § 9-510(a) (1999), provides that "A filed record is only effective to the extent that it was filed by a person that may file it under Section § 9-509." A person may file a termination under § 9-509(d) only if the secured party of record authorizes the filing.

² Curiously, the name of the secured party that authorized the termination is not required. The lack of a name in Section 9 of the termination form is not a reason for rejection authorized by § 9-516(b). Still, the best practice is to always include this information.

³ County real estate recording offices may require additional information to link a termination statement with the initial financing statement. For example, see § 9-516(b)(3)(D).

or faxes of the original document. This often results in an incorrect file number finding its way onto the termination statement.

When the filer makes an error in the file number on a termination, the outcome depends on whether it matches an active number. If it does match an active file number, the filing office will index the termination with the incorrect financing statement. Otherwise, the filing office will reject the termination statement because it does not provide a valid file number.

Refinance transactions can also lead to unauthorized terminations. Sometimes the deal falls through after the prospective new lender terminates the active financing statements. Once filed, there is no way to remove the termination statement from the record.

Even if the transaction does close, paying off the obligation through a refinance doesn't necessarily authorize the new lender to file termination statements. With limited exceptions,⁴ the secured party's authorization is still required to effectively terminate a financing statement. The financing statement may cross-collateralize multiple transactions, or secure an ongoing line of credit.

Even an authorized termination is not always fully effective. This can occur where a financing statement has multiple secured parties of record. Under § 9-510(b), "A record authorized by one secured party of record does not affect the financing statement with regard to another secured party of record." In other words, a termination filed by one secured party does not necessarily terminate the security interests of the remaining secured parties. Every secured party of record must authorize the termination statement or the financing statement may remain effective.

⁴ Under certain circumstances described in § 9-513, § 9-509(d) provides that the debtor may authorize the filing of a termination statement.

Fraud is another source of unauthorized terminations. For example, the debtor may file a termination so the collateral appears unencumbered. This makes it easier to sell the collateral, or use it to secure new financing with an unsuspecting lender. The good news is that fraudulent action makes up only a small percentage of the unauthorized termination filings.

Regardless of the reason behind the filing of an ineffective termination statement, it's up to the searcher to catch it. If a party conducts a search without closely examining each terminated financing statement, the consequences can be harsh. The secured party may not have first priority in the collateral if the debtor defaults, resulting in a potentially substantial loss. Searchers must not only review terminated financing statements, but they must also know what traps lurk for the unwary.

Searcher Beware!

An ineffective termination statement is only one of many risks inherent in the secured transactions search and filing process. Hidden liens, interpretive issues and non-uniform filing office practices all create risk that cannot be entirely eliminated. The risk can, however, be managed.

Revised Article 9 (RA9) allocates the risk between filing secured parties and searchers. Initially, the filer has the responsibility to file a financing statement in full compliance with the statutory requirements. If the filer fails to carry this burden, it bears the risk of loss. When the filer does meet the burden, the risk shifts to subsequent searching parties.

Searchers have the responsibility to conduct the search properly and to exercise reasonable diligence in analyzing the results.⁵ The requisite diligence is not limited to a review of the search results.

Revised Article 9 uses a notice filing system. A financing statement is merely a notice that the secured party 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.”⁶

The Code definition of “financing statement” in § 9-102(a)(39) includes the initial financing statement and any filed record relating to that record. Terminations fall within the scope of this definition.

The searcher has a responsibility to make further inquiries if there are questions about the effectiveness of a termination statement. Considering the prevalence of unauthorized terminations, no search can be diligently completed without careful review of all terminated financing statements, including each termination statement.

Searchers are largely on their own when it comes to interpreting the effect of termination statements. Fortunately, Revised Article 9 ensures the searcher has access to all the information required to correctly interpret search results, including terminated financing statements. Unlike former Article 9, where filing offices routinely purged records immediately after the filing of a termination, RA9 requires the filing office to maintain all UCC records until one year after the financing statement lapse date.⁷

A termination no longer removes the financing statement from the index. It remains active in the filing office records. A purportedly terminated financing statement can be amended, assigned or even continued. If

⁵ See generally *In re: Summit Staffing Polk County, Inc.*, 305 B.R. 347, 355 (Bankr. M.D.Fla. 2003) (discussion of the searcher's duty under Revised Article 9 to exercise reasonable diligence in examining search results).

⁶ Official Comment to § 9-502.

⁷ See § 9-522(a).

continued, the record will remain active for another five years. However, “active” does not equal “effective.” A record terminated with authorization is no longer effective to perfect the security interest, even though a search will continue to disclose it.

Recommendations and Best Practices

The best practice for UCC searching is to always include terminated financing statements in the search results. A reasonably diligent UCC search must include this information. The searcher’s job doesn’t stop there. The mere presence of terminated financing statement on the search is not sufficient. The searcher has a responsibility to carefully review each part of the record, determine the risk and, if necessary, conduct any follow-up due diligence.

To properly interpret the record, a searcher should consider each termination as the opposite of a financing statement. The UCC is a notice system. A financing statement is nothing more than a notice that there may be a security interest in the described collateral. Being on notice, the searcher has a duty to inquire further for more information about the transaction.

A termination statement is no less a notice than a financing statement. The difference is that a termination statement provides notice that the financing statement may no longer be effective. Just as with a financing statement, the searcher has a duty to inquire further if there are any questions about the effect of a termination statement.

It is not always easy to determine whether a termination was authorized. There are, however, some indicators that serve as “red flags” for the searcher. These indicators do not necessarily mean that the termination is ineffective. However, they should put a diligent searcher on notice that further inquiry is required.

One indicator is when the secured party that authorized the termination is different from the secured party of record. There are circumstances where this could legitimately occur, such as when the secured party of record was acquired by the authorizing party. Nevertheless, the searcher has to explain the discrepancy before it can rely on the effectiveness of the termination.

Another indicator might be where the termination does not contain reference numbers in the “Return To” or “Optional Filer Reference Data” sections. The vast majority of legitimate UCC records contain either a matter number, obligor number or some other number that allows the filer to associate the record with a particular transaction. A lack of reference numbers suggests the filer didn’t have access to that important information. At the very least, the searcher should inquire further to explain the omission.

Anytime the debtor has authorized a termination, the searcher must pay attention. While there are limited circumstances where the Code allows the debtor to file a termination statement, the searcher should always verify that the security interest is no longer effective.

There are certainly other circumstances that could cause a searcher to question the effectiveness of a termination statement. The most important thing to remember is that the searcher must make further inquiry whenever there are unanswered questions about the record.

Considering the size of the unauthorized termination problem, searchers ignore terminated financing statements at their own peril. Any party entering into a commercial transaction must conduct adequate due diligence. Failure to conduct a reasonably diligent UCC search can easily result in financial loss for the secured party.

A careful examination of unexpired, but terminated financing statements is an essential part of any reasonably diligent UCC search. Searchers

must look for problems with terminations and inquire further when necessary. Otherwise, they will suffer the consequences.

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