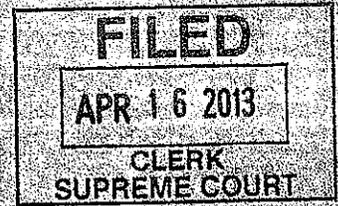


SUPREME COURT OF KENTUCKY
NO. 2012-SC-000249-D



DELPHI AUTOMOTIVE SYSTEMS, LLC

APPELLANT

v. APPEAL FROM KENTUCKY COURT OF APPEALS
NOS. 2010-CA-002303 AND 2010-CA-002332

CAPITAL COMMUNITY ECONOMIC/
INDUSTRIAL DEVELOPMENT
CORPORATION, INC.

APPELLEE

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and correct copy of this Brief for Appellant was served on this the 15th day of April, 2013, by U.S. Mail upon: Samuel Givens, Jr., Clerk, Court of Appeals, 360 Democrat Drive, Frankfort, KY 40601; Hon. Thomas Dawson Wingate, Circuit Judge, Franklin Circuit Court, Judicial Building, 669 Chamberlin Avenue, Frankfort, Kentucky 40601; Robert W. Kellerman, Esq., Stoll Keenon Ogden PLLC, 201 West Main Street, P.O. Box 5130, Frankfort, Kentucky

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Virginia Hamilton Snell

INTRODUCTION

This case raises an issue of first impression for Kentucky commerce: whether a governmental entity holding an **unperfected** security interest has priority over a **perfected** lienholder secured by the same asset. The Court of Appeals allows a governmental entity to escape the UCC filing requirements of Article 9, so necessary to the flow of commerce, despite express statutory language that compels its application.

STATEMENT CONCERNING ORAL ARGUMENT

Appellant Delphi Automotive Systems, LLC, respectfully requests oral argument. The proper interpretation of Article 9's requirements potentially affects all private lenders that extend credit to anyone doing business with an economic development authority. Lenders need confidence that their properly perfected secured loans have priority over unknown, unperfected liens. Diminished confidence could undermine commerce with development authorities when potential lenders cannot rely on the protected status of their interests under Article 9.

STATEMENT OF POINTS AND AUTHORITIES

INTRODUCTION..... i

STATEMENT CONCERNING ORAL ARGUMENT ii

STATEMENT OF THE CASE.....2

The Asset And Unperfected Security Interest.....2

The Perfected Security Interest2

Certified Tool Defaults3

Proceedings Below4

ARGUMENT.....7

I. THE AGREEMENT BETWEEN CAPITAL COMMUNITY AND CERTIFIED TOOL WAS AN UNPERFECTED SECURITY INTEREST.....7

Perry v. Williamson,
 824 S.W.2d 869 (Ky. 1992).....7

Fischer v. Fischer,
 348 S.W.3d 582 (2011).....8

II. CAPITAL COMMUNITY’S SECURITY INTEREST IS INFERIOR TO DELPHI AUTOMOTIVE UNDER ARTICLE 9.....10

III. CAPITAL COMMUNITY’S SECURITY INTEREST IN THE KOMATSU PRESS IS SUBJECT TO ARTICLE 9.....12

A. Capital Community Enjoys No “Government” Exemption From Article 9.....12

Farmers & Merchant Nat’l Bank v. Fairview State Bank,
 766 P.2d 330 (Okla. 1988).....12, 15

Bowlen v. Federal Deposit Ins. Corp.,
 815 P.2d 1013 (Colo. App. 1991).....12, 14

<i>The Peoples Bank & Trust Company v. Applewhite</i> (<i>In Re 20th Century Enterprises, Inc.</i>), 152 BR 119 (Bankr. N.D. Miss. 1992)	12, 15, 16
<i>In re Brazier Forest Products Inc.</i> , 106 Wash. 2d 588, 724 P.2d 970 (1986).....	15, 16
<i>In re Dalcon, Inc.</i> , 120 B.R. 620 (Bankr.D.Mass. 1990)	15
<i>General Cable Company v. Altek Systems, Inc.</i> , (<i>In re Altek Systems, Inc.</i>), 14 b.R. 144 (Bankr.N.D.Ill 1981)	15
<i>State of Alaska, Division of Agriculture v. Fowler</i> , 611 P.2d 58 (Alaska 1980).....	15, 16
B. Article 9 Contains No “Public Policy” Exemption For Capital Community	18
<i>JPMorgan Chase, N.A. v. Longmeyer</i> , 275 S.W.3d 697 (Ky. 2009).....	20
<i>Bailey v. Reeves</i> , 662 S..W.2d 832 (Ky. 1984).....	20
<i>Com v. Harrelson</i> , 14 S.W.3d 541 (Ky. 2000).....	20
<i>Stephenson v. Woodward</i> , 182 S.W.3d 162 (Ky. 2005).....	20
<i>Smith v. Com.</i> , 41 S.W.3d 458 (Ky. App. 2001).....	20
<i>Lincoln County Fiscal Court v. Dep’t. of Pub. Advocacy, Com. of Ky.</i> , 794 S.W.2d 162 (Ky. 1990).....	20
<i>Hurry Up Broadway Co. v. Shannon</i> , 102 S.W.2d 30 (Ky. 1937).....	20
<i>Ford Motor Credit v. Webb-Elkhorn Coal Corp.</i> , 775 S.W.2d 945 (Ky. App. 1989).....	21
<i>In re City of Moran</i> , 713 P.2d 451 (Kan. 1986).....	21, 22

Foley v. Production Credit Assoc. of the Fourth Dist.,
753 S.W.2d 876 (Ky. App. 1988)23

CONCLUSION24

APPENDIX

May It Please The Court:

Courts enforce the express language of statutes as enacted. Article 9 of the UCC governs secured transactions and controls the filing, perfection and priority of security interests. Without question, under Article 9, Appellant's perfected security interest is superior to Appellee's unperfected security interest. But the courts below allowed an unperfected security interest to triumph for reasons the General Assembly does not permit in Article 9.

The trial court exempted Appellee from Article 9 on "public policy" grounds that it perceived favoring the government. But the trial court's "public policy" conflicts with Article 9's "applicability." KRS 355.9-109, which defines Article 9's scope, states that it does not apply if "another statute of this Commonwealth expressly governs the creation, perfection, priority or enforcement of a security interest created by . . . a governmental unit of this Commonwealth." The trial court's "public policy" is not an "express statute" governing the "priority" of Appellee's security interest. There is no such statute on the books.

The Court of Appeals found a "statute" in Article 9 itself, and within it, an exception for transfers of a security interest "by" a governmental unit. *See* KRS 355.9-109(4)(q). But this appeal in no way involves a transfer "by" the government. The transaction here involved the transfer of a security interest "to" a governmental unit. The General Assembly did not say "to and by" the government. It said "by" the government only. The Court of Appeals exempts transfers involving the government entirely, contrary to the narrow exception in the statute. We respectfully urge this Court to reverse.

STATEMENT OF THE CASE

This case arises from a priority dispute between two creditors over the right to proceeds from the sale of equipment, the Komatsu Press, an asset of Certified Tool and Manufacturing Corporation ("Certified Tool"). The relevant facts are undisputed.

The Asset And Unperfected Security Interest. Appellee Capital Community Economic/Industrial Development Corporation, Inc. ("Capital Community") was established under KRS 154.50-301 to 154.50-346 as a joint city/county effort for industrial development in Franklin County (Opinion, p. 2, App. 1). In 2001, Capital Community provided a Community Development Block Grant to Certified Tool in the amount of \$335,000, of which \$320,000 was earmarked for equipment. Certified Tool bought a Komatsu Press machine in March 2001 for \$519,000 (R 184).

Thereafter, Capital Community entered into a security agreement with Certified Tool (R. 167, App. 4). The Capital Community Agreement required Certified Tool to make monthly payments to Capital Community in the amount of \$3,394.10 for 84 months (R. 167). Upon completing all payments due and owing under the Agreement, Certified Tool "shall" become sole owner of the equipment, including the Komatsu Press (R. 168, p. 2 ¶7, App. 4). Nothing else was required for Certified Tool to become the owner. It is undisputed that Capital Community never filed a financing statement to perfect and give notice of its security agreement as Article 9 requires (Opinion and Order, p. 9, App. 2).

The Perfected Security Interest. In February 2008, Working Capital Solutions, Inc. ("WCS") entered into a Security Agreement with Certified Tool (R. 26-40), granting WCS a continuing security interest in all of Certified Tool's now-owned and hereafter acquired property and assets, including all machinery and equipment of Certified Tool (R. 26). Unlike Capital Community, WCS filed UCC Financing Statements with the both

the Kentucky and Illinois Secretary of State (R. 41-44), which perfected the security interest of WCS in the property and assets of Certified Tool and provided constructive notice of WCS's rights. WCS has never been a party to this action because it later transferred all of its rights to Delphi.

Delphi entered into a loan transaction with Certified Tool in May 2008 wherein Delphi extended \$250,000.00 in credit on an as-needed basis to fund Certified Tool's cash needs. The parties executed a promissory note in favor of Delphi reflecting the loan. The parties thereafter executed a First Amended Promissory Note that increased the line of credit to \$275,000.00 (R. 10-11).

To secure the indebtedness, Certified Tool executed a security agreement in favor of Delphi (R. 12-18, App. 5). The Security Agreement granted Delphi a continuing security interest in all of Certified Tool's now-owned or hereafter-acquired property and assets, including the Komatsu Press. Delphi perfected its security interest by filing UCC Financing Statements with both the Kentucky and Illinois Secretary of State on June 16, 2008 (R. 19-25, App. 6).

Certified Tool Defaults. In August 2008, Certified Tool defaulted under its First Amended Promissory Note and Security Agreement with Delphi. when Certified Tool announced that it was going out of business (Opinion, p. 3, App. 1). Delphi then had the right to accelerate the amounts due under the First Amended Promissory Note, which totaled \$207,518.81 (principal and interest) as of August 10, 2009, and to enforce the terms of its Security Agreement, including liquidation of the Komatsu Press and application of the sale proceeds towards satisfaction of the debt. In December 2008, Delphi and WCS entered into a Purchase and Sale Agreement whereby Delphi acquired

all of WCS's right, title and interest in the WSC Security Agreement and related documents (R. 45-49). As a result, Delphi held a fully secured interest that gave it the right to all proceeds from the sale of the Komatsu Press and other assets.

Proceedings Below. To enforce its rights, Delphi filed a declaratory action in the Franklin Circuit Court (R 1-53). "The Komatsu Press was liquidated, and by agreement of the parties, the net sale proceeds of \$185,370 were placed in an interest-bearing account with the Franklin Circuit Court Clerk pending resolution of the case" (R. 83-85, Opinion, p. 4, App. 1). Delphi and Capital Community both claimed that they were entitled to the proceeds (*Id.*). The parties filed cross-motions for summary judgment.

The trial court entered judgment in Capital Community's favor (R. 305-318, App. 2). Though it ruled as a matter of law that the Agreement between Capital Community and Certified Tool created a security interest, and not a lease (R. 312), the trial court incorrectly found that Capital Community was exempt from Article 9's perfection requirements for "public policy" reasons pertaining to economic development (App. 2).

The Court of Appeals affirmed for other reasons. It agreed with the Circuit Court's finding that "the agreement between Capital Community and Certified Tool constituted a security interest and not a lease" (Opinion, p. 7, App.1). The Court of Appeals relied on KRS 355.1-201(37) as the rule governing whether an agreement creates a lease or a security interest (Opinion, p. 7, App. 1).

The Court first analyzed whether "the consideration of the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee" (*Id.*, p. 7). KRS 355.1-201(37). Because

the agreement required Certified Tool to pay Capital Community to make monthly payments for the equipment as an obligation for the term of the agreement that was not subject to termination by Certified Tool, the Court found that the first requirement was satisfied.

The Court then considered the additional requirements in KRS 355.1-201(37)(a)-(d) and found that the agreement satisfies both subsections (b) and (d). "Specifically, the agreement provides that, "Upon expiration of the Lease . . . and after Lessor has received all sums due it, Lessee shall become the sole owner thereof and Lessor aggress [sic] to take such action as may be necessary to transfer title thereto" (Opinion, p. 8, App. 1). This provision satisfies KRS 355.1-201(37)(b) because Certified Tool was 'bound to become the owner' of the Komatsu Press." The agreement satisfied KRS 355.1-201(37)(d) because Certified Tool became the owner of the Komatsu Press for no additional consideration upon compliance with the agreement (*Id.*). "Therefore, we conclude that the trial court correctly determined that the agreement between Capital Community and Certified Tool created a security interest in the Komatsu Press" (Opinion, p. 8, App. 1). Capital Community has not contested this holding of the Court of Appeals by filing a cross-motion for discretionary review. It therefore is undisputed that Capital Community has only an unperfected security interest.

This appeal therefore concerns the second part of the Court of Appeals' Opinion, which addresses the "applicability of Article 9." "Having concluded that the Capital Community Agreement created a security interest, we now address whether Article 9 of the Kentucky UCC applies to that security interest" (Opinion, p. 9, App. 1). As the Court observes, Capital Community's security interest "is subject to Article 9 unless it is

exempt by other means” (Opinion, p. 9). The Court then found an exemption in KRS 355.9-109(4)(q), which cannot apply here because this section applies only to transfers “by” government units – namely when the government transfers a security interest as a borrower/debtor, not when the government acts like every other lender and accepts a security interest transferred to it. The Court of Appeals misplaced reliance on “legislative intent,” rather than the express language of Article 9. The Court recognized that “there does not appear to be any Kentucky case law that provides guidance in the applicability of this exemption” (Opinion, p. 11, App. 1), but then reached a conclusion that other jurisdictions considering the issue have rejected. Despite the express terms of Article 9, the Court of Appeals held that “governmental issuers of assets and revenues are exempt from the perfection and filing requirements of Article 9” (*Id.*, App. 1).

Consequently, even though Capital Community was a creditor/lender with an unperfected security interest in the Komatsu Press, it achieved superiority over Delphi, which had a fully perfected security interest and no constructive notice of Capital Community’s lien. Delphi relied on compliance with Article 9 to advise it of any “superior” obligations that would leave Delphi unprotected. Yet, both courts below exempted Capital Community from any obligation to make the required UCC filing in Article 9 to perfect its interest. For different reasons, the two courts misconstrued the terms of KRS 355.9-109 and, on this issue of first impression, gave the governmental unit as creditor a privilege unavailable to private lenders. Delphi filed no petition for rehearing but proceeded instead to this Court on motion for discretionary review.

ARGUMENT

The courts below correctly ruled that Capital Community received a security interest. It is undisputed that the security interest was never perfected through the filing of a UCC Financing Statement under Article 9. The courts below nevertheless allowed Capital Community's unperfected interest to trump Delphi's perfected interest, based on errors of law subject to *de novo* review. Article 9 does not permit "public policy" exceptions, and by its own terms only exempts transfers of security interests "by" the government, which never occurred here – not all transfers involving a governmental unit. This Court should reverse.

I. THE AGREEMENT BETWEEN CAPITAL COMMUNITY AND CERTIFIED TOOL WAS AN UNPERFECTED SECURITY INTEREST.¹

Capital Community argued below that Article 9 did not apply because its Agreement with Certified Tool was a "lease," not a security interest. Both the Circuit Court and the Court of Appeals disagreed, however, and held that the Agreement entered into between Capital Community and Certified Tool was a security agreement (Opinion, p. 8, App. 1). Capital Community filed no cross-motion for discretionary review asking this Court to review the lower courts' conclusion. The nature of the Agreement as a security interest should no longer be a matter of dispute. *Perry v. Williamson*, 824 S.W.2d 869, 871 (Ky. 1992) ("Our rules are specific that if the motion for discretionary review made by the losing party in the Court of Appeals is granted, it is then incumbent upon the prevailing party in the Court of Appeals to file a cross-motion for discretionary

¹ Delphi preserved this issue on Appeal in its Answer to Counterclaim of Capital Community (R. 81), its Memorandum in Support of Motion for Summary Judgment (R. 110-124) and its Response to Capital Community's Motion for Summary Judgment (R. 248-264).

review if respondent wishes to preserve the right to argue issues which respondent lost in the Court of Appeals. . . .”).²

And, even if it were otherwise, the lower courts resolved the issue correctly. KRS 355.1-201(2)(ai) defines a security interest as “an interest in personal property or fixtures which secures payment or performance of an obligation.” “Whether a transaction in the form of a lease creates a ‘security interest’ is determined pursuant to KRS 355.1-203.” When a purported lease creates a security interest, rather than a true lease, Article 9 of the UCC governs the priority of creditors.

As the Circuit Court explained, the UCC sets forth the criteria for determining whether an agreement is, in reality, a security interest, regardless of how the parties label it. Under KRS 355.1-203, a transaction in the form of a lease “creates a security interest if the consideration that the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee,” and

- (a) The original term of the lease is equal to or greater than the remaining economic life of the goods;
- (b) **The lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods;**
- (c) The lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement; **or**
- (d) **The lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.**

² In *Fischer v. Fischer*, 348 S.W.3d 582 (2011), this Court overruled earlier case law that required an appellee to file a cross-motion for discretionary review on issues that the Court of Appeals never reached and decided. Here, both the lower court and Court of Appeals directly ruled on the nature of the Agreement as a security interest and therefore issued a holding that negatively affects the Appellee.

KRS 355.1-203(2) (emphasis added). In other words, under Kentucky law, a transaction is conclusively deemed to create a security interest if the requirements of either KRS 355.1-201(37)(a),(b),(c) or (d) are met.³

The Agreement between Capital Community and Certified Tool was styled a "Lease" agreement "but whether the parties call an agreement a 'lease' or not is not determinative of the agreement's true nature" (Opinion and Order, p. 7, App.2). The Agreement between Capital Community and Certified Tool created a security interest. As KRS 355.1-203(2) requires, the obligation to pay rent was unconditional and "not subject to termination." The "Lease" provides: "Lessee's obligation for the payment of the rent is and shall be absolute and unconditional and shall not be subject to any reduction, offset, counterclaim, abatement, suspension, deferment or diminution for any reasons whatsoever . . ." (Lease, p. 1, ¶3, App. 4). The Agreement obligated Certified Tool to pay \$3,394.10 monthly for the right to possess and use the Komatsu Press, an absolute obligation for the full term of 84 months that could not be terminated by Certified Tool for any reason. No one can reasonably question that the "Lease" satisfies the first test of KRS 355.1-203(2).

It also satisfies KRS 355.1-203(2). It only needs to meet one of the four tests in KRS 355.1-203(2) and fully comports with at least two of the four. First, the "Lease" provides that, upon expiration and after "Lessor has received all sums due it, Lessee shall become sole owner thereof and Lessor agrees to take such action as may be necessary to

³ When Certified Tool and Capital Community entered into their Agreement, many sections of the UCC were numbered differently, but the relevant substance of Article 9 remains the same. The relevant provisions in 2001, KRS 355.1-201(37), quoted by the Court of Appeals, are now contained in KRS Chapter 355.1-203.

transfer title thereto” (Lease, ¶7, App. 4). This provision satisfies KRS 355.1-203(2)(b) because Certified Tool was “bound to become the owner of the goods.”

And, Certified Tool had the right to become the owner without having to pay any “additional consideration or nominal additional consideration upon compliance with the lease agreement,” which satisfies KRS 355.1-203(2)(d). As a matter of law, no matter what label Capital Community placed on the Agreement, it created a security interest, not a leasehold. Because it was unperfected, Capital Community’s security interest cannot be superior to Delphi’s perfected security interest.

II. CAPITAL COMMUNITY’S SECURITY INTEREST IS INFERIOR TO DELPHI AUTOMOTIVE UNDER ARTICLE 9.⁴

KRS 355.9-310 dictates how to perfect security interests covered by Article 9. The statute provides that, except in certain circumstances inapplicable here, “a financing statement must be filed to perfect all security interests.” KRS 355.9-310(1). The asset here, a Komatsu Press, does not fall under any of the recognized exceptions for perfection of a security interest by means other than the filing of a UCC financing statement. Delphi filed its UCC financing statements perfecting its security interest in the Komatsu Press, while Capital Community did not (UCC Financing Statements, App. 6).

Article 9 of the UCC also determines the priority of security interests as between perfected and unperfected secured creditors. KRS 355.9-322 provides that conflicting security interests rank according to priority in time of filing or perfection and that a perfected security interest has priority over a conflicting, unperfected security interest. KRS 355.9-322 states:

⁴ Delphi preserved this issue on Appeal in its Answer to Counterclaim of Capital Community (R. 81), its Memorandum in Support of Summary Judgment (R. 122-124), and its Response to Capital Community’s Motion for Summary Judgment (R. 262-263).

(1)...priority among conflicting security interests...in the same collateral is determined according to the following rules:...

(b) A perfected security interest...has priority over a conflicting unperfected security interest...

KRS 355.9-322(1)(b) (emphasis added).

Capital Community holds an unperfected security interest in the Komatsu Press because it failed to file a UCC financing statement,⁵ while Delphi perfected security interest in the Komatsu Press by filing UCC financing statements in both Kentucky and Illinois. Under KRS 355.9-322(1)(b), Delphi's perfected security interest in the Komatsu Press has priority and is superior to Capital Community's conflicted unperfected security interest.

Delphi therefore is entitled to recover the liquidation proceeds currently being held in the trial court's registry. KRS 355.9-315 provides:

(1)(a) A security interest...continues in collateral notwithstanding sale...or other disposition thereof unless the secured party authorized the disposition free of the security interest...; and

(b) A security interest attaches to any identifiable proceeds of collateral.

KRS 355.9-315(1). A security interest in proceeds is a perfected security interest if the security interest in the original collateral was perfected. KRS 355.9-315(3). Delphi's perfected security interest in the Komatsu Press continued into the liquidation sale to encompass proceeds. This Court should reverse and direct the clerk of court to distribute the sale proceeds to Delphi.

⁵ Even if Capital Community had filed a UCC financing statement after Delphi filed their declaratory judgment action, it would remain inferior because Delphi perfected its security interest prior in time.

III. CAPITAL COMMUNITY'S SECURITY INTEREST IN THE KOMATSU PRESS IS SUBJECT TO ARTICLE 9.

A. Capital Community Enjoys No "Government" Exemption From Article 9.⁶

Although the Court of Appeals held that Capital Community's Agreement with Certified Tool created a security interest, it found an exemption from the Article 9 filing requirements that allows constructive notice of an existing security interest to others before they extend financing. The Court of Appeals relied on KRS 355.9-109(4), which provides that Article 9 does not apply to "[a] public-finance transaction or a transfer by a government or governmental unit." KRS 355.9-109(4)(q). The Court's interpretation of this exception to Article 9 is mistaken for several reasons.

First, the Court of Appeals' reasoning is contrary to other jurisdictions that have construed "transfer by a government" as having no application to the facts here. As even the trial court observed, "[w]hile there does not seem to be any Kentucky case law that can provide guidance in determining the applicability of the exclusion to the transaction at issue, other jurisdictions have held that the exclusion applies only where the government entity is the borrower/debtor" [Trial Court Order, p. 10, App. 2]. The trial court relied on the reasoning of the courts in *Farmers & Merchant Nat'l Bank v. Fairview State Bank*, 766 P.2d 330, 332 (Okla. 1988); *Bowlen v. Federal Deposit Ins. Corp.*, 815 P. 2d 1013, 1015 (Colo. App. 1991); and *The Peoples Bank & Trust Company v. Applewhite (In Re 20th Century Enterprises, Inc.)*, 152 BR 119, 123 (Bankr. N.D. Miss. 1992) (Opinion and Order, p. 10, App. 2).

⁶ Delphi preserved this issue on Appeal in its Response to Defendants' Supplemental Memorandum in Support of Motion for Summary Judgment (R. 293-297).

Other jurisdictions apply the exclusion only to situations where the governmental unit is a borrower/debtor because this interpretation comports with the language of the exclusion, which refers to transfers “by” a government entity. As the trial court recognized, Article 9 governs the transfer of security interests. “Thus, a transfer by a government entity would be the transfer of a security interest by a government entity” (Trial Court, p. 10, App.2). Here, “Certified Tool, a private entity, transferred a security interest to [Capital Community], a quasi governmental entity.” *Id.*

Second, because Capital Community was not transferring – but rather was accepting – a security interest, KRS 355.9-109(4) cannot possibly apply. Yet, the Court of Appeals disagreed with the trial court and found an exemption based on the “transfer by a government” provision in KRS 355.9-109(4)(q). Its reasoning exempts all government issuers of assets and revenues from the filing and perfection requirements of Article 9, despite the express words in the statute.

KRS 355.9-109 defines the “scope” and “applicability” of Article 9. KRS 355.9-109(1) makes clear that Article 9 applies to any transaction that creates a “security interest” unless subsections (3) and (4) provide for an express exemption from Article 9’s requirements. KRS 355.9-109(3) essentially contemplates a conflict of laws situation, for example, when a federal law preempts Article 9. To establish an exemption under this section, Capital Community must identify “another statute” that “expressly governs the creation, perfection, priority, or enforcement of a security interest created by this Commonwealth . . .” No “other” statute exists. KRS 355.9-109(3) does not apply.

Likewise, KRS 355.9-109(4) does not create an exemption for Capital Community. Subsection 4 hones in on the nature of a transaction and identifies 17 types

of transactions that are exempt from Article 9's perfection requirements. It lists no transaction applicable to Capital Community's security interest. While KRS 355.9-109(4)(q) addresses transactions involving governmental units, it only refers to "public-finance" transactions or transfers "by" a government. KRS 355.9-109(4)(q) provides:

- (4) This article does not apply to...
- (q) A public-finance transaction or a transfer **by** a government or governmental unit.

KRS 355.9-109(4)(q) (emphasis added).

This appeal does not involve a "public finance transaction" because KRS 355.9-102(b) specifically defines "public finance transaction" as a secured transaction in which "[d]ebt securities are issued" and the debtor "is a state or a governmental unit of a state." Here, it is undisputed that no one issued debt securities. Certified Tool obtained extensions of credit based on the promise of security against the credit.

The issue of first impression here, potentially affecting private lenders throughout the Commonwealth, has no relation to "debt securities" – it rather concerns the meaning of "transfers by a government or governmental unit." Other jurisdictions have held that a "transfer by a government or governmental unit" means those transactions in which the government holds the position of borrower/debtor.⁷

As the Court explained in *Bowlen v. Federal Deposit Ins. Corp.*, 815 P.2d 1013 (Colo.App. 1991),

The governmental subdivision or agency exclusion . . . covers only transactions in which the government is a debtor/borrower. See Uniform Laws Annot., Uniform Commercial Code §9-104 (Official Comment 5)

⁷ The exemptions from Article 9 currently found in 9-109 of the UCC were previously located in 9-104. KRS 355.9-109(4)(q) was formerly found in KRS 355.9-104(5). Cases that reference 9-104 analyze the exact same governmental unit exemption of the UCC currently found in Article 9-109.

(1972). *In Re Brazier Forest Products Inc.*, 106 Wash. 2d 588, 724 P.2d 970 (1986). Here, the FDIC did not act or function as the debtor, and therefore the exclusion does not apply.

See also Farmers & Merchants Nat'l Bank v. Fairview State Bank, 766 P.2d 330, 332 (Okla. 1988) (Article 9-104 (“Because no government borrowing occurred, the provision is clearly inapplicable.”)); *In re Dalcon, Inc.*, 120 B.R. 620 (Bankr.D.Mass 1990) (UCC provision excluding security interests created by government from Article 9 perfection requirements applies only to security interest created by governmental debtors, and not to private security interests approved by government); *General Cable Company v. Altek Systems, Inc.*, (*In re Altek Systems, Inc.*) 14 B.R. 144 (Bankr.N.D.Ill 1981) (Article 9-104 inapplicable because there was no government borrowing in the transaction); *State of Alaska, Division of Agriculture v. Fowler*, 611 P.2d 58 (Alaska 1980).

In *Peoples Bank and Trust Company v. Applewhite (In Re 20th Century Enterprises, Inc.)* 152 B.R. 119 (Bankr. N.D. Miss. 1992), the Court considered a lease-purchase agreement between the government – Tishomingo County – and 20th Century Enterprises that, as here, was not a true lease but an unperfected security interest. The Bank, like Delphi, made a subsequent loan and, also like Delphi, “filed appropriate financing statements as required by law perfecting its security interest in the subject equipment.” *Id.* at 122. Tishomingo County argued that it did not have to perfect its interest under the “transfer by government” exemption in Article 9. The Court disagreed because the section identical to KRS 355.9-109(4)(q) is not applicable. The pertinent transfer creating “the security interest would not be made by Tishomingo County but rather *to Tishomingo County by 20th Century.*”

Section 75-9-104(e), Miss.Code Ann., excludes transactions from coverage under the Uniform Commercial Code when the governmental agency is the debtor or borrower, **not when it is the secured creditor.**

See, In re Brazier Forest Products, Inc., 106 Wash.2d 588, 724 P.2d 970, 2 UCC Rep.Serv.2d 339 (1986), and *State of Alaska, Division of Agriculture v. Fowler*, 611 P.2d 58, 29 UCC Rep.Serv. 696 (Alaska 1980).

Id. at 123 (emphasis added). Likewise, KRS 355.9-109(4)(q) cannot exempt the government when it is the creditor as Capital Community was here.

Third, the Court of Appeals ignores the key “intent” of the statute. As the UCC Official Comments explain, an exempt transfer “by” a governmental unit **only** occurs where the government entity holds the position of borrower/debtor: “Former Section 9-104(e) [KRS 355.9-104(5) under Kentucky state law] excluded transfers by governmental **debtors.**” UCC Official Comment 9 to §9-109 [Rev] (emphasis added). Obviously, Capital Community was a lender/creditor, **not** a borrower/debtor, because under the plain language of its Agreement, Certified Tool alone was the borrower/debtor. Under the UCC Official Comments and applicable case law, this transaction cannot qualify as a “transfer by a government or governmental unit” exempt from KRS 355.9-109(4)(q).

The Court of Appeals does not address cases from other jurisdictions construing “transfer by a government,” as being only applicable to the government as debtor. Rather, the Court of Appeals points to “commentary” for the proposition that the Legislature added Subsection (4)(g) prior to July 1, 2002, due to an emergency and “to prevent Kentucky state and local government **issuers of debt** from being subject to the perfection and filing requirements of Article 9” (emphasis added) (Opinion, p. 12, App. 1). The commentary to House Bill No. 649, on which the Court of Appeals apparently relies,

Whereas Kentucky state and local government issuers of debt are now subject to the perfection and filing requirements of the revised Article 9 of the Uniform Commercial Code and on July 1, 2002, will be required to comply with these requirements **with respect to outstanding debt obligations, resulting in an increase in the burdens and costs of**

borrowing for these state and local governmental entities, an emergency is declared to exist, and this Act takes effect upon its passage and approval by the Governor or upon its otherwise becoming law.

H.B. No. 649, Section 2, 2002 Leg., Reg. Sess. (Ky. 2002) (enacted) (emphasis added).

Contrary to the law in other jurisdictions, the Court of Appeals shifts its analysis from “issuers of debt” to “issuers of assets and revenues” as being exempt under KRS 355.9-109(4)(q) (Opinion, p. 11-12). Doing so, it essentially exempts the government entirely from Article 9, a result the General Assembly could not have intended. It did not say transfers “to and by” a government; the terms of the statute are limited to “transfer by a government.” In its next sentence, the Court exempts the government as “issuers of assets and revenues,” but the latter appears nowhere in the statute or in any other case construing “transfer by a government or governmental unit.” “Issuers of debt” are not “issuers of assets and revenues.” But, with no citation, the Court of Appeals appears to view them as the same.

The Court of Appeals expands the plain meaning of a transfer “by” a government unit to include transfers “to” a government unit. If the Kentucky Legislature intended this exemption to apply to transfers **both** “to” and “by” a government unit it would have said so in KRS 355.9-109(4)(q). Article 9 governs and renders Capital Community’s unperfected security inferior. The same filing requirement for perfection should govern Capital Community, just as it applies to Delphi, so all creditors have construction notice of liens. Capital Community as creditor should be held to the same standard as any other creditor.

B. Article 9 Contains No “Public Policy” Exemption For Capital Community.⁸

While the Court of Appeals does not appear to rely on “public policy” considerations, which should be reserved for the Legislature to consider, Capital Community may rely on the trial court’s reasoning. The trial court gave Capital Community a “public policy” pass from Article 9’s filing requirements, even though no applicable statute articulates any such exemption. The recognized exemptions from Article 9 of the Kentucky UCC are set forth expressly in KRS 355.9-109(3)-(4). “Public policy” is noticeably absent.

The Circuit Court nevertheless relied on KRS Chapter 154, Subchapter 50, the Kentucky Local Industrial Development Authority Act. But this Act contains no perfection requirements for a security interest. By contrast, KRS 355.9-109(3)(b) provides that UCC Article 9 applies unless “[a]nother statute of this Commonwealth expressly governs the creation, perfection, priority, or enforcement of a security interest created by this Commonwealth or a governmental unit of this Commonwealth” (emphasis added).

On its face, Article 9 controls unless another “statute” of Kentucky “expressly” determines creation, perfection, priority or enforcement of a security interest. KRS 355.9-109(3)(b). Consistent with this statutory framework, official comments from the National Conference of Commissioners on Uniform State Laws explain that KRS 355.9-109 excludes from Article 9 “only transfers covered by another statute . . . to the extent the statute governs the creation, perfection, priority or enforcement of security interests.”

⁸ Delphi preserved this issue on Appeal in its Response to Capital Community’s Supplemental Memorandum in Support of Motion for Summary Judgment (R. 288-293), and its Memorandum In Support to Alter, Amend or Vacate (R. 326-330).

Under KRS 355.1-103(3), these official comments “represent the express legislative intent of the General Assembly and shall be used as a guide for interpretation of this chapter (KRS chapter 355).” Taken together, both the plain language of KRS 355.9-109(3)(b) as well as the official comments by the National Conference of Commissioners on Uniform State Laws to Article 9 provide that Article 9 must govern unless another statute “expressly” determines creation, perfection, priority or enforcement of a security interest.

A comprehensive review of the Kentucky Local Industrial Development Authority Act reveals that it contains no references to any exemption for perfection or priority of a security interest from Article 9. *See*, KRS Chapter 154, Subchapter 50. Nowhere within the Kentucky Local Industrial Development Authority Act (or any other statute) does it provide an alternative priority scheme for security interests afforded to development authorities like Capital Community. Simply put, KRS Chapter 154, Subchapter 50, is completely silent on creation, perfection, priority or enforcement of a security interest.

When the General Assembly intends to provide for an alternate scheme expressly in another statute, it certainly knows how to do so “expressly” as Article 9, KRS 355.9-109(3)(b) requires. For example, KRS 134.420(1) expressly gives a lien for *ad valorem* taxes “priority over any other obligation . . .” and KRS 376.160 expressly states employee wage liens “shall be superior to the lien of any mortgage or other encumbrance . . .”. KRS Chapter 154, Subchapter 50, has no comparable express provisions. The Development Authority Act therefore says nothing that “expressly” governs the creation,

perfection, priority, or enforcement of a security interest, as required to satisfy the exemption requirements of UCC Article 9. KRS 355.9-109(3)(b).

Creating an exemption for “public policy” departs from the plain language of KRS 355.9-109 and reads into Article 9 an exception that conflicts with the statute and the expressed legislative intent of the General Assembly. *See JPMorgan Chase, N.A. v. Longmeyer*, 275 S.W.3d 697, 702 & n.11 (Ky. 2009) (“It is therefore improper for a court to depart from the plain language of the statute by reading into it exceptions, limitations, or conditions which conflict with a clearly expressed legislative intent. . .”). Courts must enforce the plain language of the UCC. Doing otherwise would violate the prohibition against “adding restrictive language to [legislation] where it does not now exist.” *Bailey v. Reeves*, 662 S.W.2d 832, 834 (Ky. 1984).

Courts simply “are not at liberty to add or subtract from the legislative enactment or discover meanings not reasonably ascertainable from the language used.” *Com. v. Harrelson*, 14 S.W.3d 541, 546 (Ky. 2000). *See also, Stephenson v. Woodward*, 182 S.W.3d 162, 170 (Ky. 2005) (“[S]tatutes must be given their literal interpretation unless they are ambiguous and if the words are not ambiguous, no statutory construction is required.”) (internal quotations omitted); *Smith v. Com.*, 41 S.W.3d 458, 460 (Ky. App. 2001) (“We [the courts] are directed to follow the clear language of the statute . . .”); *Lincoln County Fiscal Court v. Dep’t. of Pub. Advocacy, Com. of Ky.*, 794 S.W.2d 162, 163 (Ky. 1990) (“Where the words of the statute are clear and unambiguous and express the legislative intent, there is no room for construction or interpretation and the statute must be given its effect as written.”); *Hurry Up Broadway Co. v. Shannon*, 102 S.W.2d 30, 31 (Ky. 1937) (“It is a cardinal rule of construction of statutes that where the

language of the statute is free from ambiguity, the exact language of the statutes will be followed”). *See also Ford Motor Credit v. Webb-Elkhorn Coal Corp.*, 775 S.W.2d 945, 946 (Ky. App. 1989) (the legislative intent expressed in the plain wording of the Uniform Commercial Code itself is controlling over a Court's notion of good public policy).

Both the Court of Appeals and the Circuit Court rely on *In re City of Moran*, 713 P.2d 451 (Kan. 1986), which involved lease-purchase agreements under the Kansas revenue bond statutes. There, the City issued bonds for the purpose of purchasing land and buildings to equip a facility that was to be leased to a cooperative association under the State's Economic Development Revenue Bond Act. *Id.* at 452-453. The City then entered into a lease agreement with the Cooperative Association for the facility, under which the City was the landlord. Seven years later, the Cooperative Association needed capital and borrowed money under the terms of a note and security agreement from its bank, which the Bank perfected by filing a financing statement. The Cooperative defaulted and thereafter a dispute arose over whether the City's interest or the Bank's perfected interest was superior.

The Kansas Court gave superiority to the City but did so for reasons that do not apply here. The Kansas revenue bond statutes were enacted before the UCC and referred to the transaction at issue as a “lease-purchase agreement.” It appears that the Court in *Moran* found the transaction to be a “lease” because otherwise the City would have exceeded its powers.

The Kentucky Local Industrial Development Authority Act is materially different from the Kansas Act and creates no conflict with Article 9. The Kentucky Local

Industrial Development Authority Act grants much broader contracting powers to a development authority:

(1) The purpose, duties, and powers of the authority shall be to:...

(d) Acquire by contract, lease, purchase, gift, condemnation, or otherwise any real or personal property...necessary or suitable for establishing industrial sites, parks, or subdivisions. The authority may dispose of any real or personal property, or rights therein, which in the opinion of the authority are no longer needed to carry out the purposes of KRS 154.50-301 to 154.50-346. **The authority may lease, sell, or convey any or all industrial sites...owned or optioned by it to any public or private organization, governmental unit, or industry** for the purpose of constructing and/or operating any manufacturing, industrial, or commercial facility.

In other words, the Kentucky Act provides that development authorities are not restricted to entering into leasing agreements for economic development. KRS 154.50-320(1)(d). Rather, under Kentucky law, the development authority has the option to “**lease, sell or convey**” industrial sites.⁹ *Id.* (emphasis added). Capital Community had the option of entering into security agreements, subject to UCC Article 9, and did so through its Agreement with Certified Tool. Capital Community simply failed to perfect its interest..

Moreover, the General Assembly amended KRS 355.9-109(3)(b) years after the Kansas Supreme Court decided *In re City of Moran* in 1986.¹⁰ The National Conference of Commissioners on Uniform State Laws rejected “public policy” exceptions to the applicability of Article 9 to prevent uncertainty in resolving competing claims to

⁹ Under KRS 154.50-310 “industrial sites” includes fixtures and equipment.

¹⁰ Notwithstanding that Capital Community’s security interest was granted prior to the effective date of the revisions to Article 9, July 1, 2001, revised KRS 355.9-109(3)(b) applies. KRS 355.9-702 provides that the provisions of revised Article 9 applies to secured transactions even if the interest in question was granted prior to July 1, 2001. *See* KRS 355.9-702.

government collateral.¹¹ See KRS 355.9-101 cmt. 4.a. (“Section 9-109 narrows the exclusion of transfers by states and their governmental units.”); see also KRS 355.9-109 cmt. 9 (Article 9 applies to security interests created by government units except to the extent that another statute governs the issue).

As one commentator explained,

Certainly, some local laws govern borrowing transactions by governmental debtors. Often times, however, these laws stop short of declaring how private lenders may perfect security interests in governmental property or how disputes will be resolved between competing interests in governmental collateral. It therefore would perhaps have been wiser to exempt transfers by governmental entities only to the extent that they were specifically governed by other state law. That is what revised § 9-109(c)(2) and (3) [Rev] [i.e. the UCC equivalent to KRS 355.9-109(3(b) and (c))] does.

9A FREDERICK H. MILLER & NEIL B. COHEN, HAWKLAND UNIFORM COMMERCIAL CODE SERIES § 9-109:10 n.3 (WESTLAW 2010) [hereinafter “Hawkland”]. In short, a governmental unit security interest is exempt from Article 9 **only** if another statute “expressly” governs its perfection and priority. Here, there is no other “express” Kentucky statute in the Kentucky Local Industrial Development Authority Act, or elsewhere, which governs the perfection or priority of Capital Community’s interest (R 305-318).

Requiring a conflicting statute that “expressly” governs perfection advances the general public policy that animates the underpinnings of the UCC, namely to simplify and clarify the law governing commercial transactions to promote predictability and certainty. See KRS 355.1-103(1); *Foley v. Production Credit Assoc. of the Fourth Dist.*, 753 S.W.2d 876, 878 (Ky. App. 1988); 1 Hawkland § 1-102:9. Adopting a vague “public

¹¹ Again, under KRS 355.1-103(3) these official comments represent the express legislative intent of the General Assembly and shall be used as a guide for interpretation of KRS Chapter 355

policy” exemption to Article 9 could increase the risk and uncertainty of collateral security for loans to borrowers who transact with economic development authorities and therefore could, in the end, stifle rather than encourage economic development.

The Circuit Court suggests that denying an exemption for Capital Community’s interest would thwart the purposes of Kentucky’s economic development statutes and erode confidence of bondholders (R. 315-316). But Capital Community could perfect its security interest in collateral by filing UCC financing statements, just as virtually all other secured creditors, like Delphi, must do. Stated differently, the law requires development authorities like Capital Community to abide by the same laws as other creditors under the perfection and recording requirements of Article 9.

Obviously, the need for predictability in enforcing collateral security for indebtedness permits lenders to assess lending risk accurately and to price such risk. If courts create “public policy” exceptions to Article 9 perfection and priority rules, uncertainty in lending could increase with respect to those borrowers. Lenders, in turn, will price such unpredictability and uncertainty when dealing with those borrowers – meaning that interest rates could rise for borrowers involved with Kentucky development authorities and, at worst, lenders will refuse to lend to such borrowers.

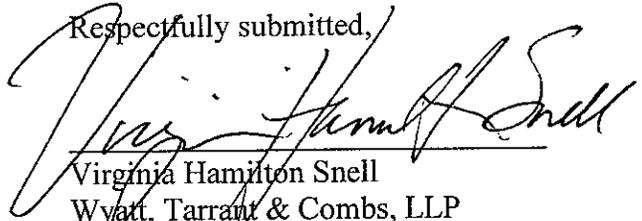
CONCLUSION

Well established rules of statutory construction compel the conclusion that Delphi’s perfected security interest trumps Capital Community’s hidden, unperfected interest. Courts should hold the government to the same filing standards applicable to private borrowers under Article 9. The express language of KRS 355.9-109(3)(b) provides that Article 9 does not apply only to the extent that another statute of this Commonwealth “expressly” governs the creation, perfection, priority, or enforcement of

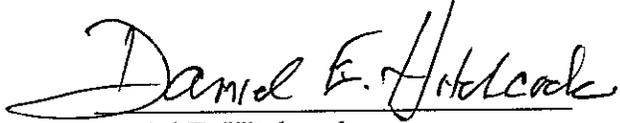
a security interest created by this Commonwealth or a governmental unit of this Commonwealth. Nowhere within the Kentucky Local Industrial Development Authority Act does it mention anything related to perfection or priority of a security interest, or exemption of same from Article 9.

And, Article 9 itself only exempts Capital Community's transaction if it is a transfer "by" a governmental unit. Capital Community did not transfer a security interest. It received a security interest that Certified Tool transferred "to" it. Capital Community failed to file a UCC Financing Statement to perfect its security interest in the Komatsu Press. Delphi complied with Article 9 and holds a perfected security interest in the Komatsu Press. Delphi therefore has priority over Capital Community to the liquidation sale proceeds. We respectfully urge the Court to reverse and hold that Delphi's perfected security interest is superior to Capital Community's unperfected interest.

Respectfully submitted,



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APPENDIX

1. Court of Appeals Opinion Rendered March 23, 2012
2. Trial Court's Opinion and Order Entered October 11, 2012
3. Trial Court's Order Entered November 23, 2010
4. "Lease" Agreement Between Capital Community and Certified Tool
5. Delphi's Security Agreement
6. Delphi's UCC Financing Statements

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