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Leveraged Finance Group Client Alert: Unauthorized UCC Filings: A Cautionary Tale In the Absence of Requisite Authority to File, a UCC Termination Statement Is Ineffective to Bring a Perfected Security Interest to an End

A recent decision by the United States Bankruptcy Court for the Southern District of New York¹ found that a UCC-3 termination statement filed on behalf of a secured creditor was not effective because it lacked the proper authorization.

The case revolved around the question of whether a UCC-1 financing statement relating to a \$1.5 billion Term Loan Facility for General Motors Corporation (GM) had been effectively terminated, despite the absence of any party's intention to terminate the statement. Had the Court found that the termination was effective, the lenders under the Term Loan Facility would have been unperfected at the time of GM's 2009 bankruptcy filing, rendering their security interest voidable under the Bankruptcy Code.² In its ruling, the Court decided in favor of the Term Loan lenders, stating that "despite the notice-filing system of the UCC, the filing of a UCC-3 termination statement does not constitute conclusive evidence that a financing statement has been effectively terminated."

The case serves as a cautionary tale that all financing parties must exercise the utmost care with respect to the filing and maintenance of UCC statements and that extra diligence may be required to confirm that when a termination statement was filed, the requisite authorization was present.

¹ The case is Official Committee of Unsecured Creditors of Motors Liquidation Company v. JPMorgan Chase Bank, N.A., 09-50026 (REG), Adv. 09-00504 (REG) (Bankr. S.D.N.Y.)

² Under Section 544 of the Bankruptcy Code, a security interest that is unperfected at the time of a bankruptcy filing may be trumped by the statutory lien of the trustee.

FACTUAL BACKGROUND

The erroneous filing giving rise to the dispute stemmed from the fact that the same financial institution acted as the agent for two unrelated GM facilities – the Term Loan Facility as well as a \$300 million Synthetic Lease Facility – and was therefore named as secured party on UCC-1 financing statements for both financings. In connection with the 2008 pay-off of the Synthetic Lease Facility, GM's counsel conducted lien searches and prepared termination statements without distinguishing between the two different financings. Consequently, several documents incorrectly listed the filing number of the UCC-1 financing statement filed with respect to the Term Loan Facility as one of the statements to be terminated. These documents were then reviewed and approved by the Agent's counsel for the Synthetic Lease Facility as well as representatives of the Agent itself. GM's counsel filed the termination statement for the Term Loan Facility lien amongst the termination statements for the Synthetic Lease Facility liens.

The error was not discovered until after GM entered bankruptcy and used a portion of its debtor-in-possession financing to pay the Term Loan Facility in full. The Committee of Unsecured Creditors then claimed that the principal lien of the secured Term Loan lenders was unperfected at the time of the bankruptcy filing and thus sought avoidance of the lien and recovery of the proceeds that had been used to satisfy the claims under the Term Loan Facility.

The Committee's claim rested on the proposition that the intent of the secured parties was irrelevant and that the burden of monitoring filings should fall on the existing secured creditor, who is in the best position to recognize and rectify any errors. Permitting inquiries into the state of mind of the existing creditor, the Committee argued, would place the burden on searchers, who will not be in a position to know whether a termination statement was authorized or not. The Agent, as representative for the secured creditors under the Term Loan Facility, contended that the lien remained perfected because the filing of the termination statement was not intended and therefore lacked the requisite authority. The existence of the UCC-3 was not dispositive, according to the Agent, because the provisions of the current UCC look to the question of authorization to establish effectiveness.

While the evidence concerning the state of mind of the parties involved conclusively established that the filing of the termination statement was never intended by anyone, the Committee and the Term Loan creditors disagreed as to the legal significance of that error and the question of what constituted "authorization." The Committee moved for partial summary judgment with respect to the perfection of the Term Loan Facility lien, and the Agent cross-moved for summary judgment.

COURT'S ANALYSIS

In its decision granting summary judgment for the Term Loan creditors, the Court sided with their contention that the intent of the secured party was relevant. The decision turned primarily on the Court's analysis of the 2001 amendments to the Uniform Commercial Code, which changed the requirements for an effective filing of UCC-3 financing statements. Under the pre-2001 regime, UCC-3 filings required the signature of the secured party, but under the UCC as amended, a filing may be made by any person that is authorized by the secured party. The Court concluded that by adding the element of authorization, a termination statement could no longer be considered to have automatic consequences under the UCC. The fact that a filing is made is not necessarily determinative since it depends on whether the filing was authorized. Where no such authorization exists, the termination is not effective.³ Although the Committee presented a number of precedents supporting the argument that mistakenly filed UCCs are legally effective, the Court found those cases inapplicable because they pre-dated the 2001 amendments.

Since the UCC does not address the issue of what constitutes authorization, the Court looked to the law of agency to determine whether GM's counsel had authority to file the UCC-3 statement. Under that analysis, the relevant question was whether GM's counsel, as an "agent" of the secured party, believed that the Agent as "principal" intended to terminate the Term Loan financing statement.

Although the Agent and its counsel had reviewed and approved a number of documents that listed the Term Loan UCC-1 filing number (but not a reference to the Term Loan specifically) as one of the liens to be terminated, as well as a draft of the termination statement, the Court did not find this sufficient to establish the necessary intent. Instead, it focused on two key facts. First, employees of GM and the Agent, as well as their respective counsels, all testified that they did not know they had terminated the unrelated financing statement and that they did not believe they had authority to do so. Second, none of the documentation produced in connection with the Synthetic Lease pay-off transaction (including emails, closing checklists, and a lease termination agreement) referenced the Term Loan Agreement, but consistently specified the Synthetic Lease.

³ Specifically, Section 9-513(d) provides for effectiveness of a termination statement upon the filing with the relevant filing office "except as otherwise provided in Section 9-510". Section 9-510(a) states that such a filing is effective "if filed by a person that may file it under Section 9-509", which in turn provides that a financing statement may be filed by a third party so long as "the secured party of record authorizes the filing." Thus, the determination of effectiveness under the UCC rests on the issue of authorization, which is not defined.

CONCLUSIONS

The Court's decision appears to raise the bar for the effective termination of UCC financing statements. No longer can it be assumed that a UCC-3 filing is effective, even where the secured party may appear to have blessed the filing. In this case, the Court concluded that Agent's failure to object to erroneous documents or to search the referenced financing statement number were not acts that constituted intent or authorization. Even a written statement of general approval by the Agent's counsel could not be deemed to be an authorization because neither the writer nor the Agent intended to terminate the UCC-1 or knew that it had been terminated. "When the authorization underlying a previously filed termination statement matters to a subsequent Lender", the Court asserted, "the Lender can simply include any necessary further inquiry as part of its due diligence." Therefore, care should be taken to establish that the required authorization has been properly documented in the form of a pay-off letter or similar agreement and that the scope of the applicable language sufficiently identifies the relevant lien or obligations.

However, given the fact-based analysis required to determine the question of authorization, it is difficult to forecast how the principles established in this case might be applied in future situations. The Court's conclusions were drawn in the context of undisputed testimony from all parties that the intention was to terminate the Synthetic Lease and not the Term Loan Facility. Under another set of circumstances, however, such a mistake could be much more damaging. Therefore, this outcome should be taken as a reason for secured parties to be more, not less, vigilant with respect to the filing, maintenance and termination of UCC statements.

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