Client Alert

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Second Circuit to Lenders: Get Your UCC Filings Right

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INTRODUCTION

On January 21, 2015, the U.S. Court of Appeals for the Second Circuit issued an opinion regarding a mistaken UCC-3 termination statement that all loan market participants should consider carefully. The Second Circuit held that a secured party's lack of intent to terminate a properly filed UCC-1 financing statement, which perfected its lien granted in connection with a secured financing, is not sufficient to deem ineffective the filing of a UCC-3 termination statement with respect thereto. Even absent the intent to terminate, the actions of the secured party and its lawyers prior to the filing of the UCC-3 termination statement were, in this case, sufficient as a legal matter to form the requisite authority to file under Article 9 of the Uniform Commercial Code (the "UCC"). As a result of the Second Circuit's ruling, a $1.5 billion prepetition financing does not have a perfected security interest on the intended collateral, and the secured creditor may not be repaid in full as part of the debtors' bankruptcy. For general unsecured creditors, the secured creditor's error created a significant source of additional distributable value, potentially improving their recoveries on their prepetition claims.

On February 4, 2015, the secured party filed a petition with the Second Circuit seeking a rehearing *en banc*. We anticipate that it will take at least one month for the Second Circuit to rule on the secured party's rehearing request.

UNDERLYING COURT DECISIONS

Bankruptcy Court

This matter dates back to the summer of 2009 when the official committee of unsecured creditors (the "Committee") in the Chapter 11 bankruptcy cases of General Motors Corporation *et al*. (collectively, "GM") commenced an adversary proceeding in the U.S. Bankruptcy Court for the Southern District of New York against JPMorgan Chase Bank, N.A., as agent ("JPM") and members of a term loan lending syndicate. The Committee sought a determination from the Bankruptcy Court that a lien securing a 2006 $1.5 billion syndicated term loan (the "Term Loan") to GM was not perfected as a matter law because the UCC-1 financing statement that perfected JPM's lien granted under the Term Loan had been properly terminated prior to the commencement of GM's bankruptcy cases.[2]

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[2] *See Off. Comm. of Unsecured Creditors of Motors Liquidation Co. v. JPMorgan Chase Bank, N.A., et al. (In re Motors Liquidation Co.)*, 486 B.R. 596, 602-03 (Bankr. S.D.N.Y. 2013).

Prior to entering into the Term Loan, GM was also a party to a synthetic lease (the "Synthetic Lease"), and JPM was also the administrative agent for the Synthetic Lease and identified on the associated UCC-1s as the secured party of record.[3] GM paid off the Synthetic Lease in 2008. Two law firms involved in the Term Loan and Synthetic Lease financing reviewed the results of a search of UCC-1 financing statements recorded against GM.[4] The search results showed three UCC-1s filed against GM in Delaware, each with a unique filing number. A UCC-3 was prepared for each of the UCC-1s. However, only two of the UCC-1s related to the Synthetic Lease; the third UCC-1 related to the Term Loan (the "Unrelated UCC-3").[5] The Unrelated UCC-3 was filed, together with the UCC-3s for the Synthetic Lease.

The goal of the Committee's adversary proceeding was to convert the Term Loan creditors' secured claim into an unsecured claim. If successful, the claims of the Term Loan creditors' would not be paid prior to the unsecured creditors with the proceeds of the Term Loan collateral. Rather, proceeds of the Term Loan collateral would be shared *pari passu* among the Term Loan creditors and the unsecured creditors, thereby significantly increasing the recoveries of the unsecured creditors.

The UCC, as amended in 2001, does not require the execution of a UCC-3 termination statement by the secured party; rather, the filing may be done without a signature by anyone, provided that the filing has been authorized by the secured party. If the requisite authorization is lacking, then the termination is ineffective.[6] As noted by the Bankruptcy Court, three sections of Article 9 of the UCC are relevant to this dispute: (i) 9-509(d), which provides that a person is entitled to file an amendment to a financing statement if the secured party of record authorizes the filing; (ii) 9-510(a), which provides that a filed record is effective only to the extent that it is filed by a person who may file it under 9-509; and (iii) 9-513(d), which provides that, except as otherwise provided in section 9-510, upon the filing of a termination statement with the filing office, the financing statement to which the termination statement relates ceases to be effective.[7]

Two fundamental facts were undisputed: (i) neither counsel to GM or JPM nor their respective clients knew that the UCC-1 filing number shown on the Unrelated UCC-3 was actually the filing number for the UCC-1 for the Term Loan; and (ii) neither GM nor the lenders under the Term Loan ever intended to affect the UCC-1 filings for the Term Loan in any way. In short, the parties to the adversary proceeding did not dispute that the filing of the Unrelated UCC-3 was an error caused by the failure of JPM and its counsel to realize that the Unrelated UCC-3 related to the Term Loan. Notwithstanding the absence of intent to effect the lien securing the Term Loan, the Bankruptcy Court had to decide whether the UCC-1 perfecting JPM's lien in the Term Loan collateral ended with the filing of the Unrelated UCC-3.[8] Since GM's counsel filed the Unrelated UCC-3, Judge Gerber's ruling centered on whether GM acted as JPM's authorized agent to complete the filing of the Unrelated UCC-3. JPM

[3] *See Official Committee of Unsecured Creditors of Motors Liquidation Company v. JPMorgan Chase Bank, N.A., et al. (In re Motors Liquidation Co.)*, 755 F.3d 78, 79 (2d Cir. 2014).

[4] *Id.* at 80.

[5] 486 B.R. at 603.

[6] *Id.* at 617.

[7] *Id.* at 618, notes 68-70.

[8] *Id.* at 604.

argued that the absence of its understanding that one of the UCC-3s to be filed in connection with the termination of the liens for the Synthetic Lease financing would also terminate the lien of the Term Loan meant that it did not give GM the authority to file the UCC-3. On the other hand, the Committee argued that JPM's subjective intent was not relevant to its grant of authority to GM, and therefore, the prepetition lien termination was authorized and valid.

The Honorable Robert E. Gerber, U.S.B.J., disagreed with the Committee and held that the Unrelated UCC-3 was ineffective because it was not authorized under the common law doctrines of actual authority, apparent authority, ratification or implied authority.

Actual Authority

"Actual authority exists when an agent has the power 'to do an act or to conduct a transaction on account of the principal which, with respect to the principal, he is privileged to do because of the principal's manifestation to him.'"[9] The four documents considered by the Bankruptcy Court to determine the scope of authority given by JPM to GM were: (i) the Synthetic Lease Termination Agreement,[10] (ii) the Synthetic Lease Closing Checklist, (iii) the Unrelated UCC-3, and (iv) the Synthetic Lease Escrow Agreement. The Bankruptcy Court found that, through the Synthetic Lease Termination Agreement, JPM authorized GM to file terminations of existing financing statements only with respect to the specific properties that were the subject of the Synthetic Lease.[11] GM's counsel prepared the Synthetic Lease Closing Checklist – a six-page listing of several dozen documents to be executed in connection with the Synthetic Lease payoff. While JPM and its counsel reviewed the document, and even though the document included the unique filing number of the UCC-1 for the Term Loan, the Bankruptcy Court did not find that any element of the document provided authorization to file the Unrelated UCC-3, especially as the document made no mention of the Term Loan.[12] With regards to the Unrelated UCC-3, the Bankruptcy Court found that, even though JPM's counsel reviewed and approved (or failed to object to) it, the Unrelated UCC-3 was not itself an authorization to terminate the Term Loan UCC-1 because it did not call for the signature of the secured party's principal or contain any sort of express granting clause.[13] The Bankruptcy Court then found that, while the Synthetic Lease Escrow Agreement was an authorization to implement the letter's joint directions with respect to the Synthetic Lease, it did not give express instructions or authority to GM's counsel to do anything, including anything affecting the Term Loan.[14] When considering these documents together with all of the relevant

[9] *Id.* at 621*, quoting Hidden Brook Air, Inc. v. Thabet Aviation Int'l, Inc.*, 241 F. Supp. 2d 246, 260 (S.D.N.Y. 2002) (citations omitted).

[10] The Termination Agreement provided, in pertinent part, "[T]he Administrative Agent [JPMorgan] and the Lessor do hereby (x) release all of their Liens …against the Properties created by the Operative Agreements [of the Synthetic Lease], (y) acknowledge that such Liens and Lessor Liens are forever released, satisfied and discharged and (x) [*sic*] authorize Lessee to file a termination of any existing Financing Statements relating to the Properties [of the Synthetic Lease]." 755 F.3d at 81.

[11] *Id.* at 624.

[12] *Id.* at 625.

[13] *Id.* at 625-26.

[14] *Id.* at 626-27.

circumstances, Judge Gerber viewed this as nothing more than a "payoff of a real estate financing under which parties intended to bring the real estate financing liens to an end, without any intention to affect anything else."[15]

Judge Gerber also noted that he could not find the filing of the Unrelated UCC-3 to have been authorized under the doctrine of actual authority because GM did not have the requisite understanding. According to the Bankruptcy Court, "[a]n agent does not have actual authority to do an act if the agent does not reasonably believe that the principal has consented to its commission,"[16] and this was affirmed by the evidence that no one at GM actually believed that it had been authorized to terminate JPM's financing statement with regards to the Term Loan.

Apparent Authority

"Apparent authority is the power held by an agent or other actor to affect a principal's legal relations with third parties when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal's manifestations."[17] In light of the fact that there were no statements to third parties with regards to the Term Loan by the principal (i.e., JPM), the Bankruptcy Court could not find any indicia of apparent authority being given to the agent (i.e., GM).

Ratification

The *Restatement of Agency* defines ratification as "the affirmance of a prior act done by another, whereby the act is given effect as if done by an agent acting with actual authority."[18] Three elements must be satisfied for there to be ratification: (i) affirmance of a prior act,
(ii) knowledge of material facts involved in the original act, and (iii) acceptance of the benefits of a transaction. Judge Gerber found each of these elements to be missing and, therefore, did not find any indicia of ratification by JPM of GM's filing of the Unrelated UCC-3.

Implied Authority

Implied authority means "either (1) to do what is necessary, usual, and proper to accomplish or perform an agent's express responsibilities or (2) to act in a manner in which an agent believes the principal wishes the agent to act based on the agent's reasonable interpretation of the principal's manifestation in light of the principal's objectives and other facts known to the agent."[19] While GM clearly had the implied authority to file the UCC-3s for the Synthetic Lease, Judge Gerber ruled that GM did not have the implied authority to do tasks other than those that were appropriate. Accordingly, the filing of the Unrelated UCC-3 was neither necessary, usual nor proper in order to terminate the UCC-1s related to the Synthetic Lease.

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[15] *Id.* at 629.

[16] *Id.* at 630.

[17] *Id.* at 634, *citing Restatement (Third) of Agency*, § 2.03.

[18] *Id.* at 635, *quoting Restatement* § 4.01(1).

[19] *Id.* at 637, *citing Restatement* § 2.01.

At the conclusion of his decision, Judge Gerber took the unusual step of approving this matter for direct certification to the U.S. Court of Appeals for the Second Circuit pursuant to 28 U.S.C. § 158. In light of the potential impact of this decision on distributions to GM's unsecured creditors as well as its impact on distributions to secured creditors, together with the fact that the decision was one of law based on a set of undisputed facts, Judge Gerber noted his belief that this matter warranted prompt attention by the Second Circuit and did not necessitate intermediate appellate review by the U.S. District Court for the Southern District of New York.[20]

Second Circuit's Preliminary Consideration

Fifteen months after Judge Gerber issued his decision, the Second Circuit issued a preliminary opinion on the matter but did not come to a final decision. Rather, the Second Circuit stated that its analysis required that two questions be taken up separately. As a result, the Second Circuit certified a question of first impression to the Supreme Court of the State of Delaware dealing with Delaware's adaptation of Article 9 of the Uniform Commercial Code. The certified question was:

> *Under UCC Article 9, as adopted into Delaware law by Del. Code Ann. Tit 6, art. 9, for a UCC-3 termination statement to effectively extinguish the perfected nature of a UCC-1 financing statement, is it enough that the secured lender review and knowingly approve for filing a UCC-3 purporting to extinguish the perfected security interest, or must the secured lender intend to terminate the particular security interest that is listed on the UCC-3?*

Once it received the answer from the Supreme Court of Delaware, the Second Circuit could then decide the second question – "Did JPMorgan grant to [GM's counsel] the relevant authority – that is, alternatively, authority to either terminate the Main Term Loan UCC-1 or to file the UCC-3 statement that identified that interest for termination?"[21]

Certification to the Delaware Supreme Court[22]

Four months after the Second Circuit certified its question to the Supreme Court of the State of Delaware, the Delaware high court provided its answer –

> *[F]or a termination statement to become effective under §9-509 and thus to have the effect specified in §9-513 of the Delaware UCC, it is enough that the secured party authorizes the filing to be made, which is all that §9-510 requires. The Delaware UCC contains no requirement that a secured party that authorizes a filing subjectively intends or otherwise understands the effect of the plain terms of its own filing.*

The Delaware court found the relevant sections of Article 9 of the Delaware UCC to be unambiguous and was not willing to accept JPM's argument that subjective intent to file is required. The Delaware court placed the onus on the secured party (i.e., JPM) to be responsible for its termination statements. In particular, it noted that "[a]

[20] *Id.* at 646-48.

[21] 755 F.3d at 84.

[22] *See Off. Comm. of Unsecured Creditors of Motors Liquidation Co. v. JPMorgan Chase Bank, N.A.*, 103 A.3d 1010 (Del. 2014).

secured party is the master of its own termination statement; it works no unfairness to expect the secured party to review a termination statement carefully and only file the statement once it is sure the statement is correct."[23] Moreover, from a public policy perspective, the Delaware court stated that "[t]o hold that parties cannot rely upon authorized filings unless the secured party subjectively understood the effect of its own action would disrupt and undermine the secured lending markets."[24]

Opinion from the Second Circuit[25]

Once it received the answer from the Delaware Supreme Court to its first question, the Second Circuit was left to decide whether JPM granted GM's counsel the relevant authority to terminate the Unrelated UCC-3. The Second Circuit decided that JPM did provide the requisite authority to GM's counsel, reversed the Bankruptcy Court's grant of summary judgment for JPM and remanded the matter back to the Bankruptcy Court to enter partial summary judgment for the Committee as to the termination of the Term Loan UCC-1.

Citing to the *Restatement of Agency*, the Second Circuit stated that "[a]ctual authority … is created by a principal's manifestation to an agent that, as reasonably understood by the agent, expresses the principal's assent that the agent take action on the principal's behalf."[26] Contrary to Judge Gerber's analysis, and in line with the answer provided by the Delaware Supreme Court, the Second Circuit placed less emphasis on JPM's subjective understanding of the effect of filing the Unrelated UCC-3 and, instead, focused on JPM's manifestations to GM, as its agent. The Second Circuit focused on the fact that neither a senior officer of JPM nor its outside counsel (both of whom reviewed the Unrelated UCC-3 and had the information necessary to discover the error) expressed any concern with the draft of the Unrelated UCC-3 or the references to it in Closing Checklist for the Synthetic Lease payoff, and with the fact that JPM's counsel assented to the draft of the Escrow Agreement (which specified that the set of three UCC-3 termination statements would be filed). These facts led the Second Circuit to rule that "although JPMorgan never intended to terminate the Main Term Loan UCC-1, it authorized the filing of a UCC-3 termination statement that had that effect."[27]

Petition for Rehearing *En Banc*[28]

Rule 40 of the Federal Rules of Appellate Procedure allows a party to seek rehearing of a court's decision. The petitioner must state with particularity the points of law or fact that it believes the court has overlooked or

[23] *Id.* at 1016

[24] *Id.*

[25] *See Off. Comm. of Unsecured Creditors of Motors Liquidation Co. v. JPMorgan Chase Bank, N.A.*, No. 13-2187, 2015 WL 252318 (2d Cir. Jan. 21, 2015).

[26] *Id.* at *5, *quoting Restatement* § 3.01.

[27] *Id.*

[28] *See* Petition for Rehearing – Appellee, *Off. Comm. of Unsecured Creditors of Motors Liquidation Co. v. JPMorgan Chase Bank, N.A.*, No. 13-2187 (2d Cir. Feb. 4, 2015).

misapprehended.[29] The Second Circuit may either: (A) make a final disposition of the case without reargument; (B) restore the case to the calendar for reargument or resubmission; or (C) issue any other appropriate order.[30]

Contrary to the Second Circuit's ruling, JPM argues that it did not authorize the filing of the Unrelated UCC-3 because the Synthetic Lease Termination Agreement did not authorize GM to include any other property or collateral in a termination statement other than the "properties" that were the subject of the Synthetic Lease. JPM argues that the Second Circuit's decision is devoid of the necessary facts that evidence a "direct manifestation" of authority to support a finding that JPM consented to the filing. Therefore, JPM argues that the Second Circuit's decision contradicts the well-established principle of agency law that "[a]n agent does not have actual authority to do an act if the agent does not reasonably believe that the principal has consented to its commission."[31] JPM also criticizes the Second Circuit for ignoring the critical question of whether the law firm handling the Synthetic Lease for JPM had authority to terminate the UCC-1 for the Term Loan security interest. In JPM's opinion, its law firm did not have such authority. As a result, any action by JPM's law firm handling the Synthetic Lease transaction that also affected the Term Loan would have been outside that law firm's scope of authority and thereby a nullity.[32] In sum, JPM argues that the matter must be reheard because if it is left to stand, the Second Circuit's ruling will endorse a "rule that binds principals to action taken by agents acting well outside the scope of their authority [that will] foist intolerable risks on businesses."[33]

PRACTICE POINTERS

Regardless of the outcome of JPM's request for rehearing, the clear and obvious lesson of this case for secured lenders is to make sure UCC financing statements are perfect. It is common practice for adverse creditors in a bankruptcy case to investigate whether other creditors properly perfected their prepetition liens. This case gives adverse creditors more ammunition to win these adversarial suits. As this case shows, mistakes are made. Secured lenders should create procedures to ensure their filings are correct and to check the accuracy of filings, particularly when their borrowers are in financial distress. Otherwise, they can find themselves unable to fully recover from their borrowers in a bankruptcy proceeding and having to share the proceeds of their prepetition collateral with adverse creditors.

[29] *See* Fed.R.App.P. 40(a)(2).

[30] *See* Fed.R.App.P. 40(a)(4).

[31] *See* Petition for Rehearing – Appellee at 8, *quoting Restatement* § 2.02 cmt. e.

[32] *Id.* at 11.

[33] *Id.* at 14.

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