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UCC LIEN TERMINATION ERROR MAY RESULT IN HUGE LOSS FOR LENDER

The legal principles governing corporate finance are often complex. Sometimes, however, the simplest of errors can be the most costly. Such was the case with a large syndicated secured loan made to General Motors. Due to a simple filing error, what had always been intended by the lender and borrower to be a secured loan will be treated as unsecured.

The Second Circuit Opinion in Motors Liquidation

On January 21 the Second Circuit issued a significant opinion arising out of the General Motors bankruptcy: *In re Motors Liquidation*, 13-2187 (2d Cir. Jan. 21, 2015). This opinion demonstrates the dire consequences of filing a UCC-3 lien termination statement in error.

A major bank served as the agent (the Bank) on two distinct credit facilities involving General Motors. The first was a US$300 million synthetic lease entered into in 2001, which was secured by real estate. The second was a US$1.5 billion syndicated term loan entered into five years later, which was secured by other GM assets.

In September 2008, as the synthetic lease financing was nearing maturity, GM requested its counsel to prepare the documents necessary to repay the lenders and release the security interests in GM's property. After review of three public lien filings listing the Bank as secured party, GM's counsel erroneously prepared three UCC-3 termination statements. The error was that only two of the UCC-1s of record related to the collateral securing the synthetic lease, while the third UCC-1 related to collateral securing the completely distinct term loan that was still in effect. The three UCC-3 termination statements prepared by GM's counsel were later reviewed by the Bank and its counsel, but no one noticed the error. It was undisputed that the Bank consented to all three UCC-3 termination statements being filed when the synthetic lease was repaid. However, the Bank clearly did not knowingly intend to authorize a release of its liens securing the term loan.

The mistake went unnoticed until General Motors filed for bankruptcy in 2009. The General Motors Creditors Committee filed an action seeking a declaration that, despite the unintended release of collateral, the UCC-3 was effective to terminate the term loan security interest. Section 9-509(d)(1) of the UCC provides that a person may file an amendment to a UCC financing statement if the "secured party of record authorizes the filing."

The Bankruptcy Court concluded that the UCC-3 termination was "unauthorized" under the theory that the Bank only intended to terminate its liens securing the synthetic lease and did not intend to terminate its liens securing the separate term loan. An appeal to the Second Circuit followed.

The Second Circuit characterized the question before it as whether the secured lender must "authorize the termination of the particular security interest that the UCC-3 identifies for termination, or is it enough that the secured lender authorizes the act of filing a UCC-3 statement that has that effect?" Delaware law applied and, because the question had never been addressed under Delaware law, the Second Circuit "certified" that question to the Delaware Supreme Court. The latter court responded with an opinion (reported at 2014 Del. LEXIS 491 (Del. Oct. 17, 2014)) holding that, under the Delaware UCC, so long as the secured creditor authorizes the filing of a UCC-3 termination statement, then that filing is effective regardless of whether the secured party subjectively intends that filing to result in a lien termination.

With that interpretation of the UCC having been made by the highest Delaware state court, the Second Circuit reached the question of whether the Bank had "authorized" the filing of the UCC-3 that mistakenly terminated the lien securing the term loan. The Second Circuit noted that "what [the Bank] intended to accomplish… is a distinct question from what actions it authorized to be taken on its behalf." The court concluded that the Bank and its counsel knew that upon the repayment of the synthetic lease, General Motors' lawyers were going to file the three termination statements, including the one that related solely to the term loan collateral and that the Bank "reviewed and assented to the filing of that statement. Nothing more is needed." Accordingly the Bank's liens that had originally secured the term loan were avoided in favor of the unsecured creditors, and the Bank's US$1.5 billion dollar secured claim will now be treated as a general unsecured claim.

The General Motors opinion comes on the heels of another circuit court's decision that refused to overlook errors made by secured lenders. In *State Bank of Toulon v. Covey (In re Duckworth)*, 14-1561 (Nov. 21, 2014), the bank's security agreement stated that it secured a note dated December 13, 2008, when the note was actually dated December 15, 2008. Both the bank and the borrower intended that the lien granted under the security agreement would secure the December 15 note. While the bankruptcy court held that the mistaken reference in the security agreement would not defeat the bank's security interest, the Seventh Circuit disagreed and held that the security agreement would be enforced as written, i.e., securing a non-existent note. Accordingly, like the secured lender in *General Motors*, the bank in *Duckworth* was left with a general unsecured claim.

Implications

In *General Motors*, the bankruptcy court had been willing to overlook the errors made by the secured lender. On appeal, however, the Second Circuit was not so forgiving. The *General Motors* opinion teaches that a failure to exercise proper care when consenting to the filing of UCC-3 termination statements can result in grave consequences. Notably the Seventh Circuit's opinion indicates that the loan documentation on the Duckworth loan had been prepared by a bank employee and without the assistance of outside legal counsel. The necessity for careful drafting at the loan inception phase, as well as careful management of UCC-1 filings and terminations are forcefully demonstrated by these opinions.

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