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Client Alert

Current Issues Relevant to Our Clients

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Court Finds Mistaken Filing Terminates Security Interest Securing $1.5 Billion Loan

As discussed in our previous client alert, Delaware Supreme Court Rules That A Mistaken Filing Can Terminate Security Interest, litigation over whether $1.5 billion in prepetition loans to GM were secured or unsecured has been pending before the Second Circuit Court of Appeals. The Second Circuit recently issued a decision holding that although the secured party did not intend to terminate the security interest, the filing of a mistaken termination statement, where the secured party was provided copies of the mistaken termination statement and a checklist listing the filings to be terminated, was nevertheless effective to terminate the security interest.

Facts Leading up to the Second Circuit Decision

In September 2008, GM repaid a secured $300 million synthetic lease facility. In connection with the repayment of that facility, GM's counsel prepared and then filed UCC termination statements terminating the security interest held by the secured party of record, JPMorgan. One of the termination statements, however, inadvertently included a security interest held by JPMorgan in its capacity as a secured party for a totally unrelated $1.5 billion secured term loan facility. Although the payoff documents, including the termination statements, were reviewed by GM, JPMorgan and their respective counsel, this mistake went unnoticed until GM's bankruptcy filing in 2009.

The unsecured creditors committee in GM's chapter 11 case brought an action to claw back amounts the term loan lenders had been paid during the bankruptcy proceeding and sought a determination that the filing of the mistaken termination statement was effective to render the term loan lenders unsecured.

The Bankruptcy Court held that the filing was unauthorized and therefore not effective to terminate the term loan security interest.[1] The Second Circuit, on appeal, found that there were two closely related questions: (1) what precisely must a secured party authorize for a termination statement to be effective, and (2) did JPMorgan grant to GM's counsel the relevant authority to file the mistaken termination statement.

The Second Circuit sought the assistance of the Delaware Supreme Court in answering the first question - for a termination statement to be effective, must a secured party intend to terminate a particular security interest listed on the termination statement or was it enough that the secured party review and knowingly approve for filing the termination statement purporting to extinguish the security interest? The Delaware Supreme Court answered that if the secured party approves the filing of a termination statement, then that filing is effective regardless of whether the secured party subjectively intends or understands the effect of that filing.[2]

The Second Circuit Decision

After receiving the answer to the first question, the Second Circuit issued a decision answering the second question in the affirmative and concluding that JPMorgan had given GM's counsel the authority to file the mistaken termination statement.

In its decision, the Second Circuit made a distinction between JPMorgan's subjective intent and what action it actually authorized. The court noted that JPMorgan and its counsel had an opportunity to review and had approved a closing checklist (which listed the termination statements by filing number, including the mistaken termination statement), the termination statements themselves, as well as an escrow agreement which instructed the escrow agent to forward the termination statements to GM's counsel for filing upon repayment of the synthetic lease facility. Based on these facts, the Second Circuit concluded that although JPMorgan never intended to terminate the security interest securing the term loan, it nevertheless authorized the filing of a mistaken termination statement that had that effect.[3]

What Next – Do the Term Lenders Have Any Recourse against the GM Estate?

The Second Circuit sent the case back to the Bankruptcy Court, with instructions directing the Bankruptcy Court to enter partial summary judgment in favor of the unsecured creditors committee on the issue of the effectiveness of the termination of the term lenders' security interest.[4] What remains to be determined is how much the term lenders must disgorge to the GM estate. If the term lenders had other collateral securing the term loans that was properly perfected prior to the bankruptcy filing (e.g. real estate, deposit accounts or securities accounts perfected by control, titled vehicles) and that was not affected by the filing of the mistaken termination statement, then they would be entitled to keep amounts equal to the value of such collateral. After the term lenders disgorge any amounts they were not entitled to receive, they would be allowed to assert a general unsecured claim against the GM estate equal to the amount disgorged.

How Does This Ruling Impact Secured Lenders?

Outside of the bankruptcy context, a secured lender may be able to correct a mistaken terminations by filing a corrective statement or a new filing or both.[5] But where a bankruptcy case is filed before the mistake is discovered or remedied, a secured lender will be unable to correct the mistake. The automatic stay of the Bankruptcy Code prevents creditors from taking action to perfect an unperfected security interest in collateral securing a prepetition claim.[6] In addition, the Bankruptcy Code confers upon a bankrupt debtor or trustee the power to avoid unperfected security interests by giving it the status of a "hypothetical lien creditor" and the power to avoid transfers of property that is voidable by such lien creditor.[7] The Second Circuit's decision makes it clear that as long as the actual "act" of filing is authorized, a party's subjective intent or understanding of both the contents and effects of that filing, even if mistaken, does not matter in the bankruptcy context.[8]

However harsh this result may be for the secured lenders, we note that this decision is consistent with a recent ruling out of the Seventh Circuit involving a bankruptcy case that voided a security interest held by a lender who had made a mistake in a security agreement by incorrectly identifying the debt to be secured and listing the wrong date for the underlying note that was to be secured.[9]

Accordingly, before a secured creditor with multiple transactions involving the same debtor or debtors authorizes the filing of amendments to UCC financing statements (and especially termination statements), it will need to be more vigilant in reviewing the collateral documents and UCC filings and may want to consider additional operational controls to assure that proposed filings effect the desired results. Only after conducting such a review should a secured creditor then carefully grant authorization to file amendments changing or releasing collateral.

Secured creditors with multiple transactions may want to consider maintaining a master list of lien filings for each transaction, and adopting procedures for checking any terminations against that list (with special approvals for any filings not on that list) or themselves generating the authorization to file only from their master list to prevent mistakes, like the one here, from occurring. On the other hand, although the result of the Second Circuit's decision is a harsh one for the term lenders involved, third parties can be more confident that they can rely on the plain terms of authorized public filings without looking behind the face of the filings.

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1 *In re Motors Liquidation Co.*, 486 B.R. 596, 647–48 (Bankr. S.D.N.Y. 2013).

2 *Official Comm. of Unsecured Creditors of Motors Liquidation Co. v. JPMorgan Chase Bank, N.A.*, 103 A.3d 1010, 1015 (Del. 2014).

3 *Official Committee of Unsecured Creditors of Motors Liquidation Co. v. JPMorgan Chase Bank N.A.,* Case No. 13-2187, 2015 WL 252318, at *5 (2d Cir. Jan. 21, 2015).

4 JPMorgan filed a petition on February 4, 2015 requesting that the full Second Circuit rehear the case; the request for a rehearing is currently pending.

5 Secured parties may still be subject to preference or other avoidance claims in the event of a subsequent bankruptcy filing by the borrower.

6 Although not applicable to the GM case, certain exceptions to the automatic stay may apply in other instances that permit creditors to take action to perfect or continue the perfection of a security interest in collateral after the commencement of a bankruptcy proceeding.

7 Under the UCC, an unperfected security interest is subordinate to the rights of a person who becomes a lien creditor before the earlier of the time the security interest is perfected or a signed security agreement describing the collateral and a financing statement has been filed.

8 The Second Circuit could perhaps have relied on Section 1-103 of the UCC (which provides for the continued applicability of general principles of law and equity, including mistake and other validating or invalidating causes, to commercial transactions) to lessen the harsh result of the decision for the secured lenders. However, the court came down on the side of predictability and reliance on publically-filed documents.

9 *State Bank of Toulon v. Covey (In re Duckworth), No. 14-156*1, 2014 WL 7686549, at *2 (7th Cir. Nov. 21, 2014) (finding UCC "directs us to enforce the agreement according to its terms").

For More Information

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