

WHY ONE COURT CASE IS COMPELLING FIRMS TO REVIEW THEIR DUE DILIGENCE POLICIES ON UCC FILINGS



“Law firms and businesses across the country were provided with a high-profile reminder of the necessity of thorough due diligence following a recent court decision.”

Earlier this year, The US Court of Appeals for the Second Circuit handed down a decision that had direct impact on due diligence conducted pursuant to Article 9 of the Uniform Commercial Code. This important decision led to numerous headlines, blog posts, and related commentary. It also changed the atmosphere within many law firms, with many putting together internal teams and having formal discussions, to promote the development of stronger and more effective due diligence practices. In what is normally the very predictable world of secured transactions under Article Nine, things just got a lot more interesting!

FACTS:

In the aforementioned case, *In Re: Motors Liquidation Company*, Case Number 13-2187, the court addressed several issues surrounding the filing of a termination statement, including issues surrounding a party's authority to file a termination statement, as well as the relevance of the secured party's intent when filing.

This form (a UCC-3 Amendment form) was part of a group of three similar terminations being prepared in the GM bankruptcy proceeding as the loan agreements were reworked. Only one of the filings was at issue in this case.

In September, 2008, General Motors contacted its legal counsel to assist with the preparation of financing documents relating to several loan agreements, including a synthetic lease and several broader loan agreements that were being reworked during the ongoing bankruptcy proceedings. In particular, a Synthetic Lease agreement was going to be paid by GM, which required UCC termination statements to be filed at the time of the payoff. The task of preparing these termination agreements fell to a paralegal at GM's law firm. The paralegal prepared the termination statements, which were subsequently reviewed by GM's legal counsel, the secured party's law firm, and finally, the secured party itself. The documents were all approved.

Unfortunately, one of the termination statements should not have been prepared, as it terminated the over-arching loan agreement (a \$1.5 billion loan), which was separate from the synthetic lease and not part of the proceedings. The paralegal and managing associate at GM's law firm was unaware of this distinction. The mistake was discovered only after GM filed for bankruptcy in 2009.

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As this case unfolded, the court addressed the issue of authority under Article Nine of the UCC. Specifically, the court found that UCC 9-509(d)(1) provides that a UCC-3 amendment filing (which includes termination statements) is effective ONLY if “the secured party of record authorizes the filing.” The secured party articulated in court proceedings that it never intended for the termination statement relating to the loan agreement to be filed, nor did it at any time authorize any party to file the termination statement on its behalf.

The Bankruptcy Committee maintained that UCC 9-509(d)(1) only requires the secured party to *authorize* the act. The Committee argued that the Article 9 statutory scheme does not permit any consideration of whether the secured party subjectively intends to terminate. In this case, the secured party clearly authorized the filing of the termination statement, despite the fact that it was not their intention to do so.

DECISION:

The Court addressed both the issues: First, whether the secured party's intent should be considered as it relates to the filing of UCC records, and second, the relationship between a secured party's authorization to file and an unintended filing made under that authorization.

On the first issue, the court relied upon a previous interpretation from the Delaware Supreme Court. In the prior case, the Delaware Supreme Court stated that if the secured party of record *authorizes* the UCC-3 termination statement, the filing is effective, regardless of whether the secured party SUBJECTIVELY intends or understands the effect of the filing. The Court further stated: Even if the statute were ambiguous, we would be reluctant to embrace secured party's proposition. Before, a secured party authorizes the filing of a termination statement, it ought to review the statement carefully and understand which security interests it is releasing and why. If the parties could be relieved from the legal consequences of their mistaken filings, they would have little incentive to ensure the accuracy of the information contained in their UCC filings.

The second issue was whether the secured party “authorized” the termination? The secured party argued that its legal counsel, as well as the legal counsel representing GM, exceeded its authority. They argued that since the secured party only authorized the termination of the Synthetic Lease, and the other loans were not part of that transaction, that the termination statement related to the overarching loan

should be unauthorized and therefore legally ineffective. The sole aim of this endeavor was to unwind and terminate the synthetic lease. Other loan agreements were not part of the transaction.

The Court looked at the actions of the secured party. GM's legal counsel created a closing checklist, as well as an Escrow Agreement, that included the erroneous UCC-3. These documents were reviewed by both the secured party's legal counsel and the secured party itself. There was also an email exchange between the law firms regarding the documents, and no objections were ever raised regarding this termination statement.



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Thus, in the Court's opinion, while the secured party never intended to terminate the over-arching loan agreement, it did in fact authorize the parties to proceed. In the Court's view: “Actual 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.” Therefore, the termination was effective. What was the net result? The \$1.5 billion term loan lost its priority. In other words, the secured party is now deemed an unsecured creditor.

NOW WHAT?

With this decision, a number of firms have elected to review their due diligence policies. This has led to a number of policy responses, from steady as it goes to significant adaptations. While there is no right or wrong solution to a matter that is still quite fresh there are some signpost firms that appear to be focusing on in efforts to improve their standards.

One such avenue is a committee approach. Some firms have elected to have groups inside their firm review the documents prepared by others to make sure the proper due diligence has been conducted. These groups can be as broad or narrow as the firm desires. The review group may only look at the UCC filing documents or it may be more robust and look at more of the specific deal. The obvious downside to this is it creates another level of review and thus more time will be

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needed. This “other pair of eyes” approach again is designed to prevent the errors witnessed in the case above.

Providers like CT can assist in such a deal review committee. In addition to our current [Next Generation Due Diligence](#) offering, if such a committee is created, a special email can be drafted so that the provider deals with the team directly to increase security and efficiency. Termination reports or expiring reports to the committee or law firm can also aid their review system. Again, the intent is to create a more complete review in order to prevent such errors from dismantling financial agreements.

Another approach being looked at is paralegal empowerment. The goal here is to make sure the paralegal has the ability to review all documents associated with the deal. This is an attempt to remove “the authority assumption” out of the equation. In this model relying on an email or statement that the authority to act exists would no longer be an accepted practice. Actual documents outlining the authority would have to be produced before anything can proceed. Under this plan you would also see adjustments to email between the law firms that better highlight the actions to be taken by the preparing party. By doing this a firm is attempting to remove ambiguity both internally and externally.

We also cannot forget about financial institutions. They have also been impacted by this decision. Some of the changes the community could see include limitations on what borrower’s counsel can do in terms of UCC document preparation. The financial institution may also require more partner involvement on larger projects (akin to the law firm committee). It may go as far as requiring formal partner approval for certain filings. After the filing is completed you may see banks MANDATING a “search to reflect” on all their filings. Again, the aims with the loaning institutions are to tighten perceived due diligence gaps.

CONCLUSION:

This case will continue to have repercussions for some time. Law firms and all parties connected to due diligence will need to continue to monitor and make the appropriate adjustments. Providers like CT will certainly be available to assist in this monitoring, and CT is proactively continuing to improve its own systems to keep pace with this evolving due diligence matter.

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