

THE NEW NORMAL? HOW MODERN DUE DILIGENCE WAS IMPACTED BY THE MOTORS LIQUIDATION CASE



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“Predictable.” That’s the word normally used when discussing due diligence under Revised Article Nine. Modern law and businesses have for years sought a uniform way to conduct secured transactions. If you’re looking for spine-tingling, suspense-filled law, you need to look elsewhere. Like a country road, the law surrounding pledging collateral is long and straight with no curves.

That tranquility was shattered last year with one case. In [The Motors Liquidation case](#), the Supreme Court of Delaware caused a thunderbolt to streak across the tranquil due diligence skies when it set off a wave of discussions and reviews seldom seen in this corner of the legal world. The interpretation of apparent/actual authority spawned several articles, comments, and water cooler conversations.

It also spurred several law firms and financial institutions into a period of review of their internal due diligence. These reviews were as varied as the entities conducting them.

The intent of this article is to give a general overview of the results from these reviews. While not divulging any “secret recipes”, this discussion may act as a guide to those still conducting exams of their systems.

THE MOTORS LIQUIDATION CASE: A CLOSER LOOK

Before any discussions can be had regarding these results, a brief discussion of the case is in order. In September 2008, General Motors contacted its counsel to assist in preparing financing documents on loan agreements being reworked in bankruptcy proceedings. In particular, GM was set to pay a Synthetic Lease agreement and thus termination documents would need to be generated and subsequently filed at the time of the pay off. The task of preparing these termination agreements fell to a paralegal at GM’s law firm. The paralegal prepared the termination agreements as part of the GM checklist. They were then reviewed by GM’s counsel, the secured party’s law firm, and finally, the secured party itself. The documents were all approved.

Unfortunately, one of the documents should not have been prepared - the one terminating the over-arching term loan agreement. This was separate from the Synthetic Lease and should not have been approved. The paralegal and managing associate at GM’s firm was unaware of this distinction. The term loan agreement was valued at \$1.5 billion. The mistake wasn’t discovered until GM filed for bankruptcy in 2009.

Defining “Authorized”

continued on page 2

The entire aim of this endeavor was to unwind and terminate the Synthetic Lease. The general loan was never the subject. One of the big questions in The Motors Liquidation case “was the termination authorized?” The secured party argued that its firm and the firm for GM exceeded its authority since the secured party only authorized terminations related to the Synthetic Lease.

To guide their decision, the Court looked at the actions of the secured party. GM’s law firm created a closing checklist and Escrow Agreement that included the erroneous UCC 3. These documents were reviewed by both the secured party’s law firm and the secured party itself. There was also an email exchange between the law firms regarding the documents in which no objections were raised regarding the termination statement.

Thus, in the Court’s opinion, while the secured party never intended to terminate the main loan agreement, it did 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. The net result? The \$1.5 billion term loan lost its priority and is unsecured.

TRACKING THE EFFECTS

To measure the effects of this case, we sent questionnaires to the groups most impacted by its outcome: financial institutions and the law firms that represent them in transactions. Their answers give a solid glimpse into how both groups plan to implement changes.

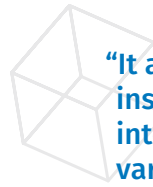
Group 1) Financial Institutions

The outcome can be boiled down to one word for the financial side: VERIFY. The level of internal review appears to have increased across the board. While that has taken a number of forms, a few aspects of the responses are universal:

- Financial institutions no longer rely solely on the information returned from the law firm but make sure the information jives with what’s in the institution’s possession. As one financial institution stated: “this is not the time to hit print screen and say ‘all good’”. There needs to be a deeper analysis, and the institution

must make certain it has the most current detailed data available.

- The next topic the financial side tackled was centralizing the process of UCC document review. While all the institutions we spoke to were in agreement on centralization, there appears to be some variance. The consensus was that financial institutions need to have a more robust central system to review and file, a system that’s tailored to groups or categories inside the bank. For example, the equipment purchase and leasing department should have a central review system that is different from, say, the real estate development department. A minority of respondents said “a form is a form” and the standards for review should be the same across the board. As we start to see the uniform commercial code is neither uniform nor commercial.



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- The last topic the financial group looked at was its relationship with the firms. The institutions we spoke to agreed on two points:
 - One, the financial institution is ultimately responsible for errors like this. They are the final gatekeeper and thus the final review is up to them. This echoes their first point: the financial institutions must verify these documents and actions since they are the secured party.
 - Second, the financial institutions feel law firms do not have to create any additional level of review. As one respondent put it: “the answer is not more paper or forms from the law firms”. They do, however, feel the firms need to create additional groups or boards to do analysis.

Group 2) Law Firms

Like the bank side, law firms also strongly feel that more review is the answer to this situation. They also agreed the secured party (the financial institution) is ultimately responsible for such omissions. Law firms also felt attorneys should be more involved in the entire review transaction process than they are currently.

continued on page 3

This review process bears deeper study as it's here the law firms seem to diverge. A number of factors play into this divergence:

- The size of the law firm is certainly one of them. A global firm has different resources than a regional firm.
- The size and complexity of the deal. The larger the deal, the greater the need for more review. Same goes for complex issues that involve multiple parties and assets.

With this background, the law firms' responses fall into three categories:

- Paralegal empowerment
- Non-deal attorney review
- Formal review panel

Again, no uniformity in the uniform commercial code. Let's take a brief look at that the three categories.

Paralegal empowerment. In this circumstance, the law firm is not making any systematic changes but instead reinforcing certain principals. Like the financial institutions, this is all about verification. Documents cannot be prepared (like a termination) without the corresponding authorization documents. One attorney's response: "You can't tell the paralegal 'don't worry about it and just file.'"

The theory is simple: if the document preparer has all the documents in their possession in a timely fashion (which is sometimes hard to do), then the chances of error will be reduced. This does not create a new level of review.

The negative here is the same attorney indicated that attorneys have a habit of returning to their old ways. If implemented, there's no guarantee things won't go back to how they were done before.

Non-deal attorney review. In this category an attorney (normally a partner) who is not involved in the deal, is asked to review the documents to make sure things pass muster.

This second pair of experienced eyes is designed to catch any potential omissions without the need of a formal panel. This creates a more flexible and quicker response time while still having a review.

Of course this review is only as good as the person reviewing the documents. Thus, while you gain speed and flexibility, you may not have a consistent standard and again fall victim to things slipping through the cracks.

Full review panel. As the name implies, a firm creates a panel that is designed to review the due diligence a firm is conducting on projects. This panel can take on several sizes and forms, with paralegals and attorneys being involved with varying responsibilities. Also, some firms may have different levels of review on this panel depending on the size of the project or deal. This panel can create a level of certainty that all matters are being given the same review and thus significantly decrease the chance of things being missed.

The obvious drawback: this takes time. It will require adjustments to attorney workflow to make sure the panel has enough time to do its job.

In conclusion, it can be seen that the GM case has left a significant imprint on modern due diligence. The larger question will be whether or not the case creates lasting changes, or more short-term, intermediate deviations.

Only time and further review will truly tell.

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