Creditors’ committees add significant value to unsecured creditors by acting as a counterweight to the power and leverage that a debtor and secured lender possess in a bankruptcy case. One of the main responsibilities of a creditors’ committee is to investigate, and if necessary, challenge the validity and perfection of the security interests and/or liens granted to a debtor’s secured lender. That means making sure that the lender has dotted all of its I’s and crossed all of its T’s. Every once in a while, a secured lender messes up and does not have either a valid or perfected security interest when the debtor files Chapter 11. A proactive creditors’ committee can pounce on the lender’s mistake, challenge the lender’s security interest and potentially recover significant value for general unsecured creditors.

This is precisely what happened in the General Motors (GM) Chapter 11 case. GM was a borrower prior to its Chapter 11 case, and JPMorgan Chase Bank, N.A. (JPM) had intended to terminate its security interest in certain GM property serving as collateral for a $300 million synthetic lease transaction that GM was paying off. Unfortunately for JPM, a UCC-3 termination statement with respect to an unrelated security interest when GM filed Chapter 11. A proactive creditors’ committee can pounce on the lender’s mistake, challenge the lender’s security interest and potentially recover significant value for general unsecured creditors.

Thereafter, GM filed for Chapter 11 protection and its unsecured creditors’ committee challenged the perfection of JPM’s security interest in the term loan collateral because of the pre-petition termination of JPM’s UCC-1 financing statement covering the term loan collateral. JPM claimed the mistaken pre-petition filing of the UCC-3 termination was not authorized and, therefore, was not effective, and JPM had retained a perfected security interest in the term loan collateral when GM filed its Chapter 11 case.

The U.S. Court of Appeals for the Second Circuit held that JPM’s UCC-1 financing statement covering the term loan collateral was, in fact, terminated even though the UCC-3 termination referencing that UCC-1 was filed by mistake. The court’s decision required that JPM disgorge the cash proceeds of the term loan collateral that JPM had recovered earlier in the case.

This story certainly demonstrates how a proactive creditors’ committee could substantially increase the recovery of unsecured creditors. It is safe to say that due to the creditors’ committee’s diligence and JPM’s mistake, the amount of cash available for distribution to GM’s general unsecured creditors will likely be materially increased.

Perfecting and Terminating a Security Interest
A creditor seeking to obtain a security interest in a debtor’s property must satisfy several requirements included in Article 9 of the Uniform Commercial Code (the “UCC”). First, a creditor must satisfy the requirements for the creation or attachment of a security interest in its collateral. A creditor obtains a security interest through a security agreement, signed by the obligor/debtor, which describes the collateral in which the creditor is granted a security interest.

Second, the creditor must perfect its security interest in the collateral. Perfection ensures that a creditor’s security interest in the collateral will withstand a challenge by
another secured creditor, a judgment lien creditor and/or a bankruptcy trustee. A creditor frequently perfects its security interest by filing a UCC-1 financing statement that includes certain specific information in the appropriate filing office. A UCC-1 financing statement must contain the debtor's correct legal name, a description of the collateral that is consistent with the collateral described in the security agreement and other specified information. A correctly prepared UCC-1 financing statement does not have to be signed by the debtor.

The public filing of a UCC financing statement serves two main purposes. Initially, it establishes a secured party's priority rights in the collateral identified in the financing statement. In addition, it provides third parties notice that the party filing the financing statement claims an interest in the assets referenced in the financing statement.

A secured creditor can be instructed to terminate its UCC-1 financing statement when a debtor pays off its obligations to the creditor. A secured creditor's UCC-1 financing statement is terminated by filing a UCC-3 termination statement in the same filing office where the original UCC-1 was filed. The UCC termination puts parties on notice that perfection of a creditor's security interest in the collateral referenced in the UCC-1 financing statement is being terminated. Like the UCC financing statement, the UCC termination need not be signed.

Three sections of the UCC are relevant in determining whether the filing of a UCC-3 termination effectively terminates the perfection of a security interest. First, UCC §9-513 states that a UCC-1 financing statement is no longer effective upon the filing of a UCC-3 termination statement referencing that UCC-1 financing statement. Second, UCC §9-510 states that the filing of a UCC-3 termination statement is only effective if it is filed by someone that "may file it under UCC §9-509" and has permission to do so. Finally, and most relevant here is UCC §9-509(d)(1), which states that a UCC-3 termination statement can only be filed if the secured party authorized the filing.

The issue in the GM case was whether the mistaken filing of the UCC-3 termination covering JPM's term loan collateral was authorized and, therefore, terminated the perfection of JPM's security interest in the term loan collateral prior to GM's Chapter 11 filing.

Facts
GM had entered into a synthetic lease (the "lease") with JPM in October 2001 through which GM obtained financing in the approximate amount of $300 million. In order to secure GM's obligation to repay the amounts owing under the lease, GM granted JPM liens on 12 pieces of real property. JPM's security interest was perfected through the filing of UCC-1 financing statements identifying: (a) JPM as the secured party of record, and (b) the collateral securing the lease.

In 2006, GM obtained an unrelated $1.5 billion term loan (the "term loan") from JPM. As security for the term loan, GM granted JPM a security interest in a variety of GM's assets, including equipment and fixtures located at 42 of GM's domestic facilities. To perfect the security interest, JPM filed 28 UCC-1 financing statements throughout the country, including one numbered "6416808 4" with the Delaware Secretary of State (the "Term Loan UCC-1"), which covered, among other collateral, the equipment and fixtures located at the aforementioned 42 facilities.

In September 2008, GM decided to repay the obligations owing under the lease. GM contacted its counsel and requested that it prepare the relevant documents to allow for the repayment of the lease obligations and the release of the related security interests. An associate at GM's counsel was tasked with preparing a closing checklist and drafts of the documents necessary to consummate the transactions. This included compiling a list of security interests in connection with the lease that would have to be terminated upon the satisfaction of GM's obligations. The associate delegated the creation of this list to a paralegal at GM's counsel who was asked to locate all of the UCC-1 financing statements recorded in Delaware against GM and in favor of JPM. The paralegal located three UCCs numbered 2092532 5, 2092526 7, and 6416808 4. While the first two UCCs related to the lease, the third UCC related to the term loan. Neither the paralegal nor the associate realized this mistake.

Due to this oversight, GM's counsel mistakenly included the Term Loan UCC-1 on the closing checklist as requiring a UCC-3 termination and prepared a separate UCC-3 termination statement referencing the Term Loan UCC-1. The closing checklist and UCC-3 termination statements, including the UCC-3 mistakenly terminating the Term Loan UCC-1, were then sent to representatives of GM and JPM and to JPM's counsel. No one recognized the error in the documents and all of the parties that received the documents approved the filing of the UCC-3 termination covering the Term Loan UCC-1.

GM satisfied its obligations under the Lease on Oct. 30, 2008. Thereafter, the three UCC-3 termination statements, including the one mistakenly referencing the Term Loan UCC-1, were filed with the Delaware Secretary of State. As a result, an opening was created for the GM creditors' committee to attack the perfection of JPM's pre-petition security interest in the term loan collateral.

Procedural History
On June 1, 2009, GM filed for Chapter 11 bankruptcy protection in the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"). An official due to the creditors' committee's diligence and JPM's mistake, the amount of cash available for distribution to GM's general unsecured creditors will likely be materially increased.
unsecured creditors’ committee (the “creditors’ committee”) was formed shortly after the filing date.

On June 31, 2009, the creditors’ committee filed an action in the Bankruptcy Court seeking a determination that the filing of the UCC-3 termination statement identifying the Term Loan UCC-1 was effective to terminate the perfection of JPM’s security interest in the term loan collateral. JPM argued that the filing of the UCC-3 termination statement was unauthorized and, thus, should not be given any legal effect because JPM, GM and their respective counsel made a mistake and never intended to terminate the Term Loan UCC-1. The creditors’ committee and JPM both moved for summary judgment. The Bankruptcy Court held that the filing of the UCC-3 termination statement identifying the Term Loan UCC-1 was unauthorized. As such, JPM’s security interest in the term loan collateral continued to be perfected when GM had filed for Chapter 11.

Perfection ensures that a creditor’s security interest in the collateral will withstand a challenge by another secured creditor, a judgment lien creditor and/or a bankruptcy trustee.

The creditors’ committee then appealed the Bankruptcy Court’s decision directly to the Second Circuit. In its initial decision, the Second Circuit recognized that it had to resolve two interrelated issues. The Second Circuit certified the first issue to the Delaware Supreme Court as follows: what precisely must a secured lender authorize in order for a UCC-3 termination statement to be effective? In other words, must the secured lender authorize the termination of the specific security interest that the UCC-3 identifies, or must the lender merely authorize the filing of a UCC-3 termination statement that references the security interest? The Second Circuit ended up subsequently resolving the second question: did JPM grant GM’s counsel the requisite authority to terminate the Term Loan UCC-1 or file the UCC-3 termination statement that identified the Term Loan UCC-1?

The Delaware Supreme Court’s Decision
In briefing before the Delaware Supreme Court, JPM argued that the UCC-3 termination statement identifying the Term Loan UCC-1 was ineffective because JPM did not intend to terminate the security interest in the term loan collateral or instruct anybody else to terminate the security interest. The creditors’ committee argued that it is irrelevant whether JPM had intended to terminate the continued perfection of its security interest in the term loan collateral. The UCC-3 termination filed with respect to the term loan collateral was effective because JPM had authorized GM’s counsel to file the relevant UCC-3 termination and, therefore, satisfied UCC §9-509. It made no difference that JPM was mistaken in providing such authorization.

The Delaware Supreme Court held that JPM’s subjective intent with respect to the continued perfection of its security interest in the term loan collateral was irrelevant under UCC §9-509(d)(1). Since JPM had authorized the filing of the UCC-3 termination statement referencing the Term Loan UCC-1, the termination statement was effective. The plain text of UCC §9-509(d)(1) only required a secured party to authorize the filing of a termination statement; there is no requirement that the secured party intend to terminate perfection of its security interest. The court also stressed how JPM and its agents had an affirmative duty to carefully review the termination statement covering the term loan collateral prior to its filing to ensure termination of perfection of the correct security interest. Any relief granted to JPM from the legal consequences of its mistake in approving the termination of perfection of its security interest in the term loan collateral would disincentivize other secured lenders from ensuring the accuracy of the information included in their UCC financing statements. The Delaware Supreme Court also stressed the underlying purpose of the UCC’s public notice filing system and the need for parties to be able to rely in good faith on the unambiguous terms of authorized public filings. Any other result would impose an impossible and impractical requirement on third parties reviewing UCC filings to interpret the intent of the party that was responsible for the filing.

The Second Circuit’s Decision Upholding the Mistaken Termination of Perfection of JPM’s Security Interest in the Term Loan Collateral
The Second Circuit then took the case back and analyzed whether JPM had authorized the filing of the UCC-3 termination statement that had mistakenly included the Term Loan UCC-1. JPM argued that GM’s counsel must have exceeded the scope of its authority by filing the UCC-3 termination statement improperly identifying the Term Loan UCC-1 because JPM’s and GM’s counsel were only instructed to terminate the security interest associated with the lease. GM intended to repay the lease and JPM would then terminate the UCC-1 financing statements perfecting its security interest in the collateral pledged to secure the lease. None of the parties involved ever intended to terminate the Term Loan UCC-1 perfecting JPM’s security interest in the term loan collateral.

The issue in the GM case was whether the mistaken filing of the UCC-3 termination covering JPM’s term loan collateral was authorized and, therefore, terminated the perfection of JPM’s security interest in the term loan collateral prior to GM’s Chapter 11 filing.
The Second Circuit ruled that the filing of the UCC-3 termination covering the term loan collateral was effective, notwithstanding that it was filed in error. The court distinguished JPM’s intent from what JPM had actually authorized. The documents that GM’s counsel had prepared (including the closing checklist and draft UCC-3 termination statements) to unwind the lease mistakenly included a UCC-3 termination of the Term Loan UCC-1. GM’s counsel sent the UCC-3 termination statements to a managing director of JPM, and sent both the termination statements and the closing checklist to JPM’s counsel. Neither JPM’s managing director nor its counsel raised any issues with the UCC-3 termination statements (including the termination statement mistakenly identifying the Term Loan UCC-1) or the closing checklist. To the contrary, JPM’s counsel responded to an email attaching the documents with “Nice job on the documents…"

The Second Circuit also relied on the fact that GM’s counsel drafted an escrow agreement that included instructions about how the escrow agent would proceed with closing the transaction. The escrow agreement outlined how the parties would deliver all three UCC-3 termination statements (including the termination statement mistakenly identifying the Term Loan UCC-1) that would be filed to terminate the obligations securing the lease. The agreement also stated that once GM repaid the remaining amounts owed under the lease, the escrow agent would forward three UCC-3 terminations to GM’s counsel for filing. JPM’s counsel that previously remarked “Nice job on the documents…” also responded to an email attaching the escrow agreement and stated that “it was fine” and subsequently signed the agreement. JPM’s and its counsel’s repeated manifestations to GM’s counsel approving filing of the UCC-3 termination covering the term loan collateral demonstrated that they both knew that GM’s counsel would be filing the problematic termination statement that terminated perfection of JPM’s security interest in the term loan collateral. That sealed JPM’s fate costing it its perfected status in the term loan collateral prior to GM’s Chapter 11 filing.

Conclusion

The creditors’ committee’s lawsuit and the Second Circuit’s ruling against JPM’s security interest in the term loan collateral would likely have gone unchallenged if there were no creditors’ committee. That would have allowed JPM to realize an unfair windfall by recovering on the term loan collateral where its security interest was otherwise unperfected prior to GM’s bankruptcy filing.

The impact of the creditors’ committee’s success simply cannot be overstated!

1. Section 1103(c) of the Bankruptcy Code provides that:
(c) A committee appointed under Section 1102 of this title may—
(1) consult with the trustee or debtor in possession concerning the administration of the case;
(2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor’s business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
(3) participate in the formulation of a plan, advise those represented by such committee of such committee’s determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;
(4) request the appointment of a trustee or examiner under Section 1104 of this title; and
(5) perform such other services as are in the interest of those represented.

2. For purposes of simplicity, this article refers to JPM as the lender on both the synthetic lease and term loan involving GM as borrower.

3. JPM was acting as agent for different syndicates of lenders with respect to the lease and term loan. Again, for simplicity of reference, JPM will be considered the lender under both the lease and term loan throughout this article.

4. On Feb. 4, 2015, JPM filed a Motion for Rehearing En Banc with the Second Circuit in connection with the GM Decision, the resolution of which is still pending.

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