Unintended Consequence — JPMorgan's Costly Mistake

BY JEFFREY A. WURST

In January, JPMorgan Chase lost a court battle with General Motors' creditors' committee regarding the accidental termination of JPMorgan's UCC securing a $1.5 billion loan. Ruskin Moscou Faltischek attorney Jeffrey A. Wurst dissects the court cases surrounding the notorious GM bankruptcy and resulting fallout from JPMorgan's costly mistake.

JEFFREY A. WURST
Senior Partner, Ruskin Moscou Faltischek

During its active operating period, the bankruptcy of General Motors made headlines daily if, for nothing else, its magnitude. The GM bankruptcy continues to warrant our attention. The latest developments came in January, when JPMorgan lost a court battle with GM's creditors' committee regarding the mistaken termination of the UCC securing a $1.5 billion loan.

The committee brought an action for a determination that JPMorgan had relinquished its rights to collateral securing the loan. On January 21, 2015, the U.S. Court of Appeals for the Second Circuit reversed the decision of the Bankruptcy Court for the Southern District of New York (*Gerber, U.S.B.J.*), which held that a UCC-3 termination statement filed by mistake was unauthorized and not effective to terminate the secured lender's interest in the debtor's property. The story that follows should leave you, at the very least, scratching your head.

History

In October 2001, JPMorgan Chase Bank, as administrative agent, provided a $300 million financing to GM by way of a synthetic lease, secured by liens. UCC-1 financing statements were filed on behalf of JPMorgan, as administrative agent, and as the secured party of record. In 2006, JPMorgan also served as the administrative agent and secured party of record on behalf of a completely different syndicate of lenders with regard to the term loan to GM in the approximate amount of $1.5 billion. This term loan was perfected by the filing of UCC-1 financing statements, but with one particular UCC-1 financing statement filed with the Secretary of State of Delaware. The Main UCC-1 covered, among other things, all of the equipment and fixtures at 42 GM facilities.

In September 2008, the synthetic lease was nearing maturity, and GM asked its counsel, Mayer Brown, to prepare documents necessary for JPMorgan and its syndicate to be repaid and release the security interests held to secure GM's obligations. In its decision, the Second Circuit details how GM's lawyers prepared the release and terminated the synthetic lease. In a throw-the-associate-under-the-bus explanation[1], the partner at Mayer Brown assigned the work to an associate who, with the help of a paralegal, searched the records of UCC-1 financing statements recorded against GM in the state of Delaware. They identified three UCC-1s but did not realize that only two were related to the synthetic lease and the third was related to the term loan. They prepared a closing checklist and draft UCC-3 termination statements for three security interests they identified on the closing checklist; that is, not only the UCC's perfecting the synthetic lease, but also those perfecting the term loan.

The error was not picked up by the partner at Mayer Brown. In fact, when JPMorgan and its counsel, Simpson Thatcher & Bartlett, received the closing checklist and draft UCC-3 termination statements, they also neglected to pick up the error. As a result, on October 30, 2008, GM repaid the amounts due on the synthetic lease, and Mayer Brown filed all three UCC-3 termination statements with the Delaware Secretary of State — including the UCC-3 that erroneously terminated the Main UCC-1.

In its decision, the Second Circuit details how GM's lawyers prepared the release and terminated the synthetic lease. In a throw-the-associate-under-the-bus explanation, the partner at Mayer Brown assigned the work to an associate who, with the help of a paralegal, searched the records of UCC-1 financing statements recorded against GM in the state of Delaware.

Bankruptcy Court

GM filed for Chapter 11 protection with the U.S. Bankruptcy Court for the Southern District of New York on June 1, 2009. As we all recall, the U.S. Treasury stepped up and provided GM with a $33 billion DIP financing facility which helped satisfy the $1.5 billion term loan owed by GM to JPMorgan.

Following the commencement of proceedings, JPMorgan informed the Committee of Unsecured

1 That is this author's terminology, not that of the court.

Creditors that a UCC-3 termination statement relating to the term loan had inadvertently been filed, and that they had only intended to terminate liens related to the synthetic lease. They claimed the "inadvertent filing" was unauthorized and ineffective. Notwithstanding, the Committee commenced an adversary proceeding against JPMorgan seeking a determination that, despite the error, the UCC-3 termination statement was effective to terminate JPMorgan's security interest in assets securing the term loan and, as a result, JPMorgan was an unsecured creditor on par with the other GM unsecured creditors.

The bankruptcy court, in a nearly 80-page decision, held: "…the Court is unable to agree that there is a general principle of law that 'UCC Filings that Mistakenly Terminate a Security Interest Are Legally Effective.' The question is rather whether they have been authorized…[and here] the requisite authority was lacking." Thus, the bankruptcy court concluded the UCC-3 filing was unauthorized and, therefore, not effective to terminate the security interest securing the term loan. In the same document the court certified a direct appeal to the court of appeals.[2]

An Appeal

The Second Circuit considered the appeal and identified two questions: 1) what a secured lender must authorize for the filing of a termination statement, which it identified as an issue of statutory interpretation; and 2) whether under agency law JPMorgan granted authority for the filing of the termination statement. Inasmuch as the Uniform Commercial Code is state (not federal) law, and despite the code being *substantially* the same state to state, questions of state law were at issue. GM was a Delaware corporation, and the UCC financing statement at issue was filed in Delaware, so the Second Circuit needed a ruling on Delaware law. Accordingly the Second Circuit Court of Appeals certified the following question to the Delaware Supreme Court:

> Under UCC Article 9, as adopted into Delaware law by Del. Code Ann. Tit. 6, Art. 9, for a UCC-3 termination statement to effectively extinguish the perfected nature of a UCC-1 financing statement, is it enough that the secured lender review and knowingly approve for filing a UCC-3 purporting to extinguish the perfected security interest, or must the secured lender intend to terminate the particular security interest listed on the UCC-3?

Delaware Supreme Court

In considering the question, the Delaware Supreme Court focused on the statutory construction of: UCC 9-513 (d) ("Except as otherwise provided in Section 9-510, upon the filing of a termination statement with the filing office, the financing statement to which the termination statement relates ceases to be effective"); 9-510 ("A filed record is effective only to the extent that it was filed by a person that may file it") and 9-509(d)(1) ("A person may file an amendment other than an amendment that adds collateral covered by a financing statement or an amendment that adds a debtor to a financing statement only if: (1) the secured party of record authorizes the filing…").

The Delaware court concluded:

> …for a termination statement to become effective under §9-509 and thus to have the effect specified in §9-513 of the Delaware UCC, it is enough that the secured party authorizes the filing to be made, which is all that §9-510 requires. The Delaware UCC contains no requirement that a secured party that authorizes a filing subjectively intends or otherwise understands the effect of the plain terms of its own filing.

Second Circuit Decision

In reaching its conclusion, the Second Circuit quoted the Delaware Supreme Court:

> Even if the statute were ambiguous, we would be reluctant to embrace JPMorgan'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 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.

Having concluded that JP Morgan had authorized the UCC-3 termination statement, the court turned to the question of whether Mayer Brown had authority under agency law to effect the filing. From these facts it is clear that, although JPMorgan never intended to terminate the Main Term Loan UCC-1, it authorized the filing of a UCC-3 termination statement that had that effect. "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." JPMorgan and Simpson Thacher's repeated manifestations to Mayer Brown show that JPMorgan and its counsel knew that, upon the closing of the synthetic lease transaction, Mayer Brown was going to file the termination statement identifying the Main Term Loan UCC-1 for termination, and JPMorgan reviewed/assented to the filing of that statement.

The take-away: Know what you are authorizing when you put your signature to a document, and do not rely solely on others. This case may result in an extremely expensive lesson for JPMorgan and Simpson Thatcher.

Petition for Rehearing En Banc

On February 4, 2015, JPMorgan filed a Petition for Rehearing En Banc, asking the Second Circuit Court of Appeals to rehear/reconsider the appeal on the grounds that the decision is a departure from existing agency law: "that one may be an agent for one purpose does not make him or her an agent for every purpose."

Watch these pages and *abfjournal.com* for developments on this important litigation. The take-away: Know what you are authorizing when you put your signature on a document, and do not rely solely on others. This case may result in an extremely expensive lesson for JPMorgan and Simpson Thatcher. Let it be a lesson to the rest of us as well. abfj

JEFFREY A. WURST is a senior partner and the chair of the Financial Services, Banking & Bankruptcy Department at Ruskin Moscou Faltischek, P.C., Uniondale, NY. He can be reached at 516-663-6535 or at *jwurst@rmfpc.com*.

2 The normal course would have been to first appeal to the District Court and then appeal its decision to the Circuit Court. On rare occasions when it is apparent that a matter will need to be adjudicated by the Circuit Court, lower courts certify the matter for a direct appeal, saving significant time and expense in achieving a final resolution.