Commercial Financial Services Brief: Inappropriate Termination Statements Continue to Haunt Secured Parties

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Those who practice in the secured transactions arena, and our clients, understand the importance of filing financing statements and continuing them on a regular basis. Failure to maintain perfection of a security interest can be disastrous to a secured lender in the case of a bankruptcy case involving its borrower. Financing statements can, however, sometimes be mistakenly terminated. Two recent cases illustrate the issues which may arise when a financing statement is inadvertently terminated.

Mistaken Termination Statements. In *In re Hickory Printing Group, Inc*., a North Carolina bank extended a line of credit to the debtor. The loan was secured by a security interest in the debtor's accounts receivable and inventory. The bank perfected its security interest by filing a financing statement in the appropriate financing office. The bank's financing statement was continued on two occasions. Several years later, the bank agreed to provide a term loan to the debtor which was secured by the same collateral. Because the bank already had a financing statement of record, it did not file a second financing statement for the term loan. When the term loan was repaid, the bank terminated the original financing statement by filing a termination statement with the filing office. Apparently, the bank's systems did not alert the bank employee to the fact that the original line of credit and the term loan had been cross-collateralized.

When it discovered the financing statement had been terminated, the bank's employees contacted the filing office to ask how to reinstate the terminated financing statement. Following this conversation, the bank filed a correction statement as provided by the UCC. Several months later, the bank filed a new financing statement. Within 90 days of the filing of the new financing statement, creditors of the debtor forced the debtor into an involuntary Chapter 7 bankruptcy. In an adversary proceeding brought in the bankruptcy case, the bankruptcy trustee sought to avoid the bank's security interest.

The Court first ruled the termination statement was effective since the bank employee was authorized to file termination statements on behalf of the bank. Her mistake in filing the termination statement did not support the bank's contention that its filing was not authorized.

The bank then contended the correction statement it filed corrected the record and, in effect, reinstated its financing statement. It argued that the combination of the original financing statement, the termination statement and the correction statement (which specifically referenced the termination statement) constituted notice of the bank's security interest in the debtor's collateral. The court rejected those arguments, correctly holding that a correction statement does not have any effect on a filed record.

As a result, the court concluded that the bank's later filing of a new financing statement could be avoided by the trustee, leaving the bank unperfected and thus, for bankruptcy purposes, unsecured.

Unauthorized Termination Statements. In another case, a secured lender was given a reprieve by a New York bankruptcy judge even though its financing statement had been terminated. The court in *In re Motors Liquidation Company, f/k/a General Motors Corporation*, was faced with a situation in which counsel for the debtor, with authorization from the secured party, prepared termination statements for the payoff of certain lease transactions. The underlying financing statements for the lease transactions contained limited collateral descriptions. However, debtor's counsel inadvertently prepared a termination statement for a separate financing statement which perfected the security interest granted by the debtor to the lender to secure a $1.5 billion line of credit as well. This financing statement contained a much broader collateral description. The closing documents, including the term loan termination statement and closing checklists identifying it, were sent to the secured party's counsel and the secured party, prior to closing. No objection was raised by either the secured party or its counsel. Following the payment of the leases, the term loan termination statement was filed by debtor's counsel.

Several months later, General Motors filed its chapter 11 case. Approximately two weeks after the commencement of the bankruptcy case, the secured party's bankruptcy counsel learned that the term loan termination statement had been filed. The secured party was ultimately sued by the creditors' committee which sought a determination that the term loan termination statement was effective to render the term loan unsecured.

Unlike the situation in the *Hickory Printing Group case*, the secured party did not mistakenly file the termination statement in the General Motors case. Rather, a third party, the debtor's counsel filed the termination statement at issue. The court, in a well-reasoned and thorough opinion in which the court carefully analyzed the terms of numerous closing documents and instructions, concluded that the debtor's counsel had not been authorized by the secured party to file the term loan termination statement. As a result, it held that the term loan termination statement was not effective.

Lessons Learned.

1. Every secured party must have policies and procedures in place to monitor the termination of its financing statements so as to limit the possibility of inadvertently terminating a critical financing

statement. While only an "authorized" termination statement has the effect of terminating a financing statement, it will be very difficult for a secured party to successfully contend that its employee was not authorized to file a termination.

2. If a third party such as a title company or counsel is to file a termination statement, the closing instructions or escrow agreement should be explicit in identifying which financing statements are to be terminated. This saved the secured party in the General Motors case. Instructions such as "Terminate all financing statements of record" should be avoided.
3. These cases illustrate that searchers may not blindly rely upon the effectiveness of a filed termination statement. If a termination statement is unauthorized, it is not effective. But if you discover one of your financing statements has been terminated, you cannot afford to simply rely upon the fact that the termination was not authorized. You must address the situation as quickly as possible since the General Motors case illustrates the difficulty in establishing the authority of the person which filed the termination statement.
4. Revisions to Article 9 which take effect on July 1, 2013 provide a mechanism to "correct" the record if an unauthorized termination statement is filed. However, the "information statement" provided by the revisions does not have any legal effect. Thus, if an unauthorized financing statement is discovered, the secured party should file a new financing statement in order to ensure the secured party is perfected. The bank in the Hickory Printing Group case may have defeated the trustee had it filed its new financing statement sooner.