The Secured Lender

Never File Your Own Financing Statement

This article will review recent events that have highlighted the risk of filing your own financing statement, especially amendments that are intended to revise the collateral description or some other minor matter but, instead, have accidentally terminated the UCC financing statement. The potential gravity of the outcome may turn on the law of agency, leading to the conclusion that you should "never" file your own financing statement.

BY JAMES D. PRENDERGAST

A few recent events highlight the risk of filing financing statements, especially amendments intended to revise collateral descriptions or some other minor matter, that mistakenly terminate your Uniform Commercial Code (UCC) financing statement.[1] For instance, consider the now-defunct law firm of Heller Ehrman. If Heller Ehrman has its way in bankruptcy court, its lenders, Bank of America and Citibank, will lose up to $51 million due to a "clerical error" that voided their secured creditor status and inadvertently terminated their financing statements.

Because of the speed of electronic filing, the absence of a signature requirement (which has reduced the number of eyes proofing the filing) and the pressure for speed in today's legal world, mistakes like that are happening. These mistakes can be really big, and the gravity of the potential outcome may lead to the conclusion that a company should "never" file its own financing statements.

The Heller **Case and the Pacific Trencher Precedent**

What happened to Heller Ehrman is not a fluke. Bank of America, acting for itself and as agent of Citibank, inadvertently terminated both institutions' financing statements against Heller on August 3, 2007, prior to Heller filing its bankruptcy petition. On October 1, a week after Heller said it would dissolve, Bank of America filed a "correction statement" saying the 2007 filing was a "clerical error" and that the initial financing statement remained in full force and effect.[2] Heller quickly filed for bankruptcy to capture as much of the repayments of the banks' facility within the 90-day preference period. The Heller bankruptcy is pending in the U.S. Bankruptcy Court for the Northern District of California.

However, the facts of the *Pacific Trencher* case are eerily similar to the Bank of America/Heller situation. The United States Court of Appeals for the Ninth Circuit answered the basic question of reforming mistakes in financing statements in *In re Pacific Trencher & Equipment, Inc*.[3]

That story begins with the appellant having a perfected security interest in the assets of the debtor, Pacific Trencher & Equipment. In September 1980, the appellant agreed to release its security interest in some of Pacific's assets so Pacific could sell those assets. While preparing the UCC amendment to release its interest, the appellant erroneously checked the box marked "Termination" instead of the box marked "Release." When Pacific Trencher later filed for bankruptcy, the appellant frantically tried to fix the mistake by filing an adversary proceeding for declaratory relief, seeking reformation of its termination statement. The Bankruptcy Court for the Northern District of California denied the request, and the Ninth Circuit BAP affirmed, holding that the doctrines of mistake and reformation were not available to alter the clear language used in UCC filing statements. The appellant appealed the BAP decision, but the Ninth Circuit affirmed.

The appellant then argued that it was entitled to reform the filing statement under the equitable principle of reformation, relying on California Commercial Code §1103. The court answered that the more specific §9-402(8) (§9-506 under current Article 9) significantly limited this general provision. The issue was whether the filing could have misled a potential creditor, and the court concluded that the error resulting in the termination of the financing statement was indeed seriously misleading when viewed from potential creditors' standpoint. As a result, the appellant's erroneous termination statement was in fact a termination.

The GM **Case**

Although the inadvertent termination in the *Heller* case may have caused a $41 million loss, this case is not the largest such problem. Let's push the envelope a bit to $1.4 billion! That was the amount involved in the complaint by unsecured creditors against JPMorgan Chase, individually and as administrative agent for 414 lenders under a 2006 term loan agreement among General Motors Corporation, Saturn Corporation, and JPMorgan.

Under the agreement, certain lenders advanced $1.5 billion and received a first-priority lien on certain assets of GM. As of the petition date in the GM bankruptcy, the outstanding principal balance was in excess of $1.4 billion. The creditors' committee then challenged the lien, claiming that the pertinent UCC filings demonstrated that the lien was not perfected when GM filed its bankruptcy petition.

Here's what happened: On November 30, 2006, the lien was perfected by filing a UCC-l financing statement, listing GM's plant and equipment as collateral. On October 30, 2008, however, the financing statement was terminated by a UCC-3 financing statement amendment (the "termination statement"). So, as of the petition date, the only two records on file with the Secretary of State of Delaware relating to the collateral were the financing statement and the termination statement.

The Creditors' Committee argued that the financing statement had been terminated by the Termination Statement. Thus, as a matter of law, the Lien was no longer perfected. Accordingly, the Lien was unenforceable against the debtors and the debtors may avoid the Lien. Further, because the Lien is subject to avoidance, defendants were not entitled to proceeds of the DIP credit facility toward payment of amounts due under the Term Loan Agreement made after the petition date. In addition, payments made during the 90 days prior to the filing of the petition were avoidable as a preference.

What is Authorized?

Section §9-509(d) of the UCC requires the secured party of record to "authorize" the filing of a financing statement amendment.[4] If an amendment is filed in a manner inconsistent with §9-509(d), such as without the authorization of the secured party, it is ineffective.[5]

Although the provisions of the UCC determine the effectiveness of a filed record, non Article 9 law determines the extent to which the secured party authorizes filing the amendment.[6] For example, an agent has authority to conduct a transaction on a principal's behalf if the principal grants the agent the authority to do so.[7] An agent's actual authority to conduct a transaction may be express or implied.[8] Express actual authority is an explicit grant of authority from the principal to the agent.[9] Implied actual authority is an indirect result of a grant of authority from the principal to the agent to carry out some act for which the authority of the agent is implicit.[10] Implied authority presumes that the agent can reasonably interpret the principal's manifestations in light of the principal's objectives and other factors known to the agent.

If the "agent" has no actual authority from the principal, either express or implied, to file the amendment terminating the initial financing statement, then the agent has no express actual authority to so alter the amendment as instructed to be filed. In other words, if the agent didn't have the authority to file an incorrect amendment, then it also does not have the authority to fix the mistake. Further, the agent arguably has no implied actual authority to file the amendment with the termination box instead of the amendment box checked, because the only communica-

tions or manifestations between the agent and principal related to the filing of an amendment would be to direct the agent to file the amendment without the error.

Accordingly, no implicit authorization should exist to file an amendment that terminates the effectiveness of the initial financing statement when the principal authorizes the agent to file an amendment to release a portion of the covered collateral, which is the usual context when these errors arise. The conclusion should be that absent "actual" authority to file the amendment with an error, the only possible authority a principal could confer on its agent is "apparent" authority. However, the doctrine of apparent authority cannot form the basis upon which an agent is authorized to file an amendment that is effective as a termination statement.

Under the law of agency, authority is "the power of the agent to affect the legal relations of the principal by acts done in accordance with the principal's manifestations to the agent."[11] The Restatement (Third) of Agency's definition of authority contrasts with what is often referred to as "apparent authority."[12] Apparent authority is not authority at all, but rather an estoppel-like doctrine that renders an agent's unauthorized actions binding on the principal if the principal's misleading manifestations to a third party lead the third party justifiably to believe that the agent has the authority to bind the principal.[13] Under Article 9, however, the secured party must authorize the filing in order to terminate the financing statement effectively. Authorization is a core requirement for a filed record relating to a financing statement to be effective.[14] If the agent has no actual authority to file the amendment to terminate the effectiveness of the initial financing statement, the amendment should be ineffective. Apparent authority, being no authority at all, should be irrelevant for purposes of the §9-509(d) requirement that the filing be authorized.

Even if this doctrine of apparent authority could be a basis for authority under §9-509, a party seeking to bind the principal must show that (i) the principal's statements or conduct misled the party into believing that the agent was authorized to engage in conduct on the principal's behalf; (ii) the party relied on the principal's representations; and (iii) its reliance was justifiable.[15] The doctrine of apparent authority, therefore, should not apply unless the principal makes misleading statements or engages in misleading conduct that leads a person to believe that an agent is authorized to file an amendment terminating the initial financing statement. If, as is usually the case, the principal forwards the amendment to the agent service bureau with only the partial-release box checked, the principal has not mislead any one.

Further, even if a principal's particular statement or other conduct could be considered misleading, the doctrine of apparent authority would not apply, because usually no reliance party seeks to invoke the doctrine of apparent authority.[16] Thus, if the agent is not authorized to file the amendment terminating the effectiveness the initial financing statement, the amendment cannot be effective as required by §9-510(a).

The Evans **Case**

We now come to *In re A.F. Evans Company, Inc.,* from the Bankruptcy Court for the Northern District of California, decided July 14, 2009.[17] In brief, City National Bank (CNB) asked the bankruptcy court to require the debtor to remit 87.5% of the proceeds from a court-approved sale of its partnership interest in AFE-Pioneer Associates, LP ("AFE Interest"). Pursuant to a court-approved cash-collateral stipulation between CNB and the debtor, CNB was entitled to the money if, at the date of the debtor's Chapter 11 petition, CNB held a valid, perfected, security interest in the AFE Interest.

The creditors' committee opposed CNB's motion (they keep doing this!), arguing that any security interest CNB may have had in the AFE Interest was avoidable or terminated by the date of the debtor's Chapter 11 petition. The committee also disputed some of the facts of the case and asked for an evidentiary hearing to resolve such issues. The court decided that CNB held a valid, perfected, security interest in the AFE Interest and granted CNB's motion.

Prior to the debtor's Chapter 11 petition, CNB financed the debtor's operations through a revolving line of credit. The debtor secured the line with a security interest in substantially all of its personal property, including the AFE Interest. On August 9, 2004, CNB perfected its security interest in the property by filing a UCC-1 financing statement with the California Secretary of State.

In December 2008, the debtor wished to sell its partnership interests in Westgate Housing Associates, L.P. and Greenery Housing Associates, L.P. To facilitate the sale, the debtor asked CNB to release its perfected security interest in the two partnership interests. The request did not extend to the AFE Interest.

To facilitate the closing, the debtor sent CNB proposed escrow instructions directed to the debtor and First American Title Insurance Co., as well as two proposed UCC-3 amendments. The instructions included an exhibit describing the collateral to release. They did not include any reference to the AFE Interest. The court noted that the debtor did not check the termination boxes in the proposed forms it submitted to CNB.

On January 8, 2009, CNB submitted the two letters of escrow instruction, accompanied by two UCC-3 amendments, to First American. The letters and the two UCC-3 amendments were in the exact form the debtor proposed, without any checkmark in box no. 2 of the forms. The escrows for the sale of debtor's interests in Westgate and Greenery closed, and the two UCC-3 amendments were recorded on January 28, 2009. Unfortunately, the amendments both referenced CNB's original UCC-1 initial financing statement and included an "X" in box no. 2. In addition, both UCC-3 amendments included a checkmark under item 8 of the amendment form, titled "Collateral Change." and in the option box to "describe collateral deleted." The description was of the debtor's interest in Westgate and Greenery and was identical to that set forth in CNB's letters of instructions dated January 8, 2009.

CNB contended that someone without authority checked the termination boxes in the UCC-3 amendments after CNB transmitted them to First American. CNB argued that, because of this lack of authorization, its security interest was not terminated except for Westgate and Greenery. The committee, of course, disagreed.

In any event, after CNB discovered what had been filed, it filed two more UCC-3 amendments on February 6, 2009, which stated that CNB had not authorized the termination of its security interests in any assets of the debtor other than Westgate and Greenery.[18] But on May 5, 2009, the debtor filed its Chapter 11 petition. Thereafter, the court approved a stipulation between the debtor and CNB that required the debtor to remit to CNB 87.5% of the proceeds of various assets when sold. Then on March 12, 2009, the debtor asked the court for permission to sell its AFE Interest. The court granted the motion.

After the sale, CNB asked for its 87.5% of the sales proceeds. The creditors' committee filed

an objection, contending that the recorded UCC-3 amendments terminated CNB's security interests in the debtor's property, including the AFE Interest. CNB, of course, disagreed.

The committee argued, based on §9-513(d), that filing the UCC-3 amendments with the termination boxes checked terminated CNB's security interest. It also argued with reference to §§9-510(a) and 9-509(d) that, as a matter of general agency law, CNB was bound by the acts of its agents, which were within the scope of their authority. The committee contended that First American was CNB's agent for purposes of the AFE Interest sale, and that accordingly, even if First American checked the boxes in error, CNB was bound by that mistake and had therefore authorized First American to terminate its security interest in "all" of the debtor's personal property.

The court agreed with the general idea. It also agreed that, for purposes of determining what a secured party did or did not authorize within the meaning of §9-509(d), laws other than the UCC may apply.[19] However, the court did not agree with CNB about the applicability of the agency principles to the undisputed facts of the case.

First of all, the evidence showed that First American was not acting within the scope of its authority when, and if, it attempted to terminate CNB's security interest in any assets other than Westgate and Greenery. The debtor's UCC-3 amendments and escrow instructions to First American only had the "delete collateral" boxes checked, followed by a description of Westgate or Greenery. They did not have the termination boxes checked. Clearly, CNB did not in fact authorize First American to terminate its security interests in assets other than Westgate and Greenery.

Further, CNB had no input and no influence on establishing an escrow for the Westgate-Greenery transactions at First American. The debtor or the purchaser of the Westgate-Greenery partnership interests established the escrow prior to the debtor preparing the escrow instructions. CNB was not involved in selecting the escrow agent, had not engaged or employed the escrow agent, and had no contact with the escrow agent about the UCC-3 amendments or the Westgate-Greenery sale.

Therefore, the court concluded that First American was not CNB's agent, except for the Westgate and Greenery sale, and was not acting within its very limited authority when it recorded the UCC-3 amendments in a form other than that what CNB had authorized. Thus, the court found that CNB was not bound by First American's unauthorized modification to the UCC-3s, if indeed the modification was by First American.[20]

The committee cited the *Pacific Trencher* case as authority to the contrary, but the court distinguished *Pacific Trencher* for several reasons. First, it said, the error in *Pacific Trencher* was the secured party's error and did not involve an unauthorized act by an escrow agent. This is particularly significant, because the Ninth Circuit decided *Pacific Trencher* prior to the enactment of §§9-509 and 9-510, which specifically address the effect of an unauthorized UCC filing.

If the court had stopped its analysis at this point, we would have a very clear case distinguishing typographical errors made by employees of the secured party and typographical errors made by third-party UCC service providers. However, the court went on, noting that the UCC form at issue in *Pacific Trencher* had only one box — the termination box — checked. Thus, the form could not reasonably be construed to effect a partial termination of the secured party's security interest.

In the *Evans* case, however, each UCC-3 amendment had "two" boxes checked: the termination box and the release-of-collateral box. Clearly, checking a release-of-collateral box is superfluous when a secured party wishes to terminate a security interest in its entirety. Thus, the court found an ambiguity on the face of the form (whereas the form at issue in *Pacific Trencher* was unambiguous), raising a red flag that a full termination may not have been intended. For these reasons, the court granted CNB's motion.

So where does all this leave the issue? For one thing, *Evans* would have been a much more important case if the court had decided that First American was an independent contractor and not CNB's agent. The court seemed to be going that direction by noting that CNB had not established the escrow and had no control over First American. The court comes close through its discussion of §9-510(a) to saying that CNB did not authorize the financing

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statement amendments. However, the court just doesn't connect all the dots, instead addressing the ambiguity of the filed forms.

One can argue that, unlike in *Pacific Trencher*, First American is not the employee of the principal but rather an independent contractor. In *Pacific Trencher* the "agent" was an employee, and the principal was subject to all of the agent's acts within the course and scope of the agent's employment. Obviously, the appellant in *Pacific Trencher* did not specifically authorize the error. So, *Evans* and *Pacific Trencher* both distinguish, on the issue of requisite authorization under §9-509(a), the status of an internal employee of a third-party independent contractor.

Nevertheless, was the ambiguity of the forms necessary for the court's decision? The *Evans* court seems to say yes, concluding that this ambiguity and the additional amendment filing should indicate the possible existence of prior encumbrances on the collateral. The court in *Pacific Trencher* sought to protect the hypothetical, innocent searcher from a termination statement clear on its face. If ambiguity is the key to *Evans*, the case could be read narrowly and limited to UCC filings containing errors if the filing on its face suggests some confusion on the part of the filer. This assumes that the error was serious enough to make the financing statement seriously misleading under §9-506(a).

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This leads to the first conclusion that the *Evans* court was more concerned about an agent acting outside the scope of its authority if the agent is a third party rather than an employee. This argument draws a significant distinction between an employee as agent of his or her employer and the independent contractor. If this is sufficient for the court's decision and First American acted outside the scope of its authority, or if First American was not an agent of CNB but rather an independent contractor, then the *Evans* case can give very useful guidance.

Why we Use UCC Insurance

If lack of authorization is sufficient to pull back a third-party mistake on a filing and ambiguous filings are not necessary for this conclusion, then *Evans* in turn leads to the idea in the title of this article: always use a third party to file your financing statement filings. If *Evans* permits companies to disavow a third-party filing on their behalf, and *Pacific Trencher* prohibits companies from disavowing employee errors (even though in both cases the error was not specifically "authorized"), then for the few extra dollars, it seems almost inconceivable not to use a third party to make the filing. Weighing $100 against $1,400,000,000 should not take much time or effort.

However, when you are using the third party to file your initial financing statement and amendments, remember that national service companies, as a rule, limit their financial exposure for their negligence to the amount paid for the filing service. First American, alone among the major service providers, has increased its liability exposure from the price of the filing, say $29, to $10,000. But even that amount is insufficient to compensate for potential exposure. The answer is UCC insurance.

UCC insurance, now offered by all the major land title companies, is the only cost-effective way to manage the risks of determining a lender's security interest in personal property. Given the generally low cost of UCC insurance and the catastrophic result if a lender is not perfected or lacks the expected degree of priority, there is no truly cost-effective alternative to UCC insurance. If, for whatever reason, a client is not perfected and in first position, the lawyer who did not advise his or her client of the availability of UCC insurance may have little defense to the resulting malpractice action. "I knew UCC insurance was available but forgot to discuss it with you" is not a great defense. **TSL**

Footnotes:

[1] UCC terms used in this article, unless otherwise defined, shall have the meaning ascribed to such terms, through definition or usage, in the UCC.
Section 9-521(b) provides the national accepted form of amendment that is used for both a termination of the financing statement record or for the continuation, assignment of amendment of the financing statement record, including the deletion or addition of collateral and the restatement of the collateral description. Checkbox #2 is for termination and checkbox #8 is for amendments. Box 8 is used for collateral changes or

restatement. The proximity of the termination box to the continuation, assignment, and amendment boxes may be a contributing factor to the type of serious error discussed in this article. There has been much discussion about revising the form.

[2] Even if filing of a "correction" statement had any retroactive effect, under the current version of §9-518, only the debtor can file a correction statement. A proposed revision would not on its face apply to an amendment filed in error by a person authorized to file the amendment. Further, both the current and the proposed §9-518 state that filing a correction statement or, under the proposed revision, "a claim under this Section," "does not effect the effectiveness of an initial financing statement or other filed record."

[3] 735 F.2d 362 (1984).

[4] The following arguments are from the opening brief in support of First American Title Insurance Company's motion to dismiss a third-party complaint against it for filing a termination statement in error in the case of *Meridian Automotive Systems-Composites Operations, Inc.,* et al. in the United States District Court for the District of Delaware. The Disclosure Statement in the proceeding was approved on October 25, 2006. The confirmation hearing on the debtor's reorganization plan was on November 29, 2006. Because no objections were filed with the court by November 22, 2006 (and none were expected, because the plan was consensual), the court approved the debtor's plan on November 22, 2006, and subsequently issued its confirmation order. There was no appeal. The order discharged all claims against First American and gave first-lien lenders a lien avoidance release. The issue of the erroneous filing became moot, because all the parties agreed to the plan.

[5] *See* UCC §9-510(a) ("A filed record is effective only to the extent that it was filed by a person that may file it under §9-509.")

[6] *See* Official Comment 5 to UCC §9-509 ("Law other than this Article … generally determines whether a person has requisite authority to file a record under this section.")

[7] *See*, e.g., Restatement (Third) of Agency, §§2.01 and 2.02; *Green v. Hellman*, 412 N.E.2d 1301, 1305-06 (N.Y. 1980); *Billops v. Magness Construction Co.*, 391 A.2d 196, 197 (Del. 1978); *Lydon v. Eagle Food Centers, Inc.,* 696 N.E.2d 1211, 1215 (Ill.App.Ct. 1998).

[8] *See id.*

[9] *See* comment b to Restatement (Third) of Agency, §2.01; Green, 412 N.E.2d at 1305-06; Lydon, 696 N.E.2d at 1215; *Guyer v. Haveg Corp.,* 205 A.2d 176, 179-80 (Del.Super.Ct.1964).

[10] *See Petrovich v. Share Health Plan of Illinois, Inc.,* 719 N.E.2d 756, 770 (Ill. 1999); Green, 412 N.E.2d at 1305; Guyer, 205 A.2d at 179-80.

[11] *See* Restatement (Third) of Agency, §2.01 (emphasis added).

[12] Apparent authority holds the principal accountable for the result of third-party beliefs about the actor's authority as an agent when the belief is reasonable and is traced to a manifestation of the principal. Apparent authority trumps restrictions the principal may have privately imposed on the agents regarding reliance by third parties. Any set of circumstances can support apparent authority where the third party reasonably believes that the agent has authority so long as that belief is traceable to manifestations of the agent by the principal. Comment c to §2.03, Restatement (Third), at 114.

[13] *See* Petrovich, 719 N.E.2d at 765-66; *Hallock v. State*, 474 N.E.2d 1178, 1181 (N.Y. 1984); *Billops*, 391 A.2d at 198; *Finnegan Construction Co. v. Robino-Ladd Co.*, 354 A.2d 142, 145-46 (Del.Super.Ct. 1976.

[14] §§9-509(d) and 9-510.

[15] *See* Restatement (Third) §2.03; *Petrovich*, 719 N.E.2d at 765-766; *Hallock*, 474 N.E.2d at 1181; *Billops*, 391 A.2d at 198; *see* also Restatement, supra, §27.

[16] This conclusion has led some of us to argue that the financing statement record should be reformed if the only complaining party is the trustee in bankruptcy, because the trustee is a hypothetical lien creditor rather than a reliance creditor on the UCC record.

[17] Both this case and the case in note 11 supra involve First American Title Insurance Company, my employer. I picked these cases for three reasons; (1) they are on point for this article; (2) I thought it better to choose cases involving First American than cases involving one of our competitors, because I do not want to be accused of picking on the competition; and (3) most important, given the inherent reality of human frailty, if we can make this kind of mistake, anyone can.

[18] If a secured party's "correction" statement under §9-518 to revise a financing statement record retroactively is inappropriate; it seems even more inappropriate to use an amendment to delete a termination statement retroactively.

[19] *See* Uniform Commercial Code, official comment to §9-509.

[20] The Court cited *Montgomery v. Bank of America Nat. Trust and Savings Ass'n.,* 85 Cal.App.2d 559, 193 P.2d 475 (1948) (a party to an escrow was not bound by the escrow holder's unauthorized alteration of a deed, which deed was rendered void by the alteration).

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