The Hazards To Secured Status Caused by Minor Mistakes In A Security Agreement

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A creditor seeking to obtain a security interest in a customer's personal property must satisfy all of the requirements for a valid and perfected security interest. They include the debtor's execution of a security agreement that adequately describes the secured indebtedness and the collateral securing payment of the claim. Any mistake in the security agreement, even a minor one, could be fatal to the creditor's secured status, particularly after the debtor files for bankruptcy.

That is the harsh lesson a lender learned being on the losing side with respect to the holding of the United States Court of Appeals for the *Seventh Circuit in State Bank of Toulon v. Charles E. Covey* (In re: Duckworth). The court addressed a minor error in the security agreement that mistakenly identified the secured debt as a non-existent promissory note dated December 13, 2008 instead of the correct promissory note actually dated two days later, December 15, 2008. The court also considered whether the bank could have fixed this error by reforming the security agreement following its borrower's bankruptcy filing.

The Seventh Circuit ruled that the Chapter 7 trustee in the debtor's bankruptcy case could avoid the bank's security interest as a result of the mistaken description of the bank's claim in the security agreement. The court also held that the trustee was not bound by state law rules, that might have otherwise enabled the bank to correct its mistake in the security agreement in the absence of the debtor's bankruptcy filing, based on the trustee's "strong arm powers" as a hypothetical lien creditor under the Bankruptcy Code.

That is really bad news for the sloppy creditor and an important lesson to avoid even minor mistakes in the description of the secured debt and the collateral in the security agreement.

Obtaining and Perfecting a Security Interest

A creditor seeking to obtain a security interest in a debtor's personal property must satisfy several requirements contained in Article 9 of the Uniform Commercial Code (the "UCC"). First, the creditor must satisfy the requirements for the creation or attachment of a security interest in a debtor's personal property. A creditor obtains a security interest when a debtor executes a security agreement that adequately describes both the secured indebtedness and the collateral securing payment of the claim.

Second, the creditor must perfect its security interest. Perfection ensures that a creditor's security interest in its 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 in the appropriate filing office. A UCC-1 financing statement need not be signed by the debtor, and must identify the debtor by its correct legal name and adequately describe the collateral consistent with the description of the collateral in the security agreement.

The *Duckworth* case addressed a minor mistake in a bank's security agreement that ended up being fatal to the bank's secured status. The security agreement mistakenly referred to the secured indebtedness as a promissory note dated December 13, 2008. No such note existed; the actual note was dated December 15, 2008.

Facts

On December 15, 2008, David L. Duckworth borrowed $1,100,000 from the State Bank of Toulon. Mr. Duckworth's promissory note was dated and signed on December 15. Duckworth had executed an Agricultural Security Agreement dated two days earlier, December 13, 2008. The security agreement granted the State Bank of Toulon a security interest in crops and farm equipment. However, the security agreement mistakenly described the secured indebtedness as the December 13, 2008 note. In fact, there was no promissory note dated December 13, 2008; the note the bank sought to secure was actually dated December 15, 2008.

Procedural History

In 2010, Duckworth filed a Chapter 7 petition in the United States Bankruptcy Court for the Central District of Illinois. Charles E. Covey was appointed Chapter 7 trustee. The bank filed two complaints in the bankruptcy court seeking recovery of the proceeds of the sale of its collateral. The trustee asserted counterclaims in both lawsuits, seeking a determination that the bank did not have a valid security interest in its collateral because of the minor error in the date of the note identified as the secured indebtedness in the security agreement.

The bankruptcy court ruled in favor of the bank, holding that its security interest was not defeated by the security agreement's mistaken reference to a non-existent December 13, 2008 note. The trustee appealed to the United States District Court for the Central District of Illinois. The district court affirmed the bankruptcy court's ruling, upholding the validity of the bank's security interest, notwithstanding the security agreement's reference to a non-existent December 13, 2008 note.

The trustee then appealed to the Seventh Circuit. The Seventh Circuit had to decide whether the trustee could avoid the bank's security interest as a result of the error in the security agreement that mistakenly described the secured indebtedness as a non-existent note dated December 13, 2008 instead of the actual December 15, 2008 note.

The Parties' Arguments

The bank argued that the security agreement was enforceable against the original borrower and should have also been enforceable against the trustee. The bank relied on the terms of the security agreement itself, as well as evidence outside of the security agreement, to save its security interest. First the bank invoked the ambiguity of the security agreement in arguing for the applicability of the parol evidence role and the admissibility of parol evidence outside of the four corners of the agreement to assist in interpreting the security agreement.[1] The parol evidence consisted of the testimony of both the debtor and an officer of the bank, who had prepared the agreement and the other loan documents, that the bank had made a mistake in its reference to the December 13, 2008 note in the security agreement. The bank also relied on the "composite document" rule[2] to read the security agreement and December 15, 2008 note together because they were executed as part of the same transaction. The bank finally argued that its transaction with the debtor satisfied the statutory requirements for an enforceable security interest under section 9-203 of the Uniform Commercial Code.[3]

The trustee relied on his strong arm powers, and his hypothetical lien creditor status to avoid the bank's security interest and block the bank from reforming the faulty security agreement (and thereby save the faulty security interest) by introducing evidence of a mistake describing the secured debt outside of the terms of the security agreement. The trustee also invoked another provision of Article 9 of the UCC, UCC section 9-201, which requires enforcement of a security agreement according to its terms. The bank did not have a valid security interest in the collateral described in the security agreement because the security agreement had mistakenly identified as the secured indebtedness a non-existent note, the December 13, 2008 note, instead of the correctly dated December 15, 2008 note.

The Seventh Circuit's Decision

The Seventh Circuit sided with the trustee and held that the security agreement was not enforceable. The security agreement was unambiguous; it secured only a non-existent December 13 note and not the actual December 15 note.

The Seventh Circuit also rejected the bank's attempt to raise the parol evidence and composite document rules to correct the mistaken description of the secured indebtedness in the security agreement because they would allow the consideration of evidence outside of the four corners of the security agreement to connect the security agreement to the December 15, 2008 promissory note. The trustee was not bound by any external evidence outside of the security agreement that the bank had sought to introduce to reform the security agreement and otherwise correct the mistaken identification of the secured debt under state law.[4] The trustee was not a party to the security agreement and the other loan documents. The trustee also could exercise his "strong-arm powers" as a hypothetical judicial lien creditor under Section 544(a) of the Bankruptcy Code to avoid any invalid security interest.

The Seventh Circuit relied on two other U.S. Circuit Courts of Appeals decisions in reaching its holding that the trustee could rely on the unambiguous text of the security agreement and the trustee's strong arm powers to avoid the bank's security interest and not be bound by parol evidence that could otherwise correct any mistake in the security agreement. The first decision was *In re Martin Grinding & Machine Work, Inc.*, also decided by the Seventh Circuit. The court held that parol evidence regarding the original parties' intentions was not binding on a bankruptcy trustee to correct a mistaken collateral description in a security agreement that failed to include accounts and inventory. Neither the UCC financing statement, which included accounts and inventory as part of the bank's collateral, nor the other loan documents, could expand the bank's collateral beyond the collateral description in the security agreement. The court noted UCC Article 9's central goal to increase the certainty, and reduce the cost, of present-day secured financing transactions. Later secured creditors should be able to rely on an unambiguous security agreement without having to worry that a prior secured creditor might offer parol evidence (which would ordinarily be unknown to the later creditor) to undermine the later creditor's security interest. If parol evidence could enlarge the description of collateral contained in an unambiguous security agreement, then a subsequent creditor could no longer rely on the security agreement to determine whether its collateral is subject to a prior security interest. Instead, that later creditor would be burdened with having to

1 The parol evidence rule governs the extent to which parties to a contract can introduce evidence of a prior or contemporaneous agreement in order to modify, explain, or supplement the contract at issue. Where the parties intended their written agreement to be the full and final expression of their bargain, by including language that the agreement constitutes the entire agreement of the parties and all prior agreements and understandings relating to the matters raised in the agreement are superseded by the terms of the agreement, then all other prior written and oral agreements are inadmissible for the purpose of changing the terms of the final agreement.

2 The composite document rule allows for documents executed by same parties in the course of the same transaction to be "construed with reference to one another because they are, in the eyes of the law, one contract."

3 Section 9-203 of the Uniform Commercial Code states that "[a] security interest is enforceable against the debtor and third parties… only if:

(1) value has been given;
(2) the debtor has rights in the collateral…; and
(3) one of the following conditions is met:… the debtor has authenticated a security agreement that provides a description of the collateral…"

4 The court noted that the bank would have been able to obtain reformation of the security agreement as against the debtor/original borrower prior to the bankruptcy based on the mistaken reference to the December 13, 2008 note in the security agreement.

examine ancillary documents that would increase the cost of, and inject significant uncertainty into, secured transactions.

The Seventh Circuit, in *Duckworth*, also relied on the holding of the United States Court of Appeals for the First Circuit in *Safe Deposit Bank and Trust Co. v. Berman*. That case, like the Duckworth case, involved a mistaken description of the lender's secured indebtedness in the security agreement. There were multiple loans evidenced by multiple promissory notes executed over several years that referred to the same security agreement. Unfortunately for the lender, the security agreement identified the secured debt as only the amount owed under the initial promissory note. By the time of his bankruptcy, the borrower had fully repaid the initial note referenced in the security agreement. As a result, the security agreement, like the security agreement in the Duckworth case, referred to non-existent indebtedness, and accordingly, there was no existing indebtedness that could be secured under the security agreement.

The First Circuit held that the lender could not use parol evidence against the trustee to prove that the loans evidenced by the later promissory notes were secured by the original security agreement. First, those notes were not identified as indebtedness in the security agreement. The court also relied on the security agreement's omission of a "dragnet clause" stating that the collateral secured payment of all present and future indebtedness. The court noted that the absence of a dragnet clause precluded the lender in any litigation against the trustee from raising parol evidence to fix the error in the security agreement.

Finally, the Seventh Circuit, in the *Duckworth* case, rejected the bank's argument that its security interest was enforceable against the trustee because the transaction satisfied the requirements of the Illinois version of UCC section 9-203 for enforcing a security interest, namely, that value was given, the debtor had rights in the collateral and the debtor had signed the security agreement. The court agreed with the trustee's reliance on UCC section 9-201(a) which requires enforcement of the security agreement as written. Since the security agreement referenced the December 13, 2008 non-existent debt, the bank did not obtain a valid security interest.

Conclusion

A secured trade creditor should be mindful to avoid even minor mistakes in its security agreement and other documents that might result in the loss of secured status. Bankruptcy trustees and other estate fiduciaries, such as creditors' committees, are usually searching for flaws, even minor defects, in security agreements and UCC financing statements that would be grounds for attacking a creditor's security interest. Dotting your I's and crossing your T's will go a long way to avoiding a horrible outcome!

About the authors:

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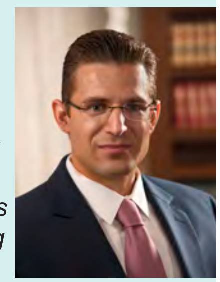

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