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Harsh Realities at Intersection of UCC and Bankruptcy Code

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A recent decision from the Seventh Circuit again emphasizes the importance of avoiding errors when it comes to drafting secured loan documents, as reformation of those documents, which may be readily available to correct mistakes under state law outside bankruptcy, is an ineffective remedy as to a trustee in bankruptcy. The mistake at issue in *State Bank of Toulon v. Covey (In re Duckworth)* appeared to be a relatively small one: The security agreement referred to the date of the promissory note as Dec. 13 instead of the correct date, Dec. 15.[1] However, when a chapter 7 trustee challenged the validity of the lien based on this arguably harmless error, the Seventh Circuit sided with the trustee and held that reformation was no longer an option[2] and that the security agreement must be enforced "according to its terms."[3] To reach its conclusion, the Seventh Circuit relied on (1) the policy of the Uniform Commercial Code (UCC) of protecting creditors by ensuring that they have sufficient notice of a prior lender's lien, and (2) the trustee's position on the petition date as a hypothetical judicial lien creditor under § 544(a).[4]

Background

In this case, the borrower, David Duckworth, had a series of loans with the State Bank of Toulon.[5] The bank lent the borrower approximately $1.1 million pursuant to a secured promissory note dated Dec. 15, 2008.[6] The related security agreement granted the bank a security interest to secure "the Indebtedness," which the security agreement defined as "the indebtedness evidenced by the Note or Related Documents."[7] However, the security agreement included a small but "critical mistake": It defined "note" as the "note executed by David Duckworth in the principal amount of $_____ dated December 13, 2008," whereas the actual promissory note was dated Dec. 15, 2008.[8] Similarly, the term "related documents" referred to documents executed in connection with the Dec. 13 "note."[9]

The borrower filed a chapter 7 case in the Central District of Illinois, and **Charles E. Covey** was appointed chapter 7 trustee.[10] The State Bank of Toulon filed two adversary proceedings against the chapter 7 trustee to determine the validity of the lien created by the security agreement in various collateral that had been liquidated after the bankruptcy filing.[11] The chapter 7 trustee filed counterclaims in both adversary proceedings seeking a declaratory judgment that the lien was invalid and to avoid the bank's security interest pursuant to 11 U.S.C. §§ 544 and 551.[12] Both parties moved for summary judgment in each of the adversary proceedings.[13]

The Bankruptcy Court's Opinions

The bankruptcy court agreed with the bank that despite the "clerical error," the security agreement remained effective to secure the promissory note, and the bankruptcy court entered summary judgment for the bank on that issue.[14] In its decision, the bankruptcy court noted that the standard for enforceability of a security agreement against a debtor and third parties is set forth in UCC § 9-203,[15] which provides, in pertinent part, that

> [a] security agreement 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.

Accordingly, the bankruptcy court held that "[o]nce those conditions are met, the issue of enforceability is resolved."[16] Thus, it was irrelevant that the security agreement failed to properly describe the promissory note (*i.e.*, the debt), because UCC § 9-203 "does not regulate the description of the value" provided by the lender.[17]

In contrast to the bank's arguments and the bankruptcy court's reasoning, the chapter 7 trustee had

1 *State Bank of Toulon v. Covey (In re Duckworth)*, 776 F.3d 453 (7th Cir. 2014).
2 *Id.* at 458.
3 *Id.* at 456.
4 *Id.* at 457-61.
5 *Id.* at 455.
6 *Id.* at 454.
7 *Id.* at 455.
8 *Id.*
9 *Id.* at 457.
10 *Id.* at 455.
11 *Id.*
12 *State Bank of Toulon v. Covey (In re Duckworth)*, Nos. 10-83603, 11-8037, 2013 WL 211231, at *1 (Bankr. C.D. Ill. Jan. 18, 2013) (*Covey II*); *State Bank of Toulon v. Covey (In re Duckworth)*, Nos. 10-83603, 11-8002, 2012 WL 986766, at *1 (Bankr. C.D. Ill. March 22, 2012) (*Covey I*).
13 *Id.*
14 *Covey II*, 2013 WL 211231, at *8; *Covey I*, 2012 WL 986766, at *5. The bankruptcy court issued opinions in both adversary proceedings. The second opinion incorporated and elaborated the reasoning of the first opinion.
15 *Covey I*, 2012 WL 986766, at *4.
16 *Id.* at *5.
17 *Covey II*, 2013 WL 211231, at *6.

argued that UCC § 9-201(a) required the court to enforce the security agreement according to its terms.[18] Section 9-201(a) provides that "a security agreement is effective according to its terms between the parties ... and against creditors." However, the bankruptcy court disagreed with the chapter 7 trustee, noting that under Illinois law, parol evidence can be used in a dispute between third parties to a contract.[19] The bank could thus use parol evidence against the chapter 7 trustee to interpret the security agreement.[20] As such, the bankruptcy court concluded that "[a]ll of the evidence in the record," including testimony from the bank's loan officer and the borrower, showed that the parties intended the security agreement to secure the promissory note.[21] The chapter 7 trustee appealed the judgments in both adversary proceedings to the district court, which affirmed,[22] and then subsequently appealed the district court decisions to the Seventh Circuit Court of Appeals.[23]

The Seventh Circuit's Ruling

The Seventh Circuit, in an opinion written by Hon. David Hamilton, reversed the bankruptcy court's decisions.[24] The Seventh Circuit first held that the security agreement was not ambiguous[25] and granted the bank a security interest to secure the "Note or Related Documents."[26] The definition of "note" in the security agreement "refers clearly to a December 13 promissory note that never existed."[27] Similarly, the agreement's defined term "related documents" was circular and referred back to the nonexistent Dec. 13 promissory note.[28] The security agreement thus clearly described a specific promissory note, albeit a fictional one.

The Seventh Circuit conceded that parol evidence showed that the parties intended to secure the debt under the Dec. 15 promissory note.[29] The evidence "makes [it] clear that the bank made a mistake in preparing the security agreement."[30] As against the borrower, the bank could also likely obtain reformation of the security agreement to correct the mistaken date using parol evidence.[31]

However, the Seventh Circuit held that parol evidence could not be used to obtain reformation against the chapter 7 trustee because "a bankruptcy trustee is in a different position" than a borrower.[32] Section 544(a)(1) of the Bankruptcy Code places the trustee in the position of a hypothetical judicial lien creditor who may "void a security interest because of defects that need not have misled, or even have been capable of misleading, anyone."[33]

The Seventh Circuit further held that the security agreement, as written, could not be enforced against a hypothetical judicial lien creditor using parol evidence.[34] "Such a creditor would be entitled to rely on the text of a security agreement, despite extrinsic evidence that could be used between the original parties to correct the mistaken identification of the debt to be secured."[35] The court relied on the reasoning in two circuit level opinions: *In re Martin Grinding*[36] and *Safe Deposit Bank and Co. v. Berman*.[37]

In *Martin Grinding*, the bank's security agreement failed to list inventory and accounts receivable as collateral.[38] On the other hand, the bank's recorded financing statement included those items as collateral.[39] After the debtor filed a chapter 11 case, the bank filed an adversary proceeding to determine the extent of its lien in the inventory and accounts receivable.[40] The bankruptcy court dismissed the complaint for failure to state a claim, refusing to consider parol evidence that the parties intended to secure the loan with the inventory and accounts receivable.[41] Both the district court and Seventh Circuit affirmed.[42] "Since the security agreement is unambiguous on its face, neither the financing statement, nor the other loan documents can expand the ... security interest beyond that stated in the security agreement."[43]

Expounding on *Martin Grinding*, the Seventh Circuit explained that the result in that case "allows later lenders to rely on the face of an unambiguous security agreement, without having to worry that a prior lender might offer parol evidence ... to understand the later lender's security interest."[44] Therefore, although the application of the rule "works ... contrary to the parties' intentions in particular cases, it reduces the cost and uncertainty of secured transactions generally."[45]

The bank tried to distinguish *Martin Grinding* as involving a description of collateral, which UCC § 9-203 expressly requires, rather than a description of the debt to be secured, which the UCC does not expressly require.[46] The Seventh Circuit disagreed, finding the holding and reasoning in the First Circuit's *Berman* decision persuasive.[47]

In *Berman*, the debtor entered into a series of secured promissory notes in favor of the lender, but only entered into a security agreement that referred to the initial promissory note.[48] By the time of the debtor's bankruptcy filing, that first promissory note had been paid in full.[49] The bankruptcy and district courts refused to consider parol evidence of the parties' intent to also secure future indebtedness owed by the debtor to the lender without the inclusion of a specific "dragnet" provision, or other reference to the subsequent promissory notes, in the security agreement.[50] The First Circuit affirmed, explaining that "[i]f security agreements, which, on their face, served as collateral for specific loans, could

18 *Id.* at *6-7.
19 *Covey I*, 2012 WL 986766, at *5 (citing Illinois law).
20 *Id.*
21 *Covey II*, 2013 WL 211231, at *7.
22 *Duckworth*, 776 F.3d at 546.
23 *Id.*
24 *Id.* at 455.
25 *Id.* at 456-57.
26 *Id.* at 456.
27 *Id.* at 456-57.
28 *Id.* at 457.
29 *Id.* at 457-58.
30 *Id.*
31 *Id.* (citing Illinois law).
32 *Id.* at 458 (citing *In re Vic Supply Co.*, 227 F.3d 928, 931 (7th Cir. 2000)).
33 *Id.*
34 *Id.* at 457-59.
35 *Id.* at 459.
36 793 F.2d 592 (7th Cir. 1986).
37 393 F.2d 401 (1st Cir. 1968).
38 793 F.2d at 593.
39 *Id.*
40 *Id.* at 594.
41 *Id.*
42 *Id.* at 593-94.
43 *Id.* at 595.
44 *Duckworth*, 776 F.3d at 459.
45 *Id.* (quoting *Martin Grinding*, 793 F.2d at 597).
46 *Id.* at 460.
47 *Id.*
48 393 F.2d at 402.
49 *Id.*
50 *Id.* at 401-02.

continued on page 75

from page 33

be converted into open-ended security agreements for future liabilities ... much needless uncertainty would be introduced into modern commercial law."[51] However, the First Circuit did note that if the security agreement had contained the missing "dragnet" provision (a common provision in most commercial security agreements), there would not have been an issue.[52] The Seventh Circuit found *Berman* indistinguishable from the case before it — because in both "the lender made a mistake and failed to ensure that the security agreement properly identified the debt to be secured."[53]

Finally, the Seventh Circuit disagreed with the bankruptcy court's holding that the bank needed merely to comply with UCC § 9-203 to have an enforceable security interest.[54] The Seventh Circuit cited UCC § 9-201(a), which requires a security agreement be "enforced as written."[55] Compliance with UCC § 9-203 is a necessary condition for the enforcement of a security interest, but it will not prevent a court from enforcing a security agreement "according to its terms" pursuant to UCC § 9-201(a). "Section 9-203 sets out the minimum requirements that must be satisfied to enforce a security interest. It does not provide a mechanism for rescuing a lender from its mistakes in drafting a security agreement."[56]

51 *Id.* at 404.
52 *Id.*
53 *Duckworth*, 776 F.3d at 461.
54 *Id.* at 461-62.
55 *Id.*
56 *Id.*

Conclusion

Although grounded in the text of the UCC, strong policy considerations seem to underlie much of the Seventh Circuit's draconian — but understandable — decision in *Duckworth*. "Later creditors and bankruptcy trustees are entitled to treat an unambiguous security agreement as meaning what [the documents say], even if the original parties have made a mistake in expressing their intentions."[57] The bank may have avoided this situation entirely if the security agreement had included a "dragnet" clause that secured all other indebtedness between the parties. Courts have also held this analysis to be applicable to debtors in possession (DIPs), despite the appearance of inequity in allowing a DIP to benefit because of its own mistake.[58] In any event, the opinion is a sobering reminder for drafting counsel to carefully review loan documents to ensure their perfection before execution. The case may also encourage chapter 7 trustees to scour loan documents for "nits" that may unravel an otherwise-perfected security interest. abi

57 *Id.* at 462-63.
58 The Bankruptcy Code grants DIPs "all the rights ... of a trustee," 11 U.S.C. § 1107(a), including the "strong-arm" powers under § 544(a). *See, e.g., In re MacroNet Grp. Ltd.*, 2004 WL 2958447, at *3 (Bankr. C.D. Ill. April 22, 2004) (granting summary judgment to DIP and avoiding security agreement under § 544(a) for failing to sufficiently describe collateral). A trustee's avoidance powers are "without regard to any knowledge of the trustee." 11 U.S.C. § 544(a). Courts have construed this provision to apply to DIPs as well. *Collier on Bankruptcy* ¶ 544.02[2] (Alan N. Resnick and Henry J. Sommer eds., 16th ed.) ("Even the [DIP] when exercising a trustee's section 544(a) powers is not charged with actual notice received while it was a pre-petition creditor."). Thus, for example, the Seventh Circuit has refused to impute a debtor's pre-petition knowledge of an improperly recorded mortgage to a chapter 11 DIP. *See, e.g., In re Sandy Ridge Oil Co. Inc.*, 807 F.2d 1332, 1335-37 (7th Cir. 1986).