MINOR MISTAKE CAN LEAD TO AVOIDANCE OF MORTGAGE

The Seventh Circuit Court of Appeal's recent decision in State Bank of Toulon v. Covey (In re Duckworth) Case Nos. 14-1561 and 1650 (7th Cir. November 21, 2014) illustrates how a banker's seemingly minor mistake in drafting secured loan documents granting a lien to secure a non-existent obligation can lead to avoidance of a lender's security interest by the borrower's bankruptcy trustee.

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On December 15, 2008, David Duckworth (the "Borrower" or the "Debtor") borrowed $1.1 million from the State Bank of Toulon (the "Bank"). The Borrower executed and delivered to the Bank a note (the "December 15 Note") for $1.1 million dated that same day. Two days earlier, on December 13, 2008, the Borrower signed a security agreement (the "Security Agreement") granting the Bank a security interest in substantially all of the Borrower's personal property. However, the Security Agreement stated that it secured a note "in the principal amount of $_____ dated December 13, 2008" (the "December 13 Note"). No such note existed. Nor did the security agreement contain a "dragnet" clause providing that the Borrower's collateral secured all of the Borrower's past, present and future obligations to the Bank. The Bank's loan officer prepared both the December 15 Note and the Security Agreement. The Bank and the Borrower both intended for the Bank's lien to secure the Borrower's obligations under the December 15 Note.

Two years later, the Borrower filed a chapter 7 bankruptcy petition. Recognizing the discrepancy between the December 15 Note and the December 13 Note referenced in the Security Agreement, the Bank filed complaints in the bankruptcy court seeking declarations that its security interest was valid. The bankruptcy court held that the mistaken reference in the Security Agreement to a December 13, 2008 Note did not defeat the Bank's security interest. The bankruptcy trustee (the "Trustee") appealed to the District Court, which affirmed the bankruptcy court's decision. The

Trustee appealed to the Seventh Circuit Court of Appeals (the "Court"), which reversed the lower court decisions.

The Trustee argued that the Security Agreement unambiguously identified the debt to be secured as the December 13 Note. However, that Note did not exist. Consequently, the Security Agreement failed to grant a security interest securing the December 15 Note. Even if the Borrower and the Bank could have corrected the Security Agreement's mistaken reference to a December 13 Note before the Borrower's bankruptcy, the Trustee argued that parol evidence (i.e. evidence of the Borrower's and the Bank's intent extrinsic to the Security Agreement) could not be used against the Trustee to correct that mistake.

In response, the Bank argued that the Security Agreement was enforceable between the parties, and was, therefore, also enforceable against the Trustee. The Bank based its argument on (1) the Security Agreement itself, (2) parol evidence of the parties original intent, (3) the "composite document" rule, and (4) the Security Agreement's satisfaction of the Uniform Commercial Code's minimum requirements for creating an enforceable security interest.

The Court rejected each of the Bank's arguments. First, the Court found that the Security Agreement unambiguously defined the indebtedness to be secured as the indebtedness reflected in the December 13 Note – a note that never existed. This lack of ambiguity barred the use of parol evidence against the Trustee to show that the Security Agreement's reference to a December 13 Note was a mistake. Next, the Court declined to employ the composite document rule (i.e., the rule that documents executed by the same parties in the course of the same transaction should be construed with reference to one another because they are, in the eyes of the law, one contract) to correct the parties' mistake. Doing so would also violate the rule barring the use of parol evidence to vary the terms of the unambiguous Security Agreement.

Even if testimony of the Borrower and the Bank officer who prepared the December 15 Note and the Security Agreement proved that the Security Agreement's reference to a December 13 Note was a mistake that could have been corrected by reformation of the Security Agreement, the Court held that such testimony could not be used against the Trustee. The Court recognized that the Trustee had a duty to maximize the value of the Debtor's estate for the benefit of unsecured creditors. To assist the Trustee in

fulfilling that duty, section 544(a)(1) of the Bankruptcy Code gives the Trustee the power of a hypothetical judgment lien creditor to avoid a defective security interest. The Court concluded that the Bank's security interest was defective. Therefore, a judgment lien creditor (who would be entitled to rely on the unambiguous text of the Security Agreement) could have avoided the Bank's security interest and lien. The Court observed that this result promoted certainty in commercial transactions:

The rigid rule 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 (which would ordinarily be unknown to the later lender) to undermine the later lender's security interest.

We must hew to the 'necessary technicalities inherent in any law governing commercial transactions,' even when the result is harsh.

Finally, the Court rejected the Bank's argument that its security interest was enforceable against the Trustee because the Security Agreement satisfied Uniform Commercial Code section 9-203(b)'s the requirements for creating a valid security interest, i.e., value had been given, the Borrower had rights in the collateral, and the Borrower had authenticated a security agreement that provided a description of the collateral. The Court agreed with the Trustee that Uniform Commercial Code section 9-201(a) Uniform Commercial Code establishes the general rule "that the terms of a security agreement must be enforced as written." That section provides, in pertinent part, as follows: "[e]xcept as otherwise provided in the Uniform Commercial Code, a security agreement is effective according to its terms between the parties, ... and against creditors." The Court held that this general rule trumps Uniform Commercial Code section 9-203. In short, satisfying Uniform Commercial Code section 9-203's requirements for creating a security interest could not cure the invalidity caused by the Security Agreement's failure to correctly identify the Borrower's debt.

The Court concluded by holding that "the mistaken identification of the debt to be secured cannot be corrected, as against the bankruptcy trustee, by using parol evidence to show the intent of the parties to the original loan... Later creditors and bankruptcy trustees are entitled to treat an unambiguous security agreement as meaning what it says, even if the original parties have make a mistake in expressing their intentions."

The lessons to be learned from Duckworth are simple: (1) read all of your loan documents carefully to make sure that each one accurately describes all other documents which are part of the transaction, and (2) be sure to include a dragnet clause in your security agreement. Foolish inconsistencies can permit the borrower's bankruptcy trustee to avoid a careless lender's security interest.