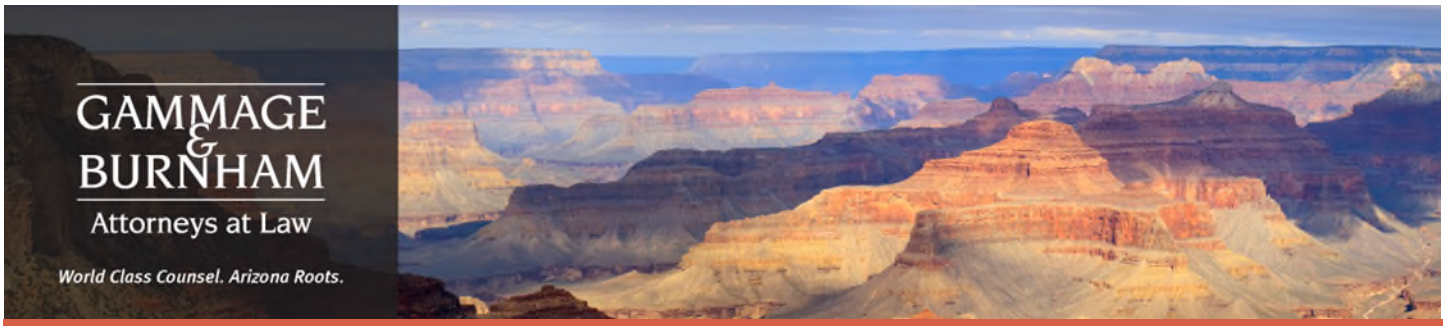

Legal Alert

July 2020

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QUESTION: HOW DID THE BANK LOSE OVER $1 MILLION WORTH OF COLLATERAL DUE TO A PETTY TYPOGRAPHICAL ERROR?

ANSWER: A BANKRUPTCY TRUSTEE ACTS AS A HYPOTHETICAL SECURED CREDITOR THAT CAN IGNORE THE REALITIES OF THE FACTS!

What a difference two days makes!

The State Bank of Toulon lost its collateral securing a loan of $1,100,000 because its security agreement had the number "13" for a date instead of the number "15." Really!

David L. Duckworth borrowed $1.1 million from the State Bank of Toulon (the "Bank") on December 15, 2008. The loan transaction was documented with a promissory note dated and signed on December 15, 2008. The document creating the lien against the collateral was an Agricultural Security Agreement ("Security Agreement") dated December 13, 2008. The Security Agreement granted a security interest in crops and farm equipment belonging to Mr. Duckworth. *In re Duckworth, 776 F.3d 453 (7th Cir., 2014)*

So what went wrong?

The Security Agreement said that it secured a promissory note "dated December 13, 2008." No promissory note dated December 13, 2008 existed, however. The promissory note was dated December 15, 2008. The Court said that the Security Agreement secured a loan that did not exist!

How could the Court reach such an absurd conclusion?

The bankruptcy trustee argued that while the Security Agreement identified the secured debt, it "did so only for a non-existent debt and therefore failed to grant a security interest to secure the note of December 15, 2008." The court stated:

> We conclude that although the evidence could have supported reformation of the security agreement as between the original parties, the evidence cannot be used against the bankruptcy

> trustee to reform the security agreement or otherwise to correct the mistaken identification of the debt to be secured.

The court refused to allow evidence of the real intent of the parties to change the result:

> On its face, the security agreement secures only a December 13 promissory note that never existed. The text of this security agreement does not incorporate the promissory note dated December 15 or the description of the debt contained therein.

Bankruptcy trustees are permitted to ignore the realities of the transaction because "trustees may exercise the so-called strong-arm power: the trustee is deemed to be in the privileged position of a hypothetical subsequent creditor and can avoid any interests that a hypothetical subsequent creditor could avoid 'without regard to any knowledge of the trustee or of any creditor.'"

The court summarized its holding as follows:

> Accordingly, we hold that the mistaken identification of the debt to be secured cannot be corrected, against the bankruptcy trustee, by using parol evidence to show the intent of the parties to the original loan. Nor do the other loan documents themselves provide a basis for correcting the error against the trustee. Later creditors and bankruptcy trustees are entitled to treat an unambiguous security agreement as meaning what it says, even if the original parties have made a mistake in expressing their intentions.

What can we learn from the Bank's difficulties?

All of the disputed loan documents "were prepared by the bank's loan officer." While we have not seen the actual loan documents, they appear to have been standard form "fill in the blank" loan documents.

Usually, any properly prepared security agreement or other document creating a lien against collateral would include a "dragnet" provision providing that the collateral secures the original indebtedness and any and all other obligations of the debtor or guarantors to the secured lender. Such language would have fixed the problem of the mistaken date of the promissory note.

Unfortunately, "fill in the blank" forms prepared by staff with no legal training can result in some very bad results.

If you need help properly documenting secured transactions or understanding the risks of those transactions, please call me.