WHY ALL THE FUSS: RECENT LITIGATION OVER SECURITY AGREEMENTS

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Creating and perfecting a security agreement is supposedly pretty straightforward.

Despite this, there has been quite a fuss in recent cases about the effectiveness and enforceability of such agreements.

This article looks at the basic requirements for creating and perfecting a security agreement, and the litigation that has ensued in three recent Illinois bankruptcy cases.

Basic Principles

Under the Uniform Commercial Code as adopted in Illinois, "security agreement" simply means "an agreement that creates or provides for a security interest." [FN1]

The statutory requirements for such an agreement are few and simple; no particular form or special language is required. The three requirements are:

1. Value has been given;

2. The debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party;

3. The debtor has authenticated a security agreement that provides a description of the collateral, or is otherwise in possession of the collateral as set forth in 9-203. [FN2]

When required, a financing statement must be filed to perfect the relevant security interest. [FN3] Such a financing statement is sufficient only if it:

1. Provides the name of the debtor;

2. Provides the name of the secured party or a representative of the secured party; and

3. Indicates the collateral covered by the financing statement. [FN4]

A financing statement substantially satisfying these requirements is effective even with minor errors and omissions, as long as those minor errors and omissions are not "seriously misleading." [FN5]

Challenge to "Value Given" Requirement

In the *Duckworth* case, a chapter 7 trustee and another interested party challenged the sufficiency of an Agricultural Security Agreement ("ASA") which did not identify the date or amount of the secured debt. The ASA identified the loan date as December 13, 2008, when the note was actually dated December 15, 2008. The ASA also did not reflect the principal amount of the loan. [FN6]

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While the parties conceded that the second and third requirements were satisfied, they contended that as a result of the discrepancies, the ASA secured a debt that did not exist. Consequently, they argued that the value requirement of UCC § 5/9-203(b) was defeated. [FN7]

The Court rejected this argument, as it found that the evidence that the lender disbursed the sum of $1.1 million under the note was uncontradicted, satisfying the value requirement. Once the three conditions of 9-203(b) were met, therefore, the issue of enforceability of the ASA was resolved. [FN8]

While the Court found the ASA effective to secure the original $1.1 million note and be enforceable against the debtor and third parties, it found that the ASA did not secure a later-made note in the amount of $950,000. The Court noted that dragnet (or future advances or cross-collateral) clauses are enforceable in Illinois if expressed in a security agreement in unambiguous terms, but the ASA in this case did not contain such a provision. [FN9]

Challenge to Form of Security Agreement

In the *Westermeyer* case, the debtor never signed a formal security agreement granting new lienholders a lien on a mobile home, but signed an "Applicable for Corrected Vehicle Title" listing the lienholders. [FN10]

After the debtor filed bankruptcy, the chapter 7 trustee contended that the vehicle title application was insufficient to serve as a security agreement under the third requirement of 9-203(b), and asked the Court to set aside the lien. [FN11] The lienholders asked the Court to find that the title application constituted a valid security agreement.

Following guidance from the Illinois Appellate Court, the Court sided with the lienholders. It found that the application for title, which contained a description of the collateral and was signed by the debtor, was sufficient to meet the statutory requirements for a security agreement. [FN12]

Challenge to Use of Non-Legal Name in Financing Statement

In the *Miller* case, chapter 13 debtors filed an adversary proceeding seeking to avoid a bank's security interest on the grounds that the bank had incorrectly identified Mr. Miller in its filed financing statements. [FN12]

Together with five promissory notes and commercial security agreements extended by the bank between 1999 until the filing of the lawsuit, the bank had filed a UCC1 financing statement and timely continuations identifying the debtors as "Bennie A. Miller" and "Debbie A. Miller."

The debtors' position was that that while "Bennie A. Miller" was the name listed on all of their loan documents with the bank and numerous other documents, that his proper legal name of "Ben Miller" should have been used for the purposes of the financing statement. [FN13]

At trial, Mr. Miller testified that he had gone for the name "Bennie Miller" much of his adult life and that is how he was known in the community. "Bennie A. Miller" was also the name listed on his unexpired driver's license, his social security card, the deed to the Millers' home, his federal income tax returns, the signature card in the original account with his bank, all the loan documents with the bank, one credit card account, and the bill of sale for his business. "Ben Miller" was the name listed on Mr. Miller's birth certificate, on a letter from another creditor, on two proofs of claim filed by Mr. Miller's accountant and his doctor, and on his American Express account. [FN14]

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The Bankruptcy Court ruled in the debtors favor, but the District Court reversed.

The District Court found that neither Illinois law nor the UCC require the use of a legal name on a financing statement in order to perfect a security interest, but only a correct name which is not seriously misleading. [FN15]

Conclusion

In each of the three cases, the lienholders prevailed on their arguments as to the validity of their agreements, but not without a battle in court.

The arguments made are technical as to the basics and lenders may complain on having their security agreements challenged on such technicalities when substantial funds have been disbursed.

On the other hand, the function of the courts and trustees in bankruptcy is to enforce the rules and seek recovery for creditors, which may include funds or property that becomes available from an avoidance action.

It will be interesting to see how this trend continues.

[FN1] *State Bank of Toulon v. Covey et al. (In re Duckworth)*, 2012 WL 986766, Bankr. No. 10-83603, Adv. No. 11-8002 (Bankr. C.D. Ill. March 22, 2012).

[FN2] *Id.* at *4 (citing 810 ILCS 5/9-203).

[FN3] *State Bank of Arthur v. Miller (In re Miller)*, 2012 WL 3589426, Dist. Ct. App. No. 12-CV-02052, Bankr. No. 10-92570, Adv. No. 11-9055 (C.D. Ill. August 17, 2012) (citing 810 ILCS 5/9-302 (1999), 810 ILCS 5/9-310 (2012)).

[FN4] *Id.* at *3 (citing 810 ILCS 5/9-502(a) (2001)).

[FN5] *Id.*

[FN6] *Duckworth*, 2012 WL 986766, at *3.

[FN7] *Id.* at *4.

[FN8] *Id.* at *5.

[FN9] *Id.* [October 8, 2012 update: Three appeals were filed by the parties with regard to the Court's order with regard to the Bank's lien. The District Court entered an order dismissing the appeals on October 2, 2012 as interlocutory, since certain priority claims remained unresolved.]

[FN10] *Pogge v. Westermeyer (In re Westermeyer)*, 2012 WL 2952176, Bankr. No. 11-72700, Adv. No. 12-7008 (Bankr. C.D. Ill. July 18, 2012).

[FN11] *Id.* at *1.

[FN12] *Id.* at *3-4 (discussing *Peterson v. Ziegler*, 39 Ill. App. 3d 379, 350 N.E.2d 356 (1976)).

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[FN13] *Miller*, 2012 WL 3589426, at *1.

[FN14] *Id.*

[FN15] *Id.* at *2, 6. A notice of appeal to the Seventh Circuit was filed in the case and is currently pending.

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