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Corporate / Financial Institutions ALERT

Central District of Illinois Bankruptcy Rulings Present New Challenges to Perfection of Security Interests

April 24, 2012

Two recent decisions issued by the U.S. Bankruptcy Court for the Central District of Illinois may seriously undermine the methods commonly used by financial institutions and other lenders to perfect their security interests in collateral. While these decisions are currently controlling only within the Central District of Illinois, if upheld on appeal, they may be used to challenge the perfection of security interests throughout Illinois.

On January 6, 2012, U.S. Bankruptcy Judge Gerald D. Fines ruled that the subject lender bank's financing statement did not perfect a security interest under Section 9-503 of the Illinois Uniform Commercial Code. The financing statement had been filed using the name commonly used by the debtor in his various business transactions. The debtor had signed the loan documents and the financing statement as "Bennie A. Miller," and his driver's license, social security card, the deed for his residence and his tax returns all carried the name "Bennie A. Miller." However, the debtor's legally given name as it appeared on his birth certificate was "Ben Miller."

The parties agreed that a UCC lien search under the name "Ben Miller," using the Illinois Secretary of State's standard search logic, would not lead to the discovery of the bank's financing statement. The court determined that if a search using the legal name does not disclose a financing statement using a different name or variation of that name, then the financing statement that is filed under a variation name is "seriously misleading" and subject to avoidance.

According to Judge Fines, Article 9 of the Illinois Commercial Code requires that a financing statement contain the debtor's legal name. Accordingly, the court ruled that the bank's financing statement filed under the name "Bennie A. Miller" failed to establish a perfected lien against the debtor's assets. The court noted that other states have amended the UCC to address the situation presented in this case; however, Illinois has not adopted these revisions.

A second decision issued by Judge Fines, on February 29, 2012, addressed whether a bank's mortgage could be voided by either a bankruptcy trustee or a subsequent bona fide purchaser if the mortgage documents previously recorded by the mortgage lender failed to contain all of the items referenced under Section 11 of the Illinois Conveyances Act. In this case, the mortgage documents recorded by the bank failed to specifically identify the interest rate and the maturity date of the mortgage obligation.

Section 11 of the Illinois Conveyances Act sets forth a brief description of what should be contained in a mortgage. However, the introductory language to Section 11 is as follows: "Mortgages of land *may* be substantially in the following form: . . ." (italics added). The court ruled that all of the elements referenced under Section 11 of the Illinois Mortgage Conveyances Act must be included in a mortgage. In the court's view, Section 11's requirements are mandatory and not permissive even though Section 11 uses the word "may." The court determined that the mandatory inclusion of the elements contained in Section 11 in the mortgage will provide constructive notice of the mortgage lender's interest to a subsequent bona fide purchaser or a trustee in bankruptcy.

The court held that the two mortgages in question were effective as between the original debtor and the bank. It ruled, however, that the failure to fully comply with the requirements imposed under the Illinois Conveyances Act allowed the bankruptcy trustee (standing in the shoes of a subsequent bona fide purchaser) to avoid the bank's lien on the properties because the bank's recorded mortgages failed to provide the trustee with constructive notice of the bank's liens. The court decided that the real estate subject to the bank's recorded mortgages was to be preserved by the trustee for the benefit of the debtor's bankruptcy estate and that the bank's security interest was avoidable as to unsecured creditors.

Although both of these decisions are being appealed, it is important that bankers and other lenders recognize their impact upon perfecting and protecting their security interests. Bankers and lenders should carefully consider whether they need to develop procedures to address the deficiencies raised by the Court's rulings.

For more information, please contact Tim M. Sullivan, Michael D. Morehead or your regular Hinshaw attorney.
