

# Commercial Financial Services Brief: Do You Know Where Your Cross-Collateral Clause Is?

April 19, 2012

In the recent decision in *In Re Duckworth* (March 22, 2012), the Chief Bankruptcy Judge for the Central District of Illinois issued a decision that may have far reaching effects on some lenders using automated loan documentation software<sup>1</sup>. In this case, the State Bank of Toulon (the "Bank") generated loan documents for a \$1.1 million agricultural loan. The promissory note was dated December 15, 2008, and stated that it was secured by a "... security agreement dated December 13, 2008 ...." The security agreement was executed on December 13, 2008, and the Bank subsequently made another loan to the borrower on January 29, 2010, in the amount of \$950,000.00 that stated it was secured by the security agreement dated December 13, 2008.

The bankruptcy trustee and a subsequent creditor challenged the assertion of the Bank that its security interest secured the loans and had priority. Their first argument was that the security agreement did not properly identify the 2008 promissory note because the security agreement stated that it secured a Note dated December 13, 2008 and the Note was actually dated December 15, 2008. The bankruptcy judge determined that although there was an inconsistency, the Bank could prove that there was a "clerical error" and that the security agreement did secure the promissory note. Although the lender prevailed on this issue, it incurred considerable expense to address a "clerical error" that could have been easily avoided.

The second argument was that the security agreement did not secure the January 29, 2010, promissory note because the security agreement did not contain a cross-collateral (or dragnet) clause. This argument was more successful—the court determined that the definition of Indebtedness in the security agreement was circular and actually served to limit the coverage of the security agreement to just the December 2008 promissory note. The court also found that the statement in the 2010 note that it was secured by the prior security agreement was ineffective to overcome the absence of cross-collateralization language in the security agreement. As a result, the security interest of the Bank in the borrower's personal property did not secure the 2010 loan.

What are the lessons to be learned? If you made loans which you intended to be secured by an earlier security agreement, you need to verify that the earlier security agreement actually contains an appropriate cross-collateralization provision. If the earlier security agreement does not contain a cross-collateralization



clause, you should consult your attorney regarding the best method to secure the new loan.

If you have existing loans for which you are relying on an earlier security agreement, you may want to verify that the security agreement contains appropriate language. If you discover any security agreements that may not contain an appropriate provision, you should consult you attorney as to what steps you should take to remedy the situation.

<sup>1</sup> The Court noted that both the promissory note and the security agreement were supplied by LASER PRO Lending.

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