The Lender's Source

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When Implementing New FinCen Rules, Don't Forget What You Know

Most domestic financial institutions are now well aware of the 2016 and 2017 Financial Crimes Enforcement Network (FinCen) regulations imposing information-gathering responsibilities in relation to legal entity customers.

The regulations, which must be implemented by May of 2018, require an institution to obtain information to identify, and verify the identity of, each beneficial owner of a legal entity (such as a corporation, partnership, or limited liability company) that opens an account with or obtains a loan from the institution after implementation. The term *beneficial owner* includes each individual that owns 25 percent or more of the equity interests (e.g., stock or membership interests) of the entity, and at least one individual that exercises substantial management responsibility over the entity.

To facilitate compliance, the rules provide a model certification form that may be used by the institution. Alternatively, the institution may use its own form so long as all substantial components of the model form are included. The individual opening the account on the entity's behalf must certify that, to the best of the individual's knowledge, the information in the certification form is correct. Based on the information in the form, the institution must obtain originals or photocopies of identifying documents—e.g., an unexpired driver's license or passport—for each individual identified as a beneficial owner.

It is important to understand that use of the regulatory certification form, or a similar in-house form, is not a true "safe harbor" assuring an institution's compliance with the regulations. While the institution can ordinarily rely upon the information set forth in the certification form as correct, reliance is not permitted where the institution has "knowledge of facts that would reasonably call into question the reliability of such information." In other words, the institution cannot blindly rely on the certification form without regard to other ownership or control information for the entity that may otherwise be in the institution's possession.

Particularly where the banking relationship at issue is a loan, the institution may have acquired, or may acquire, governing documents and resolutions for the entity—for example, operating or partnership agreements, or resolutions signed by shareholders or directors authorizing a particular debt or collateral transfer. These documents will sometimes identify persons owning interests in the entity and persons having managerial control. While insisting on such documentation is a wise practice in lending, the contents of the documents in the institution's possession might be considered as within the institution's knowledge for other purposes. Again, this knowledge could arise from documents previously provided for an earlier loan, or documents provided contemporaneously with the regulatory certification form.

An institution must have procedures in place to permit identification of instances where customer entity documents in the institution's possession conflict with the certification form so substantially that the reliability of the information in the form is called into question. This is an amorphous standard, but as in most practices the institution should err on the side of caution. Discrepancies between the form and relatively recent entity documents, or discrepancies that involve nonreporting of potential beneficial owners on the form, should prompt attention. Whenever the discrepancy reasonably calls information in the form into question, the institution should insist on, and retain, additional documentation to explain the discrepancy.

Comparing certification form information with other documents in the institution's possession may also be helpful from a lending perspective. Changes in ownership or control after extending credit may suggest that additional guarantors are needed, or that loan default may have occurred for reasons other than nonpayment. When the certification is provided at the time of making a loan, the beneficial owners should be verified where possible with the other corporate documentation, and might be considered for suitability as guarantors of the loan.

Appeals Court Addresses Dispute Over Borrower's "Receipt" of Notice of Default

In the November 2017 decision of *Y.C. Development v. Norton*, the Court of Appeals of Georgia held that a lender sufficiently complied with notice of default requirements imposed by loan documents despite evidence the borrower never received the notice.

The wrongful foreclosure dispute turned upon the specific language of the promissory note and security deed, which had been contemporaneously signed by the borrower in obtaining a loan to purchase a vacation home. The note provided that in the event of nonpayment, the lender could accelerate the debt and pursue foreclosure if the nonpayment was not cured within ten days after the borrower's "receipt" of written notice from the lender. The note did not define *receipt*. The note further provided that any notices or demands required by the note would be deemed duly given if given in accordance with the terms of the security deed.

The security deed's notice provisions did not use the word *receipt*. Instead, it provided that notice to the borrower must be in writing and would be deemed duly given if either delivered personally, or upon the lapse of two days after lender's deposit of the notice in the U.S. Mail for prepaid delivery via certified mail, addressed to the borrower's primary residence.

The borrower failed to make the necessary payments on the note. The lender sent notice of default to the borrower via certified mail, with notices addressed to the borrower's primary residence and the collateral address. The borrower did not accept any of the notices. Later, the lender sent written notice of foreclosure via certified mail to the same addresses. These were returned as undeliverable.

The lender proceeded with foreclosure, and was the purchaser at the sale. The borrower sued the lender for wrongful foreclosure, alleging the lender failed to comply with the notice of default requirements imposed by the note. The borrower argued that per the note any notice of default had to have been "actually received" by her to be effective. On motion for summary judgment, the trial court agreed with the borrower and granted judgment against the lender. The lender appealed.

On appeal, the Court of Appeals reversed the trial court. Both the borrower and trial court had incorrectly focused on the *receipt* provision in the note while ignoring the security deed. It was correct that, disregarding any contractual agreement, notice is not ordinarily effective until received by the addressee; and further, that depositing a notice in the mail creates only a presumption that it is received. The addressee can overcome the presumption by evidence the notice was not actually received. Further, the term *receipt* does commonly mean to have an item handed or directly given to the addressee.

While these principles appeared to support the borrower's position,, the security deed's notice provisions rendered them inapplicable. Again, the deed stated that any notice would be deemed duly given upon lapse of two days after deposit in the mails for delivery via certified mail to a designated address. There was no dispute that the lender had timely mailed notice of default to the borrower via certified mail, thus complying with the security deed. Crucially, the terms of the note rendered the security deed provisions controlling with respect to any notices required to be given under the note. Having complied with the notice requirements of the deed, the lender was entitled to judgment in its favor.

This decision is a good reminder to be aware of, and comply with, the specific notice requirements imposed by the various loan documents that are used. Careful reading is important, as notice provisions may vary from document to document.

Bankruptcy Court: Missing Signature Page Not Fatal to Lender's Security Deed

During the past several years there have been numerous court decisions addressing witness signature deficiencies in deeds to secure debt, with results often unfavorable to the lender. A recent opinion of the U.S. Bankruptcy Court in Macon, designated as *In re Jones*, addressed a different facet of signature deficiencies—a recorded deed that omitted the grantor (borrower) signature page.

The facts showed that in 2014 the borrowers obtained a loan secured by real property located in Houston County. The borrowers executed a security deed in favor of the bank, with the borrowers' signatures appearing on one page (page 13) and the signatures of the notary public and unofficial witness appearing on the following page. The borrowers also executed an additional "Waiver of Borrower's Rights" document that referred to the street address of the collateral property, described itself as a supplement to the deed, and was attested by a notary and an unofficial witness. Both the security deed and the waiver were then recorded in the deed records; but for reasons unknown, page 13 of the deed, featuring the borrowers' signatures, was missing from the recorded deed.

In 2017, one of the borrowers filed for bankruptcy protection. Spotting the defect in the recorded deed, the bankruptcy trustee filed a proceeding to avoid the bank's interest in the collateral property. The trustee, having powers of a bona fide purchaser of the debtor's property as of the bankruptcy filing by operation of law, argued that the deed was not properly recordable under Georgia law without the borrowers' signatures. Under various federal and state appellate decisions addressing witness signature defects, an unrecordable deed does not provide effective notice to a later bona fide purchaser even if the deed is recorded—meaning the trustee would take the property free from the bank's interests.

In an opinion addressing the dispute, the court agreed with the trustee's arguments in part. The court acknowledged that in order for a deed to be recordable, it must be signed by the grantor and attested by two witnesses. If either the grantor's signature or an attesting signature is absent, the deed is not legally recordable regardless of whether the clerk's office does, or does not, accept the deed for filing. Further, as the trustee argued, an unrecordable deed is not effective notice to subsequent bona fide purchasers. Thus, the security deed, as a stand-alone document, would be subject to attack.

However, the outcome of the dispute did not turn upon the deed as a stand-alone document. As mentioned, the borrowers had signed a Waiver of Rights document that had been recorded along with the deed. This Waiver was properly attested by a notary and an unofficial witness, and featured a property description in the form of a street address. The court held that these features made the Waiver itself a recordable "deed" providing notice of its own contents. Further, because the Waiver made specific reference to, and purported to supplement, the security deed, the Waiver provided subsequent purchasers, such as the trustee, with inquiry notice of the security deed. As he was charged with inquiry notice (essentially, a duty to inquire with the lender—but notice nonetheless) of the security deed, the trustee could not avoid the bank's interests in the property.

It is important to note that this decision, arising from the Middle District of Georgia, is at odds with at least one decision from the Northern District finding that a waiver categorically is not a "recordable" document providing notice. Further, the outcome of this decision would probably have been different if the Waiver itself did not feature all of the basic requirements of a deed: property description, grantor signature, and attestation. If any of these had been absent, the outcome would very likely have been unfavorable to the bank.

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UCC-1 Errors Cause Headaches for Lender in Collateral Conversion Suit

The recent Court of Appeals decision in *Rebel Auction Co. v. Citizens Bank* illustrates the difficulties that errors and shortcuts in financing statement preparation can cause.

Years prior to the lawsuit, the bank extended credit to a debtor (Big Metal Construction, Inc.) to be secured by specific items of equipment. At the time the loan was made in 2011, the debtor provided a list describing each item. The debtor signed a security agreement that described the collateral as "UCC-1 covering all equipment listed." There was no UCC-1 or list attached to the security agreement when signed by the debtor. Several days later, the bank filed a UCC-1 financing statement describing the items of equipment identified in the debtor's list. However, the financing statement indicated the debtor's name as "Big Metal Construction, Inc. Payroll Account". This financing statement was then stapled to the security agreement by the bank. The parties renewed the loan two years later, with the debtor signing a new security agreement referencing the earlier-filed UCC-1.

The debtor subsequently defaulted and the bank sought to repossess the equipment. At this time, the bank first learned the debtor had sold the equipment at auctions conducted by Rebel Auction Co. prior to the loan renewal. The bank sued Rebel for conversion of the collateral, and was awarded summary judgment by the trial court.

Rebel Auction Co. appealed, contending the bank was not entitled to recovery. Rebel argued the bank's financing statement was ineffective for two reasons. First, as the 2011 security agreement when signed did not list any of the equipment, the bank's UCC-1 describing the equipment was unauthorized and therefore invalid. Second, because the UCC-1 identified the debtor as "Big Metal Construction, Inc. Payroll Account" rather than the debtor's true name, the filing was ineffective.

With respect to the first argument, the Court of Appeals acknowledged that a filed financing statement is only effective if authorized by the debtor. As a matter of law, the debtor authorizes the UCC-1 filing by entering into a security agreement covering the collateral. Here, although there was no dispute the 2011 security agreement, when signed, did not list the equipment, the parties admitted the agreement was signed by the debtor, that the UCC-1 was filed, and that a renewal security agreement was signed two years later making reference to the filed UCC-1. The Court held these facts created an "inference" that the debtor intended the 2011 security agreement to cover the equipment. This inference was strong enough to prevent summary judgment to Rebel on the basis of an unauthorized filing—but was not strong enough to demand judgment in favor of the bank.

As to the second argument, the Court noted that a financing statement correctly provides the name of a corporate debtor only if the name shown matches the debtor's name as indicated in its articles of incorporation most recently filed or amended with the Secretary of State. Here, there was no dispute that the debtor's name per its articles of incorporation was "Big Metal Construction, Inc." Thus, the name on the UCC-1 (Big Metal Construction, Inc. Payroll Account) was incorrect. However, an error in the debtor's name does not render the financing statement invalid unless the error makes the statement *seriously misleading*. A financing statement is seriously misleading only if a search of the UCC records, using the debtor's correct name and the record keeper's standard search logic, would not disclose the statement.

Neither the bank nor Rebel Auction had submitted any evidence as to whether the bank's financing statement would be found using a search of the debtor's correct name. Because this was the crucial question for the UCC-1's validity, the trial court could not have properly awarded judgment to the bank without evidence resolving the question. The judgment in favor of the bank was thus reversed, with the case to continue until properly resolved by the trial court.

While the bank may ultimately be successful in its claim against the auctioneer, the errors and shortcuts in preparing the security agreement and financing statement certainly left the bank with a lengthy, uphill fight. Only a few more minutes of effort preparing the loan documents might have saved months in litigation time and thousands in litigation costs.

Understanding the UCC-1: Unauthorized Filings

The filing system established by the UCC requires the filing officer (in Georgia, a clerk of superior court) to accept a financing statement or amendment for filing so long as the proper form is used and the proper fee is paid. The officer does not verify the identity of the filer, and is not permitted to reject the filing on suspicion that the filer has misrepresented his identity. Rather than giving the filing officer the power and duty to police unauthorized filings, the UCC declares that any filing is invalid if not actually authorized by the debtor, or secured party, as appropriate.

A financing statement, or an amendment adding collateral or debtors, is valid only if authorized by the debtor. As discussed earlier in this newsletter, a debtor is deemed to have authorized a filing by entering into a security agreement covering the collateral. Other filings, such as amendments deleting collateral or assigning a security interest, are valid only if authorized by the secured party.

A filing that is not properly authorized has no legal effect despite its appearance in the record database. So, for example, if a debtor fraudulently files a termination statement either in his own name or the name of the secured party, the secured party does not lose any perfected status it may have. The termination is simply ineffective. While this is a source of comfort for the true secured party, it is also a source of worry to other potential lenders. A termination statement (or amendment deleting collateral or debtors) may be filed of record and appear regular on its face, but nonetheless be useless for its purpose. A subsequent perfecting secured creditor will remain junior in priority despite any reliance on the unauthorized termination.

Though a financing statement is valid only if authorized by the debtor, the UCC allows a secured party to file a financing statement prior to obtaining a security interest in collateral. Once the debtor authorizes the filing by signing a security agreement, the secured party's priority will relate back to the date of filing. Of course, if the debtor never enters into a security agreement, the financing statement will never become authorized and will never be effective to perfect any security interest.

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