The Lender's Source

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Appeals Court Says Agreement for Interest at "Maximum Legal Rate" Allows Creditor Only 7% Per Annum

In two separate new opinions, the Court of Appeals of Georgia applied this state's interest and usury laws to hold that contractual provisions for payment of interest at the "maximum legal rate" only entitle the creditor to receive interest at the rate of seven percent per year.

Coincidentally, each case featured homeowners associations suing to recover unpaid assessments. The controlling documents provided that delinquent assessments would accrue interest at the "maximum legal rate per annum." In both cases, the creditors were initially successful in obtaining awards of delinquent assessments together with interest at the rate of eighteen percent per year. Both cases would later be appealed and reversed.

In the first of the two cases to be decided on appeal (*Northside Bank v. Mountainbrook*), the court found that the calculation of interest was controlled by two provisions in the banking title of Georgia's statutory code. The first states that where a contract does not specify the rate at which interest is to accrue, simple interest at the rate of seven percent per annum will accrue on the principal debt. The second provision states that where the principal debt under an agreement exceeds $3,000, the parties are free to provide for any rate of interest on which they may agree.

The court reasoned that because Georgia's interest laws did not provide a maximum limitation on the interest rate, a contractual provision for interest at the "maximum legal rate" does not specify a rate of interest at all. As no rate of interest was specified, interest could only be recovered at the rate of seven percent per year. The court distinguished agreements requiring interest at the *maximum legal rate* from those requiring interest by reference to a specified prime rate. While neither states an explicit numerical value of interest, the latter allows for "easily computable" interest by examining the specified prime (or other benchmark) rate. The former, however, "provides no set and certain base for calculation" of the intended rate; as such, the agreement is treated as stating no interest rate and the seven percent "gap filler" rate applies.

In the second of the two cases (*Lend a Hand Charity v. Ford Plantation Club*) the court reached the same result. Instead of repeating its analysis at length, the court referred to its opinion in *Northside Bank* and reversed the case on grounds that interest was recoverable only at the rate of seven percent per year.

In practice, a financial institution is unlikely to use a note or similar instrument that mentions only the *maximum legal rate* as controlling before maturity. A more likely area of concern is post-default interest provisions, or provisions for accrual of interest on advances made by the lender to preserve collateral. On occasion, notes and security agreements make reference to *interest at the maximum legal rate* or the like for such post-default scenarios. With these two recent court decisions in mind, use of such language should be avoided. A lender can provide for an increased rate of interest after default, but a specific rate should be stated.

Bank Barred From Recovery on Note of Corporate Borrower Where Bank Had Reason to Know Signer Lacked Authority

In a September decision, the Court of Appeals of Georgia found that a bank was barred from recovery upon a promissory note, as against either the designated borrower or the signer of the note, where documentation in the bank's loan file suggested that the signer had no authority to act on behalf of the borrower entity.

The case, *Davison v. Citizens Bank & Trust Company*, featured two individuals (Davison and Fricks) who were owners of a business operation known as Zoegetics International. Separately, Fricks was the sole owner of an entity named HOCO Cubs, LLC, which entity was unrelated to Zoegetics and had only a single asset: a youth baseball field.

In June of 2009, Fricks and Davison met with Hardin, president of Citizens Bank & Trust, to request financing for the operations of Zoegetics. Hardin stated that some collateral would need to be provided for the requested loan, and suggested that Fricks use some of his assets as collateral. The meeting ended without resolution, and Davison was unaware that any loan had been obtained until $300,000 was deposited into Zoegetics' account days later. At that time Davison merely assumed that Fricks and the bank had negotiated a sufficient agreement using Fricks' assets as collateral.

Approximately three months later, Hardin contacted Fricks and Davison regarding renewal of the initial loan. Davison appeared at the bank, made a modest payment to reduce the overall balance outstanding to the bank, and signed several documents provided by Hardin's assistant. Davison did not read any of the documents he signed.

The loan later went into default, and Hardin contacted Davison to satisfy the debt. Confused over the nature of his obligations, Davison demanded to see all of the documents relating to the loan. When the documents were produced, Davison was surprised to see that HOCO Cubs, LLC was designated as the borrower and obligor under the June 2009 promissory note, and that his (Davison's) signature had been forged on that note as "member" of HOCO. Of course, Davison was not an owner or member of HOCO at all—Fricks was the sole owner. When Davison examined the September renewal note—which Davison had actually signed, but had not read—he noticed that HOCO was likewise indicated as the borrower and obligor. Davison contacted the police regarding the forgery, and Hardin was eventually charged for various offenses related to other loans he had originated.

Despite the forgery of the initial note, the bank pursued recovery from Davison. The bank argued that because credit had been extended, and because Davison had signed the renewal note (albeit unknowingly as purported member of HOCO), Davison was liable to the bank on the renewal note. The bank relied on section 3-403 of the Uniform Commercial Code, which states that "an unauthorized signature is ineffective except as the signature of the unauthorized signer in favor of a person who in good faith pays the instrument or takes it for value." In other words, where an individual signs a note on behalf of a borrower without authorization from the borrower, that individual—rather than the designated borrower—is liable for payment of the note to a lender that extends credit in good faith reliance on the note. Agreeing with the bank, the trial court entered judgment against Davison for the balance of the renewal note. Davison appealed.

Addressing the case, the Court of Appeals acknowledged that UCC section 3-403 does impose liability on unauthorized signers in certain instances, and that the term *unauthorized* includes both forged signatures and signatures by persons purporting to act on behalf of a corporate borrower but lacking actual authority to do so. In instances where the rule permits liability, it is only the individual signer of the note who is liable for payment, and not the named obligor (borrower) who never in fact authorized the note. So, in some foreseeable scenario, an individual such as Davison—who signed the renewal note on behalf of HOCO, without any authority to do so—might be liable on a signed, unauthorized note. However, UCC section 3-403 only imposes that liability where the lender accepts the note in good faith.

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The court, in reliance on commentary from the authors of the UCC, noted that as a rule a lender cannot accept an unauthorized note in *good faith* if the lender knows that the signature on the note is unauthorized. Applying this rule to the case, as the bank knew (according to the court) that Davison was unauthorized to sign on behalf of HOCO, the bank could not recover from Davison upon the note.

Importantly, the court's holding that the bank "knew" of the lack of authority relied on the contents of the bank's loan files, rather than the actual understanding of some specific person at the bank (such as Hardin) who had been told that Davison could not sign for the company. To point to the source of the bank's "knowledge," the court recited testimony of the bank's vice president to the extent that the bank required organizational documents (such as an operating agreement) from HOCO before issuing the loan, and that those documents did not mention Davison as having any involvement with HOCO. The same vice president further testified that the bank did not have any "presented and executed" document that gave Davison authority to sign. So in other words, because the organizational documents in the bank's possession did not give Davison authority, and because the bank had no other document providing Davison with authority, the bank *knew* that Davison was unauthorized.

The court's holding should serve as a warning to lenders dealing with corporate borrowers: if the lender requires entity documentation of authority (which the lender should), that documentation must be read and understood. The lender is effectively charged with knowing the contents of those documents. Further, where an organizational document such as bylaws or an operating agreement do not give the potential signer authority, the lender must obtain a properly executed entity resolution or similar document designating authority to the signer. Otherwise, the lender risks subsequent challenge to liability on the basis that the lender knew the note was unauthorized, and thus did not accept the note in good faith.

Lender's Title Insurance: Addressing Unsettled Question, Court Rules That No Loss Occurs Until Foreclosure

In the recent opinion of *Old Republic National Title Insurance Company v. RM Kids, LLC*, the Court of Appeals of Georgia held for the first time that no compensable loss arises under a lender's title insurance policy until the lender forecloses and obtains less than the full balance owing on the loan. The court refused to apply the established rule governing owners' policies of title insurance, which dictates that loss occurs at the time of the insured's purchase of the property.

The property at issue was a 114-acre tract in Gwinnett County. Groundwater on the property had been contaminated by a petroleum leak in the early 1990s, with the then-owner (a petroleum pipeline company) undertaking cleanup efforts for years thereafter. In 2005, the pipeline company sold the property to Black Hawk Ranch, LLC. The deed from the pipeline company featured an attached exhibit that notified the purchaser of past contamination and placed several restrictions on the property. Among these were that use of groundwater was prohibited and that the pipeline company retained a right of first refusal as to any subsequent sale.

Black Hawk Ranch sold the property to BBC Partners approximately one year later. The purchase was funded by a loan from Peachtree Bank, which obtained a deed to secure debt covering the property. Neither the deed to BBC Partners nor the security deed to the bank referenced the past contamination, the groundwater restrictions, or other content of the contamination-related exhibit that was attached to the initial deed from the pipeline company. The bank obtained a lender's title insurance policy in relation to the property. The policy did not reference or provide exceptions from coverage for any of the contents in the contamination-related exhibit in the deed issued by the pipeline company.

The initial purchase loan was later restructured into a new loan for more than $11 million. This loan was again secured by the property, and the bank again obtained a lender's title insurance policy, from the same insurer, covering the property. As with the prior loan, the policy featured no reference to or exception for the various contamination-related matters featured in the deed from the pipeline company. The bank later sold the loan.

During subsequent discussions with the borrower, the loan purchaser first learned of the past contamination and the various restrictions contained in the deed from the pipeline company. The loan purchaser sent written demand to the title insurer requesting that the title defects be addressed. The insurer refused to comply, and the loan purchaser sued the insurer for breach of the title insurance policy issued with respect to the restructured loan.

During the lawsuit, the insurer argued that the loan purchaser had not yet suffered any loss under the policy at the time the suit was filed. According to the insurer, no loss could occur until the lender foreclosed on the property and failed to obtain full repayment of the loan from the foreclosure proceeds. The loan purchaser argued in opposition that, as with an owner's policy of title insurance, the loss occurred at the time of closing of the secured loan. The judge agreed with the loan purchaser, and ruled that the closing date would be treated as the date of loss for purposes of the lawsuit. While the suit was pending, the loan purchaser did foreclose upon and sell the collateral property for $750,000—leaving a large deficiency. The jury eventually found in favor of the loan purchaser, awarding damages to compensate for loss having occurred as of the loan closing. The insurer appealed.

On appeal, the Court of Appeals noted that Georgia's appellate courts had never addressed the issue of when a compensable loss occurs under a lender's title policy. Georgia courts had previously ruled that loss under an *owner's* policy occurs at the time of closing of the purchase. The courts of most other states had treated *lenders'* policies differently, however, requiring the lender to foreclose and then prove a deficiency before recovering on the policy.

In deciding which rule to adopt as to time of loss, the court observed that a lender's title policy does not guaranty the value of the collateral property—the policy only indemnifies the lender for actual losses incurred because of impairment of the property. Thus, the court reasoned, the lender suffers no recoverable loss under the policy unless the secured debt is not repaid and the foreclosure proceeds from the collateral are insufficient to satisfy the debt. In other words, until foreclosure is completed, a court cannot determine how much of the secured debt will be repaid, and resultantly, cannot determine the payment to which the insured lender is entitled. Though this rule differs from that applied to owners' policies, the court justified the difference on the basis that the lender's interest in the property is held solely as a source for repayment of debt and is in fact extinguished upon repayment of the debt. To the extent the secured debt is repaid, the lender (unlike the owner) is not damaged by a reduction of property value.

Title insurance remains a valuable tool for protection of a lender's interest, and the outcome of this case was not entirely unforeseeable. Again, Georgia was simply brought into line with most other states that have addressed the issue. From the lender's perspective, however, the case is not a positive development in that it may only embolden title insurers to resist making sizeable loss payments under a policy prior to the lender's completion of foreclosure.

Understanding the UCC-1: The Special Meanings of *Equipment, Inventory, Farm Products,* and Other Collateral Classifications

When is equipment not *equipment*? And when is a peanut not a *farm product*? When dealing with the secured lending provisions of the Uniform Commercial Code.

The UCC uses several specially defined terms for classification of collateral, and these classification terms are commonly used by lenders in preparation of security agreements and UCC-1 financing statements. While use of these terms is an easy and simple way to incorporate the UCC's painstakingly-developed uniform meanings, mistakes can be made when a lender fails to realize that the UCC meaning of a term may not match the everyday, common-sense meaning of the same term.

For secured lending purposes, the Uniform Commercial Code classifies all movable things as *goods*. However big or small, whether a pencil or a peanut combine, if it is a tangible, moveable thing then it is a *good*.

The UCC subdivides all goods into one of four specially defined classifications: *inventory*, *consumer goods*, *farm products*, and *equipment*. All goods fit into one of these four classifications. The classifications are mutually exclusive, so a single item can never fit into more than one classification at the same time. For example, an item can never be both inventory and equipment, or equipment and consumer goods, at the same time. The same item can fit into different categories at *different* times, however. This is because the UCC's four classifications focus on the use of the item by the debtor, rather than the physical characteristics of the item itself.

Inventory is defined by the UCC to include all goods, other than *farm products*, that: are held by the debtor for sale or lease to others; are leased by the debtor to others; have been furnished by the debtor to others under a contract for service, or are held by the debtor for such a purpose; or are raw materials, work in process, or other items consumed in the course of the debtor's business. So, for example, a debtor that is a machinery manufacturer might have inventory that consists of completed items awaiting sale to retailers; partially assembled components; and basic materials such as bolts, wire, metal stock, and paint that are to be used in manufacturing the machinery. Even the pens and paper used in the debtor's offices would be *inventory*. Note that by definition any item that meets the definition of *farm product* (discussed below) cannot be inventory.

Consumer goods is defined to include all goods that are used or purchased by the debtor primarily for personal, family, or household purposes. Again, the focus is not on what the item is, but instead on how it will be used by the debtor. If a person buys a computer to be used for video games, school work, and other general family use that computer will be a *consumer good*. If the same computer were purchased by a bank for use in its offices, however, the computer would not be a consumer good.

Problems can develop where an individual such as a small business owner uses the same item for both business and personal purposes. In these cases, the rule is that the debtor's "primary" purpose of using the collateral is determinative. So if the debtor ordinarily uses his laptop computer in running his business, but occasionally uses it to play video games or music, the computer is *equipment*. But if instead the computer is ordinarily used for entertainment or school work, but is also sometimes used to check work emails or the like, it is a *consumer good* and a financing statement covering "all equipment" would not be effective to perfect.

Farm products is defined to include all goods with respect to which the debtor is engaged in a farming operation and are either crops, livestock, supplies used in the farming operation, or unmanufactured products of crops or livestock. Note that for an item to be a *farm product* the debtor must be engaged in a farming operation with respect to it. So for example unharvested cotton owned by the debtor, or un-ginned cotton harvested by the debtor awaiting sale, would be a *farm product*. Once the debtor transfers ownership of the cotton to another person, it is no longer a farm product. Further, regardless of ownership, once the item is substantially processed (cotton made into cloth, or milk made into cheese) it can no longer be a farm product. In almost all cases, post-sale or post-processing item will be classified as inventory.

Equipment is the last, and most uniquely defined, category. In UCC terminology, *equipment* means any good that is not either inventory, a farm product, or a consumer good. So in other words, an item is only *equipment* if it does not fall into any one of the other three categories. For this reason, if an item is inventory, or a consumer good, it is not *equipment* for purposes of the UCC.

The UCC meaning of equipment differs drastically from its everyday meaning, and thus can have seemingly strange results. The average person might refer to a tractor as equipment, for example, but if the tractor is in the hands of a dealer for resale, or in the hands of a hunter using it to prepare a food plot on personal hunting land, the tractor isn't *equipment* at all. In the hands of a dealer the tractor is only *inventory*; in the hands of the hunter, the tractor is only *consumer goods*.

Lenders must be careful when using any of the four UCC-defined categories in the collateral description of a UCC-1 financing statement. The most likely problem scenarios will involve either a debtor who is in the business of selling machinery or other items commonly referred to as "equipment," or a debtor who is a small business owner and may be using the same item for both personal and business purposes.

In the instance of a debtor that is a machinery dealer, the lender should assure that its financing statement covers all *inventory*, rather than, or in addition to, *equipment*.

In instance of the small business debtor with potential dual uses of collateral, the best approach is to specifically list the item by manufacturer and specific description (e.g., one FarmCo 987 tractor, serial no. 23445). This avoids any dispute over which UCC-defined category the item might qualify as. Further, if the lender has a blanket equipment lien, the phrase "all equipment" can be used in addition to the specific item description.

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