The Lender's Source

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Recent Bankruptcy Rule Change Affects Secured Lenders' Use of Proofs of Claim

The federal bankruptcy rule governing proof of claim filing in Chapter 7, 12, and 13 bankruptcy cases (Rule 3002) was amended effective December 1, 2017 to expressly require a secured creditor to file a proof of claim in order to have an "allowed claim." Previously, this rule made reference only to unsecured creditors and equity holders, but not secured creditors. As amended, the rule does clarify that failure to file a proof of claim, alone, will not void the secured creditor's lien.

What does this change mean in practice? In many scenarios, it will not mean much. It has long been common in Chapter 13 cases for fully-secured lenders receiving payments "outside of the plan" (i.e., paid by the debtor directly, rather than through the trustee) to forego filing proofs of claim in reliance on the principle that their liens will survive bankruptcy unimpaired. That basic principle has not been changed by the recent amendment.

Further, even before the rule amendment to include secured creditors, the collective effect of bankruptcy statutes and rules required a secured creditor seeking payment through a Chapter 13 plan or distribution from a Chapter 7 liquidation, or seeking court valuation of collateral, to file a proof of claim. This too remains unchanged.

Although the recent amendment does not upend these basic concepts, it provides clear notice to secured lenders: to protect any rights you may have to distribution from a plan or trustee liquidation, you must file a proof of claim just like everyone else. These rights may seem inconsequential at the outset, but subsequent events can give them real value. If for example a lender's collateral is liquidated, surrendered, or destroyed during the bankruptcy for less than its expected value, the lender may be deprived of a right to any deficiency if the lender failed to properly file a proof of claim in expectation of being oversecured.

Further, in Chapter 13 cases, a creditor secured by the debtor's residence and receiving installment payments during the bankruptcy—whether through the trustee or debtor—is required to file notice of changes in scheduled payment amounts or of expenses or fees incurred after bankruptcy filing. These notices are filed as supplements to a prior proof of claim, and failure to file can impair the ability to recover increased payments and expenses.

Given the amendment's focus on secured creditors, a timely proof of claim is only more important for protection in the event of changes occurring after bankruptcy filing. The protection may not be needed in some cases, but the minimal expense of preparing a proof of claim is often well-warranted.

Important New Court Opinion Allows Oral Rescission of Written Guaranties

In the recently issued opinion of *Crop Production Services v. Moye*, the Georgia Court of Appeals overruled nearly two decades of precedent requiring that any agreement to rescind a written guaranty must also be in writing. As a result, guaranty agreements may now face more severe threats on the basis of oral conversations between guarantors and employees of the lender.

The underlying facts of the decision showed that in 2011 and again in 2013, Mr. Moye signed written guaranty agreements in favor of Crop Production Services whereby Moye personally guarantied repayment of all credit extended to Gracie's Ridge, LLC, an entity owned by Moye's daughter. By their terms, the guaranty agreements were absolute, continuing, and unconditional, and revocable only by written notice.

In 2014, Moye visited his local Crop Production Services branch to have a conversation with the manager. Moye informed the manager that Moye was ending his working relationship with his children, and that Moye would not guaranty any credit thereafter extended by Crop Production Services. The manager's exact response was disputed: according to Moye, the manager agreed Moye would guaranty no new credit. According to the manager, the manager merely acknowledged that he under-

stood Moye's wish that the guaranty agreements would no longer be effective, but no agreement was made. Under his employer's rules, the manager had no authority to release the guaranties.

Crop Production Services continued to extend credit to Gracie's Ridge, which eventually defaulted. Crop Production Services then filed suit against Moye to recover upon the guaranty agreements. The trial court entered judgment in Moye's favor, finding that Crop Production Services had effectively agreed to rescind the guaranties in 2014.

Crop Production Services appealed, arguing that under court precedent in effect since 1991 any agreement to rescind a written guaranty must itself be in writing to be effective. Under that precedent, as Moye produced no written agreement from Crop Production Services, the guaranties remained effective regardless of the 2014 oral conversation.

Addressing the argument, the Court of Appeals explained that guaranty agreements are subject to the "Statute of Frauds," meaning that the guaranty must be in writing and signed by the guarantor to be effective. Further, being subject to the Statute of Frauds, the terms of a guaranty can only be modified by a writing signed by the parties to the guaranty. This is because the guaranty as modified would itself be a new contract, and thus must be in a signed writing to be effective.

However, according to the Court, the dispute at hand was not whether the guaranties had been *modified*, but instead whether they had been rescinded altogether. This was a crucial distinction per the Court, as a modification would mean a new contract was in place (which would need to be in writing), but a rescission would mean there was no longer any contract in place at all. As no contract would be in place after rescission, there would be no need for a writing to establish the terms of the contract. In other words, a written agreement would be required to modify the guaranties, but not to rescind them altogether.

The Court acknowledged that its own precedent dating back to 1991 had required a written agreement to rescind a guaranty. The Court expressly overruled this precedent, deeming it "unfortunate" and an "unwarranted logical leap" between modifying a guaranty and rescinding a guaranty.

Having decided the guaranties could be rescinded orally, the Court returned the case to the trial court for a jury to determine whether Crop Production Services did agree to rescind during the 2014 oral conversation between the manager and Moye.

This decision by the Court of Appeals is an unwelcome event for lenders, who will now be subject to greater attack based upon unrecorded oral conversations between employees and guarantors. All officers and employees must be extremely cautious in conversation to avoid any suggestion or inference that a guaranty will be released, or that the guarantor will no longer be bound by a guaranty.

Appellate Court Resolves Participating Banks' Dispute Over Foreclosure Proceeds

In a February 2018 decision designated as *Community & Southern Bank v. First Bank of Dalton*, the Court of Appeals determined the proper method of distributing proceeds of foreclosure of collateral securing separate loans subject to separate participation agreements.

In 2004, Gilmer Bank extended two separate loans, one in the amount of $3.7 million and one in the amount of $1.8 million, secured by a tract of land to be developed into a residential subdivision. Both loans were secured by a single security deed in favor of Gilmer. Shortly after making the loans, Gilmer entered into a participation agreement with three other banks whereby Jasper Banking Company was conveyed a 46 percent participation interest in the larger loan, and First Bank of Dalton and Community Bank of Pickens were each conveyed 27 percent interests in that loan. Later, in 2006 Gilmer Bank entered into a separate participation agreement with Jasper Banking whereby Jasper purchased a 100 percent participation interest in the smaller loan.

Both Gilmer and Jasper ultimately failed, and their assets were sold to Community & Southern Bank and Stearns Bank, respectively. Thereafter, the borrower defaulted on both loans. Community & Southern sold the property at foreclosure for $1.45 million, and two participating banks then filed suit to determine how these proceeds should be distributed. The suit eventually reached the Court of Appeals for decision.

In its opinion deciding the matter, the Court explained the general rule governing priority of payment where multiple loans are secured by the same security deed in the same item of collateral. Under this rule, if the proceeds of the collateral are insufficient to satisfy all of the loans, and if there is no contractual agreement to the contrary among the participating lenders, then each participating lender is entitled to distribution in accordance with its pro rata share of the total debt secured by the security deed and collateral. This is true regardless of the order in which the various loans were made, were assigned, or matured.

Each of the two participation agreements at issue featured a provision determining distribution with respect to the loan that was the subject of the agreement. Basically, after deducting the administrator's expenses, the collateral proceeds would be divided pro rata to the lenders participating in that particular loan. But neither participation agreement, nor any other agreement among the lenders, addressed how proceeds would be distributed as between the two separate loans.

Given the absence of any agreement for distribution among participants in the two loans, the Court held that the general rule must apply. The fact that Jasper (later Stearns) acquired its participation interests in the smaller loan two years after Pickens and Dalton acquired participation interests in the larger loan did not alter this result. Again, the general rule for pro rata distribution applies regardless of the time the loans are sold to participants. Further, the later sale to Jasper was not inequitable as to Dalton or Pickens, as these banks knew from the outset that the collateral secured both loans. Given applicability of the general rule, each of Stearns, First Bank of Dalton, and Community Bank of Pickens were entitled to a pro rata share of the total proceeds after deduction for the administrator's expenses.

Understanding the UCC-1: Trust Debtors

When preparing a UCC-1 financing statement for collateral provided by a trust, special consideration is required to select the appropriate debtor name for use.

If the trust itself is a "registered organization" (meaning a statutory trust formed by filing with the state, rather than an ordinary trust formed by agreement), then the UCC-1 must use the registered name of the trust as shown by the official record creating the trust, or any more recently filed official amendment. No other indication of trust status is necessary in the form.

Most trusts providing collateral will not be registered organizations, but will instead be trusts created solely by a trust agreement or other contractual trust instrument. For these, further work is required in preparing the UCC-1.

First, the lender must examine the trust instrument (the document creating the trust) to determine whether it specifies a name for the trust. If so, that name must be used as the name of the debtor in the UCC-1. The lender must also check the box in Item 5 of the UCC-1 form to indicate the collateral is held in a trust. This is a mandatory step for preparation of the form.

If the instrument does not specify any name for the trust, then the name of the settlor of the trust—that is, the person who created the trust—must be used as the name of the debtor. The lender must check the box in Item 5 to indicate the collateral is held in a trust, and must also provide additional "sufficient information" to distinguish the debtor trust from other trusts having the same settlor. The UCC authors suggest use of the date on which the trust was settled (created), which should be ascertainable from the trust instrument. This information should be inserted in Item 17 of a UCC1Ad form, and not in the debtor name item.

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