TORT TRIAL & INSURANCE PRACTICE
Committee News
Defending Liberty Pursuing Justice
Winter 2011

Title Insurance Litigation Committee

Wrestling with the Trustee's Strong Arm: Defending Avoidance Actions Under Section 544 of the Bankruptcy Code

By James Bruce Davis, *Bean, Kinney & Korman, P.C.*, Arlington, Virginia

Since the real estate collapse, title insurers face an increasing number of claims arising from suits by bankruptcy trustees. These suits seek to "avoid" deeds or mortgages that debtors granted prior to bankruptcy. One of a trustee's most potent tools for avoiding conveyances by the debtor is 11 U.S.C. §544. This statute, known as the "strong arm" clause, gives the bankruptcy trustee the rights of a good faith purchaser or lien creditor as of the date of the debtor's bankruptcy petition. If the trustee finds a flaw in a deed or mortgage the debtor granted prior to bankruptcy, the trustee may be able to recover property for the estate or avoid a mortgage on estate property.

The trustee may avoid an unperfected transfer that a good faith purchaser from the debtor on the petition date could have avoided. For example, a trustee may avoid a conveyance by the debtor if the grantee's deed is unrecorded at the petition date. *In re Project Homestead,* 374 B.R. 193 (Bankr. M.D.N.C. 2007). A trustee may avoid a mortgage that lacks a legal description or other means of identifying the property to be mortgaged. *In re Chateau Royale, Ltd*., 6 B.R. 8, 11 (Bankr. D. Fla. 1980). A trustee may avoid a deed of trust signed by a limited liability company that did not hold legal title to the property the company intended to encumber. *In re: Moreno*, 293 B.R. 777 (Colo. 2003). A lender that releases a mortgage by mistake may not reinstate the mortgage if the borrower files bankruptcy and the trustee objects to the reinstatement (which the trustee may be expected to do). *In re Anderson*, 324 B.R. 609, 611 (Bankr. D. Ky. 2005).

In re Crim, 81 S.W.3d 764 (Tenn. 2002), provides a notable example of the trustee's strong arm power. Edward Crim, Sr. and his wife, Jayne, owned a home in Tennessee. They gave a deed of trust to secure a $103,000 loan from EMC Mortgage Corporation. Jayne signed her own name to the deed of trust and signed Edward's name pursuant to a power of attorney. So far, so good. However, the notary certified: "On this

Continued on page 16

In This Issue:

Wrestling with the Trustee's Strong Arm: Defending Avoidance Actions Under Section 544 of the Bankruptcy Code 1
Greetings From The Chair. 3
Faulty Forms of Acknowledgement and Other Defects: The Effect of Imperfect Real Estate Documents on the Trustee's Avoidance Power Under 11 U.S.C. § 544 5
Title Insurance Claims In Latin America . . 14
American Bar Association 2010 Annual Meeting In San Francisco 15
2010-2011 TIPS Calendar 18

Wrestling...

Continued from page 1

6th day of June, 1997, before me personally appeared Edward J. Crim, Sr. and Jayne Crim" to acknowledge the deed of trust. *Id*., at 766-7. Unfortunately for the lender, Edward had not actually appeared before the notary.

When the Crims subsequently filed bankruptcy, the trustee noticed the error in the notarial certificate. He sued to avoid the deed of trust under the strong arm clause. The *Crim* court ruled the notarial certificate was defective as to Edward. The consequence was that the deed of trust did not impart constructive notice of Edward's grant. Therefore, a good faith purchaser from the Crims on the petition date would take title free and clear of the rights Edward granted to EMC. This enabled the trustee to avoid the deed of trust as to Edward's interest in the property, leaving title to the property in an uncertain state. Tennessee permits a married couple to hold title to property as tenants by the entirety, which is how the Crims held their property. Consequently, when the trustee avoided the mortgage as to Edward's interest, the lender could not even foreclose on Jayne's interest. Presumably, the lender and trustee entered into a settlement to resolve the uncertainty. It seems likely that the lender's title insurer had to pay a claim.

Although the strong arm clause is potent, the trustee does not always win. The following paragraphs summarize potential defenses to a trustee's suit to avoid a deed or mortgage. As will be seen, some of the potential defenses are more promising than others.

- *Curative statutes*. A number of states have adopted statutes providing that an instrument lodged with the recording office is deemed to impart constructive notice, even if the instrument was not entitled to recordation because of a defective notarial certificate or some other technical defect. *E.g*., Virginia Code §§55-106.2 and 17.1-223. *See In re Carrillo*, 2010 Bankr. LEXIS 180 (Bankr. E.D. Va. Jan. 14, 2010). The District of Columbia, Indiana, Kentucky and Tennessee are among the jurisdictions that have similar statutes.
- *Constructive notice*. Even if an instrument does not impart constructive notice, a properly recorded document that refers to the instrument may impart constructive notice of the instrument. *See In re: BowlNebraska*, LLC, 2010 Bankr. LEXIS 1908 (B.A.P. 8th Cir. July 1, 2010) (recorded foreclosure notice put trustee on notice of defectively acknowledged mortgage).
- *Statute of limitations*. The trustee must bring an avoidance action under the strong arm clause prior to the time the bankruptcy case is closed or dismissed. Even if the case has not been closed or dismissed, he must bring the action by the later of (A) two years after the petition in a voluntary case or two years after the order for relief in an involuntary case, or (B) one year after the appointment of the first trustee, if appointment occurs prior to expiration of the two-year period. 11 U.S.C. §546 (a).
- *Equitable subrogation*. The doctrine of equitable subrogation is well known to title insurance litigation committee members as a tool for loss mitigation when an insured lender's mortgage is defective. Subrogation "allows a person who pays off an encumbrance to assume the same priority position as the holder of the previous encumbrance." *Taxel v. Chase Manhattan Bank (In re Deuel)*, 361 B.R. 509, 517 (B.A.P. 9th Cir. 2006), *aff'd, In re Deuel,* 594 F.3d 1073 (9th Cir. 2010). A lender with a defective mortgage normally will invoke the subrogation doctrine to step into the shoes of a prior lender whose valid mortgage was paid off with funds provided by the lender seeking subrogation. In the bankruptcy context, many courts hold that a lender may be subrogated to the rights of a prior lender whose mortgage has not been released of record, but may not be subrogated to the rights of a prior lender whose mortgage has been released of record. *See, e.g., In re Reasonover*, 236 B.R. 219 (Bankr. E.D. Va. 1999). The *Reasonover* court's rationale was that the trustee would have the rights of a bona fide purchaser as to any prior mortgage that had been released of record, but would not be considered a bona fide purchaser as to a prior mortgage that had not been released of record.
- *Constructive trust*. A constructive trust is a trust created by a court (rather than by a trustor) to protect a party who has been wrongfully deprived of his property. The

constructive trust doctrine usually does not provide a defense to a trustee's suit to avoid a transfer under the strong arm clause, even if the debtor acquired property wrongfully. *See XL/Datacomp, Inc. v. Wilson*, 16 F.3d 1443 (6th Cir. 1994) (holding that bankruptcy court may recognize a constructive trust only when a court decreed the trust prior to the debtor's bankruptcy). In *In re Project Homestead*, a corporation in the business of providing affordable housing sold houses to purchasers, but the settlement attorney for the closings failed to record the deeds. When the trustee claimed the houses for the estate, the purchasers asked the bankruptcy court to impress a constructive trust on the houses, which the purchasers had paid for and were living in. The bankruptcy court refused, citing the strong arm clause. If a good faith purchaser had bought a house on the petition date without notice of that the debtor previously had conveyed the property by unrecorded deed, the good faith purchaser would have acquired title free and clear of the prior grantee's rights. Therefore, the *Project Homestead* court ruled that trustee's rights as a hypothetical bona fide purchaser trumped the rights of the prior purchasers. However, the outcome might have been different in a state like Florida, which holds that a constructive trust arises when the act giving rise to the constructive trust occurs. *See In re General Coffee Corp*., 828 F.2d 699 (11th Cir. 1987) (debtor could not retain property obtained by fraud prior to its bankruptcy petition; the constructive trust arising from the fraud had the same effect as if the debtor had acquired the property as trustee under an express trust established prior to the bankruptcy).

- *Debtor's or trustee's actual knowledge of unrecorded deed or mortgage*. The debtor's actual knowledge that he granted a deed or mortgage prior to bankruptcy usually carries no weight with the bankruptcy court because the trustee's rights under the strong arm clause are "without regard to any knowledge of the trustee or of any creditor." 11 U.S.C. 544 (a). *See In re Deuel*, 594 F.3d 1073 (9th Cir. 2010) (disclosure of unrecorded mortgage in a debtor's schedule of assets and liabilities was no defense to a suit to avoid the mortgage under the strong arm clause). However, some courts have held that a debtor's or trustee's actual knowledge of a prior unrecorded mortgage does constitute a defense to an avoidance action under the strong arm clause. *See, e.g., In re Hartman Paving, Inc*., 745 F.2d 307 (4th Cir. 1984) (debtor-in-possession's title to property was subject to a defectively recorded mortgage the debtor granted prior to bankruptcy); *Briggs v. Kent*, 955 F.2d 623 (9th Cir. 1992) (trustee was not a bona fide purchaser as to an unrecorded mortgage mentioned in an involuntary bankruptcy petition against the debtor).

- *Rights of good faith transferees*. If the trustee avoids a transfer of property in the transferee's possession, the trustee must "recover" the property from the transferee in order to bring the property into the bankruptcy estate. The Bankruptcy Code gives transferees in possession certain defenses to recovery. If the trustee recovers the property from the initial transferee, the initial transferee receives a lien for the cost of any improvement to the property that he made in good faith. 11 U.S.C. §550 (e). If the initial transferee has transferred the property to a good faith purchaser, for value, without knowledge that the initial transfer was voidable, the good faith purchaser has a complete defense to the trustee's recovery of the property. 11 U.S.C. §550 (b). Recovery is unnecessary if the trustee avoids a transfer of a non-possessory interest – e.g., if the trustee avoids a mortgage on property in the debtor's possession. *Suhar v. Burns (In re Burns)*, 322 F.3d 421 (6th Cir. 2003).