CONCURRENT SESSION

Preference and Avoidance Actions in Chapters 7 and 13

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Join our networks to expand yours:

Defining "Ordinary Course" Through Mathematical Modeling

Or

"This is no Ordinary Presentation"

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Introduction

One of the first documents I read when I was introduced to the bankruptcy world about eleven years ago was a survey conducted by the ABI regarding preference code. What struck me most about the survey was the result of the opportunity for the participants to make one write in comment regarding what they thought was the most troublesome part of the preference bankruptcy code. The following is the result as written in the survey conclusions:

> "By far the most common independent suggestion made by the respondents was to do something to make the ordinary course of business defense[1] more workable in practice. "

So ,what does this conclusion mean? I have been involved either directly or indirectly with over a couple thousand preference settlements and have witnessed the interplay and negotiations among attorneys. In these cases, only a handful have gone to trial or have been settled through mediation. With very few exceptions, the rest have been settled through what essentially amounts to an agreement on ordinary course of business ("Ordinary Course") between the parties. Determining Ordinary Course is clearly a process with a number of predictable steps and counter steps. Some of the steps are productive and some, not so much. So, it might be fair to say that "more workable in practice" is just another way to describe the need for process improvement. In this paper I will present an approach to the analysis of baseline payment practice that defines ordinary payment practice based on the results of over one thousand settlements. This methodology can provide a standard that can be applicable over a broad spectrum of preference cases.

Examining the process of determining Ordinary Course

I have worked on and around highly complex industrial processes most of my career. Much of my work has been either being directly involvement in process improvement or managing a department of process improvement engineers. One feature of process improvement that I believe is among the most important is the elimination of non-value added work, that is, the elimination of wheel spinning or ruminating over decisions without the requisite standards or facts. Looking closer at this aspect of process improvement, I think helps us identify where we might find opportunity in making Ordinary Course "more workable in practice."

Determining, or identifying, Ordinary Course generally involves an examination of payment practices, business conditions and legal considerations existing in the months or years preceding a bankruptcy. In my opinion, the analysis of this process can be facilitated by viewing it as being divided into three steps. The first step is just the mathematical compilation of the payment and invoice data. This is the rote calculation and presentation of various representative statistics, graphs, tables, spikes in the data, outliers, and an analysis that leads to an unbiased assignment of ordinary or out of the ordinary to the preference payments. The second step involves legal

[1] § 547(c)(2)(A)

research and the study of many variables? Such variables include things like the length of the baseline period, unique industry payment characteristics, seasonal variation in sales patterns, the presence of retainers or security, invoicing procedures related to delivery dates, the supply of goods or services, the existence of multiple entities, invoice factoring, and others. The third step of the process is the modification of the unbiased assignment of ordinary payment practice based on relevant issues identified in step two to determine Ordinary Course with respect to the preference period payments.

So where is the opportunity for improvement? I submit that it would in the mathematical presentation of the data. Time has shown that this has not been an easy undertaking. I have seen a variety of presentations and arguments related to what constitutes ordinary payment practice. The shortcomings of all that I have seen is that none offer a workable definition of ordinary, and none provide far reaching standards for ordinary. While a given methodology can be convincing under certain circumstances and depending on the data, the observations or standards cannot be replicated over a variety of cases or circumstances. What is needed is a way to identify and define ordinary.

So, hypothetically speaking, if a characteristic of ordinary payment practice related to invoice payment age could be identified that has universal or at least broad application, would that make the whole of Ordinary Course more workable? Stated differently, would such a methodology improve the process of determining Ordinary Course? I believe that answer is yes under certain conditions. From my experience in process improvement I have found two constraints that must be met to allow lasting improvement. I believe that the improvement must be simple in its construction and intuitive in its operation. The more complex or mysterious the system change, the less it will be used and the more it will be misused.

The concept of simplifying the complex

We have just been viewing a simulation of one of Albert Einstein's famous "Thought Experiments" dealing with how phenomena involving light are viewed. So, what does this have to do with determining Ordinary Course? It shows us that a highly simplified representation of a very complex process can add insight or clarity even when only one key variable is studied. In this thought experiment, Einstein has focused on the key relationship between state of reference and its effect on time. There is no mention of the many other variables that could affect the outcome of this experiment. This is an experiment conducted according to Einstein's Special Theory. What about the effects of acceleration and gravity that were later incorporated in Einstein's General Theory or the effect of electromagnetic forces yet to be incorporated in theories on relativity. So, as a take away from this illustration, I would ask you to consider the idea that clarity can be added to a complex process by studying the influence of a key variable. In this paper, the contribution of one key variable will be studied. That key variable is the collective judgment made regarding the mathematics of Ordinary Course.

Mathematical analysis of Ordinary Course and what does not work

I was first perplexed as to why such an important decision of whether to include or exclude payments from being a preference should be made based on such a subjective term as ordinary. As I examined the intent and application of Ordinary Course, it became clear that this process is very complex and handling that complexity with the term ordinary was a masterful act. It allowed the process of determining Ordinary Course to begin and mature. With respect to only the mathematics of the payment practice, I have seen analyses that attempt to represent some sort of statistical analysis to define the relationship between pre-preference period and preference period payments of a given preference case. On a one to one basis, this is simply not statistically possible for several reasons. Foremost, the term ordinary has no meaning relative to statistics. Also, I have seen the determination of Ordinary Course approached by using the methodology of probability testing. This methodology is not compatible with the goal of defining individual data points as ordinary or out of the ordinary. Probability testing requires a comparison of many data points to many data points as well as the assignment of confidence intervals.

Can a common characteristics of ordinary payment practice be identified and measured?

Based on the examination of the root meaning of the term, ordinary, and by observation of the process, I suggest that personal experience and personal interpretation of the data dictate the outcome not some sort of statistical determination. Therefore in order to define ordinary, one must not look at the relationship between baseline and preference period data, but to a far reaching relationship between the baseline data and the actual outcomes of preference settlements. In other words, one must construct a model that links baseline data to the actual settlement data. Considering this formidable task, three questions arise relative to constructing a model. First, "Is there a characteristic of the payment practice that can be measured and quantified?" Second, "Is the influence of the mathematical part of Ordinary Course large enough to be distinguished from the influence of the whole?" And third, "Is it possible that among the thought processes of the many negotiators there is actually common ground?" Do great minds think alike?

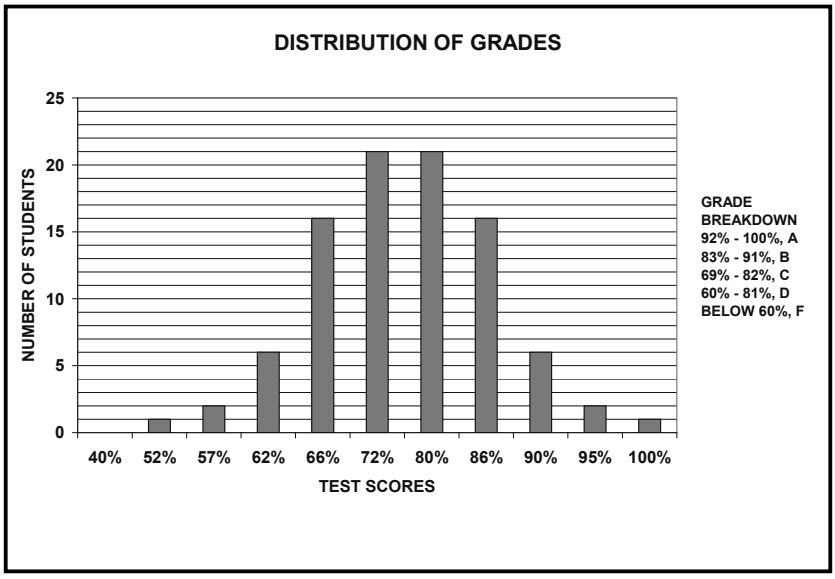
A model is created by constructing some mathematical equation that links a manipulation of variables and constants to actual results. With regard to Ordinary Course, there was no assurance that a statistic existed that would show anything of value. It was clear, though, that some sort of frequency distribution factor would offer the only possible solution. When attempting to characterize a large population of data some consideration of the variation within the population must be used. Averages and weighted averages cannot be used since they do not reveal anything about the span of the data or the variation. Also, since the distribution of data in the baselines are almost always asymmetrical and multimodal, the normally calculated standard deviation is also inadequate. A standard deviation is measurement of variation that has a certain consistent meaning relative to a symmetrical, unimodal distributions, or normal distributions. The calculation of standard deviations will not provide a replicatable number in the types of

distributions typical of baseline period payment practices. After trial and error and the examination of a lot of data, a promising statistic was developed that was centered on the median of dollars paid and assumed equal margins about the median. The development of this statistic was a major stepping stone to the model.

Simple examples of frequency distributions and payment practices

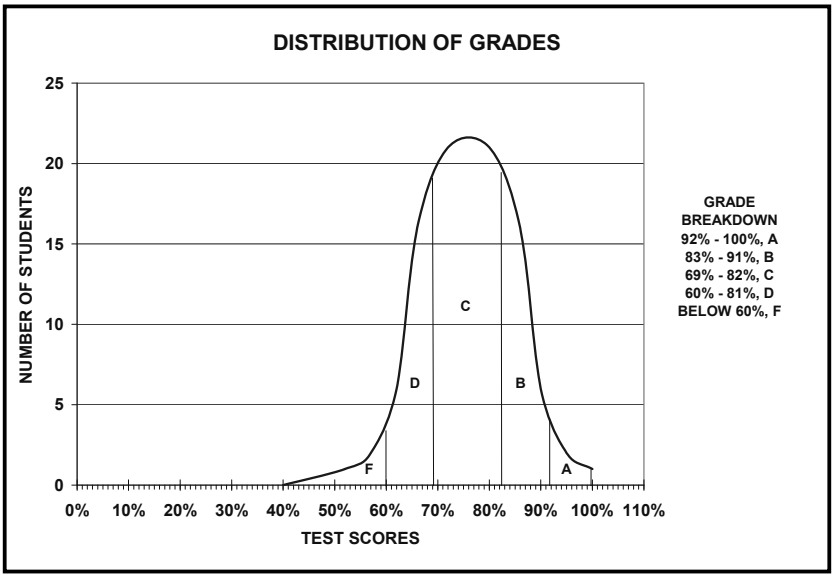
Distribution analysis might not be typical topic for dinner table discussion, but we all have had some exposure to it. Our introduction probably dates back to the first time one of our teachers said they were grading on a curve. Below in Figure 1 is an example of a simple bar graph distribution.

Figure 1



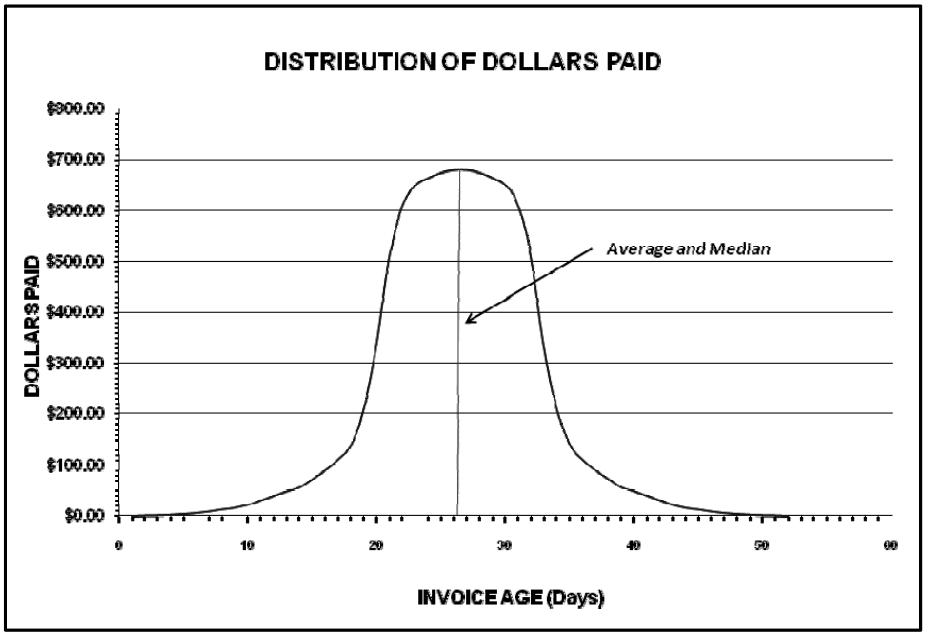
A different way of displaying this data, and more relevant to how payment distribution is displayed is as follows in Figure 2.

Figure 2



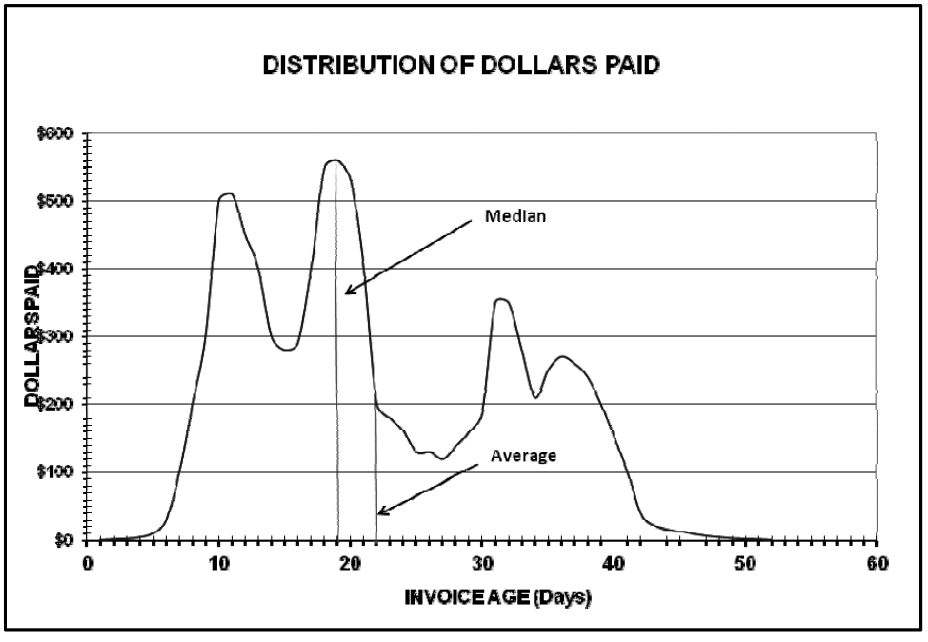
On the previous graphs the variable being measured, test scores, was on the horizontal or X-axis, and the frequency of those is shown on the vertical, or Y-axis. For the purpose of studying the frequency distribution of payments, the variable being measured is the age at which the payment was made. A normal, but unlikely, payment frequency distribution would look like the following on Figure 3.

Figure 3



A more typical distribution of dollars paid is shown below in Figure 4.

Figure 4



The development of the model

In developing a mathematical model, especially a simplified model, one must keep in mind the limitations of accuracy, and identify the characteristics of the data that lead to inaccuracies. Also, the accuracy of a model cannot be greater than the sum of the contribution of the parts. In this case, we did not know how much of the Ordinary Course assignment is based on the payment practice aspect. So the expectation of accuracy was low at the beginning of the project.

It was pointed out earlier that methodologies that assign Ordinary Course based on personal judgment lack a objective definition of ordinary and a set standard that can be replicated. In modeling, ordinary can be defined and the standard can be replicated. The definition of Ordinary Course as it relates to the unbiased payment practices is as follows, "Ordinary Payment Practice is defined as a range of age of invoice payments calculated by a standard mathematical expression. This standard expression was developed by trial and error according to the best fit of predicted preference recoveries to the actual recovery results of 1,232 preference settlements in four bankruptcy cases." The standard model can be described as the interval of payment ages inclusive of 36.5% of the dollars paid on each side of the median point extended by a constant of seven days on each side.

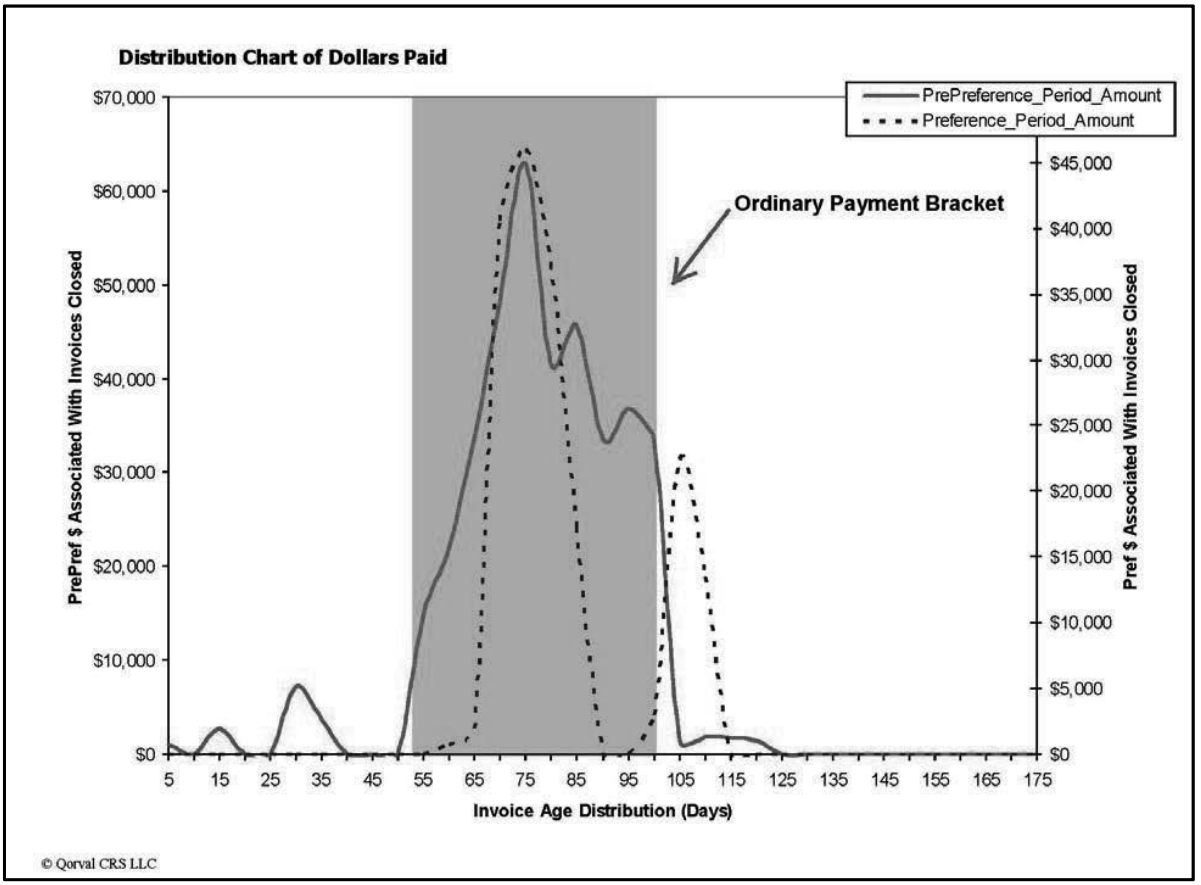
The data that was available was obtained from preference recoveries from four very different bankruptcies. Adding to the broadness of the data is the fact that the law firms conducting the legal work and negotiations were different in each bankruptcy. The bankruptcies included a coal company, an office furniture manufacturer, a Kraft paper manufacturer and a consumer electronics distributor. As can be seen on Table 1, the errors of the estimated recoveries to the actual were +6.3%, -7.6%, +16.9% and -13.5% with a total error of +1.6%.

Table 1

Company	Coal Company	Office Furnature Manufacturer	Kraft Paper Manufacturer	Consumer Electronics Distributor	Totals
Number of Creditors	277	605	229	121	1232
Total Preference Payments	$53,478,833	$36,304,285	$32,185,340	$8,684,736	$130,653,194
Model Recovery	$3,231,663	$3,698,120	$3,275,561	$2,077,186	$12,282,530
Total Recovery	$3,435,767	$3,418,234	$3,827,891	$1,797,285	$12,479,177
Percent Error	6.3%	-7.6%	16.9%	-13.5%	1.6%

The last exhibit is an example of the predicted ordinary payment practice overlaid on a distribution graph of preference period and pre-preference period payments.

Exhibit 4



Conclusions

As suggested earlier, the determination of Ordinary Course is a judgment call and a product of negotiation between two external parties depending up their respective interpretation of legal precedents and what meets their personal standard of ordinary. Also as mentioned earlier, the term ordinary is simply a subjective term in the abstract that is used to describe an outcome. If however, we record 1,232 outcomes and the outcomes are measurable, we can use that information in a mathematical model to measure and define ordinary. The accuracy of any model is related to the number of data points and the broadness of the data sources. While the applicability of this model to other bankruptcy cases is unknown, the data used to develop this model was from very different types of cases including a great dissimilarity of vendors. Agreement within this database indicates a broad application. The model predictions compared to the actual recoveries show a greater agreement than anticipated: 3.2:3.4; 3.7:3.4; 3.3:3.8; and 2.1:1.8.

We can conclude for the population of preference settlements studied that the following are true

1. There is a characteristic of the payment practice that can be measured and quantified?

2. The influence of the mathematical part of Ordinary Course is large enough to be distinguished from the influence of the whole?

3. There is common ground among the thought processes of the many negotiators of preference settlements. Yes, great minds do think alike.

Comments on process improvement

In closing, I would like to mention that what has been so interesting and challenging to me in my career is that process improvement is a never ending task. I have invariably found three thing in the aftermath of advances in processes. The bigger the change, the greater will be the opportunity for more improvement. The bigger the change, the greater will be the level of sophistication needed for further change. And finally, the bigger the change, the greater will be the opportunity for the skilled to prosper.

Preference and Avoidance Actions in Chapters 7 and 13

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I. Abstract. This manuscript reviews and details some of the avoidance actions available to Chapter 7 and 13 trustees involving liens and title to real property with an emphasis on the use of 11 USC §544.

II. General Background.

A. A bankruptcy trustee is charged with duty to ensure that creditors with similar claims and in a similar class are treated equally. Congress has long provided a tool for trustees to accomplish that task in the form of avoidance actions contained in Chapter 5 of Title 11.

B. The assortment of avoidance actions are generally referenced as the "strong arm" provisions. These powers give trustees the right, as allowed by the court, to avoid liens and interests in property under certain circumstances. The causes of action expressly reserved for the trustee include the following:

1. Turnover of property of the estate (11 USC §§542 and 543);
2. Avoidance of liens as a bona fide purchaser for value (11 USC §544);
3. Avoidance of statutory liens (11 USC §545);
4. Avoidance of preferential transfers (11 USC §547);
5. Avoidance of fraudulent transfers (11 USC §548); and
6. Avoidance of post-petition transactions and conveyances (11 USC §549)

C. Pursuant to 11 USC §551, the bankruptcy estate, and not the holder of any junior interest in the asset that may be the subject of the avoidance, benefits from the successful action by the trustee.

III. Increased Scrutiny Since Financial Crisis.

A. Panel Chapter 7 trustees and standing Chapter 13 trustees have generally been vigilant in examining loan documents when pleadings and claims are filed with the court or are produced upon requested by the trustee. The historical analysis has shown that the lender's loan documents are generally in order and the liens appear to be valid.

B. More recently, with the extended financial crisis and the discovery of mortgage fraud, the creditor loan documents are being more closely scrutinized, and trustees are bringing lien avoidance actions. Section 544 is the tool used most often to avoid improperly perfected liens caused by the lender's error in the loan transaction or recordation.

C. The lender's errors include the following:

1. Failure to identify the debt instrument (promissory note, line of credit, guaranty agreement, letter of credit);
2. Failure to record in the correct registry (not in the jurisdiction of the property serving as collateral);
3. Failure to describe adequately the real property collateral;
4. Failure to prove ownership of the debt instrument;
5. Failure to effect a proper assignment (assignment in blank or incomplete or erroneous allonge).

IV. Section 544 - Trustee as Lien Creditor and as Successor to Certain Creditors and Purchasers.

A. Section 544 confers the trustee's rights as a judicial lien creditor, a creditor with execution unsatisfied or a bona fide purchaser of real property.

B. Section 544 imposed by Congress relies on state law for its effectiveness but federal law may also be applicable.

C. Under this section the trustee has two distinctive rights as defined in Section 544(a) and 544(b), and Section 544(a) has three separate causes of action.

1. Section 544(a). Under Section 544(a) the trustee may avoid certain pre-petition transfers that could have been avoided by certain types of creditors or a bona fide purchaser for value ("BFP") regardless of whether those creditors or BFP actually existed prior to the bankruptcy.

(a) The trustee may avoid any pre-petition transfer of an interest in the debtor's property, especially any security interest, by:

(i) A hypothetical creditor who, at the time the bankruptcy petition was filed, not only advanced credit to the debtor, but instantaneously obtained a judgment lien on all of the debtor's assets under a simple contract enforcement action [Section 544(a)(1];

(ii) A hypothetical creditor who, at the time the bankruptcy petition was filed, not only advanced credit to the debtor, but instantaneously issued an execution against the debtor that is returned unsatisfied [Section 544(a)(2]; or

(iii) A hypothetical bona fide purchaser of real property, excluding fixtures, from the debtor against whom applicable nonbankruptcy law permits the transfer of title to be perfected and that has, as of the commencement of the case, perfected that transfer [Section 544(a)(3)].

(b) Effect of Section 544(a)(1)/Judicial Lien Creditor

(i) The rights of a judicial lien creditor allow the trustee to have a perfected lien in all of the debtor's assets.

(ii) If any other creditor has not properly perfected its lien prior to the bankruptcy filing (and the granting of the hypothetical judgment lien to the trustee), that creditor's lien may be junior to the trustee's lien or may be completely invalid.

(iii) The determination of lien validity is determined by applicable state law.

(c) Effect of Section 544(a)(2)/Unsatisfied Execution

(i) Section 544(a)(1) creates a lien on property when having a lien on the judgment roll is insufficient. In other cases, especially in dealing with personal property, simply having a judgment is not sufficient.

(ii) Section 544(a)(2) gives the trustee the status of a creditor who has actually attempted a levy. A levy is performed by

a sheriff or other judicial officer upon specific property by taking control of it by tagging or removal.

(iii) In some jurisdictions, this process must be fully pursued to give an inchoate lien upon the property. It also allows for the trustee to argue marshaling or insolvency if contested later. 5-544 *Collier on Bankruptcy* P544.04.

(d) Effect of Section 544(a)(3)/BFP

(i) This section applies to real property because of the required notice applicable to the transfer of title to land.

(ii) The trustee is conclusively determined to have reviewed title to the property of the estate, paid adequate consideration for the land and properly perfected recorded title to the property as of the petition date.

(iii) Under most state recording statutes, the BFP will have superior title to any other security interest or ownership interest when that interest is not properly perfected or is deemed to be invalid or deficient under state law.

2. Section 544(b). Under Section 544(b) the trustee has the powers of an actual creditor with an allowable unsecured claim that could have avoided a transfer of the debtor's property or any obligation of the debtor under applicable nonbankruptcy law. Most often the nonbankruptcy law will be a state or local statute.

(a) Effect of Section 544(b)/Trustee as Unsecured Creditor

(i) While the Bankruptcy Code can provide for much of the debtor-creditor treatment between parties, it does not ignore causes of action that may be applicable under state law.

(ii) This section allows the trustee to pursue creditors' claims that are available under state law. These causes of action include actual fraud, conspiracy, fraudulent transfers, actions under the Statute of Elizabeth and the Uniform Fraudulent Transfer Act ("UFTA") and its predecessor the Uniform Fraudulent Conveyance Act.

(iii) Unlike the hypothetical provisions in Section 544(a), this section requires that an unsecured creditor actually exists.

(b) UFTA.

(i) In the late 1980's states began adopting the standard language of the UFTA. Over 43 states have adopted the statute.

(ii) The statute replaces the prior fraudulent conveyance laws that were less artfully drafted and depended upon various "badges of fraud."

(iii) The UFTA addresses both actual and constructive fraud.

D. Avoidance Limited by Section 550

1. As with all of the "strong arm powers," Section 550 limits the recovery of Section 544.

2. The limitations include the following:

   (a) Time for bringing the action;

   (b) Lien for any improvements to the asset;

   (c) Single satisfaction of the claim; and

   (d) Protection for subsequent transferees who give adequate consideration.

V. Errors in Legal Descriptions.

A. Conflict Between Recorded Deed Reference and Recorded Plat Reference.

1. *Peterson v. Polk-Sullivan, LLC*, 206 N.C. App. 756, 698 S.E.2d 514 (2010). A reference to a recorded plat takes precedence over a reference to a recorded deed. The legal description in a deed of trust correctly identified a recorded plat but incorrectly identified a recorded deed. The NC Court of Appeals stated that reference to the recorded plat controls.

B. Conflict Between Recorded Plat Reference and Metes and Bounds.

1. *Kelly v. King,* 225 N.C. 709, 26 S.E.2d 220 (1945). The NC Supreme Court held that where the deed contains two descriptions, one by metes and bounds, and the other by lot and block according to a certain plat or map, the controlling description is the lot according to the plat. See *Nash v. Wilmington & W. R. R. Co.*, 67 N.C. 413 (1872). See also *Hayden v. Harden*, 178 N.C. 259, 100 S.E. 515 (1919).

C. Conflict Between Street Address and Reference to Lot Number on Recorded Plat.

1. *Meade v. Bank of America* (*In re Meade*), Adv. Pro. No. 10-00280-8-JRL (Bankr. E.D.N.C. July 29, 2011). A recorded plat takes precedence over a street address. In this case, the debtor-in-possession, using the strong-arm powers of Section 544(a) sought to avoid two deeds of trust granted to the defendant lender. The parties intended for each parcel to have two deeds of trust. The parcels were 228 Shawnee Drive, Lot 978 and 226 Shawnee Drive, Lot 979. The deeds of trust to be avoided had the correct street address (228 Shawnee Drive), but the incorrect lot number (Lot 979). The description based upon the recorded plat that designated Lots 978 and 979 takes priority over the street address. Street addresses change over time and this variability makes them unreliable, and using a street address is not a standard practice for identifying real estate in deeds and deeds of trust. The court avoided the deeds of trust intended for Lot 978 because that lot number was not recited in the deeds of trust.

VI. Errors in Property Descriptions.

A. *Angell v. First South Bank, et al. (In re Despaigne)*, Adv. Pro. No. 10-00045-8-JRL (Bankr. E.D.N.C. March 25, 2011). The lender's deed of trust was intended to secure a lien upon the debtor's single family home located on two adjacent tracts. The deed of trust referred to the street address, and the metes and bounds description only encompassed one of the tracts. At the time of the conveyance of the deed of trust, the debtors did not own the other tract. The debtors received

title to the other tract by a deed of correction; however, pursuant to state law, a deed of trust is not effective against lien creditors or purchasers for value until time of recording of the deed of trust. The court also stated that a street address is acceptable if it is the only description and local registries approve of that method. See *In re Walker*, No. 03-13204C-7G, 2007 WL 1575062 (Bankr. M.D.N.C. April 27, 2007).

B. *Hinson v. Chase Home Finance, LLC et al.*, Adv. Pro. No. 10-00021-8-JRL (Bankr. E.D.N.C. May 16, 2011). Even though the collateral in two deeds of trust to different lenders contained the same mistake describing Lot 17, rather than the correct Lot 7, a prudent title searcher would review the deed and granting Lot 7, as provided in a recorded plat, to the debtors. Constructive notice of the ownership of the property defeated the trustee's action under 11 USC §544.

C. *In Re Chateau Royale, Ltd.* 6 B.R. 8 (Bankr. FL. 1980). The court denied the trustee's recovery pursuant to Section 544(a) when the legal description was not attached as an exhibit; however, language in the mortgage recited a prior senior mortgage that was referenced with a book and page number designated by the public registry. The court found that the information relating to the senior mortgage was sufficient under Florida's notice statutes to provide sufficient constructive notice to an ordinary prudent title examiner.

D. *Butler v. Deutsche Bank Trust Company Americas, Residential Funding Company, LLC and Pettit (In Re Rose)* 418 Fed. Appx. 244, 2011 U.S.App. Lexis 5769 (4th Cir. 2011).

1. The property description of the pre-petition deed of trust erroneously described the lot as Block 98 rather than the correct Block 96. Fortunately for the lienholder, the property was also described by PIN number and by street address; therefore, the court rejected the avoidance action by the trustee under Section 544(a)(3). A land purchaser is assumed to examine each recorded deed and other instrument in the chain of title, and he has a duty to examine every fact affecting the title. A prudent title searcher would see that prior ownership and deeds of trust recited the correct Block 96, and that knowledge defeats the bona fide purchaser status alleged by the trustee.

2. The court distinguishes this case from *In re Law Developers*, *LLC* 404 B.R. 136 (Bankr. E.D.N.C. 2008) because the debtor in *Law Developers* owned both of the properties that were mistakenly identified in the deed of trust where the debtor in *Rose* owned no other lots than those described in the deed of trust, thereby a title searcher would be confused in *Law Developers*.

VII. Error in Recordation.

A. *In re McCormick*, 669 F.3d. 177 (4th Cir. 2012). In North Carolina, counties can elect to have an official index of either the grantor/grantee index or the PIN (parcel identification number) system. Orange County, NC has an official PIN index but also maintains a grantor/grantee index. The court held that unless the deed of trust is recorded in the PIN index, a BFP does not have proper notice,

notwithstanding the constructive notice that may be available by the grantor/grantee index, and the lien was avoided.

B. *In Re Hugh*, 2009 Bankr. Lexis 4251 (Bankr. N.D. Ga. Nov. 25, 2009) (Drake, J.) The Chapter 13 trustee sought to convert a case to Chapter 7 because he believed that a Chapter 7 trustee could avoid a first priority security interest ("First Security Deed") upon the debtor's real property to provide a dividend for unsecured creditors. The court denied the motion. The creditor held two deeds of trust upon the subject property. The second priority deed of trust ("Second Security Deed") was filed two years before the bankruptcy petition; however, due to an error, the intended First Security Deed was not recorded until two months after the bankruptcy petition was filed. The court determined that the filing of the Second Security Deed would place the trustee on notice of the First Security Deed; therefore, the trustee could not be a bona fide purchaser pursuant to Section 544(a)(3). The trustee would have constructed notice or inquiry notice of a potential senior lien. Under Georgia's race-notice law, a bona fide purchaser of real property may take an interest greater than that held by the holder of an unrecorded interest in real property, as long as the bona fide purchaser had no notice of the unrecorded interest. The court determined that the post-petition recording would normally be precluded by Section 362 and Section 549; however, the failed attempt to provide notice by recording the deed of trust post-petition has no effect because of the prior constructive notice provided by the Second Security Deed.

C. *Anderson v. SunTrust Mortgage, Inc. and EMC Mortgage Corporation (In Re Judd)* 2012 U.S.Dist. Lexis 44798 (D. S.C. March 29, 2012) (Cain, J.)

1. The post-petition transfer of real property and the recordation of corresponding mortgages where the loan proceeds from those mortgages were used to satisfy pre-petition liens were held to be valid under Florida subrogation law. The court ruled against the trustee in an attempt to avoid the post-petition liens under Section 544(a)(3) as a bona fide purchaser. Florida case law specifically provides that equitable subrogation allows a subsequent lender, who satisfies an existing mortgage lien, may assume the priority position of the lien that it satisfied, notwithstanding contrary provisions of the Florida recording statute. Equitable subrogation requires the following:

   (a) The post-petition lender must have made the payment to protect its interest;

   (b) The subrogee did not act a volunteer;

   (c) The subrogee was not primarily liable on the debt;

   (d) The subrogee must pay off the entire pre-existing debt; and

   (e) Subrogation would not work any injustice on the rights of a third party.

2. All of these factors were met by the use of the post-petition mortgage proceeds to satisfy the pre-petition liens upon the negotiated sale of the real property.

3. The court denied relief under Section 550(b) allowing for a recovery from an initial transferee or the immediate or mediate transferee for the benefit of the estate. The post-petition lender provided value in exchange for the transfer, entered into the transaction of good faith, and had no knowledge of the voidability of the voided transfer. Further, the post-petition lender has a lien to the extent of the cost of any improvements made through the transfer and any increase in value as a result of the transfer. The post-petition lender improved the property by the satisfaction of the pre-petition liens; therefore, Section 550 was not available to the trustee.

D. *Tyler v. Ownit Mortgage Loan Trust (In Re Carrillo)* 2010 Bankr. Lexis 4379 (Bankr. E.D.Va. Nov. 24, 2010) (Mitchell, J.) The trustee cannot avoid an improperly acknowledged deed of trust under Section 544 (a)(1) when under Virginia law a subsequent transfer through a foreclosure has occurred pre-petition. The deed of trust in question was acknowledged by a "managing member" rather than the "notary public". Although the court acknowledged that the deed of trust with the defected acknowledgement is no different than an unrecorded deed of trust, under Virginia law, an unacknowledged or unrecorded deed is sufficient to pass title. Acknowledgement is only necessary for recordation purposes. The foreclosure deed to the lender was properly recorded prior to the date the trustee became the hypothetical judgment creditor which precludes the avoidance action under Section 544(a)(1).

E. *In Re Spencer*, 354 B.R. 758 (Bankr. S.C. 2006). South Carolina law requires a deed and mortgage to be acknowledged by two witnesses. The mortgage in question was not witnessed when the debtors signed the mortgage but was witnessed by the closing attorney's employees afterwards. Under South Carolina law, an improper witness mortgage is not void between the parties. The purpose of the acknowledgement is for recordation and to protect creditors and subsequent purchasers. The recordation of an unacknowledged instrument is invalid and will not provide constructive notice to any subsequent purchaser. In an action to avoid the transfer under Section 544(a)(3) the debtor-in-possession, asserting its position as a bona fide purchaser, has constructive notice where the defect in the acknowledgment does not appear on the face of the instrument. Although the document was not witnessed at the time of the execution, the witnesses subsequently signed the mortgage and recorded the document which appeared to be valid on its face and would not otherwise indicate any patent defect. As only a latent defect, the recording of the mortgage gives constructive notice to all, including the debtors who cannot be a bona fide purchaser under Section 544 (a)(3), especially when they had actual knowledge of the defect.

F. *Kapilia v. Gunn, Hatt and Indymac Bank, FSB (In Re Gunn)* 2005 Bankr. Lexis 732 (Bankr. S.D.Fl Jan. 11, 2005) (Ray, J.) The court denied the trustee's request to avoid a mortgage that was recorded with only one of two required signatures prior to the filing of the bankruptcy petition. The court determined that the instrument was actually witnessed by four people and the failure to execute the

second signature was an over sight. The pre-petition recording of the deed from the debtors to the third party buyer may not have been effective as a conveyance; however, the trustee still had constructive notice of the corresponding recorded mortgage executed by the buyer. That notice defeats the bona fide purchaser status under Section 544(a)(3). Further support of constructive notice included the prior recorded mortgages of the debtor, foreclosure judgments, and lis pendens on the public record.

VIII. Error in Grantor Under Deed of Trust.

A. *Den-Mark Properties, LLC v. SunTrust Bank and Southland Assoc. (In re Den-Mark Properties, LLC)*, 2009 WL 917963, Adv. Pro. No. 08-00196-8-RDD (Bankr. E.D.N.C. March 27, 2009)(Doub, C.J.). The debtor-in-possession may use Section 544(a)(1) to avoid a deed of trust that was to have been granted by two related debtors but was actually only executed by one. The deed of trust did not appear in the chain of title of the entity that did not sign the instrument. The debtor, as a hypothetical judgment creditor, has a valid lien against the property owned the by non-signing debtor.

IX. Loan Servicer/Holder of Promissory Note/Assignment.

A. *In re Jones*, Case No. 09-04701-8-RDD (Bankr. E.D.N.C. Jan. 21, 2010)(Doub, C.J.). The loan servicer did not provide sufficient proof that it had a servicing agreement to the alleged noteholder. The failure to provide note ownership and authority to act caused the court to deny the motion for relief from stay filed by the servicer against the debtors.

B. *In re Robinson*, Case No. 07-02146-8-JRL (Bankr. E.D.N.C. Nov. 22, 2011)(Leonard, J.). A promissory note may be endorsed in blank, and then become payable to the bearer of the instrument pursuant to NC Gen. Stat. §25-3-205(b) (NC's version of the UCC). The lender proved possession of the original promissory note and was deemed to have the right to enforce the provisions of the loan.

C. *Willson v. MLA, Inc. (In the Matter of Ascot Mortgage, Inc.)* 153 B.R. 1002 (Bankr. N.D.G.A. 1993)

1. Interpreting the laws of the states of Georgia, Florida and Alabama, the court determined that the failure to record assignments of mortgages and security deeds prior to the bankruptcy filing did not avoid the assignment of loans from the debtor . The trustee was denied avoidance under Section 544(a)(1) as a judicial lien creditor and or under Section 544(a)(3) as a bona fide purchaser.

2. Under Georgia law, a transfer of a deed to secure debt must be recorded to be effective against third parties claiming superior rights in that property; however, the trustee did not prevail over the assignee of the mortgage because the real property securing the debts was not being transferred or conveyed. The transfer was of the promissory notes and security deeds. Further, the debtor did not have possession of the promissory notes being assigned at the time of the bankruptcy filing. Any potential purchaser of the debtor's interest in the mortgages and security deeds would have

constructive knowledge that the debtor could not produce and transfer the original notes; therefore, the bona fide purchase's status is defeated by this constructive notice.

3. In Florida the granting of a security interest in real property does not transfer legal title as it does in Georgia; therefore, the trustee could not use Section 544(a)(3) as a bona fide purchaser because title to the property did not transfer. The court did not allow the avoidance under Section 544(a)(1) because the Florida recording statute provides that no assignment of a mortgage on real property shall be effective against creditors of subsequent purchasers without notice unless the assignment is recorded; however, the statute extends this protection only to subsequent purchasers for value, mortgagees and other lien claimants against the underlying real property. That recording statute does not apply to assignees and assignors, as they do not have competing interest in the property. The assignees are successive claimants.

4. In Alabama the recording statute does not require any recordation of the transfers of mortgages and promissory notes. The debtor did not have possession of the promissory notes at the time of the bankruptcy filing, so Section 544(a) could not be used by the trustee as a judicial lien creditor. Further, the trustee cannot be a bona fide purchaser under Section 544 (a)(3) because any subsequent purchaser would be on notice that the debtor could not produce the original notes.

5. The court also rejected the trustee's avoidance efforts by an analysis of the Uniform Commercial Code determining that the assignee held the promissory notes as a holder in due course and took those instruments for value, in good faith and without notice of any dishonor.

X. Identification of Debt Instrument in Deed of Trust/Mortgage.

A. *Beaman v. Head (In re Head Grading Co., Inc.)*, 353 B.R. 122 (Bankr. E.D.N.C. Sept. 15, 2006)(Doub, J.). The court allowed the avoidance of a lien by the trustee under Section 544 when the deed of trust failed to refer accurately to the promissory note secured by the deed of trust. The deed of trust was dated July 29, 1998 and recited that it was given as security for a "Promissory Note of even date herewith." No promissory note dated July 29, 1998 existed; therefore, deed of trust failed to identify the obligation that it secured as required by NC law.

B. *South Bay Properties, LLC v. Bayside Property, Inc. (In re South Bay)*, Adv. Pro. No. 10-00236-8-SWH ((Bankr. E.D.N.C. June 15, 2011). Applying South Carolina law dating back to the 1800's, the court held that that the incorrect date of the promissory note identified in the mortgage did not invalidate the mortgage by failing to identify the debt instrument. The promissory note was dated September 11. The mortgage was dated September 12. The promissory note was identified by the amount of the debt and "as evidenced by the certain Promissory Note of even date herewith." That reference would have incorrectly made the Promissory Note dated September 12. The court denied the relief under Section

544(a)(1) because the established case law applied "substance over form and rejected efforts to assign undue weight to minor errors."

C. *Beckhart v. Nationwide Tr. Serv. , Inc.; Mortg. Elect Registration Sys., Inc.; BAC Loans Servicing, L.P., (In re Beckhart)* Adv. Pro. No. 09-00263-8-RDD (Bankr. E.D.N.C. July 21, 201)(Doub, C.J.).

1. The court held that the lien on property was valid, not withstanding a discrepancy in defining the "borrower." The male debtor was the sole maker of the promissory note and the sole grantor of the deed of trust. Both documents referenced the same loan number and were consistent in describing the amount of the obligation. The place in the deed of trust where the promissory note was to be described was blank; however, the court determined that other information in the deed of trust could be used to identify the obligation. Further, under the definitions portion of the deed of trust both debtors, rather than the male debtor, were erroneously listed.

2. The court determined that including both debtors in the definition of the deed of trust would protect the lender in the event the female debtor held an interest in the collateral. Under NC law, the debt must be identified in the deed of trust, and a deed of trust must have the following:

   (a) competent grantor;

   (b) grantee capable of holding title to the land;

   (c) an adequate description of the property;

(d) operative words to express a conveyance; proper execution by the grantor;

(e) proper delivery; and

(f) acceptance by the grantee.

D. *Easthaven Marina Group, LLC v. B&M Holdings, LLC and Fuss Law Firm, PC, Trustee (In re Easthaven Marina Group, LLC)*, Adv. Pro. No. 08-00221-8-AP, (Bankr. E.D.N.C. Mar. 13, 2009)(Leonard, J.). The court denied the action under Section 544(a) to invalidate a deed of trust that was flawed for not accurately identifying the date of the promissory note (true date was March 2 and not March 1 as stated in the deed of trust) and was flawed because the maker of the promissory note did not match the name of the grantor of the deed of trust. The principal of the debtor was involved in that transaction under a separate entity. The debtor ultimately acquired the property that secured the promissory note and assumed the deed of trust, albeit invalid. The principal of the debtor had knowledge of the lien and that knowledge was imputed to the debtor. This knowledge prevents a reformation of the deed of trust. Further, the debtor is estopped from the avoidance action because the debtor's principal was involved in the mistakes relating to the promissory note and deed of trust and cannot benefit from that involvement.

XI. Party to Bring Avoidance Actions.

A. *Baldwin v. Fidelity National Title Insurance Company of New York, Inc., Trustee, et al. (In re Baldwin)*, Adv. Pro No. 10-00309-8-JRL (Bankr. E.D.N.C. May 11,

2011). The Chapter 13 debtors were prohibited from bring an action under Section 544 to avoid two deeds of trust. The debtors rights and powers are found in Section 1303 which does not include the powers under Chapter 5 of Title 11.

XII. Related Cases.

A. Execution of Guaranty Agreements.

1. *In re Sisler*, Case No. 11-00787-8-JRL (Bankr. E.D.N.C. Oct. 6, 2011)(Leonard, J.). A guaranty agreement has to meet the statute of frauds by being in writing and signed by the party to be charged with the guaranty. An admitted forgery of one of the instruments does not meet the statute of frauds requirement. Further the failure of the document to provide the terms of a personal guaranty, even though the words "personal guaranty" appeared, were insufficient to invoke liability as a guarantor.

B. Reformation of Deed of Trust.

1. *Stone v. Gateway Bank & Trust Co., et al. (In re Stone)*, Adv. Pro. No. 11-00006-8-JRL (Bankr. E.D.N.C. Aug. 15, 2011)(Leonard, J.). While not a Section 544 action, the debtors unsuccessfully attempted to add the female debtor's name to the existing deed of trust by reformation in order to protect the property therein as tenants by the entirety. The male debtor was the only obligor under the promissory note. The court held that the parties have three years from the discovery of a mutual mistake to correct the action. The deed of trust was executed 15 years earlier. Further, the

debtors' prior joint financial statements clearly indicated that the property belonged solely to the male debtor.

2. *In re Law Developers, LLC*, 404 B.R. 136 (Bankr. E.D.N.C. 2008). The court denied the creditor's post-petition request for reformation of a deed of trust when the property was inaccurately described as Lot 43 when it should have been Lot 17. The error was due to a drafting error. The court held that the deed of trust was avoided under Section 544(a)(1) because the deed of trust did not provide an adequate description of the collateral, even though the borrower and lender were in agreement. Further, the lender's reformation rights terminated upon the petition date because of the rights given to the debtor-in-possession as a judicial lien creditor.

3. *Putnam County Bank v. Tolly (In Re Tolly)*, 2010 U.S. Dist. Lexis 84123 (D. W. Va. 2010). Section 544(a) prevents a post-petition reformation of a deed of trust when one parcel containing 131 acres was omitted from the other three parcels in a deed of trust. The three parcels identified were included in a legal description and did not equal the total amount of acreage also recited in the deed of trust. The debtor and the lender were in agreement at the time of the drafting of the deed of trust that all four parcels were to have been included in the deed of trust. The discrepancy between the total acreage amount listed in the description and the three parcels that did not equal that amount when mathematically added was not sufficient to provide constructive notice of the mistake. The debtor in

possession is entitled to the status of a bona fide purchaser or a judicial lien creditor pursuant to Section 544. As an innocent purchaser, the debtor in possession can prevent the reformation of the deed of trust.

XIII. Chapter 7 Lien Stripping.

A. *In re McNeal*, Case No. 11-11352 (11th Cir, 2012)(unpublished). Citing a distinction from *Dewsnup v. Timm*, 112 S. Ct. 773 (1992) where a partially secured claim could not be stripped using Section 506(d), the Eleventh Circuit, on appeal from the Northern District of Georgia, held that a fully unsecured junior lien could be stripped and avoided in full.

XIV. Conclusion.

A. Section 544 provides significant powers to trustees and debtors-in-possession, and when wielded, they can devastate a secured lender.

B. Lenders and their counsel should be extra cautious in their drafting and recording of the loan documents.