

## Little Errors Equal Big Losses with Deeds of Trust

As real estate-related bankruptcy filings continue to rise, bankruptcy courts are increasingly asked to avoid the liens of secured creditors due to a scrivener's error in the deed of trust. The Eastern District of North Carolina has ruled on four such cases in the past three years. A review of the cases shows that the court's analysis is highly fact-specific, but if a defect exists in the loan documents as of the bankruptcy petition date, the outcome of the lien challenge is largely out of the lender's control.

*In re Head Grading Co., Inc.* (unpublished) (Bankr. E.D.N.C. 2006).

In this case, the Chapter 7 trustee filed a complaint seeking to avoid a lien held by Ruby Lee Head. The dispute arose from a deed of trust granted by the Debtor to Ms. Head, dated July 28, 1998, in the amount of \$180,515.75. The deed of trust stated that it secured a "Promissory Note of even date herewith." The actual note held by Ms. Head was dated July 29, 1998. There was no note of even date with the deed of trust, and the deed of trust did not reference future advances. The court relied upon North Carolina case law requiring that deeds of trust specifically identify the debt. The court held that because the note dated July 29, 1998 did not properly identify the obligation, Ms. Head's lien was avoided and her claim was unsecured.

*In re Law Developers, LLC*, 404 B.R. 136 (Bankr. E.D.N.C. 2008).

In this case, the Debtor objected to the secured claim filed by The Bank of Currituck in the amount of \$204,117.59, alleging that the legal description in the deed of trust was incorrect. The deed of trust identified Lot 43 of Cedarwood Village, but the property intended to be encumbered was Lot 17 of Cedarwood Village. The Bank of Currituck contended that the deed of trust should be reformed to correct the mistake and reflect the true intention of the parties. The court's analysis came in three parts.

Initially, the Court found that the deed of trust was void under North Carolina law because it failed to provide an adequate description of the encumbered property.

However, the court next considered The Bank of Currituck's equitable argument that it should be able to reform the deed of trust to conform to the parties' intentions. Under North Carolina law, reformation rights cannot be

granted if the rights of a bona fide purchaser would be prejudiced by such reformation. Additionally, Fourth Circuit precedent holds that a debtor-in-possession, a bona fide purchaser pursuant to Section 544(a)(3) of the Bankruptcy Code, cannot invalidate a deed of trust where he is an original party to the deed of trust and had actual notice of its existence. Thus, the court in *Law Developers* found that the Debtor could not invalidate the deed of trust because it was a party to the original transaction with actual notice of the transaction and the recording of the deed of trust.

Unfortunately for The Bank of Currituck, the court did not stop its analysis there. In part three of its decision, the court analyzed Section 544(a)(1) of the Bankruptcy Code. This section gives a debtor-in-possession the status of a judicial lien creditor. Under North Carolina law, an intervening judgment lien will cut off reformation rights where the lien creditor lacks knowledge of the mistake and has provided new consideration or incurred new liability. The court found that The Bank of Currituck's reformation rights were cut off as of the petition date because Section 544(a)(1) assumes that a debtor-in-possession is a judicial lien creditor that has no knowledge of the mistake and has incurred new liability. Based on the Debtor's status as a judicial lien creditor, the court determined that the Bank of Currituck had an unsecured claim.

*In re Easthaven Marina Group, LLC*, (unpublished) (Bankr. E.D.N.C. 2009).

In this case, the Debtor sought an order from the court finding that the \$9,000,000.00 debt of B&M Holdings, LLC was unsecured despite the existence of a recorded deed of trust. The deed of trust was executed and delivered in favor of B&M from the grantor, SHM Marina Group, LLC, on March 1, 2007. The deed of trust referred to a note dated March 1, 2007 from Scotts Hill Marina Group, LLC, whereas the actual date of the note was March 2, 2007. Additionally, Scotts Hill Marina Group, LLC, the name used in the note, was not a legal entity but merely the trade name of SHM Marina Group, LLC.

In late 2007, SHM conveyed the property in question to David White with the following language: "[g]rantor acknowledges that this conveyance is subject to deed of trust to B&M Holdings, LLC in the amount of \$9,000,000. . . ." Subsequently, Mr. White formed Easthaven Marina (the Debtor) and conveyed the subject property to it with the following language: "[s]ubject to the Deed of trust in Book 3176, Page 109."

The court found that the deed of trust was invalid due to the errors in the date and grantor's name. However, the court held that the obligation to B&M was enforceable under the theory of estoppel. The theory of estoppel is that a person cannot accept the benefits of a transaction while simultaneously rejecting the associated burdens. Because the Debtor was attempting to invalidate a conveyance two transfers back in the chain of title, the court found that the doctrine of estoppel was applicable and refused to avoid the deed of trust.

*In re James A. Rose, III*, (unpublished) (Bankr. E.D.N.C. 2009).

In this case, the court determined whether a deed of trust in favor of Homecomings Financial Network, Inc. was invalid due to an ambiguity in the block number. The deed of trust contained three identifying markers: the tax identification number, street address and block number. Two of the markers correctly identified the property as Lots 20 and 21 in Block 96, while the third marker identified the property as Lots 20 and 21 in Block 98. Lots 20 and 21 of Block 96 had twice been encumbered by the Debtor. The prior deeds of trust contained accurate information and were satisfied prior to the Debtor filing bankruptcy.

The court focused its analysis on whether a bona fide purchaser could have defeated the claim of Homecomings. If the hypothetical purchaser was on notice of the error in the deed of trust, then the trustee/debtor-in-possession is prohibited from taking free and clear of the liens. The court held that the deed of trust was valid because a diligent purchaser of the land would have examined each recorded deed and other instrument in the chain of title, would have noted the discrepancy between Block 96 and Block 98, and would have determined that the reference to Block 98 was a minor typographical error. Because the hypothetical purchaser would have had constructive notice of a valid lien on the property, the Debtor could not take the property free and clear of Homecomings' lien.

The message to be taken from these cases is that most defects are easily spotted with careful review of the loan documents. If such defects are caught early, they can be fixed with minimal time and cost. It is well worth a lender's time and money to ensure procedures are in place for careful review of the notes and deeds of trust before and after closing to avoid defects that may render liens invalid. Lenders should also take advantage of an opportunity to correct errors when a loan secured by real estate is at risk of default, but no bankruptcy has been filed. In such situations, a lender may

have time to correct errors, and the obligors may be motivated to cooperate in exchange for the lender's agreement to forbear from collection or modify the loan terms to avoid default.

If you discover a problem with loan documents that may result in avoidance of the deed of trust, please call any member of Poyner Spruill's Creditors' Rights section for help identifying your legal options.