

**BANKRUPTCY- 11 U.S.C. §544 AND FAILURE TO PROPERLY RECORD
AND 11 U.S. C. §549 AND POST- PETITION TRANSFERS**

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1. 11 U.S.C. §544- transfers prior to filing of petition.

11 U.S. C. §544 is called the "strong arm statute". It deals primarily with pre-bankruptcy conveyances that are recorded after bankruptcy or that are deemed *not* properly recorded prior to bankruptcy after an invalid attempt to record prior to bankruptcy. The trustee has the status of a hypothetical bona fide purchaser of real property or judicial lien creditor obtaining an interest at the filing of the bankruptcy petition. Some real life examples may be helpful.

In *In Re Kline*, 242 B.R. 306 (Bankr. W.D.N.C. 1999), the following were the relevant facts: (1) on 5-15-95, the debtors purchased land in Cleveland County and gave a deed of trust securing BB&T recorded in that county; (2) on 8-25-97, the debtors gave First Plus a second deed of trust encumbering the land; (3) on 9-9-97, the First Plus deed of trust was recorded in Cleveland County (First Plus knew it was in second position and subordinate to BB&T); (4) on 4-23-98, the debtors gave a deed of trust to MIC, which was inadvertently recorded in Gaston County but was not recorded in Cleveland County, the secured proceeds being used to payoff the BB& T loan which resulted in BB&T canceling its deed of trust; (5) subsequently, MIC assigned its interest to Source One and Source One assigned to Litton; (6) on 12-16-98, the debtors filed a Chapter 7 petition; (7) on 12-17-98, a trustee in bankruptcy was appointed; and (8) on 6-12-99, the trustee filed an adversary proceeding.

Pursuant to 11 U.S.C. §544, known as the "strong arm statute," the trustee in bankruptcy has avoidance powers. The trustee has the status of a bona fide purchaser who has perfected a transfer at the time of the commencement of the bankruptcy case. When 11 U.S.C. §544, G.S. 47-20 and G.S. 47-20.1, are construed together, the trustee's interest as a bona fide hypothetical purchaser is superior to the MIC deed of trust recorded in the wrong county. 11 U.S.C. §550 (a) provides when a voidable transfer under 11 U.S.C. §544 can be avoided against MIC and successors. The transfer to MIC need not be properly recorded to be a "transfer" under 11 U.S.C. §101 (54) that is avoidable under 11 U.S.C. §544. The avoided transfer was automatically preserved for the trustee under 11 U.S.C. §551.

Even though the MIC deed of trust in *In Re Kline* could be avoided, the trustee could preserve it for the trustee under 11 U.S.C. §551 and was allowed to maintain the fact that the MIC deed of trust was equitably subrogated to the priority position of the BB&T deed of trust as against First Plus. First Plus was not a bona fide purchaser when it made its second deed of trust, according to the court. First Plus did not change its position in reliance upon the fact that MIC recorded in the wrong county. In fact, if the debtors had not filed bankruptcy, as between First Plus and MIC, MIC could have still recorded its deed of trust in Cleveland County and sought equitable subrogation to BB&T's first priority deed of trust. Now the trustee was entitled to first priority. The court cited North Carolina subrogation cases. *In Re White*, 183 B.R. 713 (Bankr. M.D.N.C. 1995); *Wallace v. Benner*, 200 N.C. 124, 156 S.E. 795 (1931); *Peek v. Wachovia Bank & Trust Co.*, 242 N.C. 1, 86 S.E.2d 745 (1955). See E. Urban, *Subrogation of the Position of One Deed of Trust to Another* (<http://www.attorneytitle.com/articles/legal/SUBROGATIONDEEDOFTRUST.pdf>), reprinted in NCLTA Annual 2006 seminar materials. The article discusses in detail *American General Financial Service, Inc., et. al v. Barnes and Pa. National Mutual Casualty Co.*, ___ N.C. App. ___, ___S.E2d ___ (2006), as well as the prior cases.

In *In Re Price*, 97 B.R. 264 (Bankr. E.D.N.C. 1989), the following occurred: (1) on 1-27-87, the debtors borrowed \$69,000 from Southern which was secured by a properly recorded deed of trust; (2) subsequently, the debtors borrowed approximately \$39,000 from Planters which was secured by a properly recorded deed of trust (Planters understood its second lien position); (3) on 2-23- 88, Southern's deed of trust was accidentally cancelled; and (4) on 9-15- 88, the debtors filed a Chapter 7 petition. 11 U.S.C. §544(a)(3) permitted the trustee to avoid Southern's lien. However, Planters did not move into first position, because Southern's lien was preserved for the estate under 11 U.S.C. §551. As between Southern and Planters, Southern could rescind its accidental cancellation. *Monteith v. Welch*, 244 N.C. 415, 94 S.E.2d 345 (1956). (Today, the rescission document would be governed by G.S. 45-36.6.) Planters was not a bona fide purchaser with respect to Southern's lien. This is because Planters knew of Southern's lien when Planters made its loan and Planters did not change its position in reliance on the erroneous cancellation.

To be properly recorded (or 'registered') under the Connor Act, a deed or deed of trust must be validly executed, acknowledged, recorded and indexed. G.S. 47-18; G.S. 47-20; G.S. 47-20.1. A delay in recording and indexing, or the recording and indexing of a document which bears a faulty execution or acknowledgment, can also cause difficulty if the grantor of the instrument then files bankruptcy because of the trustee's status as a judicial lien creditor under 11 U.S.C. §544(a)(1) and as a bona fide purchaser under 11 U.S.C. §544(a)(3). If, after that status is attained, an executed and acknowledged document that has not been recorded is subsequently recorded and indexed, voidability problems under 11 U.S.C. §544 can exist. If a document that has been recorded and indexed prior to the bankruptcy but was invalidly executed or acknowledged a similar problem can arise. Correction and rerecording subsequent to bankruptcy would not matter if the original recording was ineffective, and the set of facts existing in *In re Suggs*, discussed in the next paragraph, does not exist.

In re Suggs, 355 B.R. 525 (M.D.N.C. 2006), is noted: (1) on 9-11-03, Ingraham Homes sold and conveyed by deed property to Suggs and Suggs mortgaged the property to FNB, but, for some reason, the deed and deed of trust were not recorded; (2) on 10-24-03, an unrecorded lease with an option to purchase was given by Suggs to Tiari-El; (3) Suggs defaulted, and MERS, as nominee for FNB, discovered the deed and deed of trust had not been recorded and MERS commenced an action in Mecklenburg County "seeking a declaratory judgment that Gloria Suggs was the fee simple owner of the property," and simultaneously filed a notice of lis pendens, all occurring in March, 2005; (4) in April, 2005, Suggs and husband filed a bankruptcy petition under Chapter 7; (5) in January 2006, Ingraham Homes gave a new deed to Suggs which was recorded. MERS filed a proof of claim. There was no equity above the MERS claim. MERS sought relief from the automatic stay so that it could continue its proceeding in state court, alleging that the debtors had no interest in the property and, therefore, it was not part of the debtors' estate.

As to 11 U.S.C. §544(a)(3), the unrecorded deed gave the *In re Suggs* trustee no constructive notice of the pending dispute over title to the property, since in North Carolina, an unrecorded deed does not provide constructive notice of record. So the unrecorded deed did not defeat the trustee's status as a bona fide purchaser for value under 11 U.S.C. §544(a)(3).

The lis pendens on the property, however, did provide the Trustee with constructive notice of the defect in the property's title. Under North Carolina law, a bona fide purchaser for value must be able to show that he had no constructive notice by reason of lis pendens of pending litigation affecting title to the property. G.S. §§ 1-116, 47-18; see also *Stephenson v. Jones*, 69 N.C. App. 116, 124, 316 S.E.2d 626, 631 (1984); *Hill v. Pinelawn Memorial Park, Inc.*, 304 N.C. 159, 165, 282 S.E.2d 779, 783 (N.C.1981) ("While actual notice of another unrecorded conveyance does not preclude the status of innocent purchaser for value, actual notice of pending litigation affecting title to the property does preclude such status.") Under *In re Morgan*, 96 B.R. 615 (Bankr. N. D. W. Va. 1986), he would be precluded from exercising his 11 U.S.C. §544 (a)(3) strong arm powers to include the property in the estate.

Although the *In re Suggs* Trustee is not a bona fide purchaser under 11 U.S.C. §544 (a)(3), he is a hypothetical lien creditor under 11 U.S.C. §544 (a)(1). In its brief, MERS relied on G.S. 47-18 to argue that the Trustee and other creditors may not obtain a lien against the property since the deed was never recorded. Functionally, G.S. 47-18 means that an unregistered deed conveys title from its date of delivery as against the grantor and all others except creditors of and purchasers for value from the *grantor, donor, or lessor*, not creditors of or purchasers from the *grantee*. *City of Durham v. Pollard*, 219 N.C. 750, 750 14 S.E.2d 818, 819 (N.C. 1941) (emphasis added). Therefore, the fact that the deed from Ingraham Homes (grantor) to Gloria Suggs (grantee) was unrecorded does not prevent the trustee, as a hypothetical lien creditor of the grantee Gloria Suggs, from subjecting the Property to a hypothetical lien.

However, because MERS filed a notice of lis pendens before the petition, MERS's claims have priority over the Trustee's claims as a hypothetical lien creditor. Under North Carolina law, lis pendens preserves the priority of a lien that arises after an order of attachment has been perfected by judgment and levy. *In re Medlin*, 229 B.R. 353, 358 (Bankr.E.D.N.C.1998); G.S. 1-118 (stating that a purchaser or encumbrancer receives constructive notice by cross-indexing of a lis pendens). Therefore, a subsequent bona fide purchaser or lien creditor will take the property subject to a properly recorded notice of lis pendens. *Id.* (holding that a lis pendens filed eleven months before the debtor filed bankruptcy entitled the creditor to priority as against subsequent lienors or bona fide purchasers). Therefore, the court stated that "the pre-petition lis pendens filed by MERS preserves its priority." Further, the court stated that although the Trustee may obtain a lien on the property as a hypothetical lien creditor under 11 U.S.C. §544 (a)(1), the Trustee's interest is subordinate to MERS's lien. Since there was no equity in the Property upon which the Chapter 7 Trustee could execute a lien, MERS was entitle to relief from the automatic stay under 11 U.S.C. §362(d) to pursue remedies in state court.

Note that, in *In re Suggs* at least, MERS was able to prevail over the Trustee even though its deed of trust was *not* recorded prior to the filing of the Suggs' Chapter 7 bankruptcy petition. One must wonder whether this is correct construction of 11 U.S.C. §544. However, perhaps the explanation is that under 11 U.S.C. §544 (a)(3), it is not good enough that the Trustee be a purchaser for value under North Carolina's recording act. Instead, the trustee must be a bona fide purchaser, which means without constructive notice of MERS's claim. Under 11 U.S.C. §544 (a)(1), there is no requirement that the Trustee be a "bona fide" judicial lien creditor. Therefore, it could perhaps be argued that since the Trustee had judicial lien status, he should have prevailed against an unrecorded deed of trust. (11 U.S.C. §101 (36) defines "judicial lien" as a lien obtained by judgment, which would arguably include docketing.)

However, in summary, *In re Suggs* indicates that apparently, 11 U.S.C. §544 is *not* being interpreted solely as a "pure race recording" problem resolution statute and mortgagees such as MERS can defeat 11 U.S.C. §544 (a) status even though the deed of trust is *not* validly recorded before the filing of a petition as long as a lis pendens and civil action are filed prior to the filing of the petition, at least on facts as in this case.

It would also seem that, if prior to the filing of the petition a deed of trust is satisfied of record in error, the filing of a document of rescission under G.S. 45-36.6 prior to the filing of the bankruptcy petition should allow the lender to prevail under 11 U.S.C. §544. On the other hand, if the document of rescission is filed *after* the filing of the bankruptcy petition, the trustee will prevail under 11 U.S.C. §544.

Also, see *In re Head Grading Co., Inc.*, 353 B.R. 122 (Bankr. E.D.N.C. 2006), where the court held that a deed of trust reference to a "promissory note of even date herewith" did not properly identify the debt that was secured and was not enforceable against the trustee and the trustee's strong arm position as a judicial lien creditor under 11 U.S.C. §544. This was because the deed of trust was dated July 28, 1998 and there was no note dated July 28, 1998 in existence.

Apparently, 11 U.S.C. §544 is used for transfers *prior* to the filing of the petition which are perfected *after* the filing of the petition or not at all, whereas 11 U.S.C. §549 is used to invalidate transfers made and perfected *after* the filing of the petition.

For cases filed on or after October 17, 2005, 11 U.S.C. §362 (b)(24) provides that if a transfer is not avoidable under 11U.S.C. §544 and is not avoidable under 11 U.S.C. §549, the filing of a petition does not operate as an automatic stay under 11 U.S.C. §362 (a) as to such transfer.

2. 11 U.S.C. §549- post-petition transfers.

North Carolina is a "pure race" priority state. That means that the first to record wins. See G.S. 47-18; G.S. 47-20; *Bourne v. Lay & Co.*, 264 N.C. 33, 140 S.E. 2d 769 (1965). 11 U.S.C. § 549 governs post-petition transfers. These transfers are voidable under 11 U.S.C. § 549(a) if the proceeding to avoid is commenced within the time period in 11 U.S.C. § 549(d). However, 11 U.S.C. § 549(c) provides limited protection.

11 U.S.C. §549(c) and 11 U.S.C. §101(54) (defining the term "transfer") were amended for cases filed on or after October 17, 2005.

11 U.S.C. §549(a) provides that, subject to 11 U.S.C. §549(b) or (c), the trustee may avoid a transfer of property of the estate that occurs *after* the commencement of the case. 11 U.S.C. §549(c) states that a transfer of *an interest in* real property to a good faith purchaser *A* without knowledge of the commencement of the case and for present fair equivalent value cannot be avoided under 11 U.S.C. §549(a) unless a copy or notice of the petition is filed [in the applicable register of deeds' office for a deed, deed of trust, or lease] before the transfer to *A* is so perfected that a bona fide purchaser *B* from the debtor could not acquire an interest superior to such good faith purchaser *A*. A good faith purchaser *A* without knowledge of the commencement of the case and for less than present fair equivalent value has a lien on the property transferred to the extent of any present value given, unless a copy or notice of a petition is filed before the transfer to *A* is perfected. 11 U.S.C. §101(43) defines "purchaser" broadly enough to include a deed of trust holder, particularly when read in conjunction with 11 U.S.C. §101(54)'s definition of "transfer". 11 U.S.C. §101(54) defines "transfer" broadly so as to include the creation of a lien, foreclosure of the debtor's equity of redemption and each mode of disposition of property or an interest in property. The 2005 amendments were to overcome a holding that lenders were not protected by 11 U.S.C. §549(c). See *In re McConville*, 110 F. 3rd 47 (9th Circ.), cert. den., 118 S. Ct. 412, 139 L. Ed. 2d 315 (1997).

It should be noted that apparently, the deed of trust is considered one transfer and its foreclosure sale is considered a second transfer under 11 U.S.C. §549. See 11 U.S.C. §101(54).

Prior to the enactment of 11 U.S.C. §362(b)(24), effective October 17, 2005 for cases filed on or after that date, the majority rule was that the automatic stay provisions of 11 U.S.C. §362(a) were subject to the protective provisions of 11 U.S.C. §549(c), although the fourth circuit "has expressly refused to take a position on this issue..." K. Culpin, *The Validity of Post-Petition Transfers of Real Property: Who Does The Bankruptcy Code's Section 549(c) Protect?*, 40 *Real Property Probate & Trust Journal* 149 (Spring 2005), citing *Winters v. George Mason Bank*, 94 F. 3d 130 (1996). That article cited a growing, if erroneous, trend to the contrary. However, for cases filed on or after October 17, 2005, while certain involuntary and voluntary transfers are subject to 11 U.S.C. §362(a)'s automatic stay, new 11 U.S.C. §362 (b)(24) exempts any transfer "that is not avoidable under section 544 and that is not avoidable under section 549".

3. 11 U.S.C. §550- liability of transferee of avoided transfer.

It is noted that even if the transaction is avoidable under 11 U.S.C. § 544 or 11 U.S.C. § 549, 11 U.S.C. § 550 must be consulted to see when the property can be recovered. The property transferred can be recovered from the initial transferee. 11 U.S.C. § 550(a)(1). It can be recovered from any "immediate or mediate transferee of such initial transferee." 11 U.S.C. § 550(a)(2). However, there is some protection in 11 U.S.C. § 550. 11 U.S.C. § 550(b) provides that:

The trustee may not recover under section (a)(2) of this section from—

- (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or
- (2) any immediate or mediate good faith transferee of such transferee.

11 U.S.C. § 550(f) states that:

An action or proceeding under this section may not be commenced after the earlier of—

- (1) one year after the avoidance of the transfer on account of which recovery under this section is sought; or
- (2) the time the case is closed or dismissed.

4. Rights, powers, and duties of a debtor in possession.

It seems that a debtor in possession pursuant to a Chapter 11 proceeding has the right to use 11 U.S.C. § 544 and 11 U.S.C. § 549. 11 U.S.C. § 1107. Chapter 12 plans are treated similarly. 11 U.S.C. § 1203. However, in reference to Chapter 13 plans, see 11 U.S.C. § 1303, which specifically refers to many subsections of 11 U.S.C. § 363, but refers to no other sections of the code.