<u>Mortgagees Beware: Proceed Promptly with Care or Find your Lien is Impaired</u>

by
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Legal Description Error: Advantage Subsequent Tax Lienor

On June 30, 2008, the U.S. Bankruptcy Appellate Panel for the Eighth Circuit held that an incorrect legal description in a mortgage rendered the mortgage avoidable under 11 U.S.C. § 544 and gave priority to subsequently filed IRS tax liens on the property. <u>Ameriquest Mortgage Co. v. Stradtmann</u> (<u>In re Stradtmann</u>), B.A.P. 8th Cir., No. 07-6056 (June 30, 2008).

In May of 2004, Ameriquest took a mortgage on the Debtors' homestead to secure a $183,000 promissory note. The mortgage correctly stated the property's common address, but contained a legal description for an entirely different piece of property. Ameriquest recorded the mortgage with the incorrect legal description on May 20, 2004. Subsequently, the IRS filed three notices of tax lien against the Debtors' property.

Approximately one year after granting the mortgage to Ameriquest, the Debtors filed for Chapter 7 bankruptcy. Ameriquest moved for relief from the automatic stay to reform the mortgage to correct the legal description of the property. The bankruptcy court granted Ameriquest relief from the stay to reform the mortgage in state court. The Chapter 7 trustee removed the action and filed a counterclaim seeking to avoid the defective mortgage under 11 U.S.C. § 544(a)(3). The bankruptcy court ruled that the mortgage "was avoidable under § 544; that the interest avoided was preserved for the benefit of the estate, to be administered by the Trustee; and that the I.R.S's tax liens were superior to the interests of the Trustee." Ameriquest appealed the bankruptcy court's decision to the U.S. Bankruptcy Appellate Panel for the Eighth Circuit (the "Eighth Circuit B.A.P." or "Panel").

The Eighth Circuit B.A.P. affirmed the decision of the bankruptcy court, finding that the Chapter 7 trustee, standing in the shoes of a bona fide purchaser under Minnesota law, could avoid the conveyance to Ameriquest because the defective mortgage failed to provide either constructive or implied notice of Ameriquest's interest in the Debtors' property. Ameriquest argued that the defect in the mortgage was apparent, and thus the mortgage gave constructive notice of Ameriquest's interest, because the legal description conflicted with the common address and the tax identification number listed on the mortgage. Relying on <u>Lindquist v. Household Industrial Finance Co.</u> (<u>In re Vondall</u>), a case affirmed by the Eighth Circuit Court of Appeals in June 2008, the Panel rejected Ameriquest's argument. The Eighth Circuit B.A.P. found that, under <u>Vondall</u>, "a conflict between a tax identification number and a legal description is not considered apparent…If there is northing in the property description to trigger a duty of further

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inquiry, then a conflict between the legal description and the common address is not apparent, and therefore does not trigger constructive or implied notice."

A Preference for Procrastination: Late-Perfecting Lender's Lien Avoided as a Preference

On June 26, 2008, the U.S. Court of Appeals for the Sixth Circuit held that a late-perfected mortgage lien was avoidable as a preferential transfer and that the earmarking doctrine did not shield the lender from preference exposure. Chase Manhattan Mortgage Corp. v. Shapiro (In re Lee), 6^{th} Cir., No. 06-1538 (June 26, 2008).

In 2001, the Debtor purchased a piece of property in Pontiac, Michigan and obtained a 30-year mortgage from Flagstar Bank. The Flagstar mortgage was properly recorded with the Oakland County Recorder of Deeds. Later in 2001, Flagstar assigned the mortgage and related note to Federal National Mortgage Association, in care of Chase Mortgage Company. Chase Mortgage Company later merged with Chase Manhattan Mortgage Corporation ("Chase"). In October 2003, the Debtor refinanced the original loan by obtaining a new mortgage loan from Chase, using the proceeds of the new loan to pay off the original loan. In connection with the refinancing, Chase obtained a new 30-year mortgage on the property. Chase discharged the original mortgage by a "Discharge of Mortgage" dated October 27, 2003. The Discharge of Mortgage was recorded on January 16, 2004. The new mortgage was recorded on December 17, 2003—51 days after the original mortgage was discharged and 72 days after the closing on the new loan.

On March 4, 2004, 77 days after Chase recorded the new mortgage, the Debtor filed for bankruptcy protection. The trustee sought to avoid the new mortgage as a preferential transfer under 11 U.S.C. § 547(b). The bankruptcy court found that the new mortgage could be avoided as a preference because the perfection of the new mortgage did not relate back to the initial transfer under § 547(e)(2)(B) and the recording of the new mortgage caused a diminution of the Debtor's estate. The bankruptcy court also rejected Chase's argument that the earmarking doctrine protected the transaction, finding that the doctrine only protected the first transfer (the transfer of the funds). After the district court reversed the bankruptcy court, the trustee appealed the case to the Sixth Circuit Court of Appeals.

The Sixth Circuit Court of Appeals (the "Court") found that the earmarking doctrine did not apply to protect Chase from preference liability. As stated by the Court, the earmarking doctrine applies where "(a) the agreement is between a new creditor and the debtor for the payment of a specific antecedent debt; (b) the agreement is performed according to its terms; and (c) the transaction according to the agreement does not result in a diminution of the debtor's estate." The Court found that Chase could not rely on the earmarking doctrine to protect the transfer of the new mortgage because (1) Chase was not a "new creditor," in that Chase refinanced its own loan; (2) the two transfers made by the Debtor in the refinancing transaction cannot be treated as one for purposes of applying the defense in direct contradiction to the meaning of "transfer" in §§ 101(54) and 547(e); (3) the doctrine cannot be applied to the transfer of a lien interest, as opposed to a transfer of funds, because the grant of a lien does not involve a transfer of "earmarked" property; (4) the transfer caused a diminution in the Debtor's estate because Chase did not hold a perfected security interest from the time the original mortgage was discharged to the time the new mortgage was recorded, and the subsequent perfection of the new mortgage encumbered non-exempt equity in the property that would have been available for payment to the Debtor's unsecured creditors; and (5) allowing Chase to avoid preference liability under the earmarking doctrine would "essentially write § 547(e) out of the Bankruptcy Code" and defeat the discouragement of secret liens.

The Court also rejected Chase's argument that "it would be unfair and against public policy [to impose preference liability] because the refinancing transaction involved a mere substitution of its New Mortgage for the Original Mortgage and ultimately benefitted the Debtor's other creditors, not Chase." The Court stated that although the result in the case may be harsh, Chase could have readily prevented such result by timely perfecting its security interest.