



RISK MANAGEMENT RESOURCES

ARTICLES

Double Check That Deed of Trust Before
You Record: There May Be a Hypothetical
Lien Creditor Lurking in the Shadows

DOUBLE CHECK THAT DEED OF TRUST BEFORE YOU RECORD: THERE MAY BE A HYPOTHETICAL LIEN CREDITOR LURKING IN THE SHADOWS

In your rush to finalize the documents for the closing that is scheduled the next morning, you fail to notice a minor discrepancy between the promissory note and deed of trust. The deed of trust is dated July 28 and states that it is given as security for a promissory note of even date herewith. However, the promissory note is dated July 29, the day after the date of the deed of trust. The discrepancy goes unnoticed and the borrower later defaults and files a Chapter 7. The Chapter 7 trustee then files a complaint seeking to avoid the lender's lien. This is exactly what happened in *In re Head Grading Co. Inc.*, 353 B.R. 122 (Bankr. E.D.N.C. 2006). Applying North Carolina case law, the bankruptcy court held that, because the deed of trust did not specifically identify the debt, the deed of trust was unenforceable against the trustee as a hypothetical lien creditor.

In re Head is one of several recent bankruptcy cases in which lender's liens have been avoided as a result of minor drafting errors. Ordinarily, such errors can be cured through a reformation action. However, reformation cannot be granted where the rights of a bona fide purchaser would be prejudiced or where there is an intervening judgment lien creditor without notice of the mistake. Under 11 U.S.C. § 544, a bankruptcy trustee is given the status of a judicial lien creditor with a perfected judgment lien on assets of the debtor and a bona fide purchaser for value without regard to the trustee's actual knowledge of any claim against the real estate. In *In re Law Developers, LLC*, 404 B.R. 136 (Bankr. E.D.N.C. 2008), the court relied on this section of the Bankruptcy Code to avoid the lender's deed of trust where the deed of trust identified Lot 43 of Cedarwood Village, but should have identified Lot 17. Lot 43 had previously been transferred, and the parties acknowledged that the intended legal description was Lot 17. However, because the debtor-in-possession had the status of a protected hypothetical lien creditor, the court refused to grant the lender's request for reformation.

When a trustee is able to avoid a lender's deed of trust, that lender will likely point the finger at the lawyer who handled the closing and recorded the deed of trust. While the lender's contributory negligence would be a valid defense to a claim against the closing attorney, no lawyer wants to see his name in the caption of a complaint. These are easy claims to avoid with a simple checklist. Before any deed of trust is recorded, you should make sure to verify the following items:

- The description in the deed of trust is correct.
- The dates on the note and deed of trust match.
- The deed of trust correctly references the obligor in the promissory note.
- The deed of trust correctly identifies the amount of the debt secured by the deed of trust.
- The deed of trust was recorded in the presence of a notary after proper identification was presented to the notary.
- The names of the parties who signed the deed of trust are correctly set forth in the notary acknowledgment and all other information in the notary acknowledgment is correct.

This checklist should be followed in every closing that is conducted by your office. Additionally, when the loan documents are transmitted to the lender, you should include a separate page that sets forth in large font the following statement:

PLEASE REVIEW THE ENCLOSED ORIGINAL EXECUTED LOAN DOCUMENTS TO VERIFY THE ACCURACY OF THE INFORMATION CONTAINED THEREIN. IF ANY DISCREPANCIES OR MISTAKES ARE NOTED, PLEASE CONTACT OUR OFFICE IMMEDIATELY.

If you discover a drafting error or notary issue after recording, you should immediately contact the title insurance company and one of the real estate claims attorneys at Lawyers Mutual. Do not attempt to fix these mistakes on your own. We are here to help and have substantial experience in dealing with these issues.