AVOIDING DEFECTIVE MORTGAGES IN CHAPTER 13-
THE HOW AND WHY
(Or How to Use your Strong Arm to Strip off a
Defective Mortgage without Losing your Shirt)

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A. INTRODUCTION – How §544 works and how it can work in Chapter 13 cases

The classic use of § 544 of the Bankruptcy Code (also known as the
“Strong Arm Clause”) is for a Chapter 7 trustee to avoid a defective lien on a
declaror’s asset in order to benefit the Chapter 7 estate and its unsecured creditors.
This would typically involve the Chapter 7 trustee selling the asset subject to the
defective lien to enhance payments to unsecured creditors. While that use of this
tool is valuable for Chapter 7 trustees and the unsecured creditors in such cases,
that classic use of the Strong Arm clause rarely benefits homeowners, whose
options in such as situation is to either suffer the loss of their home or other asset
to the trustee or to work out some deal with the trustee which would involve them
refinancing to pay off the trustee and their unsecured creditors. For most
Chapter 7 debtors such refinancing would rarely be an option unless provided by
a private lender such as a family member.

The main reason that avoidance of a defective lien in this situation does
not benefit the debtor/homeowner is § 551 of the Code. Under this section, the
avoided lien is preserved for the benefit of the bankruptcy estate. What this
means is that the equity freed up by the trustee’s action in avoiding the lien can
only benefit the bankruptcy estate, and cannot be claimed as exempt by the debtor.

Use of the Strong Arm powers in Chapter 13 however presents some more flexible and more attractive options for debtor/homeowner. The basic rules are the same, however the flexibility of a Chapter 13 plan allows debtors to share in the benefits of the avoided mortgage along with their unsecured creditors. In a nutshell, this is made possible by the fact that a 60 month plan allows the debtor to pay into the plan an amount that would normally be five years of mortgage payments. If those payments were applied to a mortgage, the bulk of the payments would be applied to interest. If a mortgage is avoided however, and the mortgage loan turned into just another unsecured claim, the debtor is freed up to have those five years of payments count as part of the dividend to unsecured creditors which is necessary for the plan to pass the liquidation analysis or best interests of creditors test. Typically, in most such cases, those five years of payments will not be enough by themselves to pay enough into the Plan to make up for the equity freed up by the avoidance of the mortgage, but they go a long way toward reducing that amount to a number which the debtor can finance at the end of the plan. This requires that the Plan permit the debtor to refinance near the end of the plan, but typically at that point the debtor would have plenty of equity to support such a loan and would have little other debt to deal with at that point.
In cases were this approach has been successful, it has not been unusual for a debtor to only have to refinance a new mortgage at the end of a plan which is half or less than half the size of the avoided mortgage. In this way the unsecured creditors benefit by a much more generous dividend and the debtors benefit by a much smaller mortgage at the end of their plan. A “win-win” situation for the debtor and the general unsecured creditors, with the exception of the one holding the defective and avoided mortgage. For that creditor it is a “win-win-lose” proposition with the mortgage lender being the loser.

B. USE OF §544 TO AVOID DEFECTIVE LIENS

1. Who can use it (trustee, debtor or both?) – the question of standing and does it really matter?

Section 544 vests the “trustee” with the avoiding power found in that section. The case law is mixed as to whether Chapter 13 debtors can exercise such powers as debtors in possession as Chapter 11 debtors exercise under 11 U.S.C. § 1107. There are certainly arguments that such powers do not extend to debtors, including the distinctions that (1) there is no counterpart to § 1107 in Chapter 13 and (2) there is a trustee in all Chapter 13 cases, and there are not in all Chapter 11 cases, unless one is appointed. For purposes of these materials, it will be assumed that avoidance of a defective lien will be undertaken by the Chapter 13 trustee and the debtor, jointly. This makes the distinction of who has standing irrelevant, because between the debtor and the trustee, there can be no
one else in a Chapter 13 case who could exercise those powers. Moreover, the
approach described in these materials is not likely to work effectively unless the
debtor and trustee agree to cooperate in the process. For a trustee to undertake
avoiding the mortgage without the cooperation of the debtor would likely result in
a voluntarily dismissed case. For the debtor to undertake it without the
cooperation of the trustee would likely either result in a failure of the adversary
proceeding or a dismissal of the case, or both. Who ultimately has standing may
be an intellectually stimulating discussion, but is not likely to be a practical
concern in avoiding a defective mortgage when trustee and debtor work together.

2. The Process

Federal Bankruptcy Rule 7001 (2) provides that “a proceeding to determine
the validity, priority, or extent of a lien or other interest in property, other than a
proceeding under Rule 4003(d)” is an adversary proceeding. That requires of
course that actions to avoid defective liens under the Strong Arm Clause be
commenced as adversary proceedings, by summons and complaint and under
Part VII of the Bankruptcy Rules. This of course means that these actions
involve more work than is involved in simple motion practice. A complaint must
be drafted and served with a summons and typically most courts have pre-trial
conference rules that apply as do all of the federal discovery rules.

That said, aside from the obligatory procedures applicable to adversary
proceedings, as a practical matter, these actions tend to be fairly simple-
particularly from the factual side. In most cases, there really are no material facts in dispute. In a typical case, if there is a material defect in a mortgage, the contents of the mortgage, defect and all, is a matter of public record. Proving the content (and defect) requires little more than obtaining a certified copy of the document from the land records. Moreover, in most cases defendants are not inclined to dispute the content of the publicly recorded document anyway and usually stipulate to the content of the instrument, defect and all. This being the case, discovery does not typically take much more that requests to admit and sometimes can be dispensed with entirely if the parties are willing to stipulate to the facts underlying the claimed defect.

Since the facts generally do not generate much argument in these cases, they tend to fall into two categories (1) where the local case law is well developed, and the facts are clear, some defendants choose to fold and not contest the avoidance; (2) where the case law is less well developed or unclear, or where the defendant or their counsel is more aggressive, legal defenses come into play, such as equitable subrogation, the impact of curative statutes on the defect, whether the defect can be cured by construction or simply whether the claimed defect is material enough to render the mortgage voidable. More on those later in the materials.
3. Types of defective liens subject to avoidance

What problems in a mortgage can constitute defects sufficient to render them avoidable flow directly from whatever local statutes (typically state statutes) regulate what is necessary for a mortgage to give constructive notice of the mortgage to subsequent purchasers of the property. The way § 544 works is that it gives the trustee essentially the same rights as a subsequent purchaser for value of the property. Thus, if under state law, the defect is significant enough that it would not impart constructive notice of the mortgage, even if recorded in the land records, to a new purchaser of the property, then the defect is also significant enough for the trustee to avoid it under § 544. For this reason, any discussion of defects in these materials must be somewhat generic, and for a truly accurate list for any given jurisdiction, there is no substitute for careful research – first on the applicable statutes regarding the recording of mortgages and then on the case law interpreting the impact of those defects on subsequent purchasers (or if you are really lucky, bankruptcy trustees using § 544). However, there are some pretty general problems that in most jurisdictions will prove fatal. Such as:

a. Mortgage not recorded at all

   It is hard to get more basic than this. If it's not recorded, most recording laws are going to say it does not give notice- how can it?

b. Mortgage recording in the wrong place
Typically in most jurisdictions, land records are recorded in county offices. In some places, they are even done on the town or municipal level. Frequently the locality in which a particular parcel of land is situated may be very different than the mailing address of the property. This can often result in an out of state lender (such as ones that do business by mail or internet) in recording a mortgage in the wrong office, which is essentially just as fatal as not recording it at all.

c. Faulty property description

It should be pretty clear that if the mortgage describes some property other than the one intended to be encumbered, it cannot provide notice to a new purchaser of the encumbrance on the intended parcel.

d. Faulty or missing acknowledgment

Most jurisdictions require that mortgages include an acknowledgment by a notary public or some similarly empowered official wherein it is recorded that the signature(s) on the document were those of the grantors and that the signature was their free act and deed. There is considerable case law (some later in these materials) holding that a missing acknowledgment or one that is sufficiently defective (such as one that is missing grantor names, etc.) is a fatal flaw in the mortgage.

e. Missing witnesses
Some jurisdictions require one or more witnesses on mortgages. Some do not. Check your statutes. When they are required and they are missing, it can be a fatal defect.

f. **Missing grantor**

It doesn’t take a lot of analysis to see why a missing signature by a grantor to render an instrument voidable if not void. Where the grantors are a married couple, in states which recognize a *tenancy by the entireties* (where wife and husband own the property as a single married unit and neither can convey any interest in the property without the other joining in the transfer) the mortgage fails to encumber the marital estate unless it has been executed by *both* spouses.

g. **Others?**

The above list is only a general list of defects the author has encountered and have resulted in avoided mortgages. There are doubtless many more that may exist or arise depending upon what local recording statutes require and the applicable case law holds. There is no substitute for knowing what formalities are required in your jurisdiction and then checking to make sure mortgages you review comply with them.
4. Defenses

a. Defect? What defect? Probably the most elemental defense to an action to avoid a mortgage based on an alleged defect will go to the heart of the issue- what constitutes a fatal flaw in the document such to render it subject to avoidance by a subsequent bona fide purchaser. As pointed out above, you have to rely on your recording statues and the state law, including case law interpreting it.

b. Curative Statutes. Before you break out the champagne and give the debtors the good news that you are going to help them leave Chapter 13 with a lot less mortgage debt than what they entered with, check on your states curative statues with respect to the date of the mortgage. Most states have statutes, which require such defects to be litigated within a certain time frame after the recording of the instrument. If you are hoping to take advantage of a missing or defective acknowledgment or witness these may well torpedo your case. In cases where there is no recording or the recording is in the wrong place, they should be less of a problem. As always- check your local laws.

c. Estoppel

There is a body of case law in most jurisdictions, sometimes called “estoppel by deed” whereby the grantor under a deed is estopped from attempting to take advantage over a defect in an instrument that they presumably drafted. As an equitable doctrine it is akin to the “clean
hands” doctrine and makes perfectly good sense outside the realm of bankruptcy. The reason this defense is a loser when used against the trustee is that the trustee stands in the shoes of a subsequent purchaser and/ or hypothetical lien creditor. This defense would not work when used against a third party to the original transaction, so cannot work against a trustee using § 544.

d. Equitable Subrogation

This is an equitable doctrine where an entity that is secondarily liable on a debt pays the debt to a third person and is thereby subrogated to the rights of entity which was paid, against the primary obligor. Subrogation is most common of course when insurance companies settle claims with their insureds and then pursue collection of those claims against third parties. This doctrine has been used as a defense in mortgage avoidance cases where the mortgagee with a defective mortgage paid off a prior mortgagee with a validly perfected mortgage and then argues that the mortgagee should be subrogated to the rights of the holder of the previous valid mortgage. In most cases the author is aware of this approach has failed because typically, the conditions necessary for the doctrine to apply are not present in mortgage avoidance cases. Specifically there is generally not a relationship between the holder of the subsequent defective mortgage and the holder of the previous validly
perfected mortgage to (such as there would be between insured and insurer) which would cause the doctrine to apply. For a discussion of this doctrine applied to § 544 cases, see Lawlor v. Chittenden Trust Co., A.P. 04-1060, Bankr. D. Vt. (2005) (printed in the Appendix of Cases at the end of these materials).

**e. Correction by construction**

Where a defect in a deed is such that it is clear on the face of the document that an error has been made, and when it is possible from contents of the rest of the document to ascertain what the correction should be, courts will generally allow a cure of that defect by construction. For example, if the grantors names are John and Mary Black, and their names are correctly shown in several places in the mortgage, but one of their names is misspelled “Flack” instead of “Black” most courts would hold that the misspelling is an error that is evident and the correction should be evident by reference to the rest of the document. The 2nd Circuit Court of appeals affirmed this approach when both grantors names were missing entirely from the acknowledgment in the mortgage. Sensenich v. Bank of America, No. 09-2305 (2d Cir. 2009). Other courts have gone the other way on the same facts. Biggs v. Ocwen Federal Bank, 377 F.3d 515 (6th Cir. 2004); In re Wilson, 318 Fed.Appx. 354, WL 72319 (6th Cir. 2009). Evaluating this defense really comes down to how obvious it is that there is an error in the mortgage, and whether it is clear
from the contents of the mortgage what the correction to the error should be.

5. Some case law

What follows is by no means and exhaustive survey of the case law, but rather is a representative sampling of the cases that is useful for getting a sense of how § 544 interplays with state defective mortgage law.

i. Circuit Court Decisions

(i) First Circuit

*In re Ryan,* 851F.2d 502 (1st Cir. 1988) contains a very detailed discussion of constructive notice and how § 544 relies on state law for a determination of whether the trustee’s rights as hypothetical bona fide purchaser are sufficient to avoid a defective mortgage. Ironically the case involves the First Circuit Court of Appeals applying Vermont Law (Vermont is in the 2nd Circuit) in an appeal from a Massachusetts bankruptcy case, where the debtors owned a vacation home in Vermont. The Court of Appeals reversed the Massachusetts District Court and found that the bankruptcy trustee could avoid a mortgage which was missing a witness, holding that under Vermont Law, (based on an ancient Vermont Supreme Court case) such a defect would render the mortgage (even though it was duly recorded in the land records) inadequate to provide constructive notice of the lien to a subsequent bona fide purchaser for value.

(ii) Second Circuit

In Mortgage Lender’s Network, USA, v. Sensenich, 313 F.3d 93,94, (2d Cir. 2002), the Court of Appeals upheld the trustee’s right to avoid a mortgage where it was defective based on a missing witness signature, but certified the question of whether the recording of the foreclosure complaint in the land
records provided alternative constructive notice, to the Vermont Supreme Court. The Vermont Supreme Court ruled that compliance with the state foreclosure statute amounted to constructive notice to a subsequent BFP for value, notwithstanding the defect in the originally recorded mortgage.

**Sensenich v. Bank of America, No. 09-2305 (2d Cir. 2009)**

Even though the grantors’ names were absent from the acknowledgment attached to the mortgage, the Court held that the error could be cured by construction and affirmed both the Bankruptcy Court and District Court in denying relief to the trustee.

(iii) Sixth Circuit

**Biggs v. Ocwen Federal Bank, 377 F.3d 515 (6th Cir. 2004).** In this case the Court of Appeals, construing Tennessean Law, held that the missing names of the grantors in a deed of trust was a fatal defect, and held that the deed of trust was invalid against subsequent purchasers of the property.

**In re Wilson, 318 Fed.Appx. 354, WL 72319 (6th Cir. 2009).** In this case the Sixth Circuit, applying Kentucky law, reached the same conclusion as in Biggs, above, that a notary acknowledgment which was missing the names of the grantors was a fatal flaw in the mortgage and that the mortgage failed to provide constructive notice to subsequent purchasers.

[Author’s Note: both of these Sixth Circuit decisions reach the opposite result as the 2nd Circuit in Sensenich v. Bank of America. For obvious reasons this author believes both of these eminently well reasoned decisions reach the correct result]

[MORE CASES TO ADD]

**C. HOW TO INCORPORATE §544 LIEN AVOIDANCE INTO A CHAPTER 13 PLAN**

Litigating a § 544 adversary proceeding is one thing, but how does the debtor propose a plan which will take into consideration the unknown outcome
of the litigation? How is the debtor protected from loss of the house to the mortgage should the adversary proceeding litigation fail? Doing so takes some carful planning by debtor’s counsel and the trustee and some cooperation.

1. Avoiding the res judicata bar from plan confirmation

There is case law which holds that confirmation of a Chapter 13 Plan acts as a bar under res judicata to actions such a § 544 avoidance actions unless they are specifically proposed in the Plan and taken into account in the confirmation process. To avoid this pitfall, the plan should reference the proposed adversary proceeding and the underlying basis for it, bearing in mind that that the plan itself has no power to effect the avoidance, which requires an adversary proceeding. Ideally the order confirming the plan should also make clear that nothing in the order confirming the plan bars the proposed litigation and all matter which are brought before the court in the adversary proceeding will be determined in the adversary proceeding and that none of those issues are barred by confirmation of the plan. This of course requires that the debtor’s counsel and the trustee be aware of the defect in the mortgage prior to confirmation. Ideally both entities are checking for defective liens as part of the preparation for filing the case (debtor’s counsel) or preparing for the meeting of creditors and confirmation hearing (trustee).
2. Structuring the Plan to incorporate various outcomes to litigation

There are two possible approaches to the issue of the timing of confirmation and the pace of the mortgage avoidance action. One is to simply not confirm the case until the adversary proceeding is concluded. At the point when the adversary proceeding is done, the rights of the parties are clear and the plan can avoid having to take into account various outcomes of the litigation. The drawback to that approach is that the case may stay in an unconfirmed for many months as the adversary proceeds. Even if summary judgment resolves the action, it can still take many months to brief argue and decide a motion for summary judgment.

The other approach, and the one this trustee has more often advocated, is to confirm the Plan subject to the outcome of the adversary proceeding. Generally payments to creditors other than the defendant/mortgagee proceed and the trustee (or debtor’s counsel, via a special escrow account) holds the payments that would otherwise go to the mortgagee until conclusion of the adversary proceeding. One might point out that there is some risk that if the adversary proceeding fails and the mortgage survives, there will be accrued late fees which will have to be covered by the debtor. That is true and one of the reasons that care should be taken to chose these actions carefully. There is definitely an element of calculated risk here for both trustee and debtor.
Using this approach the plan is structured under the assumption that the adversary proceeding will prevail, and must treat the unsecured creditors as they would in a hypothetical Chapter 7 case were the trustee were to successfully avoid the mortgage and sell the house - more on that below. The plan also provides that in the event that the adversary proceeding fails and the mortgage survives intact, that any mortgage arrearage will be cured and payments maintained. These cases may also involve a proposal to modify the mortgage in the event that the adversary proceeding fails to avoid the mortgage.

3. **Impact of §511 lien preservation on the liquidation analysis**

Section 551 is what really makes a successful lien avoidance under the trustee’s avoiding powers much more of a coup for the unsecured creditors than the debtor. Section 551 is short and fairly simple. It reads:

> Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 72(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.

What this means is simply that when a trustee uses her or his magical avoiding powers under those sections, the primary beneficiary needs to be the “estate” and not the debtor. The whole purpose here is to augment the estate to provide a better payoff to unsecured creditors. When viewed in the more typical Chapter 7 context, the estate is formed when a petition is filed and then, at the time the debtors exemptions are allowed, those exemptions are take out of the estate for purposes of
distribution and what is left is what the trustee liquidates and uses to pay
the claims of creditors. By giving trustees these avoiding powers the
whole purpose is to advance payment prospects for the general
unsecured creditors.

Does this mean that avoidance of a $100,000 mortgage translates
into $100,000 going into the pockets of the unsecured creditors? The
short answer is “generally not”. The same hypothetical liquidation
analysis operates that operates in any Chapter 13 case. The test found
at § 1325(a)(4) requires that the unsecured creditors get at least as
much as they would if the estate (including the trustee's avoidance
action) were liquidated in Chapter 7. Lets use avoidance of a $100,000
mortgage as an example. Assume a Chapter 7 trustee litigated a § 544
action to conclusion, was successful and sold the house. What would
the costs of doing so likely be? Conservatively, one might expect to see
a trustee’s legal fees for doing so, including the transactional costs of
selling the house and related work to be from $5,000 to $8,000,
depending upon going rates and how much of a fight the mortgagee puts
up, etc. $10,000 probably would not be out of the question if the
adversary proceeding involved more than a simple motion for summary
judgment or the real estate transaction was complicated. Let’s use a
figure of $8,000. The Chapter 7 trustee would have to retain a broker to
see the house. Assuming the value of the house was $150,000, a
broker’s 6% commission would be $9,000. The trustee’s statutory
commissions would probably be about $8,300 (25% of the first $5,000, 10% of the next $45,000 and 5% of the next $50,000 after that, which gets us to the $100,000 of the avoided mortgage). We will assume the rest of the equity is exempt. Adding those costs, we get a total of $25,300. Subtracting that from the $100,000 of avoided mortgage gets us to a dividend to unsecured creditors of $74,700.

So how is our Chapter 13 Plan going to bring in enough to pay the unsecured creditors $74,700? With a trustee’s fee at about 7% that would require almost $80,000 to be paid into the Plan, or a little over $1,300 per month. This is likely considerably more than the debtors mortgage payment. However, lets say the debtor, without making the mortgage payment can manage a $1,000 per month plan payment. That will bring in $60,000 over a five-year plan, and if the debtor can borrow $20,000.00 by the end of the plan and make a balloon payment, we then have the $80,000 needed to fund the Plan. The debtor starts with a $100,000 mortgage and ends up with a $20,000 mortgage five years later. Assuming in addition to the holder of the avoided mortgage (now unsecured creditor for $100,000), there are $40,000 in other general unsecured claims. The total pool of unsecured claims would be $140,000. The dividend to unsecured creditors of $74,700 would yield about a 53% dividend to unsecured creditors. Based on the liquidation analysis without the avoided mortgage it would have likely been zero.
3. Providing clear title

One might say, ok, let's say you manage to get a “creative” plan like this confirmed, and then with a bit of luck and some skill and some hard work, you manage to triumph in summary judgment and get a judgment order avoiding the mortgage. What keeps the debtor from running to the land records with a certified copy of the judgment, and saying “thanks Ms. Trustee, this has been great fun, but I don’t need you anymore”, and then records the judgment avoiding the mortgage and dismissing his case before he or she makes all the plan payments. The simple solution here is that the judgment rendered by the Bankruptcy Court is not effective unless and until the debtor completes all payments under the plan and the trustee signs a certification right at the end of the judgment itself. The judgment would have language making clear that it is not effective without the trustee's certification and cannot be recorded in the land records without it. Essentially the judgment is conditional until the trustee certifies that all plan payments are complete. That protects the trustee, the estate and its creditors and gives the debtor a powerful incentive to hang in there and make all of the plan payments.

Ok, that might make sense one could say, but how is the debtor going to get a new lender to refinance that last balloon payment without that judgment avoiding the defective mortgage filed in the land records? The solution to that
chicken and egg problem is that trustee holds that Judgment (which he or she has the power to make final) in escrow pending the closing on the refinance. The trustee promises to deliver that final judgment, with his or her endorsement that all payments have been made to the closing agent upon receipt of the plan payoff funds. Once the trustee has the funds, the closing agent for the refinancing can then record the judgment avoiding the lien along with their new (and hopefully validly executed) mortgage.

Thus ends the adventure. The debtor is enjoying his new and much lower mortgage payment. The unsecured creditors are marveling at their 53% dividend (except perhaps for the largest one) and probably a title insurer somewhere cuts a check to the lender for the balance of the claim.

D. APPENDIX

1. SAMPLE CONFIRMATION ORDER
2. SAMPLE COMPLAINT
3. SAMPLE MOTION FOR SUMMARY JUDGMENT
4. SAMPLE CONDITIONAL JUDGMENT ORDER AND FINAL JUDGMENT ORDER
5. DECISIONS

_In re Ryan_, 851 F.2d 502, (1st Cir. 1988)

_In re Lawlor_, D. Vt. A.P. 04-1060 (2005)