

DEALING WITH DEFECTIVE MORTGAGES

By Robert A. Scott and Glenn Cline

Defective mortgages are the source of numerous title claims. A mortgage may be legally ineffective for a variety of reasons. The property's legal description may be missing or incorrect. Maybe the mortgage lacks an affidavit required by state law. Perhaps only one spouse has signed the mortgage even though they are joint owners.

Whatever the reason, a defective mortgage can cause big headaches for title insurers, lenders and their counsel. A bank seeking to foreclose on a defective mortgage may face adverse claims from judgment creditors, competing mortgagees and tax authorities who claim that their subsequent liens take priority over the bank's recorded -- but legally defective -- instrument. Alternatively, a bankruptcy trustee may seek to have the mortgage declared invalid, allowing the estate to avoid the lien entirely.

Fortunately, all is not (necessarily) lost. Depending on the jurisdiction, there are a number of viable equitable doctrines that can salvage the situation and put the defective mortgage back in front of the competing lien holders. This article chronicles some recent cases in which a lender sought to assert the priority of a defective mortgage.

Equitable Mortgage

One option is to ask the court to declare that the flawed instrument constitutes an "equitable mortgage" to replace the defective mortgage. This theory was successfully used in a recent Maryland case to salvage a deed of trust recorded without a property description.

In Taylor Electric v. First Mariner Bank,¹ a creditor claimed that its mechanic's lien took priority over the bank's defective mortgage. The Maryland court disagreed. Even though the recorded mortgage did not contain any legal description of the property -- or even the street address -- the court ruled that a companion loan agreement between the borrower showed that the borrower *intended* to give the bank a mortgage on the property:

It is well settled in this State, since Dyson v. Simmons, 48 Md. 207 (1878), that generally where an instrument intended to operate as a mortgage fails as a legal mortgage because of some defect or infirmity in its execution, an equitable mortgage may be recognized, with priority over judgments subsequently obtained. The theory underlying the equitable mortgage doctrine is that an instrument which is intended to charge certain lands, even though defectively executed, is nevertheless considered to be evidence of an agreement to convey, and a court of equity should enforce the obligation despite the technical defects in the instrument.²

That the Maryland court would find such an equitable mortgage as between the borrower and the lender is not surprising. However, the court went further, and held that the equitable mortgage was also effective against the third-party creditor with a perfected mechanic's lien. In so ruling, the court relied on the doctrine of "equitable conversion," and treated the bank like a purchaser with an enforceable contract of sale.³ Once the borrower signed the loan agreement and defective deed of trust, the court

¹ 992 A.2d 490 (Md. Ct. Spec. App. 2010).

² 992 A.2d at 499, quoting Lubin v. Klein, 193 A.2d 46 (Md. 1963).

³ 992 A.2d at 502.

held that equitable title passed to the bank and the subsequent mechanic's lien did not attach to the property.⁴

In an unreported opinion, the United States Bankruptcy Court for the Northern District of Ohio reached a similar result in Degiroloamo v. Suntrust Mortg., Inc.,⁵ in which it determined that a mortgage with a defective acknowledgment was an equitable mortgage that could not be avoided by a bankruptcy trustee with notice of it. Similarly, the Supreme Court of New York found an equitable mortgage that took priority over intervening judgment liens in U.S. Bank, N.A. v. V.M.E.P. Corp.⁶

Equitable Subrogation

The doctrine of equitable subrogation can also be used to mitigate the loss caused by a defective mortgage. Equitable subrogation allows courts to establish equitable liens in cases where the proceeds of the loan were used to pay off a pre-existing lien. The lien amount, however, will be limited to the amount that was paid to satisfy the prior lien (plus interest in some jurisdictions), so the lender may still suffer a loss.

In OneWest Bank v. Marshall,⁷ the lender's deed of trust lacked a signature from one of the property owners. The lender brought a declaratory judgment claim, arguing that the doctrine of equitable subrogation entitled the lender to an equitable lien in the amount that was paid to satisfy a prior mortgage that was signed by all owners. After

⁴ Id.

⁵ No. 10-6032 (Bankr. N.D. Ohio September 3, 2010).

⁶ 2011 N.Y. Slip Op. 30436 (Sup. Ct. N.Y. February 24, 2011).

⁷ 18 A.3d 715 (D.C. 2011)

the trial court dismissed the action, the District of Columbia Court of Appeals reversed, holding that the lender had stated a claim for equitable subrogation.

Under the doctrine of equitable subrogation, a lender who pays off a pre-existing mortgage and takes a new mortgage as security for the loan will be subrogated to the rights of the first mortgagee as against any intervening lienholders, even if the lender is on constructive notice of the existence of the junior liens. In other words, the lender steps into the shoes of the mortgagee whom it has paid off and receives that mortgagee's priority over subsequent liens. The subrogation extends to the amount paid to satisfy the earlier indebtedness.⁸

Courts have also applied the doctrine in the context of forged mortgages and deeds. In Bierman v. Hunter,⁹ the defendant in a foreclosure action alleged that her husband had forged her signature on a mortgage when he refinanced the couple's pre-existing mortgage. Even though the mortgage was forged, and therefore unenforceable against the wife, the Court of Special Appeals of Maryland held that the lender nonetheless was entitled to an equitable lien in the amount it paid to satisfy the couple's prior mortgage, which both the husband and wife indisputably did sign.¹⁰ On virtually identical facts, the United States Bankruptcy Court for the Southern District of Mississippi reached the same result in In re Rhymes.¹¹

⁸ 2011 D.C. App. LEXIS 149, at *17-18, quoting HSBC v. Mendoza, 11 A.3d 229 (D.C. 2010).

⁹ 988 A.2d 530 (Md. Ct. Spec. App. 2010).

¹⁰ 988 A.2d at 542-44.

¹¹ 2008 Bankr. LEXIS 779 (Bankr. S.D. Miss. 2009).

Similarly, in Tribeca Lending Corp. v. Real Estate Depot, Inc.,¹² a homeowner was facing foreclosure from his original mortgage lender. To avoid foreclosure, the homeowner conveyed the property to a foreclosure consulting company. In an effort to re-obtain title to the property, the homeowner then forged a deed from the company back to the homeowner. The homeowner also refinanced the original mortgage loan with a new mortgage loan. On appeal of a quiet title action, the court held that the new lender should be equitably subrogated to the rights of the original lender to the extent that the new loan paid amounts due on the original loan.

Equitable subrogation does not exist in all jurisdictions, however. And even in states where the doctrine is followed, not all apply it as liberally as others. For example, the Supreme Court of Missouri recently held that equitable subrogation did not apply in a case involving an ineffective deed of trust. The instrument in Ethridge v. TierOne Bank¹³ failed to create a valid lien against property owned jointly by husband and wife because it named only the husband as the borrower. Even though the proceeds of the loan were used to pay off a prior mortgage on which both spouses were indisputably obligated, the court held that the lender was not entitled to equitable subrogation:

For equitable subrogation to apply, Mary Ethridge must have engaged in fraudulent conduct or committed acts bordering on fraud that created the condition that caused the lender a loss. There are no facts asserted here that give rise to fraud or conduct bordering on fraud on the part of Mary Ethridge. Nor is there any evidence that David Ethridge acted fraudulently. The mere fact that Mary Ethridge benefited from the discharge of the preexisting loan against

¹² 42 So. 3d 258 (Fla. Dist. Ct. App. 2010).

¹³ 226 S.W. 3d 127 (Mo. 2007).

her property does not *per se* require equitable relief in favor of TierOne.¹⁴

Constructive Notice

Another argument that can defeat a claim of priority over a defective mortgage is constructive notice. The Court of Appeals of Arizona recently held that two deeds of trust recorded without property descriptions took priority over a competing mortgage because the facts showed that the holder of the competing mortgage had constructive notice of the defective liens.¹⁵ The court relied upon a provision in the written contract showing that the holder of the competing mortgage knew it was in “third lien” position when it acquired the loan. Accordingly, the court found that the competing lender took its interest subject to the two prior deeds of trust, even though those instruments were recorded without legal descriptions.¹⁶

Similarly, in the case of In re Gresham,¹⁷ the court ruled that a trustee could not avoid a mortgage that contained an incorrect property description. The court ruled that a bankruptcy trustee was charged with constructive notice of the defective mortgage because it was properly indexed under the name of the borrower, and because a separate subordination agreement recorded in the land records also indexed under the borrower’s name did contain the correct property description. Accordingly, the court ruled that a party searching the land records “with due diligence” would have

¹⁴ 226 S.W.2d. at 134.

¹⁵ 3502 Lending, LLC v. CTC Real Estate, 229 P.3d 1016 (Ariz. Ct. App. 2010).

¹⁶ 229 P.3d at 1020.

¹⁷ 373 B.R. 914 (Bankr. W.D.Mo. 2007).

“reasonably discovered” the defective mortgage.¹⁸ The United States Court of Appeals for the Sixth Circuit reached a similar conclusion in In re Bunn,¹⁹ when it ruled that a bankruptcy trustee could not avoid a mortgage recorded without a property description, because the inclusion of the street address provided constructive notice to the trustee.

However, a similar argument was rejected in the case of KleinBank v. Haugland.²⁰ In that case, the legal description attached to the recorded mortgage described only one of two tracts intended to be encumbered. Thereafter, the Internal Revenue Service (“IRS”) filed tax liens against both tracts. The lender argued that the IRS had constructive notice that the mortgage was intended to apply to the entire parcel of both tracts because both tracts were conveyed by way of the same deed, and because the county tract index, where the mortgage was indexed, described the entire parcel as including both tracts. The court rejected this argument, and held that the IRS liens took priority over the mortgage on the tract that was omitted from the property description.²¹

Substantial Compliance

Some lenders have successfully invoked the doctrine of “substantial compliance” to salvage defective mortgages. Ameriquet v. Paramount Mortgage²² involved a mortgage held by Ameriquet that a competing lender, Paramount, claimed did not

¹⁸ 373 B.R. at 924.

¹⁹ 578 F.3d 487 (6th Cir. 2009).

²⁰ 2010 U.S. Dist. LEXIS 138599 (D.Minn. 2010).

²¹ 2010 U.S. Dist. LEXIS 138599 at *15.

²² 4 A.3d 934 (Md. 2010).

comply with a Maryland state statute requiring an affidavit of consideration and disbursement signed by the lender, attesting to the timing and amount of funds advanced. Paramount, which held a mortgage secured by the same property but recorded two days after Ameriquest's mortgage, argued that Ameriquest's mortgage was invalid because the affidavit attached to it at the time of closing stated that the funds were advanced no later than execution and delivery of the mortgage. In fact, due to a series of events including the cancellation of Ameriquest's original loan, the funds were disbursed *two years after* the mortgage was originally signed. Nevertheless, the Court of Appeals of Maryland held that Ameriquest's mortgage was valid because Ameriquest attached a new affidavit to the mortgage before recording it that was true as of the date of recordation.²³ Therefore, the court ruled that the mortgage "substantially complied" with the statute.

On the other hand, the bankruptcy court in the case of In re Sauer²⁴ rejected the lender's argument that the mortgage "substantially complied" with an Ohio statute that mandated that the names of the persons acknowledging the mortgage be identified. The court ruled that the bankruptcy trustee could avoid the mortgage because the notary left blank the place where the borrowers should have been identified, which was required by state law.²⁵ The court also refused to consider an affidavit from the notary that the borrower did in fact appear before her and acknowledge the mortgage, ruling that extrinsic evidence could not be used to establish the validity of the mortgage.

²³ 4 A.3d at 945.

²⁴ 417 B.R. 523 (Bankr. S.D. Ohio 2009).

²⁵ 417 B.R. at 541.

Bankruptcy Considerations

Salvaging a defective mortgage in the context of a bankruptcy case can be more difficult than in state courts. Pursuant to the Bankruptcy Code, a bankruptcy trustee can avoid a mortgage lien if a bona fide purchaser for value could avoid the mortgage under state law. 11 U.S.C. § 544(a). Under the laws of many states, bona fide purchasers enjoy greater protections than judgment creditors. This can give a bankruptcy trustee a distinct advantage over a lender with a defective mortgage.

For example, in the case of In re Brandt,²⁶ a property description recorded with a mortgage failed to include the plat number, as required by state law. Even though the mortgage provided the property address and tax identification number, the court ruled that the bankruptcy trustee, in the same position as a bona fide purchaser for value, was entitled to avoid the mortgage because of the failure to include the plat number.²⁷

Similarly, in the case of In re Andrews,²⁸ the bankruptcy court ruled a trustee could avoid a mortgage that contained a minor typographic error in the property description. The borrowers owned property identified as “Lot 277” in a subdivision. However, the mortgage incorrectly identified the property as “Lot 227.” The court ruled that the mortgage was invalid, and that the trustee could avoid the lien entirely.²⁹

Conclusion

²⁶ 434 B.R. 493 (Bankr. W.D. Mich. 2010).

²⁷ 434 B.R. at 501.

²⁸ 2009 Bankr. LEXIS 4369 (Dec. 17, 2009 Bankr. W.D. Neb.)

²⁹ 2009 Bankr. LEXIS 4369, at *5.

Although a legally defective mortgage can pose problems, recent cases demonstrate that there are a wide variety of theories that can enable the defective mortgage to regain at least some of its expected priority position. By relying on legal theories such as the equitable mortgage, equitable subrogation, constructive notice, and substantial compliance, the artful practitioner can often turn lemons into lemonade.