

# Unforgiving Mistakes: Beaman v. Head and Its Progeny

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October 2009—Recently, there has been a spate of bankruptcy decisions in the Eastern District of North Carolina involving real estate documentation errors. This article looks at Beaman v. Head and the cases that followed in its wake. What lesson is there to learn? Real estate documentation mistakes can be unforgiving and incurable in bankruptcy.

## Background: Black Letter Law on “Property of the Estate”

In order to understand the impact of bankruptcy on title issues, a little black letter bankruptcy law is necessary. “The filing of a debtor’s petition in bankruptcy creates an estate comprised of the property listed in 11 U.S.C. § 541(a)...” Universal Cooperatives, Inc. v. FCX, Inc., 853 F.2d 1149, 1153 (4th Cir. 1988). Section 541 of the Bankruptcy Code creates and defines property of the estate. As stated by the Fourth Circuit:

The act of filing a petition for relief under an applicable chapter of the Bankruptcy Code commences a bankruptcy case and creates an estate consisting of “all legal or equitable interests of the debtor in property as of the commencement of the case.” Upon the filing of a petition, the debtor’s interests in property vest in the bankruptcy estate, and the debtor surrenders the right to dispose of or otherwise control the estate property. In re Osborn, 176 B.R. 217, 219 (Bankr. E.D. Okla. 1994). The bankruptcy trustee, as representative of the bankruptcy estate, has exclusive authority to use, sell or lease property of the estate. 11 U.S.C. § 323(a), 363(b)(1).

Richman v. Garza, 117 F.3d 1414, 1997 WL 360644, \*1 (4th Cir. 1997) (*per curiam*) (unpublished).

Pursuant to § 541, property of the estate includes all legal or equitable interests of the debtor in property. 11 U.S.C. § 541. While Congress is conferred the exclusive right to establish uniform bankruptcy laws, the bankruptcy courts will look to non-bankruptcy law to determine property rights. See e.g. In re

Merritt Dredging Company, Inc., 839 F.2d 203, 206 n. 1 (4th Cir. 1988) (citing seminal case of Butner v. United States, 440 U.S. 48, 54, 99 S.Ct. 914, 917-918, 59 L.Ed.2d 136 (1979)); and FCX, 853 F.2d at 1153. As explained by the Fourth Circuit,

[d]espite [§ 541’s] broad definition of those interests of the debtor that become property of the estate, ... , neither § 541(a), nor any other Bankruptcy Code provision, answers the threshold questions of whether a debtor has an interest in a particular item of property and, if so, what the nature of that interest is... The estate under § 541(a) succeeds only to those interests that the debtor had in property prior to the commencement of the bankruptcy case... The existence and nature of a debtor’s, and hence the estate’s, interest in property must be determined by resort to nonbankruptcy law, ...either federal law, ...or... state law.

FCX, 853 F.2d at 1153 (citations omitted) (citing, *inter alia*, Moody v. Amoco Oil Co., 734 F.2d 1200, 1213 (7th Cir. 1984) (“[W]hatever rights a debtor has in property at the commencement of the case continue in bankruptcy—no more, no less.”)).

While state law determines the property rights of the estate, the Bankruptcy Code confers certain rights upon a bankruptcy trustee. A bankruptcy trustee (and through 11 U.S.C. § 1007, a Chapter 11 debtor-in-possession “DIP”) is deemed, as of the petition date, to have the rights of: (1) a judicial lien creditor with a perfected judgment lien on all assets of the debtor; and (2) a bona fide purchaser for value (“BFP”) of real property without regard to the trustee’s actual knowledge of any outstanding claim against the real property.<sup>1</sup> 11 U.S.C. § 544. These avoidance powers are the main tools of a trustee in avoiding unperfected claims against property of the estate. However, while the trustee’s status as a BFP or judicial lien creditor is bestowed by federal law, the effect of that status with respect to other claims in any particular property of the estate is

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determined by state law. See e.g., Mahaffey, 91 F.3d 131, 1996 WL 383922, \*3-\*4; and Suggs, 355 B.R. at 527.

### **Beaman v. Head: “Bad Facts Make Bad Law”**

On September 15, 2006, the United States Bankruptcy Court for the Eastern District of North Carolina issued its opinion in Beaman v. Head, 353 B.R. 122 (Bankr. E.D.N.C. 2006) (Doub, J.), in which the court held that a simple error in the date reference in a North Carolina deed of trust will render the deed of trust unenforceable.

In Beaman, Ruby Lee Head (“Mrs. Head”) was the holder of a July 29, 1998, note in the original principal amount of \$180,515.75. Id. at 123. The note was executed by the debtor, Head Grading Co., Inc. (“Head”). Id. Mrs. Head also was the holder of a deed of trust, listing Head as the grantor and Mrs. Head as the beneficiary. Id. The deed of trust purported to secure the principal amount of \$180,515.75, and provided that it was given as security for a “Promissory Note of even date herewith.” Id. Unfortunately, the deed of trust was dated July 28, 1998, the day before the date of the note. Id.

On April 5, 2005, Head filed a bankruptcy petition under Chapter 7, and the bankruptcy trustee filed an action to avoid the deed of trust as unenforceable due to the discrepancy in the date between the note and the deed of trust. Id.

The bankruptcy court granted the trustee’s motion for summary judgment and held that the deed of trust was unenforceable. The court observed that “North Carolina law requires deeds of trust to specifically identify the debt referenced therein.” (Id.) (citing In re Foreclosure of Deed of Trust of Enderle, 110 N.C. App. 773, 431 S.E.2d 549 (1993) (holding that, where deed of trust misidentified the grantor as the obligor pursuant to the underlying debt, the deed of trust was unenforceable)). The court further cited Seventeen South Garment Company, Inc. v. Centura Bank, 145 B.R. 511, 515 (E.D.N.C. 1992) (holding that a Uniform Commercial Code (“UCC”) financing statement filed in the trade name of a corporation, rather

than its legal name, was unenforceable), for the proposition that “[c]larity and certainty in lien perfection requirements are lost if equitable exceptions are created which permit trade names when the ‘equities’ so dictate.” Id. at 124.

The bankruptcy court concluded that “[w]hile it is likely that the deed of trust was meant to identify the note dated July 29, 1998, it did not properly and specifically identify the obligation secured.” Id. Mrs. Head did not appeal the ruling, and the Judgment became final.

The record in the case shows that Mrs. Head did not assert any affirmative defenses or counterclaims. In order to consider what defenses and claims might have been available, it is important to understand the status of a Chapter 7 trustee in bankruptcy with respect to property of the estate. With respect to any property of the estate—either real or personal—the trustee has the status of a judicial lien creditor as of the commencement of the case. 11 U.S.C. § 544(a)(1). With respect to real property only, the trustee has additional standing as a bona fide purchaser (“BFP”) of such real property at the time of the commencement of the case. 11 U.S.C. § 544(a)(3). These distinctions are important because, typically, a lien creditor’s rights may be subject to equitable liens, while a BFP would take free and clear of equitable liens.

Interestingly, the court in Beaman referred to the trustee’s powers as a lien creditor, rather than as a BFP. This may have been intentional by the court because, a BFP potentially could have been charged with inquiry notice due to the recordation of the deed of trust even with its error. See e.g., Commercial Bankruptcy Litigation §10:3, n. 12 (citing, inter alia, In re Bertholet Enterprises, 88 B.R. 9, 11-12 (Bankr. D.N.H. 1988) (recording of mortgage instrument, although improper in form, was nevertheless sufficient to give constructive inquiry notice to the trustee); and In re Seaway Express Corp., 105 B.R. 28, 32 (Bankr. 9th Cir. BAP 1989, aff’d, 912 F.2d 1125 (9th Cir. 1990) (constructive notice to the trustee will remove the claim from the purview of section 544(a)(3))).

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As stated above, the deed of trust holder did not raise any potential defenses that could have been used against the trustee as a lien creditor. Generally, the trustee's status as a lien creditor is subject to equitable liens to the extent such equitable liens would have priority under state law. See Arnette v. Morgan, 88 N.C. App. 458, 363 S.E.2d 678 (1988) (where an intervening judgment creditor could not establish BFP status, the grantee of erroneous deed was entitled to a constructive trust and reformation that related back to the date of the original conveyance, and therefore possessed a superior interest in the property). Mrs. Head did not assert the rights to reformation and a constructive trust. While the court in the Eastern District of North Carolina had ruled in a preference avoidance action that reformation is not a defense to such an avoidance claim,<sup>2</sup> the trustee's attempt to avoid a preferential transfer is subject to an entirely different statutory basis and analysis than a trustee's attempt to avoid a deed of trust as a lien creditor whose rights are subject to such equitable interests. Nevertheless, as discussed below, subsequent cases have indicated that the defenses of reformation and assertion of an equitable lien likely would not have been successful in Beaman.

### **In re Law Developers: More Pain for the Draftsman**

After Beaman, the United States Bankruptcy Court for the Eastern District of North Carolina considered the previously unaddressed defenses of reformation and constructive trust. In the Chapter 11<sup>3</sup> case of In re Law Developers, LLC, 404 B.R. 136 (Bankr. E.D.N.C. 2008) (Leonard, J.), the draftsman similarly found no forgiveness. In this case, the defect was a problem in the legal description in the deed of trust. As the court pointed out, an "inadvertent draftsman's error" caused the legal description to reference the wrong lot number. Id. at 138. The opinion sets for the following facts:

- a note was signed on January 12, 2006, in the amount of \$194,500 to The Bank of Currituck (id.);
- "the legal description" was identified as lot 43 of Cedarwood Village (id.);

- the parties acknowledged the intended legal description was lot 17 ("as shown on page one of the deed of trust") (id.);
- the court observes that, "[i]n this case, the deed of trust refers to BOTH lots 17 and 43..." (id. at 138 and 139) (apparently, the legal description on page two of the deed of trust refers incorrectly and solely to lot 43, but the deed of trust refers to lot 17 on page one, presumably in the address line on the first page of the standard deed of trust form); and
- lot 43 had previously been sold by the debtor on November 3, 2006, which was after the recording of the deed of trust by The Bank of Currituck, but prior to the debtor's bankruptcy petition on February 14, 2008, (id. at 138) (the opinion does not explain how this sale occurred with a deed of trust on record purporting to grant a lien to The Bank of Currituck in lot 43— was there a release deed by The Bank of Currituck?).

The court found the deed of trust was invalid under North Carolina law because it was "not clear from the face of the document which parcel of land is intended to be encumbered by the deed of trust." Id. at 138 (citing Overton v. Boyce, 289 N.C. 291,293, 221 S.E.2d 347 (1976) ("A deed purporting to convey an interest in land is void unless it contains a description of the land sufficient to identify it or refers to something extrinsic by which the land by be identified with certainty."); and Duckett v. Lyda, 223 N.C. 356, 358, 26 S.E.2d 918 (1943), for the proposition that "[t]he description contained in the deed of trust must be 'either certain in itself or capable of being reduced to a certainty by a recurrence to something extrinsic to which the deed refers.'") The court, looking at the face of the deed of trust, found that it could not decipher the "clear" intent of the land to be encumbered.

Having determined that the deed of trust was void as written, the Court considered the plea to reform the deed, but denied reformation in its case due to the bankruptcy debtor's status as an intervening judicial lien creditor pursuant to 11 U.S.C. § 544(a)(1). In so holding, the court

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found that the debtor-in-possession, as an intervening lien creditor, was not charged with inquiry or constructive notice of the existing lien.<sup>4</sup>

### **In re Easthaven Marina Group, LLC: A Lucky Mistake**

In re Easthaven Marina Group, LLC, 2009 W.L. 703383 (Bankr. E.D.N.C. March 13, 2009) (unpublished) (Leonard, J.), is a factually-specific exception to the harsh results in Beaman and Law Developers. In Easthaven, there was a \$9,000,000 note executed, delivered and dated on March 2, 2007. The deed of trust was, unfortunately, dated March 1, 2007, and refers to a note dated March 1, 2007 (the Beaman opinion was handed down September 15, 2006). The name of the borrower was the other problem. The entity's legal name was "SHM Marina Group, LLC" (the correct name appears on the deed of trust), but the note referred to the "common name" of "Scotts Hill Marina Group, LLC" (which the court observed was "not a legal entity").

After this initial closing, SHM Marina Group, LLC, conveyed the property to David White, "SUBJECT TO" the \$9,000,000 deed of trust which also included assumption language. White then formed Easthaven Marina Group, LLC, and conveyed the land to his new LLC, again "SUBJECT TO" the prior deed of trust.

Naturally, the opinion starts off with the Beaman decision. The court went on to cite two other cases for the proposition that a deed of trust in the wrong name is, not surprisingly, invalid. The court then discussed the issues of reformation in the context of a bankruptcy filing, and comes to a similar conclusion as reached in Beaman and Law Developers.

Yet, after concluding the deed of trust was void and reformation not available, the court dusted off the estoppel doctrine and found that it was a good save for the flawed note and deed of trust. The court noted that Easthaven cannot be allowed to challenge the mortgage when the very deed by which Easthaven (and White in the prior conveyance) took title was "SUBJECT TO" the mortgage it was later trying to avoid. Moreover, those later deeds also were recorded in the chain of title.<sup>5</sup>

Although this looks like a big victory for the flawed document to prevail, the court concluded the opinion by pointing out that:

- the principal of debtor, White, was in part to blame for the error in the original documents because White used the "common" but "incorrect" name of his company in the purchase agreement; and
- "no creditors" would benefit from avoidance of the deed of trust—rather, a ruling in debtor's favor "would simply shift the beneficial equity interest in the debtor from [the holder of the mortgage] to the debtor, in complete disregard of a transaction all acknowledge was to have the opposite result."

All in all, a lucky mistake, based on the unusual facts, provided the relief to the draftsman.

### **Den-Mark Properties, LLC: A Mistake That Was Hard to Defend**

In Den-Mark Properties, LLC v. SunTrust Bank and Southland Associates, Inc., 2009 W.L. 917963 (Bankr. E.D.N.C. March 27, 2009) (unpublished) (Doub, J.), the bank made a loan to be secured by a second deed of trust. The facts were pretty simple. The borrower (and debtor) was Den-Mark LLC. The second deed of trust was executed by Den-Mark Construction, Inc. Den-Mark Construction did not have title to the land described in the deed of trust.

The bank raised the following arguments:

- unjust enrichment to the borrower/debtor if the deed of trust is invalid
- scrivener's error
- mutual mistake
- reformation
- execution by alter ego
- execution by third party acting as agent

While this is a good checklist of arguments to make when you find yourself in the position of having a deed of trust executed by the wrong party, the court found the flaw fatal. The bottom line was the party executing the

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second deed of trust did not have record title. The court discussed reformation issues and declined to reform the deed of trust.

### **In re Rose: Redemption at Last for the Draftsman**

There are not a lot of bankruptcy cases where the flawed document beats a challenge by a trustee. As in Law Developers, this case, In re Rose, 2009 W.L. 2226658 (Bankr. E.D.N.C. July 20, 2009) (unpublished) (Leonard, J.), involved an ambiguous legal description due to a typo in a block number—two of three references in the deed of trust properly described the land as lots 20 and 21 of “block 96” and a third reference mistakenly referred to “block 98.” Luckily for the holder of the deed of trust (and its title insurer) (and the draftsman), and unlike the debtor in Law Developers, the debtor did NOT own, and never had owned, any parcel of land in “block 98.”

Surprisingly, the court was sympathetic to the typographical error. The court made the following points:

- “if notice existed which would have alerted a potential bona fide purchaser to an error in the deed of trust, then the trustee is prohibited from taking free and clear of liens”
- thus the question is: would the hypothetical BFP have a duty to examine?
- the court then summarized the duty of a title searcher: “[t]he law contemplates that a purchaser will examine each recorded deed and other instrument in his chain of title and charges him with notice of every fact affecting his title which an accurate examination of the title would disclose”
- “[a] deed of trust and any documents referenced therein are inherently part of a chain of title”
- “every other document falling within the required scope of the title search becomes a permissible extrinsic reference [for interpreting a latent ambiguity]”
- likewise, the title examination extends not just to notice in the “index” but also the contents of each instrument in the chain
- the next conclusion was that each “instrument in the chain” refers even to *satisfied* deeds of trust [since when??]
- but happily the title searcher now sees that there must have been a typo since all of the other references are to “block 96”—and such a typo “could not be ignored”
- the “diligent” title searcher then turns to the grantee index and learns that the grantor never owned any lots in “block 98”—putting all the world on notice of something “amiss”

The opinion then quotes from the Affidavit of Frank Martin that a “reasonably prudent searcher would discount the reference to Block 98 as a minor typographical error, resolvable through other documents available upon examination of the chain of title, thus providing constructive notice of the valid lien on the subject property.”

The court also relied upon a 10th circuit case, Hamilton v. Washington Mutual Bank (In re Colon), 563 F.3d 1171 (10th Cir. 2009) which was exactly on point (typo of lot 29 instead of lot 79). Amazingly, the Hamilton case also relied upon the information contained in two satisfied deeds of trust to confirm the mistake.

So now you know: Be sure to check satisfied deeds of trust in your title search [or at least when you need evidence to prove a mistake is a mistake].

### **Can You Reconcile In re Rose and Law Developers?**

Judge Leonard (who wrote both opinions) explained the distinction between the error with respect to the lot number in Law Developers, which error was fatal, and the error in the lot number in In re Rose, which was overcome, as follows:

This result [In re Rose] differs from the holding in Law Developers, which at first blush appears indistinguishable. In Law Developers, the debtor was a developer who owned multiple properties in a development known as Cedarwood Village. The subject deed of trust in Law Developers also contained an inadvertent draftsman’s error. The legal description of the property

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## Membership Dues

NCLTA membership fees are currently due for 2010.

If you have not remitted payment, please do so as soon as possible.

## Loss Prevention and Education Occupy September Executive Committee Meeting

The NCLTA Executive Committee met on Thursday, September 17, 2009, at The Boardwalk Inn for its quarterly meeting. In addition to the regular agenda items, discussion focused on various educational activities, including the November 18, 2009, NC Bar Association CLE program on HUD-1 statements and attorney audits, and the status of loss prevention efforts.

The Association's second *amicus* brief in the Johnson v. Schultz case had been filed and oral argument presented by Rob McNeill of Horack Talley Lowndes and Pharr, Charlotte, before the North Carolina Supreme Court on September 8, 2009. Technical questions have arisen regarding aspects of the NC State Bar's FEO concerning attorney audits, and the Loss Prevention Committee was seeking to respond to these either through contacting the State Bar as well as developing forms that address client confidentiality disclosures and indemnity agreements.

The Executive Committee postponed updating the 2008 *Study Guide* until at least Spring 2010 as it was premature to include recent changes, such as RESPA issues, attorney audits and new lien forms.

## Around the State

*Hugh C. Talton, Jr.*, has joined **Attorneys Title, div. of FATIC**, as Title Counsel and Client Development Manager for Eastern North Carolina. He practiced real estate law for over 25 years before moving over to the title insurance side. Talton is located in a new Attorneys Title office opening at 710 Arendell Street, Suite 203, Morehead City, NC 28557, phone 800-222-4502, email htalton@attorneysitle.com.

NCLTA Secretary *Matthew J. Powers* of **Morehead Title Company** has been re-appointed to a second four-year term on the Secretary of State's Electronic Recording Council (ERC).

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encumbered was identified as Lot 43, when the intention was to encumber Lot 17. This court found that the deed of trust, as written, was void under North Carolina law for failure to adequately describe the encumbered property. [citation omitted] The distinction between Law Developers and the present case [In re Rose] is critical: the debtor in Law Developers owned both properties. Therefore, had a bona fide purchaser examined the chain of title, the ambiguity would remain. That deed of trust could have been intended to encumber either Lot 43 or 17, and nothing referenced or found in the chain of title resolved the ambiguity.

Id. at \*3. You are best advised to proof your legal descriptions and not rely on any equitable doctrines to save you from a scrivener's error in bankruptcy.

1 While the trustee is not charged with any actual knowledge the trustee may have regarding pre-existing claims in real property, a trustee's status as a BFP is subject to whatever constructive notice is imposed by state law. See In re Mahaffey, 91 F.3d 131, 1996 WL 383922, \*3-\*4 (4th Cir. 1996) (unpublished); and In re Suggs, 355 B.R. 525, 527 (Bankr. M.D.N.C. 2006) (finding that trustee's status as BFP is subject to constructive notice, and that, under North Carolina law, a lis pendens filed of record pre-petition defeated trustee as BFP).

2 Callaway v. Miller (In re Nunn), Bankr. Case No. 04-02158-8 JRL, Adversary Proceeding No. 05-00036-8 JRL (January 13, 2006) (on appeal).

3 Based upon the court's rationale in Law Developers, it is even more likely that a court will refuse to reform a deed in a Chapter 7 case, than in a Chapter 11 case due to the fact that, unlike a Chapter 7 trustee, the knowledge of the pre-petition debtor may be imputed to a debtor-in-possession pursuant to the holding in In re Hartman Paving, Inc., 745 F.2d 307 (4th Cir. 1984).

4 The court distinguished seemingly contradictory and binding Fourth Circuit precedent in Hartman Paving with respect to the debtor-in-possession's status of a BFP, with which precedent the court clearly disagreed.

5 The parties did not argue that, and the court did not address why, the recording of those later deeds did not create constructive notice that would have rendered the rights of the later-intervening trustee as a hypothetical judgment lien creditor and/or BFP subject to reformation with respect to the incorrect date **and** the incorrect name on the note.