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The thief, the mark and the holder in due course

A look at debtor-creditor law and identity theft

BY MICHAEL A. BURGER
Daily Record Columnist

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Some friends are like family. I got together with my closest friends last month at a restaurant in Syracuse. The kids had crayons, we had beer and wine — everyone was happy.

One of my friends, who is more like my brother (but whose name is also Michael), and I laughed about being able to afford good beer. We remembered earlier days, looking for change under the seats of his Ford LTD to buy a bottle of seltzer to share.

We talked about living on student loans, credit cards, our parents and our brother, Brian, who had uncanny skill with a deck of cards (which he insists is not grifting). Brian is actually Mike's brother but, like I said, these are close friends.

So when I told Mike that I now sometimes represent banks, he had to work not to let any expensive beer come out of his crooked nose. Back in the day, we both had relied heavily on "Uncle Joe" Visa for money, and we had trouble making payments on time.

A central theme to debtor-creditor law, in fact all contract law, is "information forcing." The courts require the person who has information about a debt to make it known or suffer the consequences. The law abhors secret deals.

Let's look at an example: Let's say Fred can't make payments on his high-interest mortgage and his poor credit rating won't permit him to refinance at a lower rate. Fred transfers title to a friend, Barney, who takes out his own lower-interest mortgage-loan to buy the house from Fred.

Barney agrees that this transaction with Fred is "just on paper" and that Fred will make all the payments and live in the house until Fred's credit allows him to hold the mortgage in his own name.

Barney's bank has no idea about this secret arrangement between Fred and Barney because they do not disclose their deal or file any paperwork about it in the county clerk's office.

If Barney double crosses Fred by selling the property to Mr. Slate, Fred may have a good claim against Barney, who knew of the deal, but not against the bank or anyone else who did not know about Fred and Barney's deal but took an interest in the property for value.

This really happens, even outside of Bedrock. Often, Barney is a predator who advertises that he can help homeowners in financial distress to refinance. Barney will sell the property to a third party, stripping off any equity, who will then default on the mortgage. Fred gets burned and the bank is forced to foreclose for repayment of the debt.

Fred then goes to court with a suit asking the judge to stop the foreclosure proceeding because he has been bamboozled by Barney, big-time.

Judgment for the bank.

Here's why: A bona fide lender for value without notice of a prior interest in collateral who lends in good faith reliance on the value and availability of such collateral is entitled to enforce its security interest ahead of any security interest of which it was not given notice, *see* NY Real Property Law (RPL) §§ 291, 266; *Valentine v. Lunt*, 115 NY 496, 505 (1889); *see also* EPTL § 7-3.2 (applying rule to express trusts); UCC § 3-302 (applying rule to assignees).

Statutory authority

"Every ... conveyance [of real property] not recorded [in the county clerk's office of the county in which the real property is located] is void as against any person who subsequently ... contracts to purchase or acquire by exchange, the same real property ... in good faith and for a valuable consideration," RPL § 291.

"This article does not in any manner affect or impair the title of a purchaser or encumbrancer for a valuable consideration, unless it appears that he had previous notice of the fraudulent intent of his immediate grantor, or of the fraud rendering void the title of such grantor," RPL § 266.

"An express trust not declared in the disposition to the trustee or an implied or resulting trust does not defeat the title of a purchaser from the trustee for value and without notice of the trust, or the rights of a creditor who extended credit to the trustee in reliance upon his apparent ownership of the trust property," EPTL § 7-3.2.

"The recording act (RPL art. 9) was enacted to accomplish a twofold purpose: to protect the rights of innocent purchasers who acquire an interest in property without knowledge of prior encumbrances, and to establish a public record which will furnish potential purchasers with actual or at least constructive notice of previous conveyances and encumbrances that might affect their interests and uses," *Witter v. Taggart*, 78 NY2d 234, 238, 577 NE2d 338, 340, 573 NYS2d 146, 148 (1991) (citation omitted).

Amortgage is a conveyance for purposes of the recording acts, *Gibson v. Thomas*, 180 NY 483, 489, 73 NE 484, 486 (1905); *House* -

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hold Finance Realty Corp. of New York v. Emanuel, 2 AD3d 192, 193, 769 NYS2d 511, 512-13 (First Dept. 2003).

This analysis holds true even if the bank has sold its mortgage to another lender who did not know about Fred's secret deal with Barney.

"(1) A holder in due course is a holder who takes the instrument (a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person," UCC § 3-302.

Fred's unrecorded interest is void as against the bank, a bona fide mortgagee for value and in good faith. An interest in real property that is never recorded is "void as against ... a purchaser 'in good faith and for a valuable consideration,'" *Karp v. Twenty-Three Thirty Ryer Corp.*, 55 NYS2d 856, 858 (Sup. Ct. 1945) (*citing* RPL § 291), *affd*, 270 AD 758, 758, 59 NYS2d 919 (First Dept. 1946) (awarding costs).

Viewed in the light most favorable to Fred, he is an innocent dupe and a victim of Barney, to whom he voluntarily granted title to his house. However, Fred's claim of innocence may not impress a court, cloaked under the shroud of the secret wink-wink refinancing deal.

Regardless of his claim against Barney, Fred has no claim whatsoever against the bank.

The law in New York on this issue is well-settled and has been for more than a century.

Case in point

In *Valentine v. Lunt*, 115 NY 496, 505, 22 NE 209, 212 (1889), the New York State Court of Appeals ruled that a bona fide mortgagee for value and in good faith could foreclose on her mortgage against 19 Cranberry St. in Brooklyn, despite the claim that an innocent former fee holder, Catherine A. Valentine, had been cheated out of her title to the premises by her physician, Dr. Richardt, who "entered upon illicit relations with her, and obtained control over her mind and property," *Id.* at 500.

Richardt fraudulently took advantage of Valentine and "obtained a deed dated [Jan. 7, 1886] reciting a consideration of $15,000, and conveying to him [19 Cranberry St.], but he, in fact, paying no consideration therefor," *Id.*

By Oct. 27, 1886, Richardt had sold 19 Cranberry St. to one Susan A. Austin for $12,000, which she paid.

The next year, on Oct. 1, 1887, Austin granted a mortgage on the property to the defendant, Elizabeth H. Lunt, "to secure payment of $9,000 advanced by her to Austin," *Id.*

After Valentine's death, her infant son and heir, plaintiff Ludlow W. Valentine, sued to have the above transactions, including the mortgage, declared void and to have title restored to him as his late mother's heir at law.

The court ruled for the defendant lender-mortgagee Lunt, holding that, while Valentine may have well been an innocent woman who was duped and defrauded by Richardt, the lender and mortgage holder was unaware of the fraud against Valentine and lent money secured by a mortgage in good faith.

The lesson for victims of identity theft is to notify police, creditors and credit reporting agencies often and in writing at the first sign of trouble. ... As a rule of thumb, the law generally seeks to protect the most innocent person who has done all she can to protect herself first.

The *Valentine* court recognized that, as between the late Valentine and Richardt, the doctor's title would be "invalid because of the advantage taken by him" and her innocence, *Id.* at 502. The *Valentine* court's analysis reasoned that the plaintiff's claim rested upon a "collateral matter nowhere appearing of record, or to have been brought to the attention of the mortgagee," *Id.* at 503.

"[T]o one receiving [real property] as purchaser, or as security without knowledge of any **secret** fraud, it [is] free from any taint which, as between the original parties, might have infected their transaction," *Id.* (emphasis added).

The rule of law recognized by the *Valentine* court is simple: "It has been well settled 'that a purchaser for a valuable consideration, without notice [of any fraudulent conveyance], has good title, though he purchases from one who has obtained his title by fraud,'" *Id.* (citation omitted). "It necessarily follows that the defendant [lender] Lunt, who in perfect good faith, in actual ignorance of any fraud or circumstances tending to show fraud on the part of anyone connected with the title, advanced ... money in reliance on the record title ... should not be required to give up her mortgage security except upon payment," *Id.* at 505.

Fred is not without legal recourse, however. While he will not be able to stop a foreclosure by the bank, he can sue Barney for breach of their deal.

Conclusion

A bona fide lender, holder or lender in due course in good faith and for valuable consideration who has no notice of Fred's unrecorded interest in real property retains all of its mortgage rights against such property. Any interest Fred may have had is void as against the bank, an innocent third party lender.

The lesson for victims of identity theft is to notify police, creditors and credit reporting agencies often and in writing at the first sign of trouble. Until you pass along information that you have been defrauded, you may be held responsible. As a rule of thumb, the law generally seeks to protect the most innocent person who has done all she can to protect herself first.

Michael A. Burger is a litigator and a member of the law firm Davidson, Fink, Cook, Kelly & Galbraith, LLP.