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[COURT TO LENDERS: STRICT COMPLIANCE WITH LOCAL RECORDING REQUIREMENTS NECESSARY](#)

A decision out of the District Court for the Middle District of North Carolina (the “**District Court**”), now being appealed to the Fourth Circuit Court of Appeals, highlights just how critical it is for lenders to strictly comply with local recording requirements when recording their liens. In *SunTrust Bank N.A. v. Northen*, 433 B.R. 532 (M.D.N.C. Aug. 6, 2010), the District Court affirmed the Bankruptcy Court’s decision to grant summary judgment in favor of the chapter 7 trustee (the “**Trustee**”) seeking to avoid the deed of trust of lender SunTrust Bank N.A. (“**SunTrust**”), which had been properly recorded pre-petition by SunTrust’s predecessor-in-interest in one indexing system, but improperly in another. In finding that the Trustee’s actual or constructive knowledge of the lien was irrelevant to its avoiding power and that only the official real property index was relevant in determining whether a deed is properly recorded, the District Court has sent a telling message to lenders - strictly comply with local recording requirements or face avoidance of your security interest in your borrower’s property in bankruptcy.

The Facts of the Case

Orange County, North Carolina has a unique method of recording land transactions, pursuant to which every tract of land in the county is assigned a unique parcel identifier number (“**PIN**”) and all land transactions relating to a particular tract of land are indexed under that tract’s PIN. While the county also maintains a traditional grantor/grantee indexing system in which instruments are indexed alphabetically by the names of the parties, the PIN Index is the county’s official real property index.

John Gregory McCormick (the “**Debtor**”) owned two tracts of land (“**Tract I**” and “**Tract II**”) in Orange County, North Carolina, on which he granted a deed of trust in 1999 to Central Carolina Bank and Trust Company, the predecessor-in-interest to SunTrust. The deed of trust was a single document that described and applied to both tracts of land. However, the deed of trust only contained the PIN for Tract II (the PIN for Tract I was not written on it). When the deed of trust was recorded by SunTrust’s predecessor, it was correctly indexed in the grantor/grantee index, but was indexed only under the Tract II PIN in the PIN index. In 2004, the Debtor granted a deed of trust on a portion of Tract I to Marc and Maryann Macky, which was correctly recorded in both the PIN and grantor/grantee indexes. The SunTrust deed of trust was finally correctly indexed under Tract I on August 25, 2008.

An involuntary bankruptcy proceeding was initiated against the Debtor on August 7, 2006 (Bankr. M.D.N.C. Case No. 06-80976C-7D). The Trustee sold all of Tract I and the Court transferred all liens on Tract I to the proceeds of the sale. Thereafter, on October 6, 2008, the Trustee commenced an adversary proceeding (Adv. Proc. 08-09028) against SunTrust, seeking to avoid SunTrust’s deed of trust on Tract I under section

544 of the Bankruptcy Code.

Avoidance Powers Under the Bankruptcy Code and the Bankruptcy Court's Decision

Section 544 of the Bankruptcy Code provides, among other things, that a chapter 7 trustee may, regardless of its or any creditor's knowledge, avoid any obligation incurred by the debtor that would be avoidable under applicable nonbankruptcy law by a bona fide purchaser of real property at the commencement of the bankruptcy case, whether or not such a purchaser exists. See 11 U.S.C. § 544(a)(3). Thus, a trustee can avoid a lien on a debtor's real property if a hypothetical bona fide purchaser could avoid such lien under nonbankruptcy law. Once the lien is avoided, such lienholder loses its security interest in the property and is left with an unsecured claim.

The Bankruptcy Court evaluated whether SunTrust's deed of trust was properly recorded against Tract I prior to the bankruptcy filing under North Carolina law, even though it was not recorded in the PIN Index. The Bankruptcy Court concluded that it was not, and therefore SunTrust did not have a valid interest in the property that was enforceable against a bona fide purchaser. The Bankruptcy Court granted summary judgment in favor of the Trustee and the Mackys, concluding that the Mackys had first priority on their portion of Tract I and the Trustee could avoid the SunTrust deed of trust.

The District Court Decision: No Constructive Knowledge

The District Court affirmed the Bankruptcy Court's decision, and held that, as a matter of law, "the SunTrust deed of trust was not properly indexed ahead of the Macky deed of trust on Tract I and is not effective against [the Trustee], standing in the shoes of a hypothetical bona fide purchaser, under 11 U.S.C. § 544." *Id.* at 535.

SunTrust had argued that the Trustee had constructive notice of the SunTrust deed of trust on Tract I, and thus could not avoid the lien. In rejecting this argument, the District Court explained that, by the plain language of the statute, the Trustee's actual or constructive knowledge of SunTrust's lien on Tract I was irrelevant. Additionally, as to the Trustee's knowledge in his role as the hypothetical bona fide purchaser, the District Court found that a bona fide purchaser would not have been on notice pre-petition of the deed of trust. Because the deed of trust did not include the PIN for Tract I, it would not have appeared in any bona fide purchaser's search for Tract I in the PIN Index. Requiring a bona fide purchaser to search the grantor/grantee index in addition to the PIN index would render the PIN Index superfluous and the North Carolina law adopting it meaningless. Finally, the District Court found that it was not improper for SunTrust to bear the risk of loss where its predecessor failed to ensure that the deed was properly recorded.

The Lesson for Lenders: Follow Local Recording Requirements to the Letter

The District Court's holding was explicitly limited by its conclusion that a separate search of the grantor/grantee index in Orange County, North Carolina was not required as a matter of law because the PIN Index was the official index for the relevant time period. But the decision has broader implications for

lenders across all jurisdictions. Even though a search in the grantor/grantee index would give a bona fide purchaser constructive knowledge in almost every jurisdiction in the U.S., such constructive knowledge was insufficient where the grantor/grantee index was not the official index. Therefore, lenders and their attorneys need to ensure that they know and strictly comply with the peculiarities of recording or other lien perfection requirements in each jurisdiction. Assuming that the "typical rules apply" can imperil a lien and endanger a lender's ability to recover in a bankruptcy.

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