BERGMAN ON MORTGAGE FORECLOSURES: Hidden Danger of the Misindexed Mortgage

By Bruce J. Bergman

Even the perfect mortgage foreclosure case in New York is nowadays an ordeal. So a major flaw converts it into a nightmare or, worse, a fatally defective pursuit. One such scenario is an exquisitely obscure principle emerging from the confluence of a misindexed mortgage and a bankruptcy filing—exacerbated by the inescapable actuality that bankruptcy filings in the mortgage foreclosure case are commonplace, if not epidemic.

The basic, and standard, maxim is that a misindexed mortgage (or one otherwise suffering a recording infirmity), and in the absence of something in the record otherwise affording notice, will not provide constructive notice to a subsequent purchaser or encumbrancer. That is to say, the holder of such a mortgage will not benefit from the recording statute (RPL §291). (The subject of a misindexed mortgage is very much a topic unto itself and if further exploration might be meaningful, attention is invited to a more expansive review at 1 *Bergman on New York Mortgage Foreclosures* §1.20[1], LexisNexis Matthew Bender (rev. 2014).]

This situation can also play a shockingly unique role in the context of a bankruptcy filing by a mortgagor—at least prior to the filing of a notice of pendency in an action to foreclose that mortgage.

Underlying the noted peril to the holder of an improperly recorded mortgage is the rule that a bankruptcy trustee is empowered to avoid any transfer that a hypothetical bona fide purchaser for value could have avoided pursuant to applicable law.[1] Even though state substantive law precludes one with actual knowledge from being a bona fide purchaser, bankruptcy law renders a trustee's actual knowledge of an encumbrance irrelevant.[2] This is typically a major surprise for state law practitioners. Thus, when the actual knowledge afforded the trustee comes from the bankruptcy schedules filed by the debtor, it is of no moment – the trustee is still the equivalent of a bona fide purchaser able to avoid the mortgage.[3] That is, the trustee can sell the debtor's home (for example) free of the faultily recorded mortgage, even though the trustee is *actually* aware that the mortgage exists. Such is obviously a complete disaster for the hapless mortgage holder. (As an aside, title insurance, i.e, the mortgage policy, may help.)

There are, however, two pointed exceptions to the troubling rule just mentioned. One is in the instance of an involuntary bankruptcy petition where the petition itself gives actual notice of the encumbrance.[4] The other is where there are matters of record which provide actual or inquiry notice, in which event a trustee is barred from employing avoiding powers.[5]

The cases discussing these exceptions are nuanced and well worthy of separate review. A key is to be aware of this seemingly anomalous proposition and how it may—sometimes—be avoided.

Endnotes

1. *In re Duel*, 594 F.3d 1073 (9th Cir. 2010); cert. den. 131 S. Ct. 85 (2010); *In re O'Connor*, 2010 WL 8354576 (Bkrtcy. W.D. Pa); *In re Badagliacca*, 403 B.R. 288 (W.D.N.Y. 2009); 11 U.S.C. §544(a). A bankruptcy court relies upon substantive state law to define a bona fide purchaser for value of property which is the subject of avoidance. *In re Badagliacca, supra*, citing *In re. Mosello*, 190 B.R. 165 (Bankr. S.D.N.Y. 1995). *See also In re Lopez*, 2012 WL 566265 (Bkrtcy. E.D.N.Y.) but ruling to the contrary based upon the facts.
2. *In re O'Connor* 2010 WL 8354576 (Bkrtcy. W.D. Pa), citing U.S.C. §544(A)(3); *Collier on Bankruptcy*, par. 544.02[1] at 544-5. *See also In re Duel*, 594 F.3d 1073 (9th Cir. 2010); *cert. den.*, 131 S. Ct. 85 (2010); *In re Badagliacca*, 403 B.R. 288 (W.D.N.Y. 2009); 11 U.S.C. §544(a).
3. *In re Duel*, 594 F.3d 1073 (9th Cir. 2010); *cert. den.* 131 S. Ct. 85 (2010); *In re O'Connor*, 2010 WL8354576 (Bkrtcy. W.D. Pa); *In re Badagliacca*, 403 B.R. 288 (W.D.N.Y. 2009), 11 U.S.C. §544(a).
4. *In re Duel*, 594 F.3d 1073 (9th Cir. 2010), *cert. den.*, 131 S. Ct. 85 (2010) citing *Briggs v. Kent (In re Professional Investment Properties of America)*, 955 F.2d 623 (9th Cir. 1992).
5. *In re Lopez*, 2012 WL 566265 (Bkrtcy. E.D.N.Y.); *In re O'Connor*, 2010 WL 8354576 (Bkrtcy. W.D. Pa), citing 5 *Collier on Bankruptcy*, par 544.03[2] at 544-7 to 8.

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