

The Banking Law Journal

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Unrecorded Deeds of Trust: Take Them Out of Your Pocket Before They Burn a Hole

*By Michael J. Lichtenstein and Rebekah F. Paradis**

The authors explain why bankers face a problem when they extend a loan to a borrower and secure that loan in part with a “pocket” deed of trust.

An issue that estate and trust lawyers have to confront is the “pocket deed” which is a non-delivered deed conveying title to property.¹ The grantor signs the deed but instructs that it not be recorded until after the grantor’s death.² This procedure has led to problems with the effectiveness of the conveyance because without delivery nothing passes to the grantee.³

Bankers face a similar problem when they extend a loan to a borrower and secure that loan in part with a “pocket” deed of trust. The deed of trust serves as collateral for the loan but remains unrecorded until some trigger event, at which point it may be too late because other liens have been recorded or because the recordation is deemed ineffective. As can be seen below, courts have held that the consequence of holding a “pocket” deed of trust and failing to record can be quite significant and detrimental.

When a financial institution or any other lender extends a secured loan, the collateral for that loan can take various forms. For example, the collateral might be a guaranty, accounts receivable, furniture, fixtures and equipment or real estate. If real estate secures the loan, typically a deed of trust, an indemnity deed of trust or a mortgage is signed by the property owner and then the instrument is recorded upon execution of the loan documents and delivery of the funds to the borrower. However, some lenders take a deed of trust as collateral but agree not to record the deed of trust unless some trigger event occurs. This instrument is known colloquially as a “pocket deed of trust.”

Reasons for not recording a deed of trust might include a lender’s level of comfort with other collateral securing the loan. In other instances, the property owner (borrower or guarantor) might convince the lender that recordation is

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¹ Failure To Deliver: The Problem With “Pocket Deeds” And A Review Of Alternatives, Vol. 93, No. 2, March/April 2019, Pg. 28, Kara L. Stachel, Real Property, Probate and Trust Law.

² *Id.*

³ *Id.*

not necessary and could affect the borrower or guarantor's credit worthiness. In any event, failing to record the deed of trust and holding a "pocket deed of trust" can have dire consequences, including rendering a lender an unsecured creditor in or outside of a bankruptcy proceeding.

UNRECORDED DEED OF TRUST ISSUES OUTSIDE OF BANKRUPTCY

Failure to record a deed of trust outside bankruptcy may cause a loss of priority, and thus difficulty or inability for a lender to be repaid. For example, in a non-bankruptcy setting, the first lender's deed of trust was recorded six months after a second lender acquired a lien on the disputed property.⁴ Because the second lender was the only party to have both a security interest in the property, and properly recorded that interest, the court concluded that it was entitled to protection of Tex. Prop. Code Ann. § 13.001(a), which rendered the bank's unrecorded deed of trust void.⁵ In Texas, "[a] conveyance of—an interest in real property or a mortgage or deed of trust is void as to a creditor or to a subsequent purchaser for valuable consideration without notice unless the instrument has been acknowledged, sworn to, or proved and filed for record as required by law."⁶

Although the statute by its terms renders an unrecorded deed void against creditors, courts interpret this to mean specifically creditors who have acquired liens without notice of the competing deed.⁷ Also, a creditor's lien takes precedence over a prior unrecorded deed, unless the creditor has notice of the deed at or before the time his lien is fixed upon the land.⁸ "[I]t is undisputed that Grencorp, by filing the deeds of trust in August 2007, perfected its liens on the property and did so two months *before* Liberty Bankers filed a corrected deed of trust in an attempt to fix the allegedly faulty description." Because the first lender failed to record its claimed conveyance, the court held that under Texas law, the second lender's recorded lien took priority.⁹

New York has a similar recording statute. In *Washington Mutual Bank, F.A. v. Peak Health Club, Inc.*, the initial lender appealed order granting summary

⁴ *Liberty Bankers Life Ins. Co. v. Grencorp Mgmt.*, 557 F. App'x 331, 332 (5th Cir. 2014).

⁵ *Id.* at 333.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

judgment against its favor regarding lien priority.¹⁰ After lending the borrower \$3,250,000 secured by real estate, the deed of trust was not recorded.¹¹ The borrower borrowed additional funds from a different lender, also secured by a deed of trust on the same property but this deed of trust was recorded.¹² The first lender then recorded its deed of trust and sought a determination that its deed of trust had priority.¹³

After lengthy motions practice, the court held that the initial lender's lien was subordinate to the mortgages that were granted later in time but recorded first.¹⁴ The appellate court affirmed citing to the New York Recording Act under which "a mortgage loses its priority to a subsequent mortgage where the subsequent mortgagee is a good-faith lender for value, and records its mortgage first without actual or constructive knowledge of the prior mortgage."¹⁵ In that case, the subsequent mortgagees recorded first and provided evidence that they did not have actual or constructive notice of the first unrecorded mortgage.¹⁶

There is an interesting Missouri case that involved a mortgage and a mechanics lien rather than two mortgages but ended with same result. In *Bob DeGeorge Assocs. v. Hawthorn Bank*,¹⁷ the bank appealed the trial court's grant of summary judgment holding that mechanics liens took priority over a previously unrecorded purchase money deed of trust. The initial lender lent the borrower \$2,512,500 to purchase a building but failed to record the purchase money deed of trust.¹⁸ Subsequently, the general contractor who performed work on the building but was not paid, filed a mechanic's lien against the property.¹⁹ One day later, the deed of trust was recorded.²⁰ The contractor then filed an action seeking summary judgment on its right to foreclose the mechanic's liens, which motion the court granted.²¹ On appeal, the decision was affirmed after a review of Missouri's recording statutes and the statutory

¹⁰ 48 A.D.3d 793, 853 N.Y.S2d 112, 113 (2008).

¹¹ *Id.* at 115.

¹² *Id.* at 116.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ 377 S.W.3d 592, 2012 Mo. LEXIS 234 *1(Mo., Sept. 11, 2012).

¹⁸ *Id.* at *3.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.* at *4.

rules of priority for mechanic's lines in Missouri.²² The court concluded that the deed of trust was invalid against third parties with no actual notice until recorded.²³

UNRECORDED DOT STATE LAW SPECIFIC ISSUES IN BANKRUPTCY

Bankruptcy courts have reached similar results applying state law. For example, in *In re Cancel*, the trustee sought to avoid an unrecorded Puerto Rican mortgage under § 544 of the Bankruptcy Code.²⁴ However, the court affirmed the bankruptcy court's entry of summary judgment against the trustee because Puerto Rico law does not recognize any property interest created by an unrecorded mortgage, "so there was no 'transfer of property of the debtor' that could be voided."²⁵ The court noted that state law governs interested parties' property rights, the scope of those rights, and the voidability of any such rights in a bankruptcy proceeding.²⁶

The court discussed that the "core question" under Section 544 is "whether under state law the debtor conveyed a property interest in the real property at issue that gives the current holder some enforceable rights to the property."²⁷ The court also pointed to a similar Massachusetts case, where "there was no dispute that an unrecorded Massachusetts mortgage was a transfer of an interest in real property."²⁸ Further, the "holder of an unrecorded mortgage has inferior title compared to third parties without actual knowledge of the mortgage, but he or she retains an interest in the underlying real property." Therefore, failure to record makes the mortgage voidable.²⁹

In *In re Beachley*,³⁰ the bank sought summary judgment arguing it was entitled to an equitable lien arising from its unrecorded deed of trust. After paying off a previous loan, for which that lender failed to record a deed of trust,

²² *Id.* at 6–7.

²³ *Id.* at 8.

²⁴ 7 F.4th 23, 25–26 (1st Cir. 2021).

²⁵ *Id.* at 25–26.

²⁶ *Id.* at 28–29.

²⁷ *Id.* at 29.

²⁸ *Id.*

²⁹ *Id.* See also *In re Dennis*, 2019 LEXIS 1546, *21 (Bankr. D. Idaho May 21, 2019) (under Idaho law, unrecorded deed in lieu could be defeated by recorded deed of trust held by bankruptcy trustee as hypothetical bona fide purchaser).

³⁰ 2010 Bankr. LEXIS 3349 *1 (Bankr. Md. Sept. 16, 2010).

the new lender also failed to record a deed of trust securing its \$300,000 loan.³¹ When the property owners/debtors subsequently filed for bankruptcy, they listed the loan as an unsecured claim and objected to the lender's secured proof of claim.³² The lender then commenced an adversary proceeding asserting it was entitled to an equitable lien on the property.³³

The court denied the relief sought and noted that it was in agreement with the defendants that the transfer of interest in the property was avoidable under Section 544(a)(3) of the Bankruptcy Code.³⁴ In *Beachley*, the court held that Maryland law applied which requires execution and recordation of a deed prior to transfer of title.³⁵ The deed of trust was not recorded before the bankruptcy was filed and therefore, the court held, the lender's claims for an equitable lien failed.³⁶ Given the application of Section 544 "to the unrecorded Plaintiff's Deed of trust, Plaintiff is an unsecured creditor in this bankruptcy case."³⁷

Similarly, in *In re Taylor-Ramsey Corp.*,³⁸ the unsecured creditors' committee filed a complaint seeking the avoidance of a n unrecorded deed of trust as unperfected. While the lender who lent \$1 million filed a secured proof of claim, the deed of trust securing the loan had never been recorded.³⁹ The court summarized the purpose of Section 544 of the Bankruptcy Code as enabling a trustee to "cut off unperfected security interests and other undisclosed claims against the debtor's property as of the petition date."⁴⁰ Reviewing the situation under the applicable state law, Virginia where the real property was located, the court commented that in Virginia all unrecorded deeds of trust as void as to all lien holders.⁴¹

Accordingly, the court concluded that, pursuant to Virginia law, the deed of trust would be void as to a lien creditor because the deed of trust was

³¹ *Id.* at 3.

³² *Id.*

³³ *Id.* at 4.

³⁴ *Id.* at 5. This section allows a trustee to exercise the rights of a bona fide purchaser and avoid liens in accordance with the relevant state law.

³⁵ *Id.* at 9.

³⁶ *Id.* at 10.

³⁷ *Id.* at 13.

³⁸ 458 B.R. 270, 272 (Bankr. M.D.N.C. 2011).

³⁹ *Id.*

⁴⁰ *Id.* at 273.

⁴¹ *Id.* at 274.

unrecorded.⁴² Because the deed of trust was unrecorded and therefore, under Virginia law, unperfected, the court concluded that, as a matter of law, the creditors' committee was entitled to avoid the unrecorded deed of trust.⁴³

CONCLUSION

It is evident from the case law that holding an unrecorded deed of trust is risky proposition, in or out of bankruptcy. Many states have statutes that require recordation in order to obtain lien priority. Some statutes require that the subsequent lender not have actual or constructive notice but other jurisdictions simply follow the "first in time to record" rule. Also, in many bankruptcy cases, the trustee has been able to utilize Section 544 avoidance powers, acting in the shoes of hypothetical bona fide purchaser, to avoid unrecorded deeds of trust. The dire consequence is an unsecured rather than a secured claim, which, in a typical case, will result in a significantly lower recovery.

⁴² *Id.*

⁴³ *Id.* at 275.