

Client Alert

Failure to Timely Record Mortgage May Jeopardize such Mortgage in a Mortgagor Bankruptcy

A recent decision by the First Circuit Court of Appeals underscores the critical importance of timely recordation of mortgage interests and the ineffectiveness of the “earmarking” and “contemporaneous exchange for new value” defenses in the face of the strict timing rules set forth in section 547(e)(2) of the Bankruptcy Code.

Lenders should take note of a First Circuit decision earlier this year in which the Court of Appeals highlighted the importance of timely perfection of security interests and mortgages. Rejecting two defenses commonly raised in preference actions, the Court of Appeals held that a lender who takes more than 30 days to perfect a mortgage interest in real property may have that interest avoided in a mortgagor’s bankruptcy case if the perfection occurred within the 90 days preceding the bankruptcy filing of the mortgagor.

Section 547(e)(2) is the Key Statutory Provision

Section 547(e)(2) of the Bankruptcy Code provides that a transfer effected by the creation of a lien is deemed to have been made at the time the transfer takes effect between the transferor and the transferee if the lien is perfected within 30 days. Conversely, if perfection is delayed for more than 30 days, the transfer is deemed to have been made at the time of perfection. This timing distinction is crucial when a debtor seeks to avoid, or undo, a security interest granted to a lender on the basis that the lien gave the lender preferential treatment vis-à-vis other creditors of the debtor.

The Case

In *In re Lazarus*, Civ. No. 06-1982, 2007 U.S. App. LEXIS 388 (1st Cir. Jan. 9, 2007), two sisters purchased real property as joint tenants using proceeds of a loan that was secured by a mortgage on the property. Three years later, they sought to refinance the loan to take advantage of lower interest rates. In furtherance of the refinancing, the sisters executed a promissory note and a new mortgage on the property in favor of a new lender. The new lender paid the loan proceeds to the old lender in discharge of the prior loan and in exchange for the old lender’s release of its mortgage.

The new lender failed, however, to record the mortgage with the county registry of deeds until 14 days after the closing of the refinancing. Less than 90 days later, one of the sisters filed for bankruptcy. The bankruptcy trustee filed an adversary proceeding against the new lender pursuant to section 547 of the Bankruptcy Code seeking to avoid the mortgage interest on the ground that it constituted a preferential transfer of the debtor’s property within the 90-day period preceding the bankruptcy filing.

The Trustee’s Argument

In order to succeed on the preference action, the trustee was required to show, among other things, that the transfer of the mortgage interest to the new lender was on behalf of an antecedent debt. While the debtor executed and delivered the note and the mortgage to the lender on the same day, the lender did not perfect its security interest until 14 days later. A prior version of section 547(e)(2) then in effect provided a 10-day window within which to perfect an interest in order for

the perfection to relate back to the date of the transaction. (Congress extended this 10-day period to a 30-day period for bankruptcy cases commenced on or after October 17, 2005.) Because the lender did not record the mortgage until the 10-day period then in effect had expired, so argued the trustee, the mortgage reflected a transfer on account of antecedent debt within the meaning of section 547(b) and was avoidable as a preferential transfer.

The New Lender's Defenses

The new lender acknowledged that its late perfection of the mortgage satisfied the "transfer on account of antecedent debt" element of the preference cause of action. The new lender argued, however, that the mortgage was exempt from avoidance by either the "earmarking doctrine" or the defense of "contemporaneous exchange for new value."

Under the earmarking doctrine, the repayment of antecedent debt with proceeds of a new loan specifically "earmarked" for the repayment may not be avoided as a preference on the basis that the proceeds of the new loan never became property of the debtor, a new lender is simply substituted for the old lender, and the estate is not diminished to the detriment of other creditors. The new lender in *Lazarus* asserted, and the lower court agreed, that the earmarking doctrine should be extended to the refinancing because the grant of the mortgage was in substance a transfer of the mortgage from the old lender to the new lender without any adverse consequence to other creditors of the debtor.

The First Circuit disagreed and reversed the bankruptcy court, noting that a refinancing is made up of several transactions. The debtor mortgaged real property to the new lender and, thereafter, the new lender funded the payoff of the old lender's loan. Upon satisfaction of the loan, the old lender did not transfer the old mortgage to the lender, but rather released it which merely meant that the new lender's mortgage, when properly recorded, would be first in priority. The new lender tried to direct the court's attention on the equities, arguing that the debtor's other creditors were not prejudiced irrespective of when the new mortgage was recorded. The First Circuit rejected this argument, noting that the formal requirements of section 547 were drafted to result in a clear, mechanical test and to insert an additional requirement that the trustee demonstrate prejudice to creditors before avoiding a transfer would introduce unnecessary uncertainty and result in increased litigation costs in preference actions.

The new lender also argued that its mortgage was not avoidable because the refinancing fell within the "contemporaneous exchange for new value" exception to avoidance under section 547(c)(1) of the Bankruptcy Code. That section exempts certain preferences from avoidance where (a) the debtor and creditor intend the transfer to the creditor to be contemporaneous with the provision of new value to the debtor and (b) the exchange is in fact substantially contemporaneous. The lender acknowledged its failure to record the mortgage within the 10-day grace period provided by the Bankruptcy Code, but argued that the mortgage was nevertheless recorded within two weeks of the loan, making it a substantially contemporaneous exchange for new value to the debtor. The First Circuit was sympathetic to the lender's plight and acknowledged that 547(c)(1) does provide some flexibility in determining whether a transaction is "substantially contemporaneous." Nevertheless, the Court found this defense inapplicable in light of section 547(e)'s more specific time limit applicable to security interests. The First Circuit reasoned that ignoring the grace period expressly provided under section 547(e)(2) in favor of the more imprecise contemporaneous exchange standard under section 547(c)(1) would defy the governing canon of statutory construction that the more specific prevails over the general. Moreover, the First Circuit reasoned, permitting flexibility in the face of specific time requirement would undercut Congress's choice to create a mechanical deadline. Although the First Circuit understood its ruling denied the new lender its security interest

even in the situation where other creditors were not prejudiced, the Court stressed that the test has the benefit of being specific and avoids litigation over actual prejudice.

The *Lazarus* case emphasizes the importance of timely perfecting security interests. If a lender fails to record a mortgage within the 30-day grace period under section 547(e)(2), the transfer is deemed to have been made on account of antecedent debt, subjecting the lender to a possible preference action if the transfer occurs within the 90 days preceding a bankruptcy filing of the borrower. The absence of prejudice or detriment to other unsecured creditors will not immunize the delayed filing from avoidance. Strict compliance in perfecting security interests is therefore necessary to avoid unnecessary risk in bankruptcy cases.

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