



Courts give banks protection

by wes smith
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A recent ruling by the Tenth Circuit Court of Appeals gives banks and other creditors more protection from a trustee when the loan documents contain an error in the description of the encumbered property.

Under the United States Bankruptcy Code, a trustee may avoid a lien or encumbrance on a piece of property if the property has some encumbrance which would not bind a bona fide purchaser ("BFP") of the property from the debtor. Under Kansas law, a BFP is a purchaser who has neither actual or constructive notice of the encumbrance. The issue in the Tenth Circuit case, *In the Matter of Colon*, was whether this rule permits a trustee to avoid a mortgage on the ground that it misstates the lot number in its description of the property, even though the address and parcel identification number were correct. The legal description in the Mortgage erroneously listed the parcel as "Lot 29", instead of its actual description of "Lot 79". The bankruptcy court and Bankruptcy Appellate Panel both determined that such an error in the record would not bind a bona fide purchaser, and therefore allowed the trustee to avoid the lien. Reversing the ruling from the lower courts, the Court of Appeals held that "because a purchaser is deemed to know the contents of recorded documents in the debtor's chain of title,... a reasonably prudent purchaser would readily discover that the bank's mortgage encumbers the debtor's house."

The trustee argued that because the lot number was misstated on the county register index, a BFP would not purchase the property subject to the mortgage. If a BFP could acquire the property free and clear of the mortgage, then the trustee in bankruptcy should also get the property free and clear when obtained for the bankruptcy estate. However, the court dismissed this argument and instead relied on an old Kansas Supreme Court case from 1916 and the concept of constructive notice in reaching its conclusion.

In the 1916 case, the court held that "a purchaser of real estate

in Kansas is deemed to have 'notice of the contents of all the prior recorded deeds and mortgages' in the grantor's chain of title." The bona fide purchaser would have to exercise "reasonable prudence and diligence" in determining whether the property was encumbered. In the present case, recorded documents in the debtors' chain of title gave the correct address and parcel identification number as the bank's mortgage, together with the correct lot number. Other documents, such as a subordination agreement, also indicated the bank's mortgage to be on the same property.

The court therefore held that a bona fide purchaser exercising reasonable prudence and diligence would discover the lot to be encumbered. Thus, the trustee cannot avoid the mortgage and acquire the property for the bankruptcy estate, keeping the mortgage with the "wrong" legal description intact.

This case is fairly novel in that it gets away from the notion that deeds and mortgages need be error-free in order to be effective. This should give banks and title companies some solace and ammunition when faced with a small error which is discovered at time it is too late to correct.

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He is a Partner at Stevens & Brand, LLP and primarily represents debtors and creditors in bankruptcy cases. Wes is an Adjunct Professor of Law at the University of Kansas, teaching commercial law and is frequently a lecturer on bankruptcy and commercial law for continuing education classes. In 2009, he was chosen as one of the Best Lawyers in America, in the area of bankruptcy.

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