

Update: Bankruptcy Court Challenges to Errors in Deeds of Trust and Mortgages

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As real estate-related bankruptcy filings remain steady, courts continue to see debtors challenging the validity of deeds of trust and mortgages due to minor scrivener's errors. The United States Bankruptcy Court for the Eastern District of North Carolina is viewed by debtors as a favorable venue in which to bring such challenges due to a string of prior rulings starting with *In re Head Grading* in 2006, which invalidated a North Carolina deed of trust that incorrectly cited the date of the related note by one day. The latest chapter in this saga involves an effort by a debtor in North Carolina to expand such challenges to South Carolina mortgages.

In the summer of 2010, a North Carolina limited liability company with its sole asset, real property, located in South Carolina chose to file its bankruptcy petition in the Eastern District of North Carolina, rather than in the District of South Carolina. During the bankruptcy case, the debtor filed a lawsuit seeking to avoid a multi-million dollar South Carolina mortgage based upon facts paralleling those in *Head Grading*. Similar to *Head Grading*, the facts in *South Bay Properties, LLC v. Bayside Property, Inc. et al.* involved a mortgage dated September 11, 2007, which purported to secure a promissory note of even date. However, the only promissory note in existence between the parties was dated September 12, 2007.

On cross-motions for summary judgment, the North Carolina bankruptcy court found that the South Carolina mortgage was valid and enforceable, despite the date error. The *Head Grading* and *South Bay* cases had opposite outcomes despite virtually identical facts because of which state's law applied, and not, as some lenders had hoped, because North Carolina law had taken a more creditor-friendly turn.

The lawsuits seeking avoidance of North Carolina deeds of trust predictably rely on North Carolina state law. The United States Bankruptcy Court for the Eastern District of North Carolina has held that North Carolina law requires specificity in deeds of trust, and likewise does not allow parol evidence to prove anything other than what appears on the face of the document, not even the intent of the parties. However, in deciding whether a debtor may avoid a South Carolina mortgage, the North Carolina bankruptcy court, in the *South Bay* case, held that case law dating back to 1881 required a finding that the South Carolina mortgage was valid and enforceable despite the scrivener's error. The court explained that relevant case law in South Carolina focuses on form over substance, and does not give undue weight to minor errors in descriptions of debt. The court also noted that South Carolina courts have shown a willingness to allow parol evidence to assist the court in understanding the purpose and intent of a mortgage.

Given the current state of the law in North and South Carolina, the message for lenders is that the applicable state law may matter as much or more than the exact language contained in the deed of trust or mortgage. Vigilance and attention to detail during the loan documentation process and careful review of loan documents for potential legal defects prior to commencing collection or enforcement action are critical to the protection of lenders' interests.



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