IN THE UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF TENNESSEE

In re

Case No. 99-31027

JON HOWARD TATE
CANDACE JEAN TATE

Debtors

NOTICE OF APPEAL FILED:	March 10, 2000
DISTRICT COURT NO.:	3:00-cv-279
DISPOSITION:	Notice of Appeal (Sixth Circuit) filed on December 28, 2000.

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Debtors

MEMORANDUM ON MOTION OF FIRST AMERICAN NATIONAL BANK FOR RELIEF FROM THE AUTOMATIC STAY

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RICHARD STAIR, JR.
UNITED STATES BANKRUPTCY JUDGE

Before the court is the Motion of First American National Bank for Relief From the Automatic Stay filed on October 27, 1999.[1] The Debtors, Jon Howard Tate and Candace Jean Tate, filed a Debtor[s'] Response to Motion of First American National Bank for Relief From the Automatic Stay on November 3, 1999. Pursuant to an order entered on November 29, 1999, the court will resolve the matter on the basis of stipulated facts and documents submitted pursuant to Stipulations filed by the parties on December 1, 1999, and on briefs. The Memorandum of the Debtors in Opposition to the Motion of First American National Bank was filed by the Debtors on December 1, 1999, and the Brief of First American National Bank was filed by First American National Bank (First American) on December 3, 1999. At issue is whether First American held a valid lien on the Debtors' real property at the commencement of their Chapter 11 case and the impact of 11 U.S.C.A. § 544(a) (West 1993) on the bank's interest.

This is a core proceeding. 28 U.S.C.A. § 157(b)(2)(G) and (K) (West 1993).

[1] On February 2, 2000, the court entered an Order denying the Motion of First American National Bank for Relief From the Automatic Stay accompanied by a Memorandum on Motion of First American National Bank for Relief From the Automatic Stay. It did so, in part, based on a finding that the modifications to First American National Bank's released Deed of Trust, upon which First American National Bank relies, were not entitled to registration under TENN. CODE ANN. § 66-26-103 (1993) because they were not acknowledged in substantial compliance with TENN. CODE ANN. § 66-22-107 (1993). On February 8, 2000, First American National Bank filed its First American's Motion to Alter or Amend Judgment on the ground that the acknowledgment was sufficient under TENN. CODE ANN. § 66-22-114(b) (1993), a statute that the court had not considered in its Memorandum. On February 14, 2000, the court entered an Order granting First American's Motion to Alter or Amend Judgment, vacating its February 2, 2000 Order, and providing that the court's Memorandum on Motion of First American National Bank for Relief From the Automatic Stay will be amended. The court recognizes the relevance of § 66-22-114(b) to the analysis of the acknowledgments in the modifications, however, upon further consideration the court finds that it may resolve this matter without reaching that issue. The present Memorandum amends and supersedes the February 2, 2000 Memorandum.

I

On March 9, 1993, the Debtors executed a promissory note in favor of First American in the principal amount of $127,500.00. The indebtedness evidenced by this note was secured by the Debtors' interest in real property located at 7511 Chapman Highway in Knoxville, Tennessee, pursuant to a Deed of Trust, Assignment of Leases and Rents and Security Agreement (Deed of Trust) executed by the Debtors on the same date. On March 10, 1993, the Deed of Trust was recorded by the Knox County Register of Deeds.

On April 18, 1997, the Debtors executed another promissory note in favor of First American evidencing an increase in their principal indebtedness to $278,542.47 and extended the maturity date to December 31, 1997. On the same date, the Debtors executed a Modification Agreement in order to extend the Deed of Trust. That instrument was recorded on April 21, 1997.

On May 15, 1997, First American mistakenly recorded a Full Release of Lien in the office of the Knox County Register of Deeds which provided for the "full release and discharge of [the] Lien" of the March 9, 1993 Deed of Trust. First American never intended to release the Deed of Trust and the Debtors did not discover the release until after filing their petition under Chapter 11.[2]

[2] First American does not dispute that the effect of the recorded Full Release of Lien was to release its lien encumbering the Debtors' 7511 Chapman Highway property. The record does not reflect the date First American discovered the error, although it was clearly after the Debtors commenced their bankruptcy case.

Following the release of the Deed of Trust, the parties renewed the Debtors' indebtedness three more times. On January 30, 1998, the Debtors executed another promissory note in favor of First American in the amount of $278,542.47 and reset the maturity date to March 31, 1998. The parties executed a Modification Agreement of Note and Deed of Trust on April 30, 1998. That modification was recorded by the Knox County Register of Deeds on May 12, 1998. It refers to the March 9, 1993 Deed of Trust by Trust Book and page number, provides that the interest rate would continue as under the Deed of Trust and prior notes, and provides that the debt, in the principal amount of $278,542.47, would mature on May 30, 1998. In addition, it provides as follows:

> 4. Ratification and Incorporation. The undersigned hereby ratifies, confirms and restates, in their entirety and incorporates herein by reference, all of the Loan Documents and, except to the extent set forth herein, the same are validly executed under seal, and remain in full force and effect in accordance with their terms as originally set forth. The undersigned further agrees that the Loan Documents are executed under seal. To the extent that any of the terms and provisions hereof are in conflict with the terms and provisions of the Loan Documents, as amended, the same are hereby amended to incorporate the terms hereof.[3]

On May 30, 1998, the parties executed another Modification Agreement of Note and Deed of Trust which served only to extend the maturity date of the Debtors' loan to August 28, 1998. This modification contains provisions identical to those of the April 30, 1998 modification including the paragraph addressing ratification and incorporation, and was recorded by the Knox County Register of Deeds on July 14, 1998.

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[3] The term "Loan Documents" is not defined in the instrument. The term is, however, used when referring to the interest rate and maturity date, as follows: "the Note and Deed of Trust, as [set] forth therein and in the other Loan Documents . . . ."

The parties executed a final Modification Agreement of Note and Deed of Trust on September 29, 1998, which was recorded by the Knox County Register of Deeds on October 27, 1998. That modification fixed the principal amount of the Debtors' obligation at $276,223.29, set a new loan maturity date of February 28, 1999, and included the provision from the prior modifications addressing the ratification and incorporation of the Loan Documents. This modification contains no acknowledgments.

The Debtors filed their Voluntary Petition under Chapter 11 on March 12, 1999. They included First American as a secured creditor in their schedules.

II

First American seeks relief from the automatic stay in order to foreclose on the Debtors' real property under the March 9, 1993 Deed of Trust. The Debtors assert that they may avoid First American's alleged security interest in the property by virtue of their "strong arm" powers pursuant to 11 U.S.C.A. § 544(a) which provides as follows:

> (a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—
>
> > (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;
> >
> > (2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to

> such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or
>
> (3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

In the instant matter, the Debtors are debtors in possession under Chapter 11 and as such they possess the rights and powers, and perform the functions and duties of a trustee, subject to exceptions not relevant here. *See* 11 U.S.C.A. § 1107(a) (West 1993); *Feltman v. General Motors Acceptance Corp. (In re TUSA Florida, Inc.)*, 186 B.R. 542, 545 (Bankr. S.D. Fla. 1995) ("[A] debtor in possession has the right and duty to bring avoidance actions under §§ 544, 545, 547, 548, 549 and 553. These rights and duties are subject to the same limitations as a trustee including those provided for in § 546 and 550."); *In re Revco D.S., Inc.*, 118 B.R. 468, 499 (Bankr. N.D. Ohio 1990) (Debtor in possession may bring avoidance action under § 544.).

The rights and powers to which § 544(a) refers are determined by state law. *See Terlecky v. American Community Bank (In re Godwin)*, 217 B.R. 540, 542 (Bankr. S.D. Ohio 1997) (citing *Butner v. United States*, 99 S. Ct. 914, 917-18 (1979)); *Waldschmidt v. Dennis (In re Muller)*, 185 B.R. 552, 554 (Bankr. M.D. Tenn. 1995). The priority of competing liens is determined by nonbankruptcy law. *See Godwin*, 217 B.R. at 542 (citing *United States v. Darnell*, 834 F.2d 1263, 1266 (6th Cir. 1987)). Liens created under state law are prioritized according to the rule "'first in time, first in right.'" *See id.* (quoting *Darnell*, 834 F.2d at 1266).

Here, First American mistakenly released its Deed of Trust. Subsequently, it and the Debtors executed and recorded three instruments, each entitled Modification Agreement of Note and Deed of Trust. First American argues that the modifications were recorded before the filing of the Debtors' petition and therefore that its lien was restored prior to the date on which the debtors in possession attained the status of judgment lien creditors or creditors unsatisfied after execution under § 544(a).

III

First American admits that it released its lien against the Debtors' property. The effect of the release of a lien in Tennessee has been explained as follows:

> As a general proposition it is true that upon the satisfaction of a mortgage debt the legal title to the land covered by the mortgage reverts and becomes revested by operation of law in the mortgagor. But this is true only where the mortgagor is still the owner of the equity, and has not sold or conveyed the land subsequent to the execution of the mortgage.

Anderson v. Robertson, 192 S.W. 917, 918 (Tenn. 1917) (citation omitted) (citing *Vaughn v. Vaughn*, 45 S. W. 677, 678 (Tenn. 1898)). In this instance, the Debtors had retained the property. Thus, after the release the Debtors possessed both legal and equitable title to the property.

First American asserts, however, that its lien was restored by the execution and recording of the three Modification Agreement of Note and Deed of Trust instruments subsequent to the release of the Deed of Trust. After considering the nature of a deed of trust and the requirements for its creation, the court disagrees.

"Under Tennessee law, 'a deed of trust . . . is a conveyance of an estate or an interest in land and as such within the meaning of the Statute of Frauds.'" *Newton v. Herskowitz (In re Gatlinburg Motel Enters., Ltd.)*, 119 B.R. 955, 962 (Bankr. E.D. Tenn. 1990) (quoting *Lambert v. Home Fed. Savs. and Loan Assoc.*, 481 S.W.2d 770, 772-73 (Tenn. 1972); *see also Cameron v. Campbell*, 144 S.W.2d 775, 776 (Tenn. 1940) (characterizing a deed of trust as a "conveyance to a trustee in trust to provide for the discharge of an obligation . . ."). Land conveyances, including those accomplished by deed of trust, must comply with two sets of formalities in Tennessee. *See Hildebrand v. Resource Bancshares Mortgage Group (In re Cohee),* 178 B.R. 154, 159 (Bankr. M.D. Tenn. 1995). One set of formalities involves the passing of title and the other involves notice to third parties by registration. *See id.*

A conveyance of land by deed, including a deed of trust, is effective between the parties if the deed or deed of trust is executed and delivered to the grantee in compliance with certain formalities. *See id.*; *Limor v. Daniel (In re Gee)*, 166 B.R. 314, 317 (Bankr. M.D. Tenn. 1993). One such formality is that the deed of trust must include words evidencing the grantor's intent to convey an interest in the property to the grantee. *See Gee*, 166 B.R. at 317. Suggested wording for that purpose is set forth by statute in Tennessee as follows:

> **66-5-103. Forms of conveyances**. — The following or other equivalent forms, varied to suit the precise state of facts, are sufficient for the purposes contemplated, without further circumlocution:
>
> . . . .
>
> (4) For a deed of trust: "For the purpose of securing to A. B. a note of this date, due at twelve (12) months, with interest from date (or as the case may be), I hereby convey to C. D., in trust, the following property (describing it). And if the note

> is not paid at maturity, I hereby authorize C. D. to sell the property herein conveyed (stating the manner, place of sale, notice, etc.), to execute a deed to the purchaser, to pay off the amount herein secured, with interest and costs, and to hold the remainder subject to my order."

TENN. CODE ANN. § 66-5-103(4) (1993).

In *Gee*, the court resolved the issue of whether a contract for the sale of the debtor's land could constitute a valid conveyance of the land. *See Gee*, 166 B.R. at 317. The contract included a provision that the debtor would execute and deliver a deed at another time which would convey the debtor's property interest. *See id.* The court determined that the contract did not constitute a conveyance of land by deed because it did not express "the debtor's present and actual intent to convey an interest in [the] property." *Gee*, 166 B.R. at 317.

The modifications executed by the Debtors and First American do not include language conveying the property to First American. The modifications, therefore, do not constitute deeds of trust.

In addition, the parties did not restore or reregister the March 9, 1993 Deed of Trust by arguably ratifying it and incorporating it in the modifications.[4] The Deed of Trust which First American contends was ratified was no longer registered and remains unregistered. As such, it is null and void as against subsequent creditors, including the Debtors under § 544(a)(1) and (2) of the Bankruptcy Code, regardless of whether the parties ratified its underlying validity in the modifications. *See* TENN. CODE ANN. § 66-26-103 (1993) ("Any of such instruments not so

[4] *See* supra at 4.

proved, or acknowledged and registered, or noted for registration, shall be null and void as to existing or subsequent creditors of, or bona fide purchasers from, the makers without notice."). Finally, First American cites no authority for the notion that parties may reregister a released deed of trust by incorporating it into a registered modification of the very same released deed of trust.[5] In fact, the registration of the modification itself was futile because it purported to modify a deed of trust which, as First American admits, had been released and was no longer of record.

IV

Further, First American may not prevail on the theory that it holds an equitable lien.

The mistaken release of a recorded lien instrument or the defective registration of a lien creates an equitable lien. *See First Am. Nat'l Bank v. Miller (In re Miller)*, Ch. 7 Case No. 98-20011, Adv. No. 98-2010, slip op. at 14-15 (Bankr. E.D. Tenn. Nov. 24, 1999) (citing *Hamilton Nat'l Bank of Chattanooga v. Duncan*, 132 S.W.2d 353, 354 (Tenn. Ct. App. 1939) (finding that the inadvertent release of a note secured by a deed of trust could be canceled and that the creditor could foreclose on the property subject to the deed of trust), and *Jetton v. Nichols*, 8 Tenn. App. 567, 1928 WL 2152 at *5 (Tenn. Ct. App. 1928) ("A lien discharged by mistake is still in existence . . . .")); *Hunt*, 282 S.W. at 205 (A lien that was "defectively acknowledged and not entitled to registration, created an equitable lien or mortgage, good as between the parties, and good as against purchasers with notice.").

[5] First American's argument is problematic because its Deed of Trust is not specifically incorporated into the modifications. Rather, the "Loan Documents" are incorporated into each modification. *See* supra at 4.

An equitable lien has been defined as "'"the right to have the property subjected in a court of equity to the payment of the claim. It is a floating equity until action by the court is invoked."'" *Miller,* Case No. 98-20011, Adv. No. 98-2010, at 14-15 (citing *Osborne v. McCormack*, 176 S.W.2d 824 (Tenn. 1944) (quoting *Milam v. Milam*, 200 S.W. 826, 827 (Tenn. 1918))); *see also Hunt*, 282 S.W. at 205 (An equitable lien is "merely a right to subject the property charged to the satisfaction of the debt secured — not a right to the property nor a right in the property.").

Despite the equitable lien, a court of equity will not reform or reinstate an instrument if a third party's rights intervene. *See Needham v. Caldwell*, 154 S.W.2d 535, 538 (Tenn. 1941); *Hamilton Nat'l Bank*, 132 S.W.2d at 354. By virtue of the rights and powers vested in the trustee at the commencement of a bankruptcy case by § 544(a), the trustee becomes an intervening third party at the filing of the debtor's petition.[6] *See* 11 U.S.C.A. § 544(a); *Miller*, Case No. 98-20011, Adv. No. 98-2010, at 16-17. If the petition is filed before the creditor obtains reformation of the written instrument and records it, then the trustee may avoid the unrecorded equitable lien as a judicial lien creditor, a creditor with execution returned unsatisfied, or bona fide purchaser without notice. *See* TENN. CODE ANN. § 66-26-103; *Muller*, 185 B.R. at 554.

[6] Those same rights and powers are vested in a debtor in possession in a Chapter 11 case pursuant to 11 U.S.C.A. § 1107(a). *See* supra at 6.

Here, the parties agree that the release was a mistake and that the Debtors were not aware of the release until after the commencement of their Chapter 11 case.[7] The parties' conduct also demonstrates mutual mistake in that they continued to execute modifications to the Deed of Trust after its release. It is stipulated that neither First American nor the Debtors intended that the Deed of Trust be released. First American, however, did not seek and obtain reformation and recording of the Deed of Trust prior to the filing of the Debtors' petition. The rights of the Debtors under § 544(a) as debtors in possession intervened on the date of the Debtors' petition, preventing reformation of the Deed of Trust. As a result, First American has only an unrecorded equitable lien.

As judicial lien creditors and as execution creditors under § 544(a)(1) and (2), the Debtors, as debtors in possession, may avoid First American's unrecorded equitable lien.[8] Pursuant to TENN. CODE ANN. § 66-26-103, unregistered instruments are "null and void as to existing or subsequent creditors of, or bona fide purchasers from, the makers without notice." It is well established in Tennessee that "the lien of a judgment creditor defeats the rights of an unrecorded mortgage holder." *Muller*, 185 B.R. at 554; *Anderson*, 30 B.R. 1008 (collecting cases).

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[7] Parol evidence is admissible for proving mutual mistake or fraud regarding a written instrument. *See Miller*, Case No. 98-20011, Adv. No. 98-2010, at 12-13 (citing *GRW Enters., Inc. v. Davis*, 797 S.W.2d 606, 611 (Tenn. Ct. App. 1990) and *McMillin v. Great S. Corp.*, 480 S.W.2d 152, 155 (Tenn. Ct. App. 1972)); *Retenbach Eng'g Co. v. General Realty Ltd.*, 707 S.W.2d 524, 526-27 (Tenn. Ct. App. 1985).

[8] Such an avoidance action must be pursued by way of an adversary proceeding and cannot be accomplished through First American's present automatic stay motion. *See* FED. R. BANKR. P. 7001(1).

V

In summary, First American released its Deed of Trust and did not obtain the execution and registration of another one. The modifications did not serve to reregister the Deed of Trust mistakenly released by First American. In addition, although First American holds an equitable lien against the property at issue, that lien is null and void as against the debtors in possession under § 544(a)(1) and (2).

First American has not carried its burden of establishing the validity of the lien upon which it bases its request for relief from the automatic stay. *See In re U.S. Physicians, Inc.*, 236 B.R. 593, 605 (Bankr. E.D. Pa. 1999) (Allegedly secured party who brings a motion for relief from the automatic stay bears burden of proving the validity of its security interest.); *see also Mazzeo v. Lenhart (In re Lenhart)*, 167 F.3d 139, 142 (2d Cir. 1999) ("The burden is on the moving party to make an initial showing of 'cause' for relief from the stay."). The Motion of First American National Bank for Relief From the Automatic Stay will be denied.

FILED: March 2, 2000

BY THE COURT

/s/ Richard Stair, Jr.

RICHARD STAIR, JR.
UNITED STATES BANKRUPTCY JUDGE

IN THE UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF TENNESSEE

In re

Case No. 99-31027

JON HOWARD TATE
CANDACE JEAN TATE

Debtors

O R D E R

For the reasons stated in the Memorandum on Motion of First American National Bank for Relief From the Automatic Stay filed this date, the court directs that the Motion of First American National Bank for Relief From the Automatic Stay filed by First American National Bank on October 27, 1999, requesting modification of the automatic stay to permit it to foreclose its alleged interest in property of the Debtors located at 7511 Chapman Highway, Knoxville, Tennessee, is DENIED.

SO ORDERED.

ENTER: March 2, 2000

BY THE COURT

/s/ Richard Stair, Jr.

RICHARD STAIR, JR.
UNITED STATES BANKRUPTCY JUDGE