Apparently, "No Good Deed Goes Unpunished": The Earmarking Doctrine, Equitable Subrogation, and Inquiry Notice Are Necessary Protections When Refinancing Consumer Mortgages in an Uncertain Credit Market

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NOTES

APPARENTLY, "NO GOOD DEED GOES UNPUNISHED": THE EARMARKING DOCTRINE, EQUITABLE SUBROGATION, AND INQUIRY NOTICE ARE NECESSARY PROTECTIONS WHEN REFINANCING CONSUMER MORTGAGES IN AN UNCERTAIN CREDIT MARKET

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INTRODUCTION

On October 6, 2003, the Lee family obtained the relief they desperately needed—the same relief that many families who have subprime mortgages need.\(^1\) Chase Mortgage Company...
("Chase"), the bank that recently acquired the Lees’ mortgage, agreed to refinance the mortgage. The refinancing arrangement

_Ibid._. Subprime mortgages enabled previously unqualified individuals to receive mortgages and buy homes. _Ibid._ § 2. Subprime borrowers generally present at least one of the following credit risks:

- Two or more thirty-day delinquencies in the last twelve months, or one or more sixty-day delinquencies in the last twenty-four months;
- Judgment, foreclosure, repossession, or charge-off in the prior twenty-four months;
- Bankruptcy in the last five years;
- Relatively high default probability as evidenced by, for example, a credit bureau risk score ("F.I.C.O.") of 660 or below (depending on the product/collateral) or other bureau or proprietary scores with an equivalent default probability likelihood; and/or
- Debt service-to-income ratio of fifty percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

_Ibid._ § 2[1][a]. Because of this increased default risk, these loans carried higher interest rates and fees than their prime cousins. _Ibid._. Financial institutions were able to make large sums of money off these loans because of their high price and the practice of securitization. _See id._ § 2[1][a]–[b]. The securitization process allowed the institutions to sell their subprime portfolios at a profit while still retaining their servicing rights. _Ibid._

These profits were short lived because, not surprisingly, many of the subprime borrowers were simply unable to pay back these expensive loans. _See_ James R. Hagerty, _Foreclosures, Overdue Mortgages Increase Again; Troubles Extend into Prime Loans Via Option ARMs_, WALL ST. J., Sept. 6, 2008, at A3. This resulted in a large increase in defaults and foreclosures. _Ibid._ ("For prime loans, 5.35% of loans were past due or in foreclosure in the latest quarter. For subprime, the rate was about 30%. In the latest quarter, 2.75% of all loans were in the foreclosure process, up from 1.40% a year earlier."). The subprime market subsequently collapsed, causing ripples throughout the rest of the financial markets and a drastic drop in housing prices. _See_ Isabelle Clary, _BlackRock’s Fink: Full Recovery Will Require Housing Revitalization_, PENSIONS & INVESTMENTS, Sept. 29, 2008, at 47. This turmoil has contributed to the tightening of credit markets. _See_ Michael A. Fletcher & Neil Irwin, _Bernanke Warns of ‘Grave Threat’ to U.S. Economy; Fed Chairman Pushes Bailout, Citing Worsening Credit Market_, WASH. POST, Sept. 25, 2008, at D01.

Due to the tightened credit market, subprime borrowers are stuck between the proverbial rock and a hard place; they are unable to make their current payments and unable to refinance their current mortgages. _See_ Renae Merle, _Resets Peaking on Subprime Loans; Jumping Payments Raise Foreclosure Projections_, WASH. POST, July 1, 2008, at D01. This unavailability of credit, which is driving the cycle of foreclosures, has only driven this cycle further. _See_ Kevin G. Hall, _As Wall Street Tanks, We’re All Suffering: Banks Are Unable or Unwilling To Lend—We Didn’t Understand It, . . . We Understand It Now_, SEATTLE TIMES, Oct. 10, 2008, at A1.

_Flagstar assigned the Promissory Note and the Original Mortgage to the Federal National Mortgage Association, in care of Chase Mortgage Company, an Ohio Corporation . . . pursuant to an Assignment of Mortgage_
reduced the Lees’ minimum monthly payments from $942.16 to $567.31. Despite their savings of nearly $400 a month, the Lees were still unable to avoid bankruptcy. On March 4, 2004, the Lees filed a voluntary chapter 7 bankruptcy petition. This unfortunate turn of events left Chase in the precarious position of not knowing the status of its mortgage.

Chase’s problems arose from the timing of the perfection of its mortgage. During the refinancing process, the Lees granted Chase a new mortgage. Chase then executed a discharge of the original mortgage. Although the new mortgage and the discharge were both properly executed, there was a substantial delay in recording both of these documents. Because the mortgage was recorded within ninety days of the Lees’ bankruptcy, the chapter 7 trustee (“trustee”) was able to avoid the mortgage as a preferential transfer. As a result, Chase lost its mortgage on the Lees’ home and became a general unsecured creditor. This meant that Chase would have to share the

that was recorded by the Register of Deeds in early 2002. By merger of Chase Ohio into Chase, Chase became the holder of both the Original Mortgage and the loan evidenced by the Promissory Note.

Id.

3 Id.
4 Id. at 462.
5 Id. at 461.
6 For the purpose of § 547 of the Code, a security interest in real property, such as a mortgage, is considered “perfected when a bona fide purchaser of such property from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interest of the transferee.” 11 U.S.C. § 547(e)(1)(A) (2006).
7 In re Lee, 530 F.3d at 461.
8 The mortgage was executed on October 6, 2003. Id.
9 The discharge was executed on October 27, 2003. Id.
10 Although the Register of Deeds received the discharge on November 12, 2003—sixteen days after the discharge was executed—it was not recorded for another sixty-five days on January 16, 2004. Id. The circumstances surrounding the recording of the new mortgage are less clear. Although the decision does not indicate when the Register actually received the mortgage, it was not recorded until December 17, 2003—seventy-two days after the mortgage was granted and fifty-one days after the discharge was executed but about one month before the old mortgage discharge was recorded. Id. Both recordings were valid under state law. Id. at 466.
11 The Lees filed for bankruptcy seventy-seven days after the mortgage was recorded. Id. at 461.
12 Id. at 474; see also Bankruptcy Abuse Prevention and Consumer Protection Act, 11 U.S.C. § 547(b) (2006). The specific requirements of § 547 and the Sixth Circuit’s rationale for reaching its decision in Lee will be discussed throughout this Note.
13 See In re Lee, 530 F.3d at 462.
proceeds of the home sale with the other unsecured creditors instead of being paid the full balance of its mortgage before the other unsecured creditors were paid anything.\footnote{See id. at 472.}

A primary goal of bankruptcy policy in the United States is “equality of distribution among creditors of the debtor.”\footnote{5 COLLIER ON BANKRUPTCY ¶ 547.01 (15th ed. 2008).} Although a solvent debtor normally has the choice to pay any creditor the debtor chooses,\footnote{The lack of payments by a debtor will not preclude legal action against the solvent debtor by the unpaid creditors outside of bankruptcy. See 11 U.S.C. § 362(a) (2006) (imposing an automatic stay on the creditors in a bankruptcy proceeding).} in bankruptcy, a payment or transfer of interest in property to one creditor over another may constitute a “preference” under § 547(b) of the Bankruptcy Code (“Code”), which allows the trustee to avoid certain preferential pre-bankruptcy transfers.\footnote{See 11 U.S.C. § 547(b); see also Kenan v. Fort Worth Pipe Co. (In re George Rodman, Inc.), 792 F.2d 125, 127 (10th Cir. 1986) (discussing the requirements for avoiding preferential transfers).} After the transfer is avoided, one option for the trustee is to force the creditor who received a preferential payment to return that payment to the estate under § 550 of the Code.\footnote{11 U.S.C. § 550(a)(1) (2006) (“[T]he trustee may recover, for the benefit of the estate, the property transferred ... from ... the initial transferee of such transfer or the entity for whose benefit such transfer was made ... .”). The trustee may also recover a transfer from “any immediate or mediate transferee of such transferee.” Id. § 550(a)(2).} Where the transfer is a security interest, the secured creditor will lose his security interest in the property, and therefore, become an unsecured creditor.\footnote{See, e.g., Superior Bank v. Boyd (In re Lewis), 398 F.3d 735, 747 (6th Cir. 2005) (finding that the defendant-creditor was unable to evade avoidance of a mortgage on debtor’s real property).}

Section 547(b) explicitly governs which transfers the trustee may avoid.\footnote{Section 547(b) provides that: Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property-- (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made-- (A) on or within 90 days before the date of the filing of the petition; or (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and}
insolvent debtor to satisfy all or part of an antecedent debt within ninety days of a bankruptcy filing, which also enables a creditor to receive more than it would have under chapter 7, may be avoided. Granting a security interest in the debtor's property is considered a transfer. This look-back period begins once the debtor files a bankruptcy petition. Under the Code, a transfer of a security interest in real property "is perfected when a bona fide purchaser of such property from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interest of the transferee . . . ."

Realizing that a secured creditor may face potential problems if it did not record the security deed instantaneously, which may be impossible because of bureaucratic delays at the states' real-property recording offices, Congress enacted a grace period. If the security interest is perfected within this grace period, for the purposes of the bankruptcy proceeding, the date of the transfer of the security interest will relate back to when the lender issued credit to the debtor. This grace period has subsequently been extended to thirty days under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("2005 Amendments to the Code"). This section serves to protect a secured creditor who perfected within ninety days of the

(5) that enables such creditor to receive more than such creditor would receive if:

(A) the case were a case under chapter 7 of this title;
(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.


21 Section 547 allows any preferential transfer to an "insider" to be avoided for up to one year. Id. § 547(b)(4)(B). However, this Note focuses only on noninsiders, and thus, this provision will not be discussed.

22 See id. § 547(b).

23 See Chase Manhattan Mortgage Co. v. Shapiro (In re Lee), 530 F.3d 458, 474 (6th Cir. 2008) (holding that the recording of a new mortgage constituted a transfer).


26 See 11 U.S.C. § 547(e)(2) (2006); see also, e.g., Collins v. Greater Atl. Mortgage Corp. (In re Lazarus), 478 F.3d 12, 14 (1st Cir. 2007) (discussing the statutory requirements under the pre-2005 Amendments to the Code).


28 Id.; In re Lee, 530 F.3d at 465 n.2 ("BAPCPA increased the grace period from 10 days to 30 days.").
bankruptcy filing but issued the underlying credit outside of that ninety-day period. Traditionally, preferential transfers were viewed as transfers from a debtor to a favored or powerful creditor. However, this principle has been applied to avoid the security interest of lenders who refinance with a debtor outside the ninety-day period, but then record within the preference period as well as beyond the bounds of the grace period.

Although preferential transfers are voidable by the trustee, this power of avoidance is not based on fault—generally, the debtor’s or creditor’s motives for making the preferential transfer are of no importance in bankruptcy. Preference actions serve a dual purpose: (1) to prevent creditors from racing to the courthouse seeking legal protection as the debtor slides into bankruptcy, and (2) to achieve the goal of equal distribution to creditors in the same class.

Section 547(c) provides affirmative defenses to preference actions. In the case of a late-recording refinancing lender, the only statutory defense that the lender would be able to raise would be that the transfer constituted a “contemporaneous exchange.” Section 547(c)(1) provides that a transfer cannot be avoided if it was: (1) “intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange,” and (2) “in fact a substantially contemporaneous exchange.” Circuits are currently divided over whether to apply a bright-line

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30 See In re Lazarus, 478 F.3d at 14, 19. These mortgages were recorded after the grace period in § 547 that would have allowed them to relate back to the date of the original transfer. See Gold v. Interstate Fin. Corp. (In re Schmiel), 319 B.R. 520, 525 (Bankr. E.D. Mich. 2005) (discussing a ninety-six day delay in recording a home mortgage from the date of closing); see also infra Part II.B.
32 See G.H. Leidenheimer Baking Co. v. Sharp (In re SGSM Acquisition Co.), 439 F.3d 233, 238 (5th Cir. 2006) (discussing the intended advantages of preference actions).
34 Id. § 547(c)(1)(B).
35 Id. § 547(c)(1).
approach, requiring that the transaction occur within the thirty-day grace period found in § 547(e) or whether to take a flexible approach and look at the totality of the circumstances.

There are also applicable three common law defenses beyond the statutory defenses found within § 547(c). There is currently a circuit split over whether these lenders should be protected by the earmarking doctrine. Moreover, circuits are split over how to apply the state law doctrines, which vary depending on the state, of equitable subrogation and inquiry notice.

“The earmarking doctrine applies whenever a third party transfers property to a designated creditor of the debtor for the agreed-upon purpose of paying that creditor.” Although the circuits agree that the doctrine is available, the split arises over whether to view the refinancing process as (1) a single transaction comprised of multiple parts, or (2) a series of multiple transactions.

Equitable subrogation, a state law doctrine, allows the refinancing lender who paid off the prior mortgage to be subrogated to the prior mortgage holder’s properly perfected lien. Thus, under equitable principles, the refinancing lender may assert the prior lender’s status and priority. Some circuits

36 See, e.g., Collins v. Greater Atl. Mortgage Corp. (In re Lazarus), 478 F.3d 12, 17–18 (1st Cir. 2007).
37 See, e.g., Gordon v. Novastar Mortgage, Inc. (In re Hedrick), 524 F.3d 1175, 1187 (11th Cir. 2008), modified and reh’g denied, 529 F.3d 1026 (11th Cir. 2008), cert. denied, 129 S. Ct. 631 (2008); Lindquist v. Dorholt (In re Dorholt, Inc.), 224 F.3d 871, 874 (8th Cir. 2000); Dye v. Rivera (In re Marino), 193 B.R. 907, 915–16 (B.A.P. 9th Cir. 1996), aff’d 117 F.3d 1425 (9th Cir. 1997).
38 See Chase Manhattan Mortgage Corp. v. Shapiro (In re Lee), 530 F.3d 458, 468 (6th Cir. 2008); see also Dan Schechter, Refinancing Lender That Refinances Its Own Mortgage Cannot Invoke Earmarking Defense to Preference Liability (In re Lee (6th Cir.)), COM. FIN. NEWSL., July 7, 2008 (critiquing the application of the earmarking doctrine in In re Lee).
39 See In re Hedrick, 524 F.3d at 1181–82; see also Dan Schechter, Belated Recording of Refinancing Mortgage Is Not Preferential Because Lien Relates Back to Prior Mortgage Due to Equitable Subrogation; “Substantially Contemporaneous” Defense Requires Consideration of Circumstances Surrounding Delayed Perfection (In re Hedrick (11th Cir.)), COM. FIN. NEWSL., May 5, 2008 [hereinafter Schechter, Equitable Subrogation] (critiquing the application of equitable subrogation in In re Hedrick).
40 In re Hedrick, 524 F.3d at 1183.
41 In re Lee, 530 F.3d at 468.
42 Id. at 468–69. The applicability of the earmarking doctrine depends on this distinction. See infra Part II.
43 See Schechter, Equitable Subrogation, supra note 39.
44 See In re Hedrick, 524 F.3d at 1182.
have declined to apply this defense because these refinancing lenders are both (1) barred under state law because they are mere volunteers who do not have a legal or equitable duty to refinance the debt and (2) are sophisticated institutions that are aware of the Code’s requirements.45

Inquiry notice, also a state law doctrine, provides another possible way for a refinancing lender to prevent its mortgage from being avoided. Inquiry notice “imputes knowledge of an earlier interest to a later purchaser of an interest in land whenever there is ‘[a]ny circumstance which would place a man of ordinary prudence fully upon his guard, and induce serious inquiry.’”46 This imputed knowledge prevents a hypothetical purchaser from obtaining bona fide status.47 Therefore, for the purposes of bankruptcy, the mortgage would always be perfected and would not constitute a preference.48

This Note asserts that Congress should amend the Code to include an express statutory defense exempting home refinancing from preference actions. Part I of this Note discusses the “contemporaneous exchange” affirmative defense codified within § 547(c)(1). Part II of this Note discusses the current circuit split over whether the earmarking doctrine, a judicially created defense, protects the security interest of a late-refinancing lender. Part II further discusses the history of bankruptcy courts, looking to substance of a transaction over its form. Part II advocates that the Eighth Circuit’s unitary transaction approach to the earmarking doctrine is more appropriate than the multiple transaction approach. Part III of this Note examines the doctrine of equitable subrogation as an alternative defense to a preference action. Part IV of this Note discusses the doctrine of inquiry notice and how it can protect late-perfecting mortgages. Part V of this Note proposes an amendment to § 547(c) that would provide an express affirmative defense to protect refinancing lenders against preference actions.

45 E.g., In re Lee, 530 F.3d at 473–74.
46 See In re Hedrick, 524 F.3d at 1183 (quoting Page v. Will McKnight Constr., Inc., 639 S.E.2d 381, 383 (Ga. Ct. App. 2006)).
47 See Id.
I. CONTEMPORANEOUS EXCHANGES AS A DEFENSE TO PREFERENCE ACTIONS

Section 547(c) provides statutory defenses to preference actions.\textsuperscript{49} The only statutory defense that the new creditor in a

\begin{quote}
\textsuperscript{49} The trustee may not avoid under this section a transfer--
(1) to the extent that such transfer was--
\begin{itemize}
\item (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
\item (B) in fact a substantially contemporaneous exchange;
\end{itemize}
(2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was--
\begin{itemize}
\item (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
\item (B) made according to ordinary business terms;
\end{itemize}
(3) that creates a security interest in property acquired by the debtor--
\begin{itemize}
\item (A) to the extent such security interest secures new value that was--
\begin{itemize}
\item (i) given at or after the signing of a security agreement that contains a description of such property as collateral;
\item (ii) given by or on behalf of the secured party under such agreement;
\item (iii) given to enable the debtor to acquire such property; and
\item (iv) in fact used by the debtor to acquire such property; and
\end{itemize}
\item (B) that is perfected on or before 30 days after the debtor receives possession of such property;
\end{itemize}
(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor--
\begin{itemize}
\item (A) not secured by an otherwise unavoidable security interest; and
\item (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;
\end{itemize}
(5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of--
\begin{itemize}
\item (A)
\begin{itemize}
\item (i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or
\item (ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; or
\end{itemize}
\item (B) the date on which new value was first given under the security agreement creating such security interest;
\end{itemize}
(6) that is the fixing of a statutory lien that is not avoidable under section 545 of this title;
(7) to the extent such transfer was a bona fide payment of a debt for a domestic support obligation;
\end{quote}
home refinancing could plausibly raise is that the transfer was a “contemporaneous exchange.” If the new creditor can establish this defense, the mortgage cannot be avoided. Under the Code, a transfer may not be avoided if it was “intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor” and was “in fact a substantially contemporaneous exchange.” While the circuits recognize this statutory defense, they have disagreed over the meaning of “substantially contemporaneous.” This split, however, has become less meaningful because of subsequent extensions to the grace period under the 2005 Amendments to the Code.

The main disagreement over this section’s applicability is the length of time a creditor can wait to record its mortgage and still have it qualify as a substantially contemporaneous transfer. There are two interpretations of how long of a delay in recording can still constitute a substantially contemporaneous exchange:

(8) if, in a case filed by an individual debtor whose debts are primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than $600; or
(9) if, in a case filed by a debtor whose debts are not primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than $5,475.

Id. § 547(c).

See id. Although this Note does not take this position, it has been argued that “§ 547(c)(1) codifies and therefore abolishes earmarking.” David Gray Carlson & William H. Widen, The Earmarking Defense to Voidable Preference Liability: A Reconceptualization, 73 AM. BANKR. L.J. 591, 592 (1999). Even assuming that this argument is still viable, which is not clear, “[i]t is certainly easier to find that an 11 day gap is substantially contemporaneous than a 35 day gap.” E-mail from David Gray Carlson, Professor of Law, Benjamin N. Cardozo School of Law, to author (Oct. 10, 2008, 2:16 PM EDT) (on file with author) (arguing that this conception of the earmarking doctrine is still valid).

See 11 U.S.C. § 547(c)(1). The other defenses listed in § 547(c) are not applicable to the single-shot transfer of a mortgage to a consumer.

Id.

(1) a strict requirement that corresponds to the recording grace period under § 547(e), and (2) a flexible approach that can extend beyond the grace period.55

The First Circuit, which supports a strict requirement, has cautioned that “the seeming flexibility [of § 547(c)(1)] is deceptive.”56 One rationale for applying this strict application is that not doing so would open a “Pandora’s box of evils” by inviting litigation to determine whether a transaction is a substantially contemporaneous exchange.57 A second rationale is that “[i]n statutory construction, the more specific treatment prevails over the general.”58 The courts argue that by not examining each case individually, they are “protect[ing] against undermin[ing] limitations created by a more specific provision”59 even though Congress chose not to enact a requirement. However, this argument ignores the fact that Congress could have chosen to write a bright-line rule, yet it chose instead to use the contemporaneous exchange test. Finally, proponents of the strict approach argue that reading the statute to require a period is in accordance with the congressional intent of the contemporaneous exchange affirmative defense to preference actions: Congress wanted to ensure that a party on the verge of bankruptcy would still be able to continue buying goods using checks, which take longer to clear, without sellers fearing the possibility of losing the payment as a preference if the party later files for bankruptcy.60 Section 547(c)(1) was designed to prevent these transactions from being considered avoidable preferences.61 By contrast, proponents of the strict approach argue that Congress’s concern

54 See, e.g., Collins v. Greater Atl. Mortgage Corp. (In re Lazarus), 478 F.3d 12, 17–18 (1st Cir. 2007).
56 In re Lazarus, 478 F.3d at 17.
58 In re Lazarus, 478 F.3d at 18; In re Arnett, 731 F.2d at 363.
59 In re Lazarus, 478 F.3d at 18.
60 Id. at 19 (quoting Varity Corp. v. Howe, 516 U.S. 489, 511 (1996)).
61 Id. at 18; In re Arnett, 731 F.2d at 363.
63 See In re Lazarus, 478 F.3d at 18; see also H.R. REP. NO. 95-595, at 373–74 (1977).
with § 547(e) was “getting the mortgage recorded within a reasonably brief and predefined period” and not whether the exchange was simultaneous.64

Other circuits have rejected this strict approach, instead adopting a flexible case-by-case analysis.65 These courts have relied on a plain language approach to statutory interpretation.66 They argue that the existence of bright-line rules in other parts of the Code,67 coupled with the lack of a bright-line rule in § 547(c)(1), illustrates that while Congress could have enacted a strict time rule, it chose not to do so.68 This leads to the conclusion that Congress specifically intended a flexible rule. “Instead of applying the strict [time] limit enumerated in § 547(e)(2), an inquiry into the facts and circumstances of the particular transaction should be made to determine whether a transfer was substantially contemporaneous in fact.”69 Courts consider: (1) the length of the delay, (2) the cause of the delay, and (3) the motivations for the delay.70

64 In re Lazarus, 478 F.3d at 18 (emphasis omitted).
65 See, e.g., Gordon v. Novastar Mortgage, Inc. (In re Hedrick), 524 F.3d 1175, 1187 (11th Cir. 2008), modified and rehe’d denied, 529 F.3d 1026 (11th Cir. 2008); cert. denied, 129 S. Ct. 631 (2008); Lindquist v. Dorholt, Inc. (In re Dorholt, Inc.), 224 F.3d 871, 874 (8th Cir. 2000); Dye v. Rivera (In re Marino), 193 B.R. 907, 915 (BA.P. 9th Cir. 1996), aff’d, 117 F.3d 1425 (9th Cir. 1997).
66 See In re Hedrick, 524 F.3d at 1186 (“We have no license to assume that Congress did not mean what it said in § 547(c)(1)(B), but we are instead bound to assume that it meant exactly what it said.”); In re Dorholt, Inc., 224 F.3d at 874 (“[T]he plain language of the statute is at odds with the trustee’s bright-line test.”).
68 See In re Hedrick, 524 F.3d at 1187; In re Dorholt, Inc., 224 F.3d at 874.
69 In re Marino, 193 B.R. at 916.
70 In re Hedrick, 524 F.3d at 1190. In re Hedrick involved two cases heard together on appeal. Id. at 1178. The Sharma case illustrated this argument. Sharma—the debtor—and Gupta—a nondebtor who co-owned the home—refinanced the home mortgage with ABN Amro Mortgage Group, Inc. (“ABN”) on May 20, 2003. Id. at 1184. On May 27, 2003, ABN sent checks to Union Planters Bank to cover Sharma’s outstanding balance and to Atlantic States Bank to cover Gupta’s debt. Id. The parties agreed that the earliest the checks could have arrived was on May 28, 2003, which was the date that ABN sent the mortgage to the Register’s office to be recorded. Id. The mortgage was recorded on June 10, 2003. Sharma and her husband filed for a joint chapter 7 petition for bankruptcy on June 18, 2003. Id. at 1184–85. “The county clerk recorded the cancellation of the Union Planters and Atlantic deeds to secure debt on the Sharma home on June 23 and 26, 2003, respectively.” Id. at 1185.

The trustee sought to avoid ABN’s mortgage as preferential transfer under § 547(b). Id. While the trustee did not disagree that the transfer was “intended to be [a] contemporaneous exchange [] for new value given to the debtor,” he argued that it
The Eleventh Circuit stated that § 547(c)(1) and § 547(e)(2) serve two distinct purposes.\(^{71}\) "Section 547(e)(2)(A)’s purpose is to move some transfers that occur within the ninety-day preference avoidance period and would otherwise be avoidable outside of that period."\(^{72}\) "By contrast, § 547(c)(1) does not fix or move the date the transfer of an interest was made."\(^{73}\) The Eleventh Circuit argued that if the two requirements of § 547(e)(1)—first, the transfer was intended “to be a contemporaneous exchange for new value given to the debtor,” and second, was “in fact a substantially contemporaneous exchange”—are met, then it serves to not only relate the transfer back to a date outside of the ninety-day avoidance period of § 547(b), but it also protects transfers that are made within ninety days of bankruptcy.\(^{74}\)

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71 Id. at 1188–89.
72 Id. at 1189. ("The transfers it applies to are those that take place within eighty to ninety days before the petition is filed, provided that they are perfected within ten days.").
73 Id.
74 Id. ("If both of § 547(c)(1)’s conditions are met, the trustee may not avoid the transfer even if it was perfected more than ten days after the exchange and even if it occurred within ninety days, or nine days, or one day, of the filing of the bankruptcy petition.").
Although this split exists, Congress, through the 2005 Amendments, expanded the ten-day period of § 547(e)(2) to thirty days, which make this split less relevant. While a bank could easily argue, and a court could agree, that a fourteen-day period between closing a loan and recording a mortgage is substantially contemporaneous, it is now much harder to make the argument that a mortgage that was recorded over thirty days after the closing constitutes a contemporaneous exchange. Moreover, an argument by a lender that delayed recording (or even delivering) of its mortgage by several months constituted a contemporaneous exchange probably would not even pass the "blush test." However, because of the delays at some recording offices, banks that file their deeds in a timely manner may still not be able to record within thirty days, and thus, may still be able to make a contemporaneous exchange argument. Notwithstanding the uncertainty of the applicability of § 547(c)(1) under the new Code, there are other common law defenses that a late recording lender can assert: the "earmarking doctrine," "equitable subrogation," and "inquiry notice."

II. THE EARMARKING DOCTRINE: A JUDICIALLY CREATED DEFENSE IN PREFERENCE ACTIONS

Courts have created a common law preference action defense, beyond the statutory protections of § 547, for third parties who refinance an antecedent debt owed by the debtor. 


76 See Lindquist v. Dorholt (In re Dorholt, Inc.), 224 F.3d 871, 874 (holding that a mortgage was a contemporaneous exchange even though it was recorded sixteen days after the closing); but see Collins v. Greater Atl. Mortgage Corp. (In re Lazarus), 478 F.3d 12, 17–18 (1st Cir. 2007) (holding that a recording of a mortgage was not a contemporaneous exchange because of the fourteen-day delay in recording). However, it is also possible that a mortgage recorded within the thirty-day period of § 547(e)(2) would not constitute a contemporaneous exchange.

77 The "blush test" is simple: If, in making an argument, the lawyer can look the judge in the eye and not blush, then at least the argument doesn't seem outrageous to the lawyer. Of course, it could also be true that the lawyer herself isn't blushing because she has no shame. The "blush test" is not infallible. Still, it's not bad.


79 See 5 COLLIER, supra note 15, ¶ 547.03[2] (discussing the "earmarking doctrine" as a defense to preference actions).
The “earmarking doctrine” applies “where the borrowed funds have been specifically earmarked by the lender for payment to a designated creditor, [courts have held that there is] no transfer of property of the debtor even if the funds pass through the debtor’s hands in getting to the selected creditor.” The refinancing party, in order for the doctrine to apply, must prove that: (1) there was an agreement between the debtor and a new creditor that the funds would be used to pay a specific antecedent debt, (2) the parties performed the agreement according to its terms, and (3) the transaction made according to this agreement did not result in a diminution of the debtor’s estate.

Bankruptcy courts widely accept the earmarking doctrine defense against a preference claim, “primarily because the assets from the third party were never in the control of the debtor, and therefore, payment of these assets to a creditor in no way diminishes the debtor’s estate.” As a result, a transfer to the creditor that would have otherwise been a preference will not be avoidable by the trustee.

However, there is a circuit split over whether the “‘earmarking’ doctrine... protect[s] creditors whose otherwise voidable late perfected security interest replaces the secured claim of a previous creditor.” This problem is exemplified by the following hypothetical circumstance:

Bridgett and William Morrison owned a home in Fake Town, Michigan. Bank A held a mortgage against this home. The Morrisons refinanced the mortgage with Bank B on April 25, 2006, in an effort to lower their monthly mortgage payments. The new mortgage was granted to Bank B to secure the payment of $151,945. On April 30, 2006, Craig Jones, an employee of Acme Title Company, delivered the mortgage to the Imaginary County Register of Deeds. That same day, the title company wire transferred money to pay off the Bank A mortgage. Despite the fact that the new mortgage was delivered to Imaginary County Register on April 30, 2006, it

80 Chase Manhattan Mortgage Corp. v. Shapiro (In re Lee), 530 F.3d 458, 467 (6th Cir. 2008).
82 Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351, 1356 (5th Cir. 1986).
83 5 COLLIER, supra note 15, ¶ 547.03[2] (noting the “harsh effect of section 547”).
was not recorded until July 30, 2006, ninety-six days after the April 25, 2006 closing. This delay resulted from overall delays in recording at the Register. The Morrmors filed their chapter 7 bankruptcy petition on September 26, 2006, sixty-two days after the mortgage. The chapter 7 trustee brought an action under § 547(b) to avoid the mortgage as a preferential transfer because it was within ninety days of bankruptcy and would allow Bank B to be paid in full as a secured creditor rather than sharing the proceeds with the general unsecured creditors.\footnote{This hypothetical is based on the facts set forth in Gold v. Interstate Financial Corp. (In re Schmiel), 319 B.R. 520, 522 (Bankr. E.D. Mich. 2005), and will be used to illustrate the different results throughout this Note. The dates have been changed to allow the illustrations to reflect the thirty-day grace period enacted in the 2005 Amendments to the Code.}

Bank B's ability to use the earmarking doctrine in this situation depends on whether the refinancing is viewed as either a unitary transaction or as a transaction of multiple parts.\footnote{See In re Lee, 530 F.3d at 468 (“[C]ourts have split over whether to characterize the refinancing as a single unitary transaction or as a number of parts.”).}

A. The Unitary Transfer Approach to Refinancing Transactions Under the Earmarking Doctrine

When the Eighth Circuit adopted the unitary approach, it went in a "new direction," allowing a refinancing lender to successfully assert the earmarking doctrine when the lender failed to perfect within the statutory period of § 547(e).\footnote{See Kaler v. Cmty. First Nat'l Bank (In re Heitkamp), 137 F.3d 1087, 1089 (8th Cir. 1998); 5 COLLIER, supra note 15, ¶ 547.03[2]. In Heitkamp, the debtors started building a home with a loan from a bank and credit from a subcontractor but ran out of money during the construction. 137 F.3d at 1088. The debtors borrowed more money from the bank to pay their outstanding balance to the subcontractors. Id. As part of the new loan agreement, the bank issued a cashier's check to the subcontractors in exchange for a mechanic's lien waiver from the subcontractors and a second mortgage against the home. Id. Due to an oversight, the bank did not record the new mortgage for five months. Id. The debtors filed a chapter 7 bankruptcy petition three days after the mortgage recording, causing the recording to fall well within the statutory period of § 547. Id. The bankruptcy trustee sought to avoid the second mortgage as a preferential transfer of the debtors' property under § 547(b). Kaler v. Cmty. First Nat'l Bank (In re Heitkamp), Nos. 96-30260, 96-7035, 1996 WL 33366965, at *3 (Bankr. D.N.D. Dec. 10, 1996), rev'd, 137 F.3d 1087, (8th Cir. 1998); see 11 U.S.C. § 547(b) (1994). The bankruptcy court rejected the bank's earmarking defense and set aside the second mortgage as an avoidable preference. In re Heitkamp, 1996 WL 33366965, at *3-4. The district court affirmed the bankruptcy court's decision. In re Heitkamp, 137 F.3d at 1088.} Under
the unitary transfer theory of refinancing, the refinancing is viewed in its entirety as a single transaction, consisting of multiple steps.\textsuperscript{87} Courts treat the payment to the creditor for the antecedent debt and the granting of the security interest as “two sides of the same coin.”\textsuperscript{88} As one court correctly noted, “[t]o view it any other way would be to elevate form over substance.”\textsuperscript{89} Viewing the refinancing as a single transaction consisting of multiple parts, the trustee would be unable to avoid Bank B’s mortgage on the Morrisons’ home.

Under this approach, all of the elements of the earmarking doctrine are met: (1) Bank B and the Morrissons agreed that the secured funds would be used to pay specific preexisting debts, (2) the agreement was performed according to its terms, and (3) there was no diminution in the Morrissons’ bankruptcy estate.\textsuperscript{90} In applying earmarking, the essence of the refinancing would be such that Bank B was merely replacing Bank A’s security interest—the original mortgage—with its own security interest: the second mortgage.\textsuperscript{91} Because the transfer of funds from Bank B to Bank A and the Morrisons granting Bank B a new mortgage are considered two parts of the same transaction, the transfer of the mortgage interest did not diminish the

The Eighth Circuit reversed the lower court’s decision holding that the bank’s second mortgage was protected by the earmarking doctrine. \textit{Id.} at 1088. The court noted that “[t]he bank and the [debtors] agreed the secured funds would be used to pay specific preexisting debts, the agreement was performed, and the transfer of the mortgage interest did not diminish the amount available for distribution to the [debtors’] creditors.” \textit{Id.} at 1089. In applying earmarking, the court reasoned that the essence of the transaction was such that the bank was merely replacing the subcontractors’ security interest—the mechanic’s lien—with its own security interest—the second mortgage. \textit{Id.} The court dismissed the argument that recognizing the security would be unfair to the unsecured creditors. \textit{Id.} (“In these circumstances, recognition of the bank’s security interest does not give the bank an unfair advantage over other creditors.”). Although \textit{Heitkamp} involved a case where the original security interest was a mechanic’s lien, this unitary approach has been applied to refinancing transactions. \textit{See, e.g.}, George v. Argent Mortgage Co. (\textit{In re Radbil}), 364 B.R. 355, 359 (Bankr. E.D. Wis. 2007).


\textsuperscript{88} \textit{Id.}

\textsuperscript{89} \textit{Id.}

\textsuperscript{90} \textit{See In re Heitkamp}, 137 F.3d at 1089; \textit{see also} McCuskey v. Nat’l Bank of Waterloo (\textit{In re Bohlen Enters., Ltd.}), 859 F.2d 561, 565 (8th Cir. 1988).

\textsuperscript{91} \textit{See In re Heitkamp}, 137 F.3d at 1089.
amount available for distribution to the Morrisons’ creditors. The court would properly deny the trustee’s preference action, recognizing that allowing the security would not be unfair to the unsecured creditors because they never had any expectation of receiving the proceeds from the sale of the home, unless there was equity above and beyond the homestead exemption. Given that this is a judicially created doctrine, it is unclear why the Eighth Circuit tried to fit refinancing transactions into a preexisting view of earmarking, rather than simply expanding on this doctrine.

B. The Multiple Transaction Approach to Refinancing Transactions Under the Earmarking Doctrine

Although the Eighth Circuit’s unitary approach examines the substance of the refinancing transaction instead of its form, other circuits have decided to take a more mechanical approach that focuses on the form of the refinancing transaction instead of its substance. The unitary transfer approach has been criticized as outside the scope of the earmarking doctrine. Under the multiple transaction approach, “a [re]financing transaction involves [essentially two] distinct transfers”: (1) the payment by the new creditor for the antecedent debt, and (2) the debtor granting the new creditor a security interest in the debtor’s property.

Under this theory, if the mortgage recordation occurs within ninety days of the bankruptcy petition and outside thirty days of the transfer of funds, then the

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93 In re Heitkamp, 137 F.3d at 1089. (“In these circumstances, recognition of the bank’s security interest does not give the bank an unfair advantage over other creditors.”).
94 E.g., Chase Manhattan Mortgage Corp. v. Shapiro (In re Lee), 530 F.3d 458 (6th Cir. 2008); Collins v. Greater Atl. Mortgage Corp. (In re Lazarus), 478 F.3d 12 (1st Cir. 2007).
95 5 COLLIER, supra note 15, ¶ 547.03[2] (“This unwarranted extension [of the earmarking doctrine] has wisely been rejected by several courts.”).
96 In re Lee, 530 F.3d at 469. There are other steps involved in a refinancing including “a pre-arranged use of the proceeds of the loan to pay off the old loan and the release of the old mortgage.” In re Lazarus, 478 F.3d at 16.
97 This application to the Morrisons’ hypothetical assumes that the creditor cannot assert any of the other statutory defenses of § 547. See 11 U.S.C. § 547.
mortgage constitutes a voidable preferential transfer.98 As such, the trustee could avoid Bank B’s mortgage on the Morrisons’ home in bankruptcy.99

Courts have rejected the unitary approach, stating that it ignored “the plain language of section 547(b) in the case of a belatedly-perfected transfer of a security interest.”100 A court following the multiple transfer approach would still agree that the first two elements of the earmarking doctrine are met: (1) Bank B and the Morrisons agreed that the secured funds would be used to pay specific preexisting debts, and (2) the agreement was performed according to its terms.101 Under the multiple transfers approach, the Morrisons “made a new mortgage in favor of [Bank B]” and “[t]hen, when [Bank B] paid off [Bank A’s] loan, the latter released its own mortgage.”102 Applying a plain language approach, the court would reason that this new mortgage, which was outside the thirty-day grace period, constituted a voidable preferential transfer.103 Applying Lazarus, “the earmarking concept does not provide [Bank B] an escape from the plain language of section 547(b) in the case of a belatedly-perfected transfer of a security interest.”104 Thus, following the multiple transfer approach, the trustee would be able to avoid Bank B’s mortgage on the Morrisons’ home.105

This multiple transaction approach to applying earmarking to refinancing transactions has been adopted by more than one circuit.106 While these courts are unwilling to allow a new refinancing lender to assert earmarking, courts have gone further to totally bar the defense when the new lender and old lender are the same entity, as in the Lee case.107

98 In re Lee, 530 F.3d at 472.
99 See id.
100 In re Lazarus, 478 F.3d at 16; see also In re Lee, 530 F.3d at 470–71.
101 See In re Lee, 530 F.3d at 470; see also McCuskey v. Nat’l Bank of Waterloo (In re Bohlen Enters., Ltd.), 859 F.2d 561, 565 (8th Cir. 1988).
102 In re Lazarus, 478 F.3d at 16 (emphasis in original).
103 Id. (“The debtor did not act merely as a bailee with the mortgage passing through her hands from [the old lender] to [the new lender].”).
104 See id. The First Circuit criticized the unitary approach, saying that it “amounts to ignoring the statutory language.” Id.
105 In re Lee, 530 F.3d at 472; In re Lazarus, 478 F.3d at 16.
106 In re Lee, 530 F.3d at 470; In re Lazarus, 478 F.3d at 15–16.
107 In re Lee, 530 F.3d at 470.
In *Lee*, the Sixth Circuit also rejected the unitary transaction approach as “ignor[ing] the plain meaning of the Bankruptcy Code.”108 The Sixth Circuit declined to extend the earmarking doctrine because Chase was not a new lender.109 This conclusion relied on the court’s reading of *McCuskey v. National Bank of Waterloo (In re Bohlen Enters., Ltd.)*.110 However, the Bohlen court stated that “[i]n every earmarking situation there are three necessary *dramatis personae*. They are the ‘old creditor’, (the pre-existing creditor who is paid off within the 90-day period prior to bankruptcy), the ‘new creditor’ or ‘new lender’ who supplies the funds to pay off the old creditor, and the debtor.”111 The Sixth Circuit’s construction of *dramatis personae* fails to perceive the situation where a single actor plays more than one role.112 In this case, Chase simultaneously played the role of the old creditor and the new creditor.113 Moreover, if a new bank that refines a loan can be protected by earmarking because it does not lead to a diminution of the estate, it follows *a fortiori* that the original bank that made the original loan should also be protected when the original bank refines that loan. However, the Sixth Circuit did not end its analysis there;114 the court stated that it would reject earmarking even if Chase was regarded as a new lender.115

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108 Id. at 470.
109 Id.; see also *McCuskey v. Nat’l Bank of Waterloo (In re Bohlen Enters., Ltd.)*, 859 F.2d 561, 565 (8th Cir. 1988) (stating the rule for earmarking).
110 In re Lee, 530 F.3d at 470.
111 In re Bohlen Enterprs., Ltd., 859 F.2d at 565.
112 For example, see DR. STRANGELOVE OR: HOW I LEARNED TO STOP WORRYING AND LOVE THE BOMB (Columbia Pictures 1964), where Peter Sellers played the roles of Group Captain Lionel Mandrake, President Merkin Muffley, and Dr. Strangelove. For another example, see COMING TO AMERICA (Paramount Pictures 1988), where Eddie Murphy played the roles of Prince Akeem, Clarence, Randy Watson, and Saul. Finally, although NORBIT (DreamWorks 2007) provides a modern example of this principle, as Eddie Murphy again plays multiple roles, this author implores you not to actually see this movie.
113 See In re Lee, 520 F.3d at 460.
114 See id. at 470.
115 Id. (“Yet even if we were to deem Chase to be a new creditor, the earmarking doctrine would not shield it from preference liability under the circumstances of this case.”). The court explicitly rejected *Heitkamp’s* unitary transaction approach as being against the plain meaning of the Code. Id. (“The common theme in the Supreme Court’s bankruptcy jurisprudence over the past two decades is that courts must apply the plain meaning of the Code unless its literal application would produce a result demonstrably at odds with the intent of Congress.”).
C. The Appropriateness of the Unitary Approach to Refinancing

The Eighth Circuit’s unitary transaction approach allows the bankruptcy courts to encourage lending, while still working within the constraints of the Bankruptcy Code. It recognizes the true nature of refinancing, a borrower taking a secured loan in order to reduce his monthly payments on a current loan. On the other hand, proponents of the multiple transaction approach claim that treating the refinancing process as a single transaction with multiple parts violates the plain

Initially, the court noted “when the statute’s language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms.” Id. (quoting Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 6 (2000)) (quotations omitted). Relying on the definition of “transfer” in § 101(54) and § 547(e), the court concluded that the refinancing process consists of multiple individual transfers. Id. at 471. The court then rejected the use of earmarking to protect transfers of security interests. Id. Further, the court stated that “applying earmarking to the transfer of a lien interest—as opposed to a transfer of funds—extends the doctrine beyond its logical limits. A debtor’s grant of a mortgage lien in a refinancing transaction does not involve a transfer of ‘earmarked’ property.” Id. It is unclear why the court took such a formalistic stance, especially given that earmarking is a judicially created doctrine.

Next, the court found that earmarking was not applicable because the refinancing resulted in a diminution of the bankruptcy estate. Id. at 472. The court reasoned that the recording of the new mortgage encumbered nonexempt property that otherwise would have been available to the unsecured creditors. Id. The court, however, ignored the fact that the unsecured creditors received the same amount, if not more, that they would have had the Lees never refinanced.

Finally, the court said that allowing Chase to use earmarking to insulate itself would encourage creditors to create secret liens. See id. (“By enacting § 547(e) and establishing a definite and firm 10-day time period for lien perfection (now expanded to 30 days by BAPCPA), Congress sought to promote the Bankruptcy Code’s policy of discouraging secret liens on property of the estate.”). Another court stated:

By contrast, section 547(e)’s 10-day limit is directed specifically to mortgages and applies even if the loan and mortgage are exchanged simultaneously. Congress’ concern, therefore, was not with whether the exchange was simultaneous or nearly so, but with getting the mortgage recorded within a reasonably brief and predefined period. The aim was to combat secret liens and protect those who might lend in ignorance of the mortgage.

Collins v. Greater Atl. Mortgage Corp. (In re Lazarus), 478 F.3d 12, 18 (1st Cir. 2007). For additional authority, see Ray v. Sec. Mut. Fin. Corp. (In re Arnett), 731 F.2d 358, 363 (6th Cir. 1984) (“One of the principal purposes of the Bankruptcy Reform Act is to discourage the creation of ‘secret liens’ by invalidating all transfers occurring within 90 days prior to the filing of the petitions.”). Given that there was always a mortgage of record, this secret-lien analysis appears to be obtuse.

See, e.g., In re Lee, 530 F.3d at 462 (noting that the debtor’s monthly payments were reduced by about four hundred dollars).
meaning of the Bankruptcy Code. This, however, depends on how you view a mortgage-backed refinancing loan. The First and Sixth Circuit take an overly formalistic approach.

Legally, a mortgage is “[a] conveyance of title to property that is given as security for the payment of a debt or the performance of a duty and that will become void upon payment or performance according to the stipulated terms.” In the refinancing setting, the debt that the debtor secures is the new lender’s loan that pays the debtor’s antecedent debt. This ignores the everyday reality of the common conception of a mortgage—that it is a secured loan to purchase a house. Generally, in these refinancing transactions, the parties are looking simply to exchange one more expensive secured loan for another less expensive secured loan. Therefore, the parties to home refinancing agreements intend that these loans be secured by a mortgage.

By treating the refinancing process as one transaction instead of multiple transactions, the bankruptcy courts are following their well-established doctrine of elevating substance over form. The Eighth Circuit’s unitary approach follows the leading thought in fraudulent conveyance cases. It recognizes that the parties intended for the “new creditor [to] merely step[] into the shoes of [the] old creditor.” In applying the

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117 See, e.g., In re Lazarus, 478 F.3d at 16.
118 BLACK’S LAW DICTIONARY 1031–32 (8th ed. 2004). By granting a first mortgage, a debtor is transferring one of many rights in his real property. See Wesley Newcomb Hohfeld, Fundamental Legal Conceptions as Applied in Judicial Reasoning, 26 YALE L.J. 710, 723 (1916) [hereinafter Hohfeld I]; Wesley Newcomb Hohfeld, Some Fundamental Legal Conceptions as Applied in Judicial Reasoning, 23 YALE L.J. 16, 22–23 (1913) [hereinafter Hohfeld II]. Therefore, a refinancing debtor could not effectively grant a second “first mortgage” because he no longer possesses that right to his real property. See supra Hohfeld I; supra Hohfeld II. Theoretically, this leads to the conclusion that there has been no actual transfer, and thus, no preference. See The Bankruptcy Abuse Prevention and Consumer Protection Act, 11 U.S.C., § 547(b) (2006) (requiring a “transfer of an interest of the debtor in property”). Since this argument has yet to be raised, its viability is uncertain.
119 See In re Lazarus, 478 F.3d at 13.
120 See Bailout Plan Is Far from the End of Nation’s Debt Crisis, USA TODAY, Sept. 25, 2008, at 11A (“With people unable to get mortgages ... home prices will fall.”) (emphasis added).
121 This assumes that the debtor is not incurring new debt by taking out a larger refinancing loan than what is owed under the old loan.
122 See infra notes 132–134 and accompanying text.
123 Kaler v. Cmty. First Nat’l Bank (In re Heitkamp), 137 F.3d 1087, 1089 (8th Cir. 1998).
earmarking doctrine, the unitary transfer approach follows the parties’ intent and “collapses” the refinancing transactions to conform to that intent.\(^\text{124}\) Courts should adopt the unitary approach because it (1) does not lead to a meaningful diminution of the bankruptcy estate, (2) recognizes the intent of the parties, and (3) follows the bankruptcy principle of elevating substance over form.

1. Lack of Any Meaningful Diminution of the Bankruptcy Estate

Applying the unitary approach, by collapsing the refinancing transaction, prevents the absurd disposition\(^\text{125}\) of avoiding the refinancing lender’s mortgage.\(^\text{126}\) Using the multiple transaction approach’s formalistic view, which allows the new lender to evoke the earmarking doctrine to protect the security interest in the home, will result in a diminution of the bankruptcy estate “because the non-exempt equity in the [home] that otherwise would have been available for distribution to [debtor’s] unsecured creditors became encumbered, and unavailable to unsecured creditors . . .”\(^\text{127}\) Proponents of this approach assert that this result is consistent with § 547(e)’s purpose of discouraging secret liens.\(^\text{128}\)

However, the multiple transaction approach ignores the common sense realities of the transaction. From a holistic standpoint, there has been no diminution of the estate because the debtor’s “assets and net obligations remained the same.”\(^\text{129}\) What is essentially happening in this situation is that the new creditor is taking over the old creditor’s security interest in the house.\(^\text{130}\) Arguably, the refinancing lender may be able to avoid this technical problem by actually taking over the old creditor’s security interest through an assignment of the mortgage. This

\(^{124}\) *Id.*; see also infra notes 135–156 and accompanying text.

\(^{125}\) *Contra* Chase Manhattan Mortgage Corp. v. Shapiro (*In re Lee*), 530 F.3d 458, 470 (6th Cir. 2008).

\(^{126}\) *In re Heitkamp*, 137 F.3d at 1089.

\(^{127}\) *In re Lee*, 530 F.3d at 472.

\(^{128}\) *Id.*; Collins v. Greater Atl. Mortgage Corp. (*In re Lazarus*), 478 F.3d 12, 18 (1st Cir. 2007).

\(^{129}\) *In re Heitkamp*, 137 F.3d at 1089.

\(^{130}\) *Id.*
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would seem to satisfy the First Circuit because, if the mortgage was assigned, then the debtor would be acting as bailee when passing the mortgage from one creditor to another.\textsuperscript{131}

2. The Unitary Approach Is Consistent with the Bankruptcy Principle of Elevating Substance over Form

Bankruptcy courts are courts of equity.\textsuperscript{132} When exercising these equitable powers, courts are often asked to examine the nature of transactions as they relate to the Bankruptcy Code. Courts in bankruptcy proceedings have a history of elevating “substance over form.”\textsuperscript{133} Through their substance/form analysis, the courts will examine a transaction to see what its true purpose was, not just focus on how it formally operates.\textsuperscript{134} The Eighth Circuit’s conceptualization of refinancing—collapsing the multiple transactions into one overarching transaction—is not unique in bankruptcy proceedings.

a. Letters of Credit: Collapsing Multiple Transfers into a Single Transaction

The Fifth Circuit has used this collapsing method in a preference action involving letters of credit.\textsuperscript{135} In \textit{Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)}, a business debtor

\textsuperscript{131} \textit{In re Lazarus}, 478 F.3d at 15.

\textsuperscript{132} \textit{See} Young v. United States, 535 U.S. 43, 50 (2002) (“[B]ankruptcy courts . . . are courts of equity.”); \textit{see also} Katchen v. Landy, 382 U.S. 323, 327 (1966) (“[B]ankruptcy courts are essentially courts of equity.”); \textit{but see} Edith H. Jones, \textit{The Bankruptcy Galaxy}, 50 S.C. L. Rev. 269, 270–71 (“Approaching bankruptcy from the standpoint of a law court instead of an equity court may, in my view, lead to a more even balance between debtors’ and creditors’ rights.”).

\textsuperscript{133} \textit{See}, e.g., \textit{In re Comdisco, Inc.}, 434 F.3d 963, 965 (7th Cir. 2006) (applying this substance over form analysis to a business transaction designed to minimize a corporation’s tax burden); Gaudet v. Babin (\textit{In re Zedda}), 103 F.3d 1195, 1203–04 (5th Cir. 1997) (“To achieve the equitable purpose of bankruptcy law . . . a trustee must look at the realities of the situation and examine the true nature of all transactions made on or within one year of the filing of the petition. Substance trumps form.”); \textit{In re Eastmare Dev. Corp.}, 150 B.R. 495, 501 (Bankr. D. Mass. 1993) (“Illinois land trusts are similar to the nominee trusts prevalent in Massachusetts. A line of cases from the Seventh Circuit elevate substance over form and hold that trust beneficiaries are the actual equitable owners of the trust res.”).

\textsuperscript{134} For a discussion of elevating substance over form in cross-default clauses cases, \textit{see} \textit{In re Sambo’s Restaurants, Inc.}, 24 B.R. 755 (Bankr. C.D. Cal. 1982); \textit{In re Wheeling-Pittsburgh Steel Corp.}, 54 B.R. 772 (Bankr. W.D. Pa. 1985); and \textit{In re Plitt Amusement Co. of Washington Inc.}, 233 B.R. 837 (Bankr. C.D. Cal. 1999).

\textsuperscript{135} \textit{Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)}, 831 F.2d 586, 595 (5th Cir. 1988), \textit{reh’g granted}, 835 F.2d 584 (5th Cir. 1988).
purchased oil from a supplier on credit but failed to make a timely payment. The debtor then induced a bank to issue an irrevocable standby letter of credit to the supplier for the antecedent debt. The terms of the letter of credit called for the supplier to be paid in full if the debtor failed to pay its balance within approximately a month and a half. The letter of credit did not need a security agreement because the bank and the debtor had a previous security agreement that covered all future advances.

A customer who benefits from the provision of goods or services most commonly arranges letters of credit. "The [customer] will request a bank to issue a letter of credit which names the [supplier] as the beneficiary. Under a standby letter of credit, the bank becomes primarily liable to the beneficiary upon the [customer's failure] to pay for the goods or services." The independence principle dictates that the bank's obligation to pay the supplier is independent from any obligation between the customer and the supplier. "It is well established that a letter of credit and the proceeds therefrom are not property of the debtor's estate under 11 U.S.C. § 541." When a bank honors the letter of credit, it is using its own assets, and not those of the debtor, to pay the beneficiary. Thus, the trustee cannot avoid the payments because it is not a transfer of the debtor's property.

However, the Fifth Circuit went beyond the form of the transaction—a non-avoidable letter of credit—and examined its substance. The court noted that the "letter of credit in this case did not serve its usual function of backing up a contemporaneous

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136 Id. at 588–89.
137 Id. at 589.
138 Id.
139 Id.
140 Id. at 590.
141 Id.
143 In re Compton Corp., 831 F.2d at 589.
144 It is a threshold requirement of § 547(b) that the payment is a transfer of the debtor's property. See Bankruptcy Abuse Prevention and Consumer Protection Act, 11 U.S.C. §§ 547–548 (2006); see also In re Compton Corp., 831 F.2d at 589–90.
credit decision but instead served as a back up payment guarantee on an extension of credit already in jeopardy. The letter of credit was issued to pay off an antecedent unsecured debt. Because the debtor pledged his assets to secure this letter, it became a transfer of the debtor's property. The trustee could not avoid the bank's security interest because, under state law, the security interest was perfected well outside of the ninety-day period provided in § 547. But since this case involved two transfers—(1) one direct: the transfer of the increased security interest to the bank; and (2) one indirect: the payment by the bank to the supplier—the Fifth Circuit collapsed them, allowing the trustee to avoid the indirect transfer because all of the requirements of § 547(b) had been met. The Fifth Circuit correctly looked at the parties' intent and collapsed the direct and indirect transactions to protect the unsecured creditors who would have been harmed had the court taken an overly formalistic approach.

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145 In re Compton Corp., 831 F.2d at 590.
146 Id.; see also 11 U.S.C. § 548.
147 In re Compton Corp., 831 F.2d at 591.

The phrase “takes effect” is undefined in the Bankruptcy Code, but under Uniform Commercial Code Article 9 law, a transfer of a security interest “takes effect” when the security interest attaches. Because of the future advances clause in MBank's 1980 security agreement with Compton, the attachment of the MBank's security interest relates back to May 9, 1980, the date the security agreement went into effect. The bottom line is that the direct transfer of the increased security interest to MBank is artificially deemed to have occurred at least by May 7, 1981, the date MBank filed its final financing statement, for purposes of a preference attack against the bank. This date is well before the 90 day window of 11 U.S.C. § 547(b)(4)(A).

Id.

148 Id. at 594–95.
149 All of the requirements of 11 U.S.C. § 547(b) have been satisfied in the trustee's preferential attack against [the supplier]. There was (1) a transfer of [the debtor's] property for the benefit of [the supplier] (2) for an antecedent debt owed by [the debtor] (3) made while [the debtor] was insolvent (4) within 90 days before the date of the filing of the petition (5) that enabled [the supplier] to receive more than it would receive under a Chapter 7 liquidation. The net effect of the indirect transfer to [the supplier] was to remove $585,443.85 from the pool of assets available to [the debtor's] unsecured creditors and substitute in its place a secured claim for the same amount.

Id. at 595.
b. Fraudulent Conveyances: Collapsing Multiple Loans into a Single Transaction

The bankruptcy courts, in cases involving fraudulent conveyances, such as leveraged buyouts, have also applied this collapsing model. Under the Code, the trustee or debtor in possession ("DIP") has the ability to undo conveyances that were actually or constructively fraudulent, either directly under the Code or under applicable state law. Courts have 'collapsed' a series of transactions into one transaction when it appears that despite the formal structure erected and the labels attached, the segments, in reality, comprise a single integrated scheme when evaluated focusing on the knowledge and intent of the parties involved in the transaction. This collapsing doctrine has been generally applied to the following "paradigmatic scheme":

One transferee gives fair value to the debtor in exchange for the debtors' property, and the debtor then gratuitously transfers the proceeds of the first exchange to a second transferee. The first transferee thereby receives the debtors' property, and the second transferee receives the consideration, while the debtor retains nothing.

The HBE Leasing Corp. v. Frank Court established a two-pronged requirement to collapse such a series of transactions: (1) "the consideration received from the first transferee must be reconveyed by the debtor for less than fair consideration or with

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152 Section 544 of the Code allows the trustee or DIP to use any applicable state law that would have been available to any creditor to avoid a transfer. See 11 U.S.C. § 544. The Uniform Fraudulent Conveyance Act provides a state law remedy that allows a creditor to avoid fraudulent transfers. See UNIF. FRAUDULENT CONVEYANCE ACT § 4; see also UNIF. FRAUDULENT TRANSFER ACT § 5.


an actual intent to defraud creditors,” and (2) the initial transferee had “actual or constructive knowledge of the entire scheme that renders her exchange with the debtor fraudulent.”

These requirements look to what the transferring parties intended, not simply how they structured their transaction. When examining these transactions, courts have “correctly disregarded the form of [the] transaction and looked instead to its substance.”

i. Leveraged Buyouts

This collapsing doctrine has been applied to leveraged buyouts. A leveraged buyout (“LBO”) “is a shorthand expression describing a business practice wherein a company is sold to a small number of investors, typically including members of the company’s management, under financial arrangements in which there is a minimum amount of equity and a maximum amount of debt.” In a hypothetical transaction, Company B is acquiring Company A through an LBO. Courts may apply this collapsing doctrine when the LBO is structured in multiple steps. In the first step, the bank lends money to finance the LBO to Company A and secures this loan with mortgages on all of Company A’s assets. Company A then immediately turns the funds over to Company B in exchange for an unsecured promissory note. Company B will also raise capital by selling “high risk bonds, popularly known as ‘junk bonds,’” that have high interest rates. Company B is using Company A’s assets to partially finance this transaction. The proceeds from this LBO are used to pay Company A’s equity holders and not Company A itself. The LBO transaction causes Company A to become insolvent because it will have obligations under the mortgage and bond debt.

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155 HBE Leasing Corp., 48 F.3d at 635.
156 Id. at 638; see also In re Best Prods. Co., 168 B.R. 35, 56 (Bankr. S.D.N.Y. 1994), aff’d 68 F.3d 26 (2d Cir. 1995). But see In re Sunbeam Corp., 284 B.R. at 372–73.
157 United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1292 (3d Cir. 1986). “The financing typically provides for a substantial return of investment capital by means of mortgages or high risk bonds, popularly known as ‘junk bonds.’” Id.
158 See, e.g., id. at 1292–93.
159 See, e.g., id. at 1293.
160 See id. at 1292.
161 See id.
If Companies A and B were to subsequently file a bankruptcy petition, a court may collapse the two transactions—(1) the transfer of funds from Company A to Company B, and (2) the transfer from Company B to Company A’s shareholders—into a single transaction. While formally this LBO consists of two separate transactions, in substance, “[t]he two exchanges were part of one integrated transaction.” This collapsed transaction would constitute constructive fraud because Company A received less than fair consideration for its loan obligations. In fact, Company A received nothing as a result of the mortgage—its shareholders received the benefit. Therefore, the court could recover the transfer from the shareholders. Moreover, the court could then order the bank that lent Company B the money to finance the LBO “to disgorge fees, interest and other sums paid to them” and also possibly leave them with “no claim for what they disgorge or the outstanding LBO obligations.”

c. Applying Substance over Form to Refinancing

Bankruptcy courts should look to the substance of the refinancing and collapse the series of transactions, just as they do when hearing LBO and letters of credit cases. By examining the form of the transaction, the multiple transaction approach distorts the general principles of bankruptcy because it creates artificial and convoluted class distinctions. Under this approach, the refinancing lender is an unsecured creditor. Yet, as the unitary approach recognizes when it looks to the substance, the debtor and the refinancing lender intended the refinancing lender to be secured, just as the old lender was secured. Furthermore, although the refinancing lender recorded late, it is still validly secured under state law. Thus, the only issue is whether the bankruptcy courts should allow the trustee to assert

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162 This hypothetical does not depend on whether Companies A and B both file chapter 7, chapter 11 petitions, or any combination on the two.
163 Tabor Court Realty Corp., 803 F.2d at 1302.
164 See UNIF. FRAUDULENT CONVEYANCE ACT § 4 (1918).
165 Tabor Court Realty Corp., 803 F.2d at 1307.
167 See, e.g., Chase Manhattan Mortgage Corp. v. Shapiro (In re Lee), 530 F.3d 458, 473 (6th Cir. 2008).
168 See Kaler v. Cmty. First Nat’l Bank (In re Heitkamp), 137 F.3d 1087, 1089 (8th Cir. 1998).
§ 574(b) to avoid this security interest as a preferential transfer. Avoiding these transactions does not serve the purpose of preference actions.\textsuperscript{169} While in many cases the refinancing lender recorded the mortgages shortly before the debtor filed for bankruptcy,\textsuperscript{170} this was not done because the debtor was sliding into bankruptcy.\textsuperscript{171} A lender who refines a home wants to secure the loan in order to be adequately protected, not because the individual debtor is showing signs of insolvency.\textsuperscript{172} This is not a situation where the refinancing lenders were creating “secret liens”\textsuperscript{173} because anyone who looked would have seen a lien on the property, albeit a different lien.\textsuperscript{174} Moreover, even the First Circuit recognized that in these situations, there is no prejudice to the unsecured creditors.\textsuperscript{175} In reality, “[n]o unsecured creditor ever had the slightest basis to believe that he would be entitled to recover his debt from mortgage proceeds.”\textsuperscript{176}

Not only did the refinancing lender’s recording of its mortgage not prejudice the unsecured creditors, it also arguably benefited all parties involved in the transaction. These refinancing agreements lowered the debtors’ monthly payments,\textsuperscript{177} thus leaving more money for the debtors to pay their unsecured creditors. Given that borrowers may currently be unable to pay their expensive loans\textsuperscript{178} and the ever-increasing prospect of bankruptcy,\textsuperscript{179} bankruptcy courts should adopt a policy that helps keep people out of their courtrooms. By

\textsuperscript{169} See G.H. Leidenheimer Baking Co. v. Sharp (In re SGSM Acquisition Co.), 439 F.3d 233, 238 (5th Cir. 2006).
\textsuperscript{170} E.g., In re Lec, 530 F.3d at 461; Gordon v. Novastar Mortgage, Inc. (In re Hedrick), 524 F.3d 1175, 1180, 1184–85 (11th Cir. 2008), modified and reh’g denied, 529 F.3d 1026 (11th Cir. 2008), cert. denied, 129 S. Ct. 631 (2008); Collins v. Greater Atl. Mortgage Corp. (In re Lazarus), 478 F.3d 12, 13 (1st Cir. 2007); In re Heitkamp, 137 F.3d at 1088.
\textsuperscript{171} See In re SGSM Acquisition Co., 439 F.3d at 238.
\textsuperscript{172} See Richard A. Oppel Jr. & Steve Brown, Rates and Balances; Negative Equity Leaves Homeowners in Money Pit, DALLAS MORNING NEWS, Mar. 28, 1993, at 1H (discussing homeowners’ inability to refinance their mortgages because they owed more than their homes were worth).
\textsuperscript{173} In re Lee, 530 F.3d at 472.
\textsuperscript{174} In re Hedrick, 524 F.3d at 1183–84.
\textsuperscript{175} See In re Lazarus, 478 F.3d at 16.
\textsuperscript{176} In re Lee, 530 F.3d at 475 (Merritt, J., dissenting).
\textsuperscript{177} E.g., id. at 462 (majority opinion).
\textsuperscript{178} See supra text accompanying note 1.
removing the risk that the refinancing lender's security interests will be avoided, the courts will act to encourage the banks to reduce the debtor's monthly payments through refinancing, thus allowing the debtor to pay his other debts. The unsecured creditors will get the greatest amount if the debtor never files for bankruptcy protection.

III. EQUITABLE SUBROGATION AS A DEFENSE TO PREFERENCE ACTIONS

Beyond the earmarking doctrine, a refinancing lender can raise the doctrine of equitable subrogation to protect a late-recorded mortgage. Under this doctrine, the new lender will be able to assert the rights of the old lender's mortgage. Because the old lender's mortgage was recorded, the trustee would never be able to be a hypothetical bona fide purchaser. Therefore, the trustee cannot successfully bring a preference action, as the new creditor's mortgage will be deemed perfect outside the ninety-day preference period. Because equitable subrogation is a state law doctrine, whether a new lender will be able to assert this defense will depend on where the debtor's home is located.

A. Michigan's Version of Equitable Subrogation

In *Lee*, the Sixth Circuit declined Chase's equitable subrogation argument, noting that it was a "sophisticated creditor facing a problem of its own making." The court applied Michigan's version of equitable subrogation. Under Michigan law, "[e]quitable subrogation is a legal fiction through which a person who pays a debt for which another is primarily responsible is substituted or subrogated to all the rights and remedies of the other." Under this conceptualization of

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182 See *In re Hedrick*, 524 F.3d at 1180 (applying the Georgia doctrine of equitable subrogation).

183 Chase Manhattan Mortgage Corp. v. Shapiro (*In re Lee*), 530 F.3d 458, 473–74 (6th Cir. 2008).

equitable subrogation, there is a threshold requirement that the party seeking subrogation must have a "legal or equitable duty" to make the payment in question, and thus is not a "mere volunteer." Therefore, Bank B would be barred from the outset from using this doctrine to protect its mortgage on the Morrisons' home because it had no legal or equitable duty to refinance their loan. This requirement seems unnecessary, especially since, as the Sixth Circuit itself said, it leads to a result that is "arguably harsh."

However, under the Sixth Circuit's reading of the doctrine, even if Bank B could get past this initial hurdle, the trustee would still be able to avoid the mortgage because the court would likely find that the delay resulted from Bank B's negligence. The Sixth Circuit has been unsympathetic to banks that seek to apply this doctrine to protect late-recorded mortgages. It has set up guidelines for applying this doctrine in refinancing cases. Under these guidelines, courts consider: (1) the length of time of the delay, (2) the excuse for the delay in recording, and (3) whether the bank was negligent in recording its mortgage.

Bank B failed to record the Morrisons' mortgage for over three months. Because the Sixth Circuit is under the mistaken belief that the lender is in total control of the recording process, Bank B would not have a reasonable excuse and would

\[\text{id.} \ (\text{citing Beaty v. Hertzberg \& Golden, P.C., 571 N.W.2d 716, 720 (Mich. 1997)).}\]

\[\text{In re Lee, 530 F.3d at 473.}\]

\[\text{The Sixth Circuit has repeatedly said that the refinancing banks are "sophisticated creditor[s]" who created their own problems. Id. at 473–74; In re Lewis, 398 F.3d at 747. However, given the numerous collapses of financial institutions, it appears that the Sixth Circuit may be giving these banks too much credit. See, e.g., Eric Dash \& Andrew Ross Sorkin, In Largest Bank Failure, U.S. Seizes, Then Sells, N.Y. TIMES, Sept. 26, 2008, at A1 (discussing the seizure and sale of Washington Mutual by the federal government); Eric Dash \& Andrew Ross Sorkin, Regulators Push for Sale of Wachovia, N.Y. TIMES, Sept. 29, 2008, at A15 (discussing the seizure and possible sale of Wachovia Corporation by the federal government); Walter Hamilton \& Peter G. Gosselin, With Markets on Edge, Fed Takes Urgent Action To Calm Investors; It Aids a Fire Sale of Bear Stearns at $2 a Share, Cuts a Key Rate and Broadens Lending to Investment Houses, L.A. TIMES, Mar. 17, 2008, at A1 (discussing the deal brokered by the Federal Reserve to have JPMorgan Chase \& Co. acquire Bear Stearns); Risky Business Sinks Economy; Former Treasury Secretary Blames Wall Street for Financial Calamities, GRAND RAPIDS PRESS, Sept. 16, 2008, at C1 (discussing Lehman Brothers filing for chapter 11 protection and Bank of America acquiring Merrill Lynch).}\]

\[\text{In re Lewis, 398 F.3d at 747.}\]

\[\text{Id.}\]
thus be negligent. While there may be circumstances where a bank that fails to record within the thirty-day period is actually negligent, in the Morrisons' case Bank B was faced with a Catch-22—it was impossible to meet this requirement because the Register delayed recording the new mortgage. Even though Bank B delivered the mortgage to the Register in five days, the Register did not record it for another ninety-one days. The Sixth Circuit seems to ignore the fact that once the document is delivered, whether or not it is recorded and thus perfected is completely out of the bank's control. Although Bank B is unable to use equitable subrogation to protect its mortgage in Michigan, had the Morrisons lived in Georgia, there would have been a different result—Bank B's mortgage could not have been avoided because of equitable subrogation.

B. Georgia's Version of Equitable Subrogation

Under Georgia law, equitable subrogation may be used by "a party who 'advances money to pay off an [earlier] encumbrance on realty either at the instance of the owner of the property or the holder of the encumbrance . . . [and] the new security is for any reason not a first lien on the property.'" In a case such as this "if the new creditor is 'not chargeable with culpable or inexcusable neglect, [it] will be subrogated to the rights of the prior encumbrancer under the security held by [it], unless the superior or equal equity of others would be prejudiced thereby.' Therefore, the new creditor would be able to assert the rights under the old mortgage, which would prevent the trustee from avoiding the mortgage because no hypothetical bona fide purchaser could take title superior to that of the new

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190 This dismissive attitude ignores the situation that many banks face where they cannot record a mortgage in thirty days because there is a delay in recording at the Register. See, e.g., Gold v. Interstate Fin. Corp. (In re Schmiel), 319 B.R. 520, 522 (Bankr. E.D. Mich. 2005).
191 See generally, JOSEPH HELLER, CATCH-22 (Simon & Schuster Paperbacks 2004) (1961) (discussing situations where an outcome is theoretically possible but where there is no existing set of circumstances in which that outcome can be achieved).
194 Id. (quoting Hardy, 640 S.E.2d at 20.).
While these requirements are similar to Michigan’s, Georgia law does not bar “mere volunteers” from exercising this doctrine. Moreover, the Eleventh Circuit has been more amicable than the Sixth Circuit to banks seeking to apply this doctrine. The crux of this analysis requires the courts to examine when the actual transfer of funds took place and not to focus on the bank’s delay in recording.

Applying this liberal interpretation to the Morrisons’ case, Bank B would easily be able to prevent the trustee from avoiding its mortgage. Because Bank B’s payment to Bank A for the Morrisons’ original mortgage was transferred within thirty days of the closing, the transfer of the security interest would relate back to the date of the closing. Therefore, the trustee would be unable to avoid the mortgage because it would have been made outside of the ninety-day statutory period of § 547(b).

Under Georgia law, the Eleventh Circuit has another tool, inquiry notice, which it can use to protect Bank B’s mortgage on the Morrisons’ property.

C. Incorporating Georgia’s Equitable Subrogation Doctrine Within the Bankruptcy Code Is Problematic

Although applying the unitary transaction approach of the earmarking doctrine will protect most refinancing lenders who record their mortgages outside of § 547(e)’s thirty-day period, it is still unavailable for a lender that refinances its own loan. This is essentially a situation where a lender is just lowering the payments that the debtor is making to the same creditor. Because the doctrine of equitable subrogation is derived from state law, its applicability varies depending on the debtor’s

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196 In re Lewis, 398 F.3d at 747.
197 Hardy, 640 S.E.2d at 20.
198 In re Hedrick, 524 F.3d at 1191.
199 Id. at 1184 ("Because the delivery and the closing occurred within ten days of each other, the transfer was ‘made’ at the closing for purposes of § 547(e)(2)(A)’s relation-back provision.”).
202 Chase Manhattan Mortgage Corp. v. Shapiro (In re Lee), 530 F.3d 458, 462 (6th Cir. 2008). The creditor may be protected, however, if it simply modified the original mortgage instead of recording a new one.
Refinancing lenders may be unable to use this doctrine because they are mere volunteers. Codifying Georgia’s version of equitable subrogation within the Code provides protection to these lenders, as well as lenders located in circuits that have declined to extend the unitary approach to earmarking to lenders who refinance their own loans.

Courts’ reliance on the idea that these refinancing lenders are “sophisticated” exemplifies the difficulty with codifying this doctrine. Equitable subrogation may be misused to allow judicial manipulation that leads to an “unjust and unlawful result by arbitrarily causing the lender to lose the entire value of a perfectly valid mortgage for money the lender had advanced to the debtor in good faith.” Although they should not, courts like the Sixth Circuit are ignoring the fact that in some circumstances, it is simply impossible to record within thirty days of closing. By focusing on culpability and inexcusable neglect, the courts are able to serve the purposes of § 547—preventing secret liens and a race to the courthouse by unsecured creditors—while still preventing the refinancing lender from being victimized by circumstances outside of its control. Inevitably, courts will struggle with what constitutes inexcusable neglect; therefore, more should be done to protect a refinancing lender’s security interest. Courts should continue to apply the doctrine of equitable subrogation liberally for the purpose of protecting lenders; however, Congress should not codify this doctrine because mere codification would not resolve the issue of late-recorded mortgages.

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203 See Mort v. United States, 86 F.3d 890, 893 (9th Cir. 1996).
206 See In re Lee, 530 F.3d at 474. Given the numerous collapses of financial institutions, it appears that the Sixth Circuit is giving these banks too much credit. See supra note 187 and accompanying text.
207 In re Lee, 530 F.3d at 475 (Merritt, J., dissenting).
IV. INQUIRY NOTICE AS A DEFENSE TO PREFERENCE ACTIONS

Applying Georgia real property law to the facts of the earlier Morrison hypothetical, no one could be a bona fide purchaser from the Morrisons after Bank B recorded the mortgage because a purchaser would have inquiry notice, thus no purchaser could take priority over Bank B’s mortgage. It is not clear whether a bona fide purchaser could take an interest superior to that of Bank B between the time of the closing and the recording of the mortgage. The Eleventh Circuit correctly recognizes that no hypothetical purchaser would be considered bona fide because, during this period, Bank A’s mortgage was perfected and Georgia recognizes that any purchaser would be on inquiry notice.

Georgia’s conception of inquiry notice “imputes knowledge of an earlier interest to a later purchaser of an interest in land whenever there is ‘[a]ny circumstance which would place a man of ordinary prudence fully upon his guard, and induce serious inquiry.’” Because of this duty of inquiry, a purchaser under inquiry notice cannot be a bona fide purchaser if she acquires her interest before a previous creditor’s mortgage is cancelled. Any hypothetical purchaser who would find the old mortgage of record would be under a duty to contact the old mortgager, who would then notify the hypothetical purchaser that a new bank had satisfied the debt. This would in turn lead the hypothetical purchaser to contact the new bank that would inform her about its mortgage. Therefore, under no circumstances could the hypothetical purchaser be considered bona fide.

Applying these principles, no one could have received a security interest on the Morrisons’ property superior to that of Bank B’s. Before Bank B “recorded its security deed, a hypothetical intervening purchaser would have inquiry notice of [the deed] under [Georgia common law].” After Bank B recorded, any subsequent purchaser would be on constructive notice of the mortgage, and thus could not be considered bona

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210 See In re Hedrick, 524 F.3d at 1182.
211 See id. at 1182–83.
212 Id. at 1183 (quoting Page v. Will McKnight Constr., Inc., 639 S.E.2d 381, 383 (Ga. 2006)).
214 In re Hedrick, 524 F.3d at 1184; see also Rossville, 154 S.E.2d at 246 (expanding on the role of Georgia common law in this analysis).
Therefore, because no hypothetical purchaser could obtain a security interest in the Morrisons’ property superior to Bank B’s, the mortgage was perfected at the time of the closing.\textsuperscript{216}

Interestingly, both the Morrisons’ and the Lees’ mortgages would have also been protected by this concept under Michigan law. Michigan has a similar requirement to that of Georgia, which imputes inquiry notice to a purchaser of real property in order to successfully assert bona fide status.\textsuperscript{217} Because Chase never asserted this defense,\textsuperscript{218} the court never decided this issue in the Lees’ case.\textsuperscript{219}

\textbf{A. Incorporating Inquiry Notice Within the Bankruptcy Code Is Problematic}

Inquiry notice provides refinancing lenders with an added level of security that comes from a bright-line rule, while still preventing banks from creating secret liens. When the lender refinances the debtor’s original mortgage and fails to record the mortgage within the statutory period, there is no way a hypothetical bona fide purchaser could come in and take superior title because “[t]here was always a ‘perfected’ (i.e., publicly recorded) mortgage in place.”\textsuperscript{220} Any hypothetical purchaser would be on inquiry notice that the land was encumbered.\textsuperscript{221} It is possible, no matter how improbable, that this purchaser would be told by the old mortgage holder that the old mortgage was satisfied but not that a lender had paid off the balance. However, it stretches the imagination to believe that a company that refinanced its own mortgage would notify a purchaser that the

\begin{itemize}
  \item \textsuperscript{215} See GA. CODE ANN. § 44-2-3 (2009); see also In re Hedrick, 524 F.3d at 1184 (applying the statute to its facts and reaching the same conclusions).
  \item \textsuperscript{216} See The Bankruptcy Abuse Prevention and Consumer Protection Act, 11 U.S.C. § 547(e)(2)(A) (2006); see also In re Hedrick, 524 F.3d at 1184 (finding the mortgage perfected at the time of closing by relation back).
  \item \textsuperscript{217} See, e.g., Smelsey v. Guarantee Fin. Corp., 17 N.W.2d 863, 867 (Mich. 1945); see also MICH. COMP. LAWS § 565.29 (2009) (codifying the common law rule).
  \item \textsuperscript{218} Chase never raised the issue of inquiry notice in its brief to the court. See generally Brief of Appellee, Chase Manhattan Mortgage Corp. v. Shapiro (In re Lee), No. 06-1538, (6th Cir. Feb. 16, 2007). Chase instead argued that the hypothetical purchaser had actual or constructive notice. \textit{Id.}
  \item \textsuperscript{219} See generally Chase Manhattan Mortgage Corp. v. Shapiro (In re Lee), 530 F.3d 458 (6th Cir. 2008).
  \item \textsuperscript{220} \textit{Id.} at 475 (Merritt, J., dissenting).
  \item \textsuperscript{221} See In re Hedrick, 524 F.3d at 1183.
\end{itemize}
debtor owns the property free and clear of its security interest if it has not yet recorded its mortgage. Under both of these circumstances, no one would be misled into thinking that the property was unencumbered.\(^2\)

[It seems to [be] mere legalistic manipulation of the language of §§ 547(b) and (e) to arrive at the conclusion that the mortgage and the house should be treated as a preference and set aside—taking the mortgage security away from the lender who had simply agreed to lighten the load on the debtor . . . \(^3\)]

Inquiry notice does not act to encourage secret liens or a race to the courthouse by unsecured creditors. By allowing for inquiry notice, a lender who loans money to a home purchaser will not be protected if it fails to record because there will not be a mortgage of record against the purchaser. Any “man of ordinary prudence fully upon his guard” would find no mortgage on record because the old owner’s mortgage would have been discharged.\(^4\) Thus, he could be considered a bona fide purchaser and the trustee, assuming that the other requirements of § 547 have been met, could avoid the mortgage.\(^5\) This result would still encourage the new creditor to record the mortgage to put the world on notice.

However, incorporating inquiry notice into the Code is not without problems. The first and most glaring problem with this “solution” becomes clear when the facts of the Morrisons’ hypothetical refinancing are changed. Suppose that Bank A’s old mortgage had been discharged before Bank B’s mortgage was recorded and the other circumstances remained constant. Under such circumstances, during the gap period, a hypothetical purchaser would not find a mortgage of record. Therefore, a “man of ordinary prudence fully upon his guard” would find no mortgage on record, and thus would be considered a bona fide purchaser.\(^6\) This would allow the trustee to avoid Bank B’s mortgage.\(^7\) Unlike the situation discussed above where the

\(^2\) See In re Lee, 530 F.3d at 475 (Merritt, J., dissenting).
\(^3\) Id.
\(^6\) In re Hedrick, 524 F.3d at 1183.
\(^7\) See 11 U.S.C. § 547(b) (assuming that the other doctrines do not apply).
refinancing lender waited to record, here Bank B promptly delivered the mortgage to the recording office, which, due to its own inner workings, recorded the discharge first. Therefore, while inquiry notice does provide some protections to refinancing lenders, there are still some circumstances where a refinancing lender, through no fault of its own, would not be protected from a preference action.

A second issue is that states are making policy choices when they construct their common and statutory laws regarding inquiry notice. As a result, the requirements of inquiry notice may vary from state to state. Although Congress has the power to incorporate inquiry notice within the Code for bankruptcy purposes only, the states have made clear policy decisions, which should not be superceded by Congress because there is a simpler solution to this problem. Therefore, this Note proposes that Congress amend the Code to include an affirmative defense in § 547(c) to cover these refinancing loans.

V. THE NEED TO PROTECT REFINANCING LENDERS

There is little doubt, given the ongoing credit crisis, that the law, including bankruptcy law, should seek to encourage the refinancing of the millions of outstanding subprime mortgages. Although bankruptcy courts are equitable courts, they “do not possess limitless power to ‘do equity.’” These courts are limited by the power vested in them by Congress.

With these restrictions in mind, the bankruptcy courts should work within their limited powers to encourage the refinancing of loans within the bankruptcy context. These courts need to encourage lending while still maintaining the general principle of the Code that there should be “equal distribution to creditors within the same class.” The earmarking and equitable subrogation doctrines, along with inquiry notice,

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229 U.S. CONST. art. I, § 8 (“The Congress shall have Power . . . [t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States.”).
currently provide the bankruptcy courts with the ability to conform to their restrictions while promoting refinancing.

Before discussing the virtues of these doctrines, it should be noted that these refinancing banks might have been able to elude the problem of preference actions had they taken an assignment of the old mortgage and then entered into a modification agreement with the debtor. Under this arrangement, the refinancing bank would be in a better position to argue that the debtor had not transferred an interest in his property, but rather the security interest passed “through the debtor’s hands” and “he is merely a kind of bailee.” Under this proposed arrangement, the debtor arguably never grants an interest in his property because the refinancing bank is receiving a preexisting mortgage. It is unclear whether the modification agreement would be considered a preference. However, given that this arrangement of assigning mortgages does not seem to be the practice in some circuits, those courts and Congress should adopt doctrines that protect banks’ security interests and encourage refinancing.

A. Proposed Amendment to § 547(c) To Protect Refinancing Lenders

Although defense to preference actions—whether it be contemporaneous exchanges, earmarking, equitable subrogation, or inquiry notice—already exist for refinancing lenders, as we have seen, some judges have been unsympathetic and have misconstrued the law when lenders have tried to assert these defenses. Codifying these defenses may prove problematic because even if Congress was willing to codify any of them, a court—such as the Sixth Circuit—could still find ways not to apply them properly, and therefore, allow the trustee to avoid the new mortgage. Thus, we are still left with the question of how to protect a refinancing lender’s security interest in order to encourage refinancing.

233 See Collins v. Greater Atl. Mortgage Corp. (In re Lazarus), 478 F.3d 12, 15 (1st Cir. 2007).
Occam’s Razor suggests that the simplest solution to this problem is probably the correct one.\textsuperscript{234} Section 547 of the Code already enumerates a number of affirmative defenses which, if established, prevent the trustee from avoiding an otherwise preferential transfer. The simplest way to protect a refinancing lender from having its mortgage avoided is to write in an exception for refinancing transactions. The following proposed amendment to § 547(c) would serve this purpose.

1. Proposed § 547(c)(10)\textsuperscript{235}

§ 547(c) The trustee may not avoid under this section a transfer—

(10) that creates a perfected security interest on real property, to the extent that such transfer was—

(A) made on account of a loan that refinances an antecedent debt that was secured by such real property by a perfected security interest;
(B) the parties intended to refinance this antecedent debt;
(C) the loan did in fact refinance this antecedent debt; and
(D) the parties intended that the refinancing debt be secured by such real property through a perfected security interest.

When Proposed § 547(c)(10) is applied to the Morrisons’ facts, Bank B would be able to defend successfully against a preference action brought by the trustee seeking to avoid Bank B’s mortgage. At the start of the refinancing process with Bank B, the Morrisons owed Bank A money under a loan that was secured by a mortgage. Therefore, the Morrisons’ refinancing transaction created a “perfected security interest” on real property that was made on account of the Morrisons’ “antecedent debt that was secured by such real property by a perfected

\textsuperscript{234} MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY (11th ed. 2003) (“[A] scientific and philosophic rule that entities should not be multiplied unnecessarily which is interpreted as requiring that the simplest of competing theories be preferred to the more complex.”).

\textsuperscript{235} As currently written, § 547 provides for nine exceptions. See Bankruptcy Abuse Prevention and Consumer Protection Act, 11 U.S.C. § 547(c) (2006). This author does not want to be responsible for a hanging paragraph should Congress adopt this proposed exception. See, e.g., id. § 1325(a), hanging paragraph at the end.
security interest”—their loan debt to Bank A, which was secured by a mortgage. Thus, Bank B would meet the first requirement of Proposed § 547(c)(10).

The Morrisons went to Bank B intending to refinance their mortgage with Bank A, and as a result of Bank B’s loan, the Morrisons refinanced their debt. Therefore, the second and third requirements of Proposed § 547(c)(10) are met. This leaves open only the question of whether the Morrisons and Bank B intended the loan to be secured by a perfected mortgage. The Morrisons executed a mortgage with Bank B, and Bank B then delivered the mortgage to the Register—the office that records the mortgage—which makes it a perfected security interest for the purposes of the Code. From these facts, it is evident that the Morrisons and Bank B “intended that the refinancing debt be secured by such real property through a perfected security interest.” Therefore, Bank B would be able to successfully defend, without having to go through the other defenses previously discussed, against a preference action if Proposed § 547(c)(10) is adopted.

Moreover, had Proposed § 547(c)(10) been enacted at the time the Lees filed their bankruptcy petition, Chase’s mortgage would have also been protected. When the Lees went to Chase to refinance their home mortgage, the Lees and Chase intended the new loan to refinance the old mortgage, and the actual agreement did refinance the loan. Therefore, the first three elements of Proposed § 547(c)(10) are met. Additionally, because Chase recorded its mortgage, the refinancing loan was secured by real property. Thus, Chase would have been protected had Proposed § 547(c)(10) been enacted at the time. Under this proposed statute, the fact that Chase refinanced its own loan would be irrelevant.

Proposed § 547(c)(10) recognizes the realities of recording a mortgage. There are delays at the recording office that are beyond the control of the new lender. By setting forth simple requirements that a bank can meet, Proposed § 547(c)(10) replaces complicated defenses that are often misapplied. This

236 See supra Proposed § 547(c)(10)(A).
237 See supra Proposed § 547(c)(10)(A), (B).
239 See supra Proposed § 547(c)(10)(D).
240 See supra Proposed § 547(c)(10)(A)-(C).
works to protect a refinancing lender, who lowered a debtor's monthly mortgage payments, from losing its mortgage in bankruptcy. The law should work to encourage refinancing, not to punish good deeds.241

CONCLUSION

Given that many Americans currently have subprime mortgages that they cannot afford to pay, bankruptcy courts will play an increasing role in the refinancing process. These courts should adopt already existing doctrines that serve to protect lenders and encourage refinancing that will hopefully keep debtors out of their courts altogether. The unitary approach to the earmarking doctrine, the doctrine of equitable subrogation, and inquiry notice provide the necessary protections to lenders who refinance loans.

Although ideally a lender should record within thirty days, there is no sound bankruptcy policy to allow a trustee to avoid the loan. The parties always intended the refinancing lender to be secured, and the unsecured creditors will not receive less than they reasonably expected to in bankruptcy if the mortgage is not avoided. With these policies in mind, the courts should elevate substance over form and collapse the refinancing into a single transaction with multiple steps, thus allowing the lender to assert the earmarking doctrine as a defense to preference actions.

Moreover, because the earmarking doctrine, equitable subrogation, and inquiry notice are unavailable to certain lenders that cannot meet the doctrinal requirements simply because they are located in the wrong state, Congress should codify Proposed § 547(c)(10). This proposed amendment to § 547(c) recognizes that delays in recording may be outside the refinancing lenders control. By looking to the parties' intent, Proposed § 547(c)(10) examines the substance of the refinancing transaction and not its form—a consistent theme of bankruptcy law. This amendment recognizes the simple fact that there was a mortgage on the home before the refinancing and after the refinancing. The only change in circumstances is the terms of the loan, terms which

often leave the debtor with more money each month to pay the other unsecured creditors.

All of these protections ensure that lenders are protected when refinancing, thereby reducing the risks of lending. While it is true that the bankruptcy courts should see that all the debtor’s creditors receive the most money possible, the courts should also realize that the creditors are better off if the debtor is able to avoid bankruptcy altogether. Congress should be willing to remind courts of this fact through legislation that seeks to protect refinancing lenders in the bankruptcy courts. Encouraging refinancing by protecting lenders serves the purpose of making more money available to every class of creditors.