

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF INDIANA
HAMMOND DIVISION AT LAFAYETTE

IN RE: CASE NO. 06-40080)
)
OCJ REALTY GROUP, LLC)
)
Debtor)
)
)
KIMBERLY A. GILBERT, TRUSTEE)
)
Plaintiff)
)
vs.) PROC. NO. 06-4056
)
)
MAINSOURCE BANK, ET AL.)
)
Defendants)

**DECISION AND ORDER ON PLAINTIFF'S MOTION
FOR SUMMARY JUDGMENT**

At Lafayette, Indiana, on August 17, 2007.

By this adversary proceeding, the plaintiff/trustee has asked the court to determine the validity and priority of the liens asserted by the different defendants as to the property commonly known as 438 and 442 East Main Street in Brownsburg, Indiana. The matter is before the court on the trustee's motion for summary judgment as to the defendant MainSource Bank. For a variety of reasons, under a variety of theories, the Bank claims a lien upon the property as the result of a mortgage given by 136 Self Storage, LLC.

Summary judgment is appropriate where there is "no genuine issue as to any material fact" and "the moving party is entitled to a judgment as a matter of law." See, Fed. R. Civ. P. Rule 56(c); Fed. R. Bankr. P. Rule 7056. The moving party must initially identify "those portions of 'the pleadings, depositions, answers to interrogatories, and admissions on file, together with the

affidavits, if any,' which it believes demonstrate the absence of a genuine issue of material fact.” Celotex Corp. v. Catrett, 477 U.S. 317, 323, 106 S.Ct. 2548, 2553 (1986). Once it does so, the non-moving party must affirmatively demonstrate, by specific factual allegations, that there is a genuine issue of material fact requiring trial. Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp., 475 U.S. 574, 587, 106 S.Ct 1348, 1356 (1986). In ruling on the motion, the court accepts the non-moving party’s evidence as true, draws all inferences in favor of the non-moving party, and does not weigh the evidence and credibility of the witnesses. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 249, 106 S. Ct. 2505, 2511 (1986).

The present dispute has its origins in what can best be described as a botched real estate closing that took place on March 12, 2004. The debtor and 136 Self Storage are separate, but related, entities, both having been organized and managed by the same individual. The debtor had orally agreed to transfer the property in question to 136 Self Storage for the development of a self storage facility, all of which was being financed by the bank. At the closing, 136 Self Storage executed a promissory note for \$550,000 and gave the bank a mortgage on the property in order to secure payment of the note. The loan proceeds were used to satisfy the debtor’s obligation to Salin Bank (\$120,505.14), which released its existing mortgage against the property, and to fund the development of the storage facility. The problem in all of this is that those involved neglected to have the debtor execute a deed conveying the property to 136 Self Storage.

136 Self Storage apparently defaulted on the loan and, on April 11, 2006, the bank commenced foreclosure proceedings in the Hendricks Superior Court. One week later, on April 18, its counsel filed a lis pendens notice which stated that the bank was asserting a mortgage upon the property. The next day, April 19, 2006, the debtor filed a petition for relief under Chapter 7 of the

United States Bankruptcy Code. The plaintiff, Kimberly Gilbert, is the duly appointed and qualified trustee of the debtor's bankruptcy estate.

As a result of the foregoing events, as of the date of the petition, the debtor was the record owner of the real estate in question. The bank claimed a lien upon the property by virtue of the mortgage given by 136 Self Storage. It had also initiated proceedings in state court to foreclose that mortgage and, in connection with doing so, had filed a lis pendens notice concerning its asserted interest.

The trustee's motion for summary judgment argues that the bank's mortgage can be avoided through the strong-arm powers of § 544(a)(3), 11 U.S.C. § 544(a)(3), or, in the alternative, is invalid under Indiana law. In response, the bank contends that the lis pendens notice gave sufficient notice of its interest in the property to survive the challenge under § 544. As for the trustee's state law challenge to the validity of the bank's interest, the bank argues that doctrine of reformation and/or various equitable theories will recognize that interest, giving it a valid and enforceable lien.

Through section 544(a)(3) of the United States Bankruptcy Code, the trustee may avoid:

any transfer of property of the debtor . . . that is voidable by –

* * * *

(3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists. 11 U.S.C. § 544(a)(3).

In Indiana, a bona fide purchaser takes free of any interest in real estate which is unrecorded and of which it has no constructive or actual notice. United States v. Arnol & Mildred Shafer Farms, Inc., 107 B.R. 605, 607 (N.D. Ind. 1989). See also, In re Graham, 110 B.R. 408 (S.D. Ind. 1990). The

only change to this rule because of bankruptcy is that actual notice is irrelevant. 11 U.S.C. § 544(a). Instead, only the constructive notice gained by a review of the title record matters. Shafer Farms, 107 B.R. at 608.

The entire purpose of a lis pendens notice is to give third parties notice of litigation in which the filer is asserting or attempting to enforce an interest in real property that, inter alia, is not founded upon a recorded document executed by the record legal owner of the property. See, I.C. 32-30-11-3, 9. See also, Mid-West Fed. Sav. Bank v. Kerlin, 672 N.E.2d 82, 86-87 (Ind. Ct. App. 1996); Sheehan v. Mahoney Chevrolet-Olds, Inc., 23 F.Supp. 2d 926, 928 (N.D. Ind. 1998). Third parties, including BFPs, who acquire an interest in the property after such a notice has been filed take subject to that interest. Since the debtor did not file bankruptcy until the day after the bank's lis pendens was notice filed, the trustee had constructive notice of the bank's claimed mortgage on the real estate. Therefore, although § 544(a)(3) gives the trustee the rights of a BFP, even a BFP acquiring an interest in the property on the date of the petition would have taken subject to the bank's claim, and, thus, so does the trustee.

A lis pendens is merely notice of litigation asserting or seeking to enforce an interest real property. It does not create an interest in the property but, instead, gives third parties notice that there may be an interest which the pending litigation seeks to vindicate. As a result, the lis pendens notice, by itself, is not sufficient to allow the bank to prevail over the trustee. It only allows the bank to overcome the trustee's status as a BFP without notice. Having done that, the bank must still prove that Indiana law would recognize and enforce its claim to a mortgage upon the property as of the date of the petition, see, Matter of Leonard, 125 F.3d 543, 545 (7th Cir. 1997) (applying Illinois law) – a mortgage that was granted, not by the debtor who was the legal owner of the property but by a

related entity, 136 Self Storage. To do this it advances several arguments: it claims an equitable mortgage upon the property, seeks reformation of the documents executed at closing to change the identity of the mortgagor from 136 Self Storage to the debtor, and finally claims to be equitably subrogated to the rights of Salin Bank whose mortgage was satisfied at closing with the proceeds of the loan to 136 Self Storage.

An equitable mortgage arises from a transaction which, for one reason or another, lacks the form and substance of a mortgage but is, nonetheless, treated as “a security, or an offer or attempt to pledge land as security for a debt or liability.” 59 C.J.S. Mortgages § 12 (2007). The doctrine has been applied in a variety of situations such as when a mortgage has been promised upon certain property but the mortgage itself was left blank, Warner v. Riddell Nat’l Bank, 482 N.E.2d 772, 774 (Ind. Ct. App. 1985), or when a deed to property is given as security for a debt. See, Patterson v. Grace, 661 N.E.2d 580, 584 (Ind. Ct. App. 1996). A common theme in these cases is that the record owner of property, the one who had the authority to convey it, took some type action which is regarded as creating the equitable mortgage.¹ Thus, “the doctrine is not available where the person or persons who executed the mortgage did not have the legal power to do so.” In re Wilkinson, 186 B.R. 186, 189 (Bankr. D. Md. 1995).

“[T]here can be no mortgage of any kind unless the mortgagor has some real estate to pledge.” Schiffner v. Chicago Title & Trust Co., 244 P. 1012, 1013 (Col. 1926). See also, 59 C.J.S. Mortgages § 12. It is on this point that the bank’s argument falters. The central problem in this case

¹The bank also points to Shaw v. Meyer-Kiser Bank, 156 N.E. 552 (Ind. 1927), where a legal guardian who had no authority to do so granted a mortgage upon the ward’s property as an example of situations where the courts will recognize an equitable mortgage. Shaw is best understood as involving equitable subrogation and not as recognizing an equitable mortgage. Id., at 554-55.

is not the sufficiency of the form or the substance of the mortgage the bank was given, or even the intent of its mortgagor, 136 Self Storage, but rather the fact that the bank's mortgagor is not and never was the owner of the property. The record owner is, and always has been, the debtor. The bank's argument depends upon either disregarding the separate existence of the debtor and 136 Self Storage or treating 136 Self Storage as though it were the owner of the property. As to the first point, the bank has failed to come forward with any evidence that would suggest the debtor and 136 Self Storage should be treated as the same entity or that the veils which protect their separate existences should be pierced. As for treating 136 Self Storage as though it were the owner of the property, that would, in effect, require the court to enforce the agreement between it and the debtor for the transfer of the real estate, yet the Statute of Frauds requires some kind of writing, signed by the debtor, before that can be done, I.C. 32-21-1-1, and here there is no writing of any kind. Admittedly, the doctrine of equitable conversion treats the buyer under a land sale contract as the equitable owner of the property, even though legal title remains in the seller, see, Skendzel v. Marshall, 301 N.E.2d 641 (Ind. 1973), but there is nothing about that doctrine that would override the requirements of the Statute of Frauds. The debtor is and was the record owner of the property and we should not proceed as though the property was owned by 136 Self Storage.

The bank's second argument is that the court should reform the mortgage, in accordance with what it claims were the parties' intentions, to reflect that it was granted by the debtor, instead of 136 Self Storage. Reformation is an equitable doctrine that is called upon to change or correct errors in written documents so that they accurately reflect the parties' intentions. Estate of Reasor v. Putnam County, 635 N.E.2d 153, 158 (Ind. 1994). Before doing so, however, there must first be a mistake in the document being reformed and here there was no mistake. The mortgage quite accurately

reflects the intent of the parties, which was that 136 Self Storage would grant the bank a mortgage upon the property. It was never anyone's intention that the debtor would do so.² The problem does not lie with the mortgage, but rather with the fact that a deed transferring the property from the debtor to the bank's mortgagor was never executed. In essence then, the bank seeks to use the doctrine not so much to correct a mistake in an existing document (the mortgage) but to create a document that never existed (a deed). Reformation is not appropriate.

The bank's final argument is that if the court will not recognize the validity of the mortgage it received from 136 Self Storage, it should at least be equitably subrogated to the rights of Salin Bank, the debtor's mortgagor, which was fully paid from the proceeds of the loan. Equitable subrogation is the substitution of one creditor for another. It arises by operation of law and is independent any contractual relations between the parties affected by it. See, Home Owners' Loan Corp. v. Henson, 29 N.E.2d 873, 876 (Ind. 1940). It comes into play when one party, not acting as a volunteer, pays the debt of another in full. The one who paid the debt may be allowed to step into the shoes of the original creditor and succeed to that creditor's rights in relation to the debt and any security for it. See, Bank of New York v. Nally, 820 N.E.2d 644, 651-52 (Ind. 2005); Henson, 29 N.E.2d at 876; Wilshire Servicing Corp. v. Timber Ridge Partnership, 743 N.E.2d 1173, 1178 (Ind. Ct. App. 2001). The doctrine is to be applied liberally to help effectuate a just result. Nally, 820 N.E. 2d at 652; Osterman v. Baber, 714 N.E.2d 735, 738 (Ind. Ct. App. 1999). Despite this, it is not available when the party who claims the right of subrogation acted with culpable negligence.

²Even reformation might not help the bank. Since 136 Self Storage received most of the loan proceeds, if the mortgage was reformed to show the debtor as grantor, the result might be that the transaction could be characterized as a fraudulent conveyance – one in which the debtor received less than reasonably equivalent value – and avoided on that basis, using either § 548 or state law, via § 544(b).

Wilshire Servicing Corp., 743 N.E.2d at 1178. Culpable negligence “contemplates action or inaction which is more than mere inadvertence, mistake, or ignorance.” Nally, 820 N.E.2d at 655 (quoting Wilshire Servicing Corp., 743 N.E.2d at 1178). It seems, however, that sophisticated financial institutions, such as the bank, are held to a higher standard. Wilshire Servicing Corp., 743 N.E.2d at 1178-79; Osterman, 714 N.E.2d at 738. See also, First Federal Savings Bank of Wabash v. United States, 118 F.3d 532, 534 (7th Cir. 1997)

It would be a gross misapplication of the doctrine of subrogation were we to hold that its cloak settles automatically upon one who has simply made a mistake, when it is a commercial transaction involving a consideration. Osterman v. Baber, 714 N.E.2d at 738 (Ind. Ct. App. 1999) (quoting Coy v. Raabe, 418 P.2d 728, 731 (Wash. 1966)).

Thus, “one factor [the court must consider in assessing the equities of the case] is whether the party requesting equitable relief engages in commercial transactions for consideration.” Wilshire Servicing Corp., 743 N.E. at 1179.

For the purposes of this case, an interesting example of a situation where the Indiana courts applied the doctrine of equitable subrogation is found in Shaw v. Meyer-Kiser Bank, 156 N.E. 552 (Ind. 1927). There, in order to avoid the foreclosure of existing mortgages, the Illinois guardian of an incompetent, who had no authority to grant a mortgage upon the ward’s property in Indiana, borrowed \$3,600 and granted the lender mortgages in order to secure the debt. The loan subsequently went into default and a dispute arose concerning the validity of the mortgages. The Indiana Supreme Court held that the mortgages granted by the guardian were unenforceable, as a matter of law, and the trial court had erred by recognizing them as valid liens, but the lender was, nonetheless, entitled to be subrogated to the rights of the creditor whose debt had been paid from the loan proceeds, which right could be enforced as an equitable lien. Id., at 554-55. See also, Home Owners’ Loan Corp. v. Henson, 29 N.E.2d 873 (Ind. 1940).

In light of Shaw, it seems that Indiana law might allow the bank, which received a mortgage from one who had no authority to grant it, to be subrogated to the rights of Salin Bank, whose mortgage was satisfied from the proceeds of the bank's loan. There is, however, the question of whether the bank, which is a sophisticated financial institution, acted with "culpable negligence" that would prevent subrogation. As to that question, there are genuine issues of material fact, precluding summary judgment. The trustee's motion is, therefore, denied.

SO ORDERED.

/s/ Robert E. Grant
Judge, United States Bankruptcy Court