

New Jersey Law Journal

VOL. CXCIIV - NO.3 - INDEX 330

OCTOBER 20, 2008

ESTABLISHED 1878

Real Estate Title Insurance & Construction Law

Correcting Mortgage Lien Priorities In Spite of the Recording Act.

By Dennis M. Gonski

Under early English law there was no recording office and legal interests in real property were determined by a simple standard: "Qui prior est tempore potior est jure" (first in time is first in right).

It would take American legislation to establish a recording system — and also to change the common-law rule.

The Recording System in New Jersey

New Jersey's Recording Act establishes a county recording system. Instruments pertaining to real property ownership must be recorded in the county in which the land resides. Each county maintains a recording office to accept and record (for a fee) a variety

of title documents (N.J.S.A. 46:16-1, et seq.). Each county also maintains indices (N.J.S.A. 46:20-1, et seq.) from which recorded documents may be searched.

By statute (N.J.S.A. 46:21-1; 22-1), New Jersey's is a race/notice system — meaning that the first person to "record" (i.e. win the "race" to the recording office) enjoys superior rights — provided that person does not already have actual knowledge of an earlier, unrecorded interest.

In theory, the title to any property is ascertainable by searching the appropriate land records — save only for the possibility of forgery.

Actual vs. Constructive Knowledge

A race/notice system recognizes two levels of "knowledge."

"Actual knowledge," which as one might expect, is a conscious awareness of a particular fact relevant to an interest in land. Under the Recording Act, "actual knowledge" (or "actual notice") may come as equally from parol as from a recorded document.

"Constructive knowledge," on the other hand — is a legal fiction. It is the imputation of presumed fictional knowledge of a document's contents. And, it is here where mischief occurs under the Recording Act.

The Recording "Gap"

Mention the term "gap" to a title searcher — and he or she will likely wince.

The "gap" is a "blind spot" existing between the time a document is "received" into the recording system, and the time that same document is actually "indexed." All counties are equally prompt in receiving documents (and fees). "Indexing," however, may take days or weeks, depending upon the volume of documents received.

The backlog of "received" but not yet "indexed" documents changes daily. The date to which a county index is deemed current is called the "board date." The term comes from an early practice of writing a "good to" date upon a blackboard located in each county's records room.

So, When is a Document Truly Recorded?

The Recording Act (N.J.S.A. 46:21-1) states that a document is "recorded" when it is: "lodged for record in the office of the county record-

Gonski is a member of Dollinger, Gonski & Grossman, with offices in Fairfield and Carlye Place, N.Y. The author represented First American Title Insurance Company, as a defendant in the Manchester case, and represented U.S. Savings Bank under title insurance by the New Jersey Title Insurance Company in the Hylton case.

ing officer in which the real estate or other property affected thereby is situated or located."

An early case seized upon the "lodged for record" language, ruling that "recording" is complete when a document is "received" by the recording office — without regard to indexing. In *New Jersey Bank v. Azco Realty Co.* (148 N.J.Super. 159), the court refused to recognize the recording "gap," holding instead:

Deficiencies in procedures in the county clerk's office which prevent discovery of documents 'lodged for record' should not deprive a validly lodged security instrument of its priority.

Azco's imputation of "constructive notice" to a document notwithstanding its unavailability to the searching public seems nonsensical. Yet, for too many years *Azco* was the law.

The 1990s brought two "Recording Act" cases: *Howard Savings Bank v. Brunson* (244 N.J.Super. 571) and *Manchester Fund, Ltd. v. First American Title Insurance Company* (332 N.J.Super. 336), each questioning the logic of *Azco*. Why should recording be deemed complete merely upon "receipt"? Is not the purpose for recording an instrument accomplished only when that document is made available for public scrutiny?

Both *Howard Savings Bank* and *Manchester Fund* concluded that "indexing" is the "litmus test" for "recording" — and that is the law today.

So, When Is a Document Indexed?

Title instruments are generally indexed in the order they are "received." The date and time of receipt is affixed upon each document. However, there is no record of when a document is actually "indexed."

Query: If "constructive notice" only occurs upon "indexing" — should not indexing also be memorialized?

Sometimes "Equity" Must Intervene

Until indexed — a "received" document is little more than a "needle in an enormous haystack." In most mortgage transactions, lenders need to know the existence of all prior liens. However, a search of the indices at the time a new loan is about to be made, will reveal only indexed mortgages. "Gap" mortgages are not revealed in a routine title search. Unless a borrower confesses, a lender may not know of a "gap" mortgage until after it has disbursed its loan. By then, monies advanced to discharge indexed liens may have effectively catapulted a "gap" mortgage to an unintended lien priority.

If the "gap" lender thereafter refuses to subordinate its lien, judicial relief must be sought. The new lender must request "equitable subrogation" (or as it is sometimes called, "equitable assignment") seeking to "step into the shoes" of a "paid" prior mortgage, just as if that mortgage had been assigned and not discharged. In theory, "equitable subrogation" is not unfair to a "gap" mortgagee who has failed to pay off prior liens. Indeed, by failing to discharge prior liens, the "gap" lender has demonstrated its contentment in obtaining a subordinate lien. "Equitable subrogation" also protects the "new" lender's funds used to pay off prior liens. Had the new lender actually known of the existence of the "gap" lien — a formal assignment of the "old" mortgage could have been sought, thereby preserving the priority of that lien. An equitable assignment merely accomplishes the lien priorities each lender intended.

The Actual Notice Approach

Under our "race/notice" system, lien priority is determined first by "race," and then by "notice." The winner of the "race" is generally determined by the order of recording. The "notice" element, if an issue, must be determined by the court.

An example is *Metrobank for Savings v. National Community Bank* (262 N.J.Super. 143), where a lien prior-

ity dispute erupted when a new lender discharged all but one of the borrower's prior mortgages. Equitable subrogation was sought and the issue focused upon what knowledge the new lender actually had at the time it made its loan. "Equitable subrogation" was denied, because the new lender was demonstrably aware of the existence of the unpaid prior mortgage but took no steps to protect itself against it. Hence, the new lender effectively received what it bargained for — a lien behind a known prior lienor.

The rule of *Metrobank* is that "actual knowledge" of a prior lien accompanied by inaction, defeats a claim for equitable subrogation.

The Hylton Case

The thornier problem comes when the new lender's lien is frustrated by a "gap" mortgage. Here the new lender lacks actual knowledge upon which to act. If the court were to deny equitable subrogation — it would have to do so based only upon "constructive notice." Such was the issue presented to Judge Sypek, in *U.S. Bank v. Hylton* (Ch. Div., June 13, 2008).

Hylton began as a typical mortgage foreclosure action brought upon a "refinance" mortgage held by Mortgage Lenders (assigned to U.S. Bank). The title search obtained at the time of the loan revealed only one indexed mortgage — held by Countrywide. Intending a new first lien, Mortgage Lenders paid \$300,000.00 to Countrywide and discharged that mortgage.

Months later, a second title search was obtained in connection with the foreclosure. This search revealed a \$35,000.00 "home equity" mortgage owned by American General, arising in the "gap." As a result, when Mortgage Lenders paid Countrywide, it literally catapulted American General to a first lien — an entirely unintended result.

American General argued: "first in time, first in right." U.S. Bank argued "equitable subrogation."

In resolving the matter, the court began by recognizing the misdemeanor the "gap" can cause to lien priorities. Refusing a strict application of constructive notice, the court turned instead to an "intent-based approach." The court looked to the reasonable expectations of these two lenders to determine the outcome. American General (due to the relatively modest amount of its loan) could have no "reasonable expectation" that its "home equity" mortgage would obtain a first lien superior to that of Countrywide unless someone else paid Countrywide. To allow American General to retain a superior lien under such circumstances

would be "unjust enrichment." By contrast, Mortgage Lenders actually paid Countrywide intending to acquire a first lien. Through the use of "equitable subrogation," Mortgage Lenders was allowed to "step into the shoes" of Countrywide, and protect itself, at least to the extent of that lien priority — which (until cancelled) was always ahead of American General.

The importance of *Hylton* is the court's recognition that documents in the "gap" impart no practical notice to lenders. Absent disclosure by its title search (or confession by the borrower), Mortgage Lenders had no reliable means to obtain actual knowledge

of the American General mortgage. As a result, the court granted "equitable subrogation" to Mortgage Lenders.

Conclusion

The unswerving imputation of constructive notice is finally an anachronism. Under *Hylton's* logic, lien priorities are decided not by legal fiction, but rather by what each lender intended. *Hylton* narrowed the court's focus in lien priority disputes to an "intent-based approach." The logic of *Hylton* is sound, and truly reduces the mischief caused by the Recording Act. ■