The Doctrine of Equitable Subrogation

Should Actual Knowledge Bar Its Application?

by Russell M. Finestein and Glenn Berman

The doctrine of equitable subrogation is often invoked in mortgage priority disputes that arise in mortgage foreclosure actions. Although the doctrine of equitable subrogation has been applied in New Jersey for over 75 years, there remains a question regarding whether the use of the doctrine should be barred if the new lender had actual knowledge of the prior mortgage at or prior to its closing. The case law is inconsistent, primarily due, in the authors' opinion, to a misreading of an Appellate Division decision rendered 30 years ago. This article will discuss recent developments in the case law, as well as some practical considerations in representing lenders in cases involving equitable subrogation.

Background

Generally stated, the doctrine of equitable subrogation provides that if a third party loans or advances funds to pay off an existing mortgage or other encumbrance in the belief that no junior liens encumber the subject premises, and it later appears that intervening liens existed, the new lender will be deemed to be substituted into the position of the prior mortgage holder by equitable assignment of the prior mortgage to give effect to the new lender's expectation, and to prevent unjust enrichment of the junior encumbrancers, provided there is no prejudice to the junior encumbrancer. The right of subrogation is recognized to the extent that the money advanced is actually applied to the payment of senior liens, plus interest on the amount applied.[1]

The doctrine of equitable subrogation has been followed even where the party asserting the right of subrogation is negligent.[2] As stated by the Appellate Division in *Kaplan v. Walker,* the remedy of equitable subrogation "will be extended to one who supplies funds to discharge an old lien when the new security, by fraud or mistake, turns out to be defective."[3]

In 2009, the authors were involved in the case of *UPS Capital Business Credit v. Kenneth J. Abbey, et al.*[4] There, the new lender, Washington Mutual Bank, N.A., in 2002, paid off a prior 2001 mortgage it acquired by virtue of its purchase of Dime Bancorp. and its subsidiaries. The 2001 mortgage was prior to a collateral mortgage granted to UPS Capital Business Credit as a result of a recorded postponement of mortgage. Prior to the closing of the 2002 mortgage loan, Washington Mutual obtained a title commitment that did not disclose the UPS Capital mortgage, and the affidavit of title delivered by the borrower was also silent. While Washington Mutual acknowledged the loan application listed the UPS Capital mortgage, there was a notation on the application that it was subordinate.

UPS Capital argued that notwithstanding the notation, the doctrine of equitable subrogation should not be applied, because Washington Mutual had actual knowledge of the UPS Capital mortgage. The court reviewed the cases invoking the doctrine of equitable subrogation in situations where lack of knowledge on the part of the new mortgagee occurred as a result of negligence.[5] Among them was *First Fidelity Bank, National Association South v. Travelers Mortgage Services,*[6] where the court stated that: "although some courts have denied subrogation when the lender's ignorance of junior encumbrances is due to his own negligence, the better view, followed in New Jersey, is that negligence is not a bar to subrogation unless subsequent intervening rights are involved." Also instructive was *Camden County Welfare Bd. v. Federal Deposit Insurance,*[7] in which the court provided guidance on when a mistake would be a valid ground for claiming a lack of knowledge of a prior lien:

> But what degree of vigilance is to be exercised must depend upon the facts of each case. Where the act done by mistake is one calculated to induce others to take a line of conduct which will put them to loss if the mistake is corrected, it ought to be clear that the party asking for relief has been led into the mistake in spite of the employment of the highest degree of vigilance. Where, however, no one is injured by the mistake but the party himself, and no one has changed his position by reason of the act executed through the influence of the alleged mistake, I see no

> reason why the mistake should not be corrected although the highest degree of vigilance has not been exercised.

The *Abbey* court noted that the funds from the new loan were used to pay off a prior Washington Mutual mortgage and, in fact, the borrower did not receive additional or new funds. The court agreed that UPS Capital would be unjustly enriched if it were put in a first lien position, as it had expressly agreed its lien would be subordinated to the initial Washington Mutual mortgage.

Constructive Notice and Actual Notice

The issue of notice, however, both actual and constructive, remains a vexing one in the context of equitable subrogation law, and one that has still not been definitively resolved by the state Supreme Court. Constructive notice is notice by virtue of the fact that a document is duly recorded under the Recording Act. It has been consistently held that constructive notice is not a bar to the application of the doctrine of equitable subrogation.[8] In fact, most cases involving equitable subrogation arise because a title commitment fails to disclose a recorded mortgage. Accordingly, the courts in New Jersey generally have applied the doctrine where the lack of knowledge of an intervening mortgage is due to error or negligence, even though the intervening mortgage is recorded.

Court decisions, however, are inconsistent regarding whether actual knowledge should be a bar to the application of the doctrine. One of the first cases considering this issue was *Home Owners' Loan Corp. v. Collins*.[9] There, the court found the complainant was entitled to subrogation despite the fact that both the application for the loan and the title search revealed another mortgage. In fact, the court found there was some carelessness on the part of some employee of the complainant, and also found mistake or fraud on the part of the borrowers, because they submitted an affidavit that did not provide for the existence of the mortgage.

In 1983, the Appellate Division rendered a decision involving equitable subrogation in *Trus Joist Corp. v. Nat'l Union Fire Ins. Co*.[10] While this case has been frequently cited for the proposition that actual knowledge bars the application of the doctrine, the case, in fact, held to the contrary. In *Trus Joist*, while the new mortgagee was aware the mortgaged property was the subject of a fraudulent conveyance action and a *lis pendens* had been filed, the refinancing went forward and prior liens were paid off. The court held the doctrine of equitable subrogation should nevertheless be applied, otherwise the intervening lienholder would be unjustly rewarded. The court reasoned that "[t]he fact that National Union [the new lender] was aware of the challenge to [the owners'] title does not require a different result, particularly since National Union did not participate in the fraudulent conveyance."[11] Ten years later, however, *Metrobank for Savings, FSB v. Nat'l Community Bank of N.J.*[12] erroneously cited *Trus Joist* for the proposition that actual knowledge bars application of the doctrine. That led to a series of cases holding that actual knowledge is a bar.

The erroneous attribution to the *Trus Joist* court of a rule that actual knowledge is a bar to equitable subrogation was not challenged until the bankruptcy court addressed the issue in *Ricchi v. American Home Mortgage, Servicing, Inc. et al*.[13] There, the court observed (finally) that *Trus Joist* had been incorrectly relied upon and that *Trus Joist* and *Metrobank* actually conflicted with one another. Most importantly, the *Ricchi* opinion pointed out there was no New Jersey Supreme Court case that squarely addressed the issue. If it *did*, said Judge Judith Wizmur, it would hold that the doctrine of equitable subrogation should be applied even in cases where the new mortgagee had actual knowledge of the junior lien.

As the court observed:

> A comparison of the *Trus Joist* and *Metrobank* decisions evidences conflicting approaches to the issue of the impact of actual knowledge on the application of equitable subrogation. We have found no recent New Jersey Supreme Court case addressing the issue. Where New Jersey's highest court has yet to address particular application of state law, the role of the federal court is to "predict how [the state's highest court] would decide the issue were it confronted with the problem." *Jaworowski v. Ciasulli,* 490 F.3d 331, 333 (3d Cir. 2007) (quoting *Packard v. Provident National Bank,* 994 F.2d 1039, 1046 (3d Cir. 1993)). The dictum discussed in the latest Appellate Division case addressing this issue, *Investors Savings Bank,* references the view of the Restatement (Third) of Property that actual knowledge of an intervening recorded lien should not defeat the right to equitable subrogation in the absence of a showing that the intervening liener was prejudiced by the refinancing of the original mortgage. Several state supreme court decisions agreeing with the Restatement are referenced as well. *It is within the realm of reasonableness to predict that the New Jersey Supreme Court would opt for a fact sensitive inquiry that focuses on unjust enrichment or prejudice to the junior mortgagee if equitable subrogation is imposed, rather than impose an absolute bar to the application of the doctrine where the new mortgagee had actual knowledge of the junior lien.*[14]

In *Ricchi*, the court concluded the junior lienholder would be unjustly enriched by the failure to apply the doctrine of equitable subrogation, as the expectation of the junior lienholder was always to be subordinate to the first

mortgagee and the new lender intended to have a first-priority mortgage. The court held the circumstances appeared to be more akin to negligence on the part of the new mortgagee in accepting a mortgage from the debtors without insuring that all junior liens were accounted for.

The most recent pronouncement concerning the effect of knowledge upon the application of equitable subrogation is *Sovereign Bank v. Joseph M. Gillis, et. al.*[15] The facts of the case were straight-forward and uncontested:

1. Joseph and Eulaia Gillis borrowed $650,000 from Washington Mutual Bank (WaMu) in May 1998, for a 30-year term, with an annual interest rate at 6.625 percent.
2. In December of that year, Gillis obtained a home-equity line of credit from Broad National Bank, secured by a mortgage placing Broad National Bank in second position.
3. In Oct. 2001, Gillis obtained another mortgage loan, from Crown Bank, placing Crown Bank in third position.
4. In March 2003, Gillis obtain another home-equity line of credit, this time from Independence Community Bank, in the principal amount of $500,000, also secured by a mortgage. The funds from this loan were used to pay off the loans from Broad National Bank and Crown Bank, whose mortgages were discharged. This resulted in Independence Community Bank being in second place behind WaMu.
5. In Jan. 2005, Gillis borrowed $1.19 million from WaMu for a 30-year term, but with an adjustable interest rate lower than the first mortgage loan rate. This loan carried an adjustable interest rate initially set at 4.027 percent. The loan was used to pay off the remaining debt of $482,023.67 from the original WaMu mortgage, as well as the debt of $499,921.93 on the Independence Community Bank line of credit.
6. Clearly, WaMu knew about the Independence Community Bank line of credit, but failed to have that mortgage discharged of record, and Gillis continued to borrow on that line.

Gillis defaulted on both the new WaMu loan and the Independence Community Bank line of credit. Deutsche Bank, as assignee of the WaMu mortgage, and Sovereign Bank, as assignee of the Independence Community Bank mortgage, both filed foreclosure actions, each asserting they should be in first-lien position. Sovereign Bank contended equitable subrogation should not be invoked, since WaMu had actual knowledge of the Independence Community Bank line of credit.

Judge Jack Sabbatino, writing for the court, viewed the refinancing as a "replacement" or a "modification," since the refinancing by WaMu was of its own mortgage, and did not believe that priority had to be determined by equitable subrogation principles. But the court agreed the analysis should focus on "material prejudice," examining "...such aspects as the respective loan amounts involved, the interest rates, and, potentially the loan terms." Of critical importance was the court's following conclusion: "Actual or constructive knowledge by the refinancing lender, if it is the same original lender or its corporate successor, should be irrelevant."

As stated above, the new loan by WaMu was in the principal amount of $1.19 million compared with the original WaMu loan of $650,000, and the court addressed whether the "cap" on the priority of the new WaMu mortgage should be: 1) the original $650,000 loan amount; 2) the $534,000 balance at the time the Independence Community Bank loan issued in 2003; or 3) the approximate $482,000 balance at the time of the refinancing in 2005. The case was ultimately remanded, the court deferring to the trial court, on the question of whether there was "material prejudice" to Sovereign and the appropriate priority amount. What is abundantly clear, however, is the WaMu mortgage would be in first place, but not for more than $650,000, thereby putting in peril the balance of its outstanding loan (*i.e.*, the amount due in excess of $650,000), as it failed to discharge the initial line of credit of Independence Community Bank at the time WaMu issued its loan. The result is that all parties were put at risk: WaMu for the excess of its loan over the cap; Independence Community Bank for having continued to allow advances on the line of credit; and WaMu's counsel and title company, who failed to discharge Independent Community Bank's line of credit.

Practical Problems

As explained, if the doctrine of equitable subrogation applies, the new lender is subrogated to the extent of all monies advanced to pay off prior loans (plus interest), but *not* the full amount of the new mortgage. As such, even if the doctrine applies, the new lender still faces problems with its foreclosure, depending on the value of the property, the amount of its mortgage, and the timing of any pending foreclosure actions. For example, assume the existing first mortgage is $500,000, the existing second mortgage is $100,000, the new loan is in the amount of $750,000, and the value of the property is $1,000,000. Further, assume the second mortgage is already in foreclosure and the sheriff's sale is pending. If the doctrine is applied, the new mortgage is effectively in first and third position (first regarding the $500,000 paid off, but third regarding the last $250,000 advanced). If the second mortgagee gets to final judgment and sheriff's sale first, the 'third mortgage' of $250,000 is effectively extinguished, and the successful bidder at the sheriff's sale would acquire title, subject only to a first mortgage of $500,000. Even if the first mortgagee gets to sheriff's sale first, it may compel the second mortgagee

to bid to protect its second position, and then the first mortgagee has to make a decision whether it needs to bid to protect its third position.

Successfully asserting an equitable subrogation argument is obviously most beneficial when the new mortgage is close in amount to the first position it is stepping into. ⚖

Endnotes

1. 29 Roger A. Cunningham and Saul Tischler, *N.J. Practice, Law of Mortgages* § 147 (1975); Lawrence J. Fineberg, *Handbook of New Jersey Title Practice* § 8121 (1995); *Restatement of Restitution* §§ 162 & 207 (1937)).
2. Roger A. Cunningham and Saul Tischler, 29 *N.J. Practice, Law of Mortgages* § 147 (1975); Lawrence J. Fineberg, *Handbook of New Jersey Title Practice* § 8121 (1995); George E. Osborne, *Handbook on the Law of Mortgages* § 282 (2d ed. 1970).
3. *Id*. at 138 (*citing Home Owner's Loan Corp. v. Collins,* 120 N.J. Eq. 266, 267-68 (Ch. 1936)).
4. 408 N.J. Super. 524 (Ch. Div. 2012).
5. *Kaplan v. Walker,* 164 N.J. Super. 130, 138 (App. Div. 1978).
6. 300 N.J. Super. 559, 565 (App. Div. 2000).
7. 1 N.J. Super. 532, 550 (Ch. Div. 1948).
8. *First Fidelity Bank, Nat'l Ass'n, South v. Travelers Mortg. Servs., Inc.,* 300 N.J. Super. 559, 565 (App. Div. 1997).
9. 120 N.J. Eq. 266, 269 (Ch. Div. 1936).
10. 190 N.J. Super. 168 (App. Div. 1983) *rev'd on other grounds*, 97 N.J. 22 (1984).
11. *Id*. at 179.
12. 262 N.J. Super. 133, 143-44 (App. Div. 1993).
13. 470 B.R. 715, 2012 Bankr. LEXIS 2216 (D.N.J. 2012).
14. *Id.* at 722 (emphasis added). There is an extensive discussion by the court in *Ricchi* of recent Appellate Division case law questioning the impact of actual knowledge on the application of the doctrine, the court noting that in *Investors Savings Bank v. Keybank Nat'l Ass'n.,* 424 N.J. Super. 439, 446, fn.3 (App. Div. 2012), "the Appellate Division noted that courts in other jurisdictions, as well as the Restatement, have suggested that equitable subrogation should be applied even in cases where the refinancing mortgage holder had actual knowledge of junior liens." 470 B.R. at 721. In *Investors*, the court specifically stated:

> Because there is no evidence from which it could be found that ISB had actual knowledge of Keybank's judgment when it closed on the loan to Kelliher and the mortgage securing that loan, there is no need to decide whether New Jersey should follow the view of the *Third Restatement of Property* that even actual knowledge of an intervening recorded lien should not defeat the right to equitable subrogation in the absence of a showing that the intervening lienor was prejudiced by the refinancing of the original mortgage. See *Restatement (Third) of Prop. Mortgages* §7.6 comment 9E) (1997) ("Under this Restatement...subrogation can be granted even if the payor had actual knowledge of the intervening interest.") A number of other jurisdictions have adopted this view of the doctrine of equitable subrogation.

   424 N.J. Super. at 446, fn.3 (citations omitted).
15. 432 N.J. Super. 36 (App. Div. 2013).

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