New Jersey Supreme Court to Review Appellate Division Decision Affecting Lien Priority

Jessica A. Goldfinger

Greenbaum, Rowe, Smith & Davis LLP Client Alert
March 2016

During this term, the New Jersey Supreme Court will decide whether a New Jersey law firm's subsequently recorded mortgage for unpaid legal fees has priority over a factor's earlier recorded mortgages. This follows the Appellate Division ruling in *Rosenthal & Rosenthal, Inc. v. Benun, et al* that the law firm's mortgage could leap frog the factor's mortgages because the factor knew about the law firm's mortgage but continued to make discretionary advances to the borrowers.

A key element of the Appellate Division's decision was the finding that the factor's advances were discretionary rather than mandatory. Another important element was the finding that the factor's mortgages secured a revolving debt so that the amounts that were owed to the factor were advanced after it had acquired knowledge of the law firm's mortgage.

The Appellate Division's ruling created a dilemma for factors and other lenders providing revolving working capital financing. On the one hand, continuing to make advances after an intervening mortgage has been recorded might result in a loss of priority. On the other hand, refusal to make advances and cutting off the borrower's cash flow might lead to lender liability exposure. Since it will now review the Appellate Division's ruling, the Supreme Court may alleviate this problem.

Background

Rosenthal & Rosenthal, Inc. provided businesses with traditional factoring services by purchasing accounts receivables at a discount and then providing cash to satisfy immediate cash flow needs. In July 1995, Rosenthal entered into a factoring agreement with Jazz Photo Corporation, a camera sales business, owned by Jack Benun. In the factoring agreement, Rosenthal agreed to advance to Jazz Photo, at its discretion, "up to seventy percent (70%) of the net amount of receivables" it purchased.

In August 2000, defendant Vanessa Benun, Jack Benun's daughter, executed a guaranty pursuant to which she agreed to pay Rosenthal the amounts owed by Jazz Photo. The guaranty was secured by a first mortgage on an Ocean Township property.

In March 2005, Rosenthal entered into another factoring agreement with Ribi Tech Products, LLC. The agreement provided that Rosenthal would advance sums to Ribi Tech "in its sole discretion." In connection with this transaction, another guaranty was executed by Vanessa Benun, secured by a second mortgage on the Ocean Township property.

In March 2007, Vanessa Benun executed a third mortgage on the Ocean Township property in favor of defendant Riker, Danzig, Scherer, Hyland & Perretti, LLP. At the time, Jack Benun owed the Riker firm $1.68 million in unpaid legal fees.

Rosenthal now had two mortgages on the Ocean Township property, recorded in 2000 and 2005, while Riker had a subsequent mortgage on the same property recorded in 2007.

In April 2012, Rosenthal filed a foreclosure action against Vanessa Benun, her husband and Riker. However, Riker claimed that its 2007 mortgage had priority over Rosenthal's 2000 and 2005 mortgages. Rosenthal and Riker filed motions for summary judgment on the issue of priority. The trial court granted Rosenthal's motion.

Riker filed an appeal arguing that its 2007 mortgage had priority over the discretionary advances Rosenthal made after it had actual notice of Riker's mortgage. The Appellate Division concluded that Riker had priority over Rosenthal as to any discretionary future advances made after Rosenthal had actual notice of Riker's 2007 mortgage. The Court found that Rosenthal had actual knowledge of Riker's 2007 mortgage by no later than August 2007.

In reaching its decision, the Court noted that Rosenthal was "in a position to avoid subordination of its future advances simply by declining to make additional advances until the [2007 mortgage] might expressly be made subordinate to the Rosenthal mortgages."

Conclusion

Based on the Appellate Division's decision, if a factoring agreement provides for discretionary advances, and the factor makes those advances with actual knowledge of a subsequent mortgage, the factor's lien priority will be at risk. Accordingly, lenders should review their loan documents on this issue to ensure their priority is adequately protected under such circumstances.

The issue for a factor may be more complicated than "simply . . . declining to make additional advances" as suggested by the Appellate Division. Typically, factoring of accounts receivable is the borrower's source of working capital. A decision to decline to make additional advances could well put the borrower out of business and expose the factor to a "lender liability" claim. Therefore, the factor may incur greater loss exposure by "declining to make additional advances" than it would if the additional advances were subordinated. It would depend on the amounts involved and the specific circumstances.

Since the New Jersey Supreme Court will review the Appellate Division's ruling, it may have recognized these business concerns and may provide further guidance and clarification.

The author of this Alert, **Jessica A. Goldfinger**, is a member of the firm's **Banking, Business Financing & Creditors' Rights Practice Group**.