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Establishing the Priority, Validity and Enforceability of Mortgage Liens

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Lenders, unfortunately, are confronted with the situation in which the validity or priority of a mortgage is challenged based on a prior mortgage not being paid off due to acts ranging from simple negligence on the part of an attorney, settlement agent or title agent, to forgeries of discharges or some other fraudulent conduct. There are several ways in which lenders and other lienholders may seek to establish the validity or priority of their liens in the face of such claims. Two such methods, and their recent evolution, will be discussed here: equitable subrogation and ratification.

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Equitable Subrogation

"When a lender advances money to pay off a mortgage, the new mortgagee may be subrogated to the priority rights of an old mortgagee by assignment or by express agreement with the debtor or creditor." *Metrobank For Sav., FSB v. Nat'l Cmty. Bank of New Jersey*, 262 N.J. Super. 133, 143 (App. Div. 1993). When no such assignment or agreement exists, the new lender nonetheless may use the doctrine of equitable subrogation to be subrogated to the priority rights of the old mortgage. "The prototypical situation in which a court will apply the doctrine of equitable subrogation is where a mortgage with priority over other liens on a property is refinanced by a new mortgage used to pay off the outstanding balance on the old mortgage." *Investors Sav. Bank v. Keybank Nat. Ass'n*, 424 N.J. Super 439, 444 (App. Div. 2012).

Traditionally, a lender utilizing the doctrine of equitable subrogation has to prove it had no knowledge of the alleged title issue threatening the validity or priority of its mortgage. "[A] mortgagee who accepts a mortgage whose proceeds are used to pay off an older mortgage is equitably subrogated to the extent of the loan so long as the new mortgagee lacks knowledge of the other encumbrances. In that situation, the new mortgagee, by virtue of its subrogated status, can enjoy the priority afforded the old mortgagee." *U.S. Bank, N.A. v. Hylton,* 403 N.J. Super. 630, 638 (App. Div. 2008) (citations omitted); see also, *Metrobank*, 262 N.J. Super. at 143-44 (same). However, "[e]quitable subrogation may still be afforded even though the lack of knowledge on the part of the new mortgagee occurs as a result of negligence." *U.S. Bank*, 403 N.J. Super. at 638.

Recently, however, courts in New Jersey have begun to broaden the applicability of the equitable subrogation remedy. Though the New Jersey case law still requires that a mortgagee not have actual knowledge of an intervening lien or another issue with title to be able to argue equitable subrogation, recent decisions have indicated—without explicitly holding—that New Jersey courts may be accepting of the approach recommended by the Restatement and a minority of other jurisdictions that actual knowledge alone should

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not be a bar. See, *Sovereign Bank v. Gillis*, 432 N.J. Super. 36, 47 (App. Div. 2013) ("Under the *Third Restatement's* alternative approach, the pertinent limiting factor is not the new lender's knowledge, but instead whether there has been 'material prejudice' to the intervening lienor."); *In re Ricchi,* 470 B.R. 715, 721 (Bankr. D.N.J. 2012); *Investors Sav. Bank*, 424 N.J. Super. at 446 .

Indeed, though technically distinguishable from equitable subrogation, a New Jersey court also recently found that, if the lender who holds a priority lien replaces it with another mortgage via a refinancing, this "replacement lien" is given priority regardless of the lender's knowledge of other encumbrances. See, *Gillis*, 432 N.J. Super. at 47 (giving a refinancing lender priority over a junior lienholder despite the lender's knowledge of the junior lien because "[a]ctual or constructive knowledge by the refinancing lender, if it is the same original lender or its corporate successor, should be irrelevant").

New Jersey's creeping move away from the actual knowledge prohibition on equitable subrogation liens is consistent with other recent decisions in jurisdictions nationwide. See, eg., *Bank of Am., NA v. Prestance Corp.,* 160 P.3d 17 (Wash. 2007); *Bank of New York v. Nally*, 820 N.E.2d 644, 654 (Ind. 2005); *Lamb Excavation v. Chase Manhattan Mortgage Corp.,* 95 P.3d 542, 548 (Az. App. 2004).

This move is also on the right side of the law, as it would be inequitable if a lender, with knowledge of multiple mortgages on a property, advanced money to discharge all prior mortgages only to later discover that only some of the mortgages had been paid off, such as the situation in *Metrobank*. There, the borrower's attorney discovered at the closing that the new lender's loan would be $15,000 short of paying off all prior mortgages and allegedly reached an oral subrogation agreement with the remaining mortgagee. 262 N.J. Super. at 137-138. The agreement was never confirmed in writing, however, and the court held that the new lender's actual knowledge of the other mortgage barred equitable subrogation. Id. at 143-44.

Ratification

In addition to the equitable subrogation remedy, a lender may seek to uphold the validity of a mortgage lien through the doctrine of ratification. Ratification is the affirmance by a principal of "a prior act which did not bind him" but was done on his account by his agent. *In re Dwek*, 2010 WL 2196417, at *4 (D. N.J. June 1, 2010). Upon ratification, the act is given full effect as if it was originally authorized. Courts have noted that an unauthorized act may be ratified if "'exacting standards' are met." *Citizens First Nat. Bank of N.J. v. Bluh,* 281 N.J. Super. 86, 98 (App. Div. 1995).

In order to ratify an unauthorized act, a principal must have the intent to ratify it. See, *In re Dwek*. The principal must also have "full knowledge of all the relevant facts and [a] full appreciation" of what was done. *Citizens First Nat. Bank of N.J.,* 281 N.J. Super. at 98. Further, they "must be 'fully apprised of the effect of the act … and his or her legal rights in the matter.'" Id. Nevertheless, "'[t]he intent to ratify an unauthorized transaction may be inferred from a failure to repudiate it.'" Id. Silence may constitute ratification, if "it is shown that the principal did nothing or said nothing after he was fully informed of what his agent has done." Id. Thus, if "the silence of a principal may cause loss to a third person," he must repudiate his agent's act "without unreasonable delay," upon receiving notice that an agent has exceeded his authority. Id. at 99.

In *Citizens First National Bank of N.J.*, the Appellate Division held that the validity of a mortgage may be upheld based on the doctrine of ratification. 281 N.J. Super. at 86. There, one member of a partnership mortgaged the partnership's property without the other partners' knowledge and in violation of the partnership's requirement that a majority interest of the partners approve any such acts. Eventually, another partner discovered the mortgage, but failed to repudiate it based on the mortgaging partner's promise that he would pay it off quickly. The partnership then defaulted on the mortgage and the lender initiated a foreclosure action. The partnership filed a counterclaim requesting that the mortgage be invalidated because it was void ab initio, as the mortgaging partner lacked the authority to place the mortgage on the property. The trial court agreed with the partnership's argument, but the Appellate Division reversed that decision. Though it found that the bank had been put on notice that it needed to make a further inquiry into the partnership's interest in the property and the partner's ability to mortgage it, the court nonetheless held that the non-mortgaging partner may have ratified the mortgage when he discovered its existence and did not immediately repudiate it and remanded the case to the trial court for further analysis.

Likewise, in *In re Dwek*, the property owners challenged the validity of a mortgage on their property that secured a $1.5 million loan. 2011 WL 843635 (D.N.J. Mar. 8, 2011). The property owners, a husband and wife, argued that their nephew, Solomon Dwek, had forged their signatures on the note and mortgage and that the documents were therefore invalid and the mortgage was unenforceable. The court, however, found that Joseph Dwek, the husband, had discovered the allegedly void mortgage by at least March 2005 and did not repudiate it to the bank until June 2006, and that "[b]y waiting from March 2005 to June 2006 to repudiate the loan, instead allowing Solomon to continue servicing the loan on the basis of Solomon's representations that he would take care of it, without any further communication to the bank, Joseph manifested an intent to ratify the loan." Id. at *8. Moreover, the court found that Joseph's ratification could be imputed to his wife because his wife allowed him to act as her agent in financial matters, and the bank therefore did not have to prove that she independently ratified the mortgage.

Though lenders confronted with claims of missed liens, fraud or forgery often may believe themselves to be without an adequate remedy, New Jersey's equitable doctrines, including equitable subrogation and ratification, may offer some solace. More importantly, they offer an opportunity for the lender to re-establish the validity or priority of the mortgage and the potential to recoup some of the lender's potentially lost investment. ■