



# New Jersey Court Holds Actual Knowledge Does Not Bar Equitable Subrogation

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In a letter opinion issued on June 21, 2018, the Superior Court of New Jersey, General Equity Part in Hudson County, held that a lender's actual knowledge of a prior mortgage does not operate as a bar to equitable subrogation. See Citizens Bank, N.A. v. Davis, et al., HUD-F-18941-17 (June 21, 2018). While unpublished, this opinion is significant in that it is a continuation of the departure by New Jersey courts from prior precedent holding that actual knowledge of a lien bars the application of equitable subrogation, as expressed in First Union Nat. Bank v. Nelkin, 354 N.J. Super. 557 (App. Div. 2002) ("the new lender is not entitled to subrogation, absent an agreement or formal assignment, if it possesses actual knowledge of the prior encumbrance").

In this case, the owner of a residential property encumbered the property with two mortgages in 2011 (the "Prior Mortgages"). In May 2012, the owner sold the property to her nephew. On October 19, 2012, the nephew obtained a home equity line of credit secured by a mortgage on the property from Citizens Bank (the "First Mortgage"). The First Mortgage was recorded in November 2012. On October 26, 2012—after the First Mortgage was executed but before it was recorded—the nephew obtained another loan and executed a mortgage to MERS, as nominee for TD Bank (the "Second Mortgage") that was recorded in December 2012. After the nephew defaulted on his loan with Citizens Bank, Citizens Bank brought this foreclosure action. TD Bank contested the action by arguing that its Second Mortgage should have priority over the First Mortgage pursuant to the doctrine of equitable subrogation because the proceeds from TD Bank's loan paid off the Prior Mortgages. At trial, TD Bank's representative testified that TD Bank believed it was getting a first mortgage on the property because it purportedly was unaware of the then-unrecorded First Mortgage and that the documentary evidence demonstrated that its funds were used to satisfy the Prior Mortgages. Citizens Bank's representative at trial testified that it ran a title search that did not reveal any prior mortgages, and that it also believed it was getting a first

mortgage on the property.

The Court agreed with TD Bank and held that TD Bank is entitled to have the Second Mortgage equitably subrogated to the first lien position on the property. After explaining the doctrine of equitable subrogation, the Court noted that the court in In re Ricchi, 470 B.R. 715 (Bankr. D.N.J. 2012) predicted that the New Jersey Supreme Court would adopt the holding of Restatement (Third) of Prop. Mortgages § 7.6 that rejects the traditional view that actual knowledge operates as a bar to equitable subrogation. Instead, the court in In re Ricchi held that actual knowledge is not a bar and that the inquiry should instead focus on “unjust enrichment or prejudice to the junior mortgagee.” The Court here agreed with that analysis and, although it found that there was no cognizable evidence that TD Bank had actual knowledge of the First Mortgage, it held that “[e]ven if Plaintiff demonstrated that Defendant had actual knowledge of Plaintiff’s prior mortgage, the Court finds that Defendant would still be protected by equitable subrogation under the [R]estatement approach, as the pertinent factor is not the Defendant’s knowledge, but rather whether there has been ‘material prejudice’ to the intervening lienor, or in this instance, Citizens Bank.” The Court then proceeded to state: “While it is unfortunate that Plaintiff was the victim of a defective title search, the Court will not simply ignore the two (2) prior mortgages on the property because of a third-party’s mistakes. . . . the Court finds that Plaintiff will not suffer prejudice by the imposition of equitable subrogation, and that any harm to the Plaintiff was caused by a third party, which is of no moment to the case at hand.” Thus, because TD Bank paid off the Prior Mortgages, it was entitled to equitable subrogation despite being the second mortgage recorded on the property.

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