New Jersey Appellate Division Finds Actual Knowledge Does Not Bar Equitable Subrogation

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In a decision approved for publication, the New Jersey Appellate Division recently found that actual knowledge is not a bar to the doctrine of equitable subrogation for a lender who paid off a prior mortgage but failed to discharge an intervening lien. See New York Mortg. Tr. 2005-3 Mortg.-Backed Notes, U.S. Bank Nat'l Ass'n as Tr. v. Deely, 2021 WL 520063 (N.J. Super. Ct. App. Div. Feb. 12, 2021). In 2005, the borrowers executed a $664,000 first mortgage secured by their home. Three months later, they executed a second mortgage that secured a home equity credit line account (the "HECLA Mortgage") that was assigned to defendant. A few months after that, the borrowers refinanced with a $726,000 mortgage that eventually was assigned to plaintiff (the "NYMT Mortgage"). The proceeds from this loan were used to pay off the prior first mortgage on the property. At the time of closing, defendant advised that the HECLA Mortgage had a zero balance. Nonetheless, the HECLA Mortgage was never discharged, and the borrowers later successfully sought two amendments to the credit line increasing the limit from $80,000 to $200,000 and drew down on same.

In 2013, the borrowers defaulted on the NYMT Mortgage with plaintiff. Plaintiff's title search revealed that the HECLA Mortgage was not discharged and was the first mortgage of record. In its foreclosure complaint, plaintiff sought a judgment that the NYMT Mortgage was the first mortgage under the doctrine of equitable subrogation because it had paid off the prior first lien on the property. Plaintiff moved for summary judgment and, in opposition, the HECLA Mortgage lender argued that plaintiff had actual knowledge of the HECLA Mortgage and that equitable subrogation could not apply. The trial court granted plaintiff's motion for summary judgment, finding that plaintiff was, at most, negligent in not discharging the HECLA Mortgage, and that negligence is not a bar to equitable subrogation.

On appeal, the Court affirmed. The Court first acknowledged that it previously had held that actual knowledge of an intervening lien acts as a bar to equitable subrogation. See Metrobank for Savings, FSB v. National Community Bank of New Jersey, 262 N.J. Super. 133, 143-144 (App. Div. 1993) ("a mortgagee who accepts a mortgage whose proceeds are used to pay off an old mortgage is subrogated to the extent of the loan only where the new mortgagee lacks knowledge of other encumbrances."); First Union Nat. Bank v. Nelkin, 354 N.J. Super. 557, 565 (App. Div. 2002) ("[t]he new lender is not entitled to subrogation, absent an agreement or formal assignment, if it possesses actual knowledge of the prior encumbrance."). Nonetheless, it found that the Third Restatement's recommended approach—which allows for subrogation when the payor expected to receive a first lien and so long as the intervening lender would not be prejudiced—was preferable in this situation:

> We depart from the holding in Nelkin and adopt the Third Restatement's sound approach. Equitable subrogation is appropriate when loan proceeds from refinancing satisfies the first mortgage, the second mortgage is paid in full as part of the transaction, and the transaction is based on a discharge of the second mortgage, so long as the junior lienor, here defendant, is not materially prejudiced. See Gillis , 432 N.J. Super. at 50. Under such circumstances, equitable subrogation should not be precluded by the new lender's actual knowledge of the intervening mortgage. "To do otherwise would allow [defendant] to reap an undeserved windfall" by "allowing the junior lienor to vault over the priority of the refinancing mortgage lender."

The Court's decision here adopting the Third Restatement approach is the culmination in a recent line of cases that implied New Jersey eventually would follow the Third Restatement and find that actual knowledge is not a bar to equitable subrogation in such cases. See In re Ricchi, 470 B.R. 715, 721 (Bankr. D.N.J. 2012) ("courts inin 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"); Sovereign Bank v. Gillis, 432 N.J. Super. 36, 47 (App. Div. 2013) (finding that the doctrine of "replacement," rather than equitable subrogation, applied because the original and subrogated loans were from the same lender, but that actual knowledge should

not act as a bar).

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