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'Deely' Expands Lender's Use of Equitable Subrogation to Protect Priority Status

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All practitioners involved in New Jersey real estate litigation need to be aware of the Appellate Division decision in *Tr. 2005-3 Mortg.-Backed Notes, U.S. Bank Nat'l Ass'n as Tr. v. Deely*, 2021 WL 520063 (App. Div. 2021), which expands the situations in which a lender can use the doctrine of equitable subrogation to protect the priority status of a lien by holding that a lender's knowledge of a prior competing lien does not bar the application of the doctrine.

Case Law Pre-Deely

To appreciate the import of *Deely,* some background is helpful. The doctrine of equitable subrogation allows a lender's refinance mortgage to obtain priority over earlier-recorded mortgages and other property interests by placing the lender's refinance mortgage by equitable assignment in the position of the mortgage that was discharged by the proceeds of the lender's refinance loan. *See Equity Sav. and Loan Ass'n v. Chicago Title Ins. Co.*, 190 N.J. Super. 340, 342 (App. Div. 1983). The doctrine is frequently used on behalf of lenders to secure a priority lien position when a mortgage is found to be technically invalid, improperly recorded, or other prior mortgages are not discharged as intended due to mistake, fraud or other circumstances. *See Mortg. Elec. Registration Sys. v. Massimo*, 2006 WL 1477125, *4 (N.J. Super. Ch. Div. May 26, 2006). The doctrine is an equitable device intended to avoid the unjust enrichment and "to compel the ultimate discharge of an obligation by the one who in good conscience ought to pay it." *Standard Acc. Ins. Co. v. Pellecchia*, 15 N.J. 162, 171 (1954).

In 1993, the Appellate Division held in *Metrobank for Savings, FSB v. National Community Bank of New Jersey*, that a

lender is not entitled to the application of the doctrine of equitable subrogation if it had actual knowledge of the other encumbrances over which it seeks to obtain priority. 262 N.J. Super. 133, 143-144 (App. Div. 1993). Interestingly, in support of the imposition of this knowledge exception to the doctrine of equitable subrogation, *Metrobank* relied on *Trus Joist Corp. v. Nat'l Union Fire Ins. Co.*, which actually applied equitable subrogation despite a mortgagee's knowledge of a prior encumbrance. 190 N.J. Super. 168 (App. Div. 1983), *rev'd on other grounds,* 97 N.J. 22 (1984).

Nonetheless, following *Metrobank* numerous New Jersey cases recognized and/or applied this knowledge exception. See, e.g., *First Fidelity Bank, NA, South v. Travelers Mortgage Servs.,* 300 N.J. Super. 559, 568 (App.Div.1997); *First Union Nat. Bank v. Nelkin*, 354 N.J. Super. 557, 565 (App. Div. 2002); *U.S. Bank Nat. Ass'n v. Hylton*, 403 N.J. Super. 630, 638 (Ch. Div. 2008). The main justification given for this rule was that "a new lender would not be 'unjustly' enriching an intervening lienor if it deliberately loaned new funds to the creditor well aware of the existence of that prior lien." *Sovereign Bank v. Gillis*, 432 N.J. Super. 36, 45 (App. Div. 2013).

Almost a decade after *Metrobank*, courts began to question the wisdom of the knowledge exception. In a footnote in its 2012 decision in *Investors Savings Bank v. Keybank Nat'l Ass'n,* the Appellate Division acknowledged, but did not adopt, the modern trend set forth in the Third Restatement of Property §7.6 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." 424 N.J. Super. 439, 446 fn.3 (App. Div. 2012).

In *Ricchi v. American Home Mortgage, Servicing,* the U.S. Bankruptcy Court for the District of New Jersey analyzed equitable subrogation law and concluded that the New Jersey Supreme Court would not adopt the knowledge exception. 470 B.R. 715 (Br. D.N.J. 2012). Then, in *Gillis*, the Appellate Division again questioned the knowledge exception and carefully analyzed the merits of the Third Restatement of Property's approach to equitable subrogation. 432 N.J. Super. at 46. The *Gillis* court ultimately found it unnecessary to decide whether to adopt a new rule as to equitable subrogation because it decided the case based on the *loan replacement and substitution theory* also promulgated by the Third Restatement. Both *Investors* and *Gillis* recognized that a number of other jurisdictions had rendered decisions adopting the Third Restatement's approach that actual knowledge of a pre-existing lien should not bar a refinancing lender from obtaining equitable subrogation. *See, e.g., Bank of N.Y. v. Nally*, 820 N.E.2d 644, 652–54 (Ind. 2005); *Bank of Am., N.A. v. Prestance Corp.*, 160 P.3d 17, 21–19 (Wa. 2007); *Am. Sterling Bank v. Johnny Mgmt. LV*, 245 P.3d 535, 539 (Nev. 2010).

The Appellate Division's *Deely* Decision

It is with this history that the *Deely* case came before the Court. In *Deely* the borrowers executed a first mortgage secured by their home. Three months later, they executed a second mortgage that secured a home equity credit

line account (HECLA). Later, the borrowers refinanced the first mortgage. At the time of closing, the refinancing lender was advised that the HECLA mortgage had a zero balance. Nonetheless, the HECLA mortgage was never discharged, and the borrowers later successfully increased the credit limit of the HECLA from $80,000 to $200,000 and then drew down on it. When the borrowers defaulted on the refinancing loan, the assignee of the refinancing lender sought to foreclose based on the doctrine of equitable subrogation. The assignee of the HECLA mortgage opposed that relief based on the fact that the refinancing lender had actual knowledge of the HECLA mortgage. The trial court granted summary judgment in favor of the refinancing lender based on the court's finding that the lender was entitled to equitable subrogation.

In its decision, the Appellate Decision acknowledged its prior case law holding that actual knowledge prevents application of the doctrine of equitable subrogation. Nonetheless, relying heavily on the analysis in *Gillis*, the court formally adopted the Third Restatement's approach to equitable subrogation. Specifically, the court held that:

> 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. Under such circumstances, equitable subrogation should not be precluded by the new lender's actual knowledge of the intervening mortgage.

Id. (citation omitted). Quoting *Gillis*, the court held that "[t]o 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." *Id.* Finding no prejudice would inure to the HECLA lender, the court therefore affirmed the decision of the trial court that the refinancing lender was entitled to equitable subrogation.

Deely thus expands the situations in which the doctrine of equitable subrogation may be applied by confirming the end to the prohibition against the application of the doctrine in situations where a refinancing lender had knowledge of a prior lien. So long as an existing lender is not materially prejudiced, a refinancing lender whose funds were used to pay off a first mortgage may now be able to assert a viable claim for prior-lien status, even if it knew of the existence of a property interest over which it seeks priority at the time it made a loan.

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