Lenders Will Not Lose Mortgage Priority in New Jersey

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A July 26, 2016 article published on Lexology addressed a recent decision by the New Jersey Supreme Court, Rosenthal & Rosenthal v. Benun, 2016 WL 39119107 (N.J. July 21, 2016) concerning mortgage priority in a very limited situation involving optional loan advances. The article is entitled "In Stinging Rebuke to Financial Institutions and Title Companies, NJ Supreme Court Favors Law Firm's Effort to Collect Unpaid Legal Bills," by Sherman Wells Sylvester & Stamelman, LLP. Unfortunately, the article's title mischaracterizes the decision and its import. While a superficial review of the case might lead one to conclude that the decision made new law or was a "rebuke" pitting the collection of legal fees against the concerns of lenders and title companies, those conclusions would be mistaken.

In fact, the case does not make new law but, rather, as the Supreme Court stressed, merely applies well-settled priority rules that have been in place at least since the mid-19th century and were codified by the New Jersey Legislature in the 1980's. The case involved a straightforward issue: did optional advances made by the plaintiff, which were secured by recorded mortgages, take priority over a mortgage securing legal fees owed to Riker Danzig Scherer Hyland & Perretti, LLP, which was recorded after the plaintiff's mortgages, but before its advances, where the advances were made with actual knowledge of Riker Danzig's intervening mortgage? Every Appellate Division Judge and Supreme Court Justice who reviewed the case sided with Riker Danzig and held that its intervening mortgage took precedence over the lender's advances under the well-settled case law and the governing statute. The trial judge's initial judgment in favor of the plaintiff was reversed by a unanimous Appellate Division panel, in a decision reported at 441 N.J. Super 184 (App. Div. 2015), and the Appellate Division was unanimously affirmed by the New Jersey Supreme Court.

The appellate courts' unanimity is unsurprising. Since the 19th century, the common law rule in virtually every jurisdiction that has considered the issue, including New Jersey, has been that discretionary loan advances secured by a previously-recorded mortgage, but made with actual knowledge of an intervening lien, are subordinated to that lien. Though it dates back over a hundred years, the rule was reaffirmed by the New Jersey Supreme Court as recently as 1970 (in Mayo v. City Nat'l Bank & Trust Co., 56 N.J. 111, 117 (1970)) and by the Chancery Division in 1982 (in Lincoln Federal S & L Assoc. v. Platt Homes, Inc., 185 N.J. Super. 457, 462 (Ch. Div. 1982)).

As is discussed at length in the Supreme Court's decision, the common law rule essentially was codified in 1985. The rule received attention in the early 1980's because of the proliferation of home equity lines of credit ("HELOCs") and concern that advances made under those loan facilities could be subordinated to intervening liens. Under N.J.S.A. 46:9-8.1, et seq., which has been twice amended, in 1997 and 1998, where future advances secured by a mortgage are obligatory, as in a typical HELOC, the advances "relate back" to the date of the mortgage, and are not subordinated to intervening liens. However, where the advances are optional, they do not relate back and, thus, may be subordinated. Thus, after repeated consideration, the Legislature left common law rule in place.

Notably, the statute contains protections for lenders that agree to make so-called obligatory advances. Under the statute, advances remain "obligatory," and, thus, retain the original mortgage priority, even if the lender has the right to withhold advances for a number of specific reasons, including:

- "the financial condition of the borrower";
- an expiration date in the loan agreement;
- breach of the loan agreement;
- "an adverse change in the value or condition of any collateral";
- procedural conditions on draw-down requests;
- or a withdrawal of the lender from the business of providing such lines of credit.

Indeed, the lender has the right simply to cancel the agreement "on notice to the borrower" without affecting the "obligatory" status of advances and, therefore, their priority.

Plainly, with these protections spelled out in the statute, lenders can, and do, draft loan agreements to protect their ability to withhold funds and close lending facilities based on changed circumstances and business considerations, while still ensuring that their advances retain priority over any intervening liens.

In the Rosenthal matter, both the Appellate Division and the Supreme Court simply applied settled law by holding that Riker Danzig's intervening mortgage took priority over the plaintiff's subsequent advances because they were

(i) optional and (ii) made with actual knowledge of Riker Danzig's lien.

For a number of reasons, the Supreme Court's decision was neither a "rebuke" to financial institutions or title companies nor did it favor collection of legal fees over loans. First, the Court simply applied established law. Second, the nature of the debts was immaterial. Third, there is little reason to believe that the decision will have far-reaching consequences for either the lending or the title industry. If the rule were going to have a chilling effect on lending activity, for example, it would have done so long ago, since it has been around for well over a century and was codified thirty years ago. The absence of reported decisions concerning the rule shows that it rarely comes up and has not caused problems.

Indeed, the priority rule addressed in Rosenthal only arises in a narrow set of circumstances: where loan advances are optional with the lender and the lender obtains actual notice of the intervening lien. It does not apply to typical HELOCs, committed loan facilities (where the borrower simply draws down on a line of credit) or construction loans (which are governed by a separate set of rules). As noted, with the guidance provided in N.J.S.A. 46:9-8.1, et seq., lenders can, and do, draft loan agreements to ensure that the priority of their advances is protected while still retaining flexibility. In addition, even optional advances are not subordinated based merely on the recording of an intervening mortgage – the lender making such advances must have actual notice of the intervening lien. Therefore, lenders do not need to perform so-called "run-down" searches of title for liens before every discretionary advance.

As the Court stated, given that the Legislature has stepped in to regulate this arena, if the banking or title industries wish to further modify the rule, it would be most appropriate for such concerns to be raised directly with the Legislature.

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