REBUTTAL: Lenders Won‘t Lose Mortgage Priority In NJ

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A recent guest article in Law360 suggests that a case before the New Jersey Supreme Court "may have far-reaching ramifications for the lending industry." "NJ High Court: Lenders Could Lose their Mortgage Priority," Honecker and Stevinson, Law360, June 20, 2016, speculates that a long-settled mortgage priority rule applied by the New Jersey Superior Court Appellate Division — and now before the New Jersey Supreme Court — could raise transaction costs and interest rates and have a chilling effect on certain types of loans that provide for future advances.

Such consequences are unlikely. The case, Rosenthal & Rosenthal v. Benun, Docket No. 076266, involves the priority of discretionary loan advances secured by a previously-recorded mortgage but made after the lender obtains actual knowledge of an intervening mortgage — i.e., one given after the mortgage securing the advances was recorded, but before the advances were made. Since the 19th century, the common law in virtually every jurisdiction, including New Jersey, has been that, in that situation, the advances are subordinated to the intervening 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 National Bank & Trust Co., 56 N.J. 111, 117 (1970)) and by the Chancery Division in 1982 (in Lincoln Federal S&L Association v. Platt Homes Inc., 185 N.J. Super. 457, 462 (Ch. Div. 1982)). In the Rosenthal matter, the Appellate Division simply applied settled law to the facts before it by holding that an intervening mortgage recorded by the law firm of Riker Danzig Scherer Hyland & Perretti LLP took priority over subsequent advances secured by a prior mortgage because it was undisputed that the advances were (i) optional and (ii) made with actual knowledge of Riker Danzig's lien.

For a number of reasons, the "concerns" discussed in the Law360 article are unsupported. The most obvious

reason is that the Appellate Division simply applied established law. If the rule at issue were going to have a chilling effect on lending activity, increase borrowing costs, etc., it would have already done so. The dearth of case law concerning the rule indicates that it rarely comes up and has not been controversial.

Indeed, the rule at issue 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 home equity lines of credit (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). 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, under the rule, lenders do not need to perform so-called "run-down" searches of title for liens before every discretionary advance.

Significantly, the rule in the construction context is more onerous for lenders than the common law rule applied to the loans at issue in Rosenthal. Advances under construction loans are subordinated to intervening liens based on the mere recordation of those liens; actual notice is not required.

Further, the rule at issue has been visited three times by the New Jersey Legislature in the last 30 years — and reaffirmed by statute. The rule received considerable attention in the early 1980s because of the proliferation of HELOCs and concern that advances made under those loan facilities could be subordinated to intervening liens, even though they were obligatory. In New Jersey, the common law rules were essentially codified in 1985 in N.J.S.A. 46:9-8.1, et seq. Since then, the statute was twice amended, in 1997 and 1998. Under that statute, both in its original and in its current form, 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 has left the rule as it was at common law.

Importantly, 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 not to make the advances for a number of specifically-listed 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 drawdown 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.

In short, the Appellate Division's Opinion was well thought out and, in our view, the remote "risks" discussed in the

article do not warrant overturning over a century of well-settled law.

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