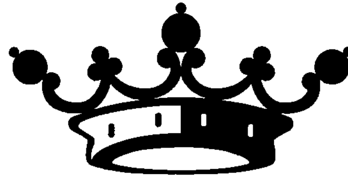
INSIDE THE MINDS

Mortgage and Finance Fraud Litigation Strategies

Leading Lawyers on Managing the Complexities of Fraud Cases, Understanding Government Regulations, and Structuring an Effective Litigation Plan



ASPATORE

©2010 Thomson Reuters/Aspatore
All rights reserved. Printed in the United States of America.

No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, except as permitted under Sections 107 or 108 of the U.S. Copyright Act, without prior written permission of the publisher. This book is printed on acid free paper.

Material in this book is for educational purposes only. This book is sold with the understanding that neither any of the authors nor the publisher is engaged in rendering legal, accounting, investment, or any other professional service. Neither the publisher nor the authors assume any liability for any errors or omissions or for how this book or its contents are used or interpreted or for any consequences resulting directly or indirectly from the use of this book. For legal advice or any other, please consult your personal lawyer or the appropriate professional.

The views expressed by the individuals in this book (or the individuals on the cover) do not necessarily reflect the views shared by the companies they are employed by (or the companies mentioned in this book). The employment status and affiliations of authors with the companies referenced are subject to change.

Aspatore books may be purchased for educational, business, or sales promotional use. For information, please email West.customer.service@thomson.com.

For corrections, updates, comments or any other inquiries please email TLR.AspatoreEditorial@thomson.com.

First Printing, 2010
10 9 8 7 6 5 4 3 2 1

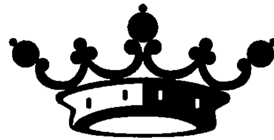
If you are interested in purchasing the book this chapter was originally included in, please visit www.west.thomson.com.

Protecting the Validity and Priority of Mortgage Liens in the Midst of Fraudulent Schemes

Michael R. O'Donnell

Partner

Riker Danzig Scherer Hyland & Perretti LLP



ASPATORE

Introduction

You have just been informed that a loan your institution has extended and that is secured by a mortgage is, in whole or part, the product of fraud. Is there any way you can preserve your mortgage? Yes. Even in situations where the putative borrower alleges that he or she did not give a mortgage, did not get value for the mortgage, or did not record the mortgage in a timely fashion, a lender may be able to protect the validity and priority of its mortgage under certain circumstances.

This chapter discusses five legal mechanisms by which a lender can defend the priority of its mortgage lien when faced with allegations of or actual fraud relating to the loan it made: equitable subrogation, ratification, reformation, equitable mortgage, and cure of defective notarization. Application of these equitable principles will aid mortgage lenders as they seek to mitigate losses due to fraud.

Equitable Subrogation

The doctrine of equitable subrogation holds that the lender's mortgage may obtain priority over earlier-recorded mortgages or liens not discharged for some reason (usually mistake or fraud) if that lender's mortgage loan paid off liens that were themselves superior to the earlier-recorded liens not discharged. The doctrine is an exception to the well-established principle that the first-recorded lien still of record prevails. See e.g., N.J. STAT. ANN. 46:21-1 (West 2003); see also TENN. CODE ANN. §66-26-101 (West 2009). In sum, it is an "equitable remedy invoked to reorder the priorities so that the lien that was junior remains so, and the new lien obtains priority position to the amount of the lien it paid off." J. BUSHNELL NIELSEN, TITLE & ESCROW CLAIMS GUIDE, § 3.4.7.3 (Woodridge Legal Publishers, 2d ed. 2007); see also RESTATEMENT (THIRD) OF PROP. § 7.6 (1997) (discussing the general availability of equitable subrogation to a mortgagee that paid a prior lien as a result of fraud or mistake). See also, *Metrobank for Sav., FSB v. Nat'l Cmty. Bank of N.J.*, 620 A.2d 433, 438 (N.J. Super. Ct. App. Div. 1993); *Suntrust Bank v. Riverside Nat'l. Bank of Fla.*, 792 So. 2d 1222 (Fla. 4th Dist. Ct. App. 2001); *Smith v. State Sav. & Loan Ass'n.*, 175 Ca. App. 3d. 1092 (Cal. 2d. Dist. Ct. App. 1985); *United States v. Baran*, 996

F.2d 25 (2nd Cir. 1993). (See Appendix A for a Sample Equitable Subrogation Pleading.)

While it may not always be applicable, a lender should evaluate invoking the doctrine of equitable subrogation whenever its loan funds have been used to pay off a prior lien. For example, equitable subrogation may apply where, because of fraudulent conduct, an intervening lien was not discharged as contemplated in connection with the loan transaction. The doctrine may also apply where a lender's lien was not recorded promptly, thereby causing it to lose its first-tier position. Finally, equitable subrogation does not apply just to the payment of prior mortgages, but also to "all kinds of debts," including the payment of real estate taxes. See NIELSEN, § 3.4.7.3.

When evaluating the application of equitable subrogation to a particular loan, a lender must focus on whether it was aware of the intervening lien over which it seeks to assert priority, and if not, why it was not. States differ as to whether a lender's knowledge of an intervening lien bars the use of equitable subrogation. In certain states, equitable subrogation does not apply when the lender seeking to assert the doctrine has actual knowledge of an intervening lien. See, *Metrobank,* 620 A.2d at 439 ("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."). In others, the remedy of equitable subrogation is available even where the lender had actual knowledge of the intervening lien. See *Lamb Excavation Inc. v. Chase Manhattan Mortgage Corp.,* 95 P.3d 542, 544 (Ariz. 2004) (awarding equitable subrogation to lender who had actual notice of the intervening lien); *E. Sav. Bank, FSB v. Pappas,* 829 A.2d 953 (D.C. 2003).

States also differ as to the effect of the negligence of a lender or its agent in failing to discover an intervening lien. Some states hold that, even where the lack of knowledge is due to negligence on the part of the subsequent mortgagee, equitable subrogation may still be effective. *Metrobank*, 620 A.2d at 438-439; *Trus Joist Corp. v. Nat'l Union Fire Ins. Co.,* 462 A.2d 603, 609 (N.J. Super. Ct. App. Div. 1983) ("There is no doubt that a mortgagee who negligently accepts a mortgage without knowledge of intervening encumbrances will subrogate to a first mortgage with priority over the intervening encumbrances to the extent that the proceeds of the new

mortgage are used to satisfy the old mortgage."), rev'd on other grounds sub nom, *Trus Joist Corp. v. Treetop Assocs. Inc.*, 477 A.2d 817 (N.J. 1984). Other states require a lender "to offer an excuse for his failure to discover the intervening lien." See NIELSON at § 3.4.7.3 (citing *Hieber v. Fla. Nat'l. Bank,* 522 So. 2d 878 (Fla. Dist. Ct. App. 1988) (denying equitable subrogation where purchaser missed junior lien, despite that it paid off another lien and the junior lien was of record)). Finally, certain states also preclude the use of equitable subrogation where the lender was negligent in performing the title search. See, e.g., *Roth v. Porush*, 281 A.D.2d 612 (N.Y. App. Div. 2001) (finding that equitable subrogation does not apply where an intervening lien was missed); *Centreville Car Care Inc. v. N. Am. Mortgage Co.*, 559 S.E.2d 870 (Va. 2002).

The application of equitable subrogation becomes more complex when a lender's loan funds have been used to pay down a first-position lien securing a line of credit. This is because most courts hold that the mere pay-off of a line of credit, unaccompanied by a signed authorization from the borrower to close the line, only pays down the lien but does not extinguish it. See, e.g., *First Union Nat'l Bank v. Nelkin*, 808 A.2d 856 (N.J. Super. Ct. App. Div. 2002) (denying equitable subrogation to a lender who paid off a line of credit where no signed authorization from the borrower was included.); *Chase Manhattan Bank v. Parker*, 2005 WL 880235 (Ohio Ct. App. Dist. Apr. 18, 2005). In such cases, the lien remains open, and the lender cannot be said to have discharged it.

Illustrating the Use of Equitable Subrogation: Sample Cases

Mortgage Electronic Registration Systems v. Massimo

An example of a lender's use of the doctrine of equitable subrogation to protect the priority of its mortgage is found in *Mortgage Ele.c Registration Sys., Inc. v. Massimo*. 2006 WL 1477125 at *1 (N.J. Super. Ct. App. Div. May 26, 2006). In *Massimo*, SIB Ivy Mortgage Corporation (SIB) sought a judicial determination that a mortgage given to it had priority over a mortgage in favor of a prior lender, Advantage Bank (Advantage). There, the borrower/owner Massimo first executed a note and mortgage in favor of SIB. He then mortgaged the same property to Advantage Bank. About a year later, Massimo asked Advantage for permission to refinance the

existing SIB mortgage. Advantage agreed to the refinance and stated that it would discharge its mortgage and record a new mortgage once the refinanced mortgage was recorded. SIB funded the re-finance loan, and the bulk of these proceeds were used to pay off its existing mortgage loan. Massimo then defaulted on the notes and mortgages given to SIB and Advantage, and a foreclosure action ensued.

The court found that SIB's mortgage was entitled to priority on the grounds of equitable subrogation. In doing so, the court noted that Advantage specifically agreed to grant priority to the refinancing of SIB's mortgage. It further noted that SIB did not have actual knowledge of Advantage's second mortgage, as it was recorded just five days before SIB's refinance. Finally, the court further found that Advantage would be unjustly enriched if it were allowed to jump ahead of at least the amount owed on the SIB mortgage recorded first that was discharged per the refinance ($502,000).

United Orient Bank v. Lee

While the court did not specifically refer to equitable subrogation, it applied similar principles in *United Orient Bank v. Lee*, 504 A.2d 1215 (N.J. Super. Ct. App. Div. 1986). In *United Orient*, the borrower refinanced his home and used funds from the refinance to pay off a prior mortgage with United Orient Bank. The payoff was accompanied by a cover letter that stated that the check represented "payment in full for your mortgage/loan as above. Interest has been added through June 4, 1984." Moreover, the payoff check bore the notation "Lee refinance mtg payoff 636 Kenwood Rd., Ridgewood, N.J." However, despite the explicit instructions, United Orient Bank applied these proceeds to a different loan for which the mortgagor was a guarantor and commenced a foreclosure proceeding on the mortgage that the refinancing bank intended to pay off. The court held that the United Orient Bank mortgage should have been paid off, finding that "having accepted the check which was the subject to these limitations [set forth in the cover letter and noted on the check], plaintiff had an independent duty to carry out these instructions" and discharge the mortgage. Id. at 1218. The court further held that "[t]he deposit of the check with the instructions "constituted acceptance of these terms, and

plaintiff thereafter had no right to act in derogation of defendants' directions." Id.

Centreville Car Care Inc. v. North American Mortgage Co.

Centreville Car Care Inc. v. North American Mortgage Co. represents a case where the doctrine of equitable subrogation was held not to apply. 559 S.E.2d 870 (Va. 2002). Fleet Mortgage Corporation (Fleet) was the holder of a first lien position on the relevant property, with Centreville Car Care Inc. (Centreville) holding a second lien position. When the property was sold, a new purchaser took out a loan from North American Mortgage Co. (North American) to make the purchase. North American paid off the Fleet loan; however, the title search missed the Centreville lien. Therefore, because of the sale, the Centreville lien got advanced to a first lien position, with North American assuming a second lien. North American then moved to be equitably subrogated to Fleet's first lien position.

In reversing the lower court, the Virginia Supreme Court found that the equities favored denying North American's request for equitable subrogation. Specifically, the court found that it was North American's negligence in failing to discover the Centreville mortgage in the first place. The court found that, if North American were granted equitable subrogation, Centreville would be prejudiced in that the original owner of the home was still obligated under the promissory note, but the collateral no longer belonged to them. Therefore, there was no incentive for the original owner to pay the Centreville mortgage. The court thus found that the equities favored Centreville and denied North American's request for equitable subrogation.

Ratification

Ratification is the "affirmance by a person of a prior act which did not bind him but which was done, or professedly done on his account, whereby the act, as to some or all persons, is given effect as if originally authorized by him." RESTATEMENT (SECOND) OF AGENCY § 82 (1957). The doctrine makes it "possible for a principal to be bound by an unauthorized act of the agent by ratifying the agent's act." 10 THOMPSON ON REAL PROPERTY §

86.02(b)(4) (1998). Ratification is not a doctrine unique to property or lending law, but rather is a general principle of agency law. RESTATEMENT (SECOND) OF AGENCY § 82 (1957).

Some courts, including those in New Jersey, New York, Maryland, and Tennessee, have applied the doctrine of ratification to uphold the validity of mortgages in situations where a mortgage was fraudulently obtained in the name of a borrower, but the borrower later ratified the transaction. *Rothschild v. Title Guarantee & Trust Co.*, 97 N.E. 879 (N.Y. 1912) (A mortgagor who knew her signature was forged and paid two installments of interest on the mortgage could not protest the validity of the mortgage.); *Smith v. Merritt Sav. & Loan Inc.,* 295 A.2d 474, 480 (Md. 1972) (holding that while the original transaction was invalid, plaintiff had ratified the mortgage by retaining the benefits from the proceeds of the mortgage after he obtained knowledge of the transaction.); *Citizens First Nat'l Bank of N.J. v. Bluh*, 656 A.2d 853 (N.J. Super. Ct. App. Div. 1995); *Farmers' Loan & T. Co. v. Memphis & C. R. Co.*, 83 F. 870 (W.D. Tenn. 1897); *Jones v. Watkins*, 140 So. 920 (Fla. 1932). These cases stand for the proposition that a "defect in the execution of a mortgage may be cured by the subsequent act of the mortgagor in ratifying it and acknowledging its validity." 59 C.J.S. Mortgages § 160 (2010). Thus, a borrower "may ratify a mortgage to which his signature was forged, by receiving and appropriating the proceeds with full knowledge of the proceeds or by voluntarily paying interest on the mortgage." *Id.* (citing *Livings v. Wiler*, 32 Ill. 387 (1863); *Rothschild,* 97 N.E. at 879)).

It must be noted, however, that other cases have reached the opposite result, holding under facts that where a mortgage or deed of trust contains a forged signature by one not authorized to make it, it cannot be ratified by the borrower because the instrument is void as a matter of public policy. *See* 59 C.J.S. Mortgages § 160 (citing *1st Coppell Bank v. Smith* 742 S.W.2d 454 (Tex. App. 1987) (Deed of trust containing forged signatures cannot be validated by ratification); *Finley v. Babb*, 46 S.W. 165 (Mo. 1898) (mortgage to which mortgagor's name and acknowledgement were forged is void despite acquiescence and ratification by mortgagee)); *Henry Christian Bldg. & Loan Assoc. v. Walton*, 37 A. 261 (Pa. 1897) ("forger does not act on behalf nor profess to represent person whose handwriting he

counterfeits and the subsequent adoption of instrument cannot supply authority which forger did not profess to have"). While the applicability of the doctrine of ratification to a fraudulently obtained mortgage loan may vary depending on the facts and jurisdiction, a lender should analyze whether the doctrine applies whenever its borrower claims that she either did not sign or was fraudulently induced into signing the note and/or mortgage.

In states where a party can ratify a mortgage obtained by fraud, a lender must show that that the actions of the putative borrower demonstrate that the parties had full knowledge of the situation and intended to confirm the mortgage. C.J.S. Mortgages § 190 ("To ratify a mortgage procured by fraud, there must be an unequivocal act of confirmation made with full knowledge of the facts, and where one acts in ignorance of the true facts, ordinarily no ratification results."). The party to be charged must adopt the forgery or apparent signature as her own. 9-95 Warren's Weed New York Real Property § 95.24. ("A mortgage will, however, be later binding on the parties if the party to be charged subsequently adopts the forgery or apparent signature as the party's own signature with the intent thereby to authenticate the instrument."). Evidence of intent to adopt the fraudulently obtained mortgage can be found from the fact that the putative borrower knew of the fraud and sought to enforce the agreements (*Kepler v. Kepler*, 199 A. 198 (Pa. 1938)), accepted the benefits of the mortgage loan, paid interest thereon, and asked for a forbearance in making payments (*Carr v. McColgan*, 60 A. 606 (Md. 1905) (by accepting the benefit of the mortgage loan, paying interest, asking for forbearance, and participating in a mortgage sale without raising a claim of fraud, mortgagors were estopped from excepting the validity of the mortgage)) or utilized the funds loaned pursuant to the mortgage. (*DeAndrade v. Trans Union LLC*, 2006 WL 5671233 at *6 (D.R.I. Nov. 29, 2006) ("Plaintiff's use and enjoyment of the windows for twenty-two months and his utilization of Key Bank's money to pay for those windows establishes ratification of the agent's acts and acceptance of the Key Bank loan")).

Sample Ratification Cases

Citizens First National Bank of New Jersey v. Bluh

An example of a court applying the doctrine of ratification in favor of a mortgage lender can be found in *Citizens First Nat'l Bank of N.J. v. Bluh*, 656 A.2d 853 (N.J. Super. Ct. App. Div. 1995). In *Citizens*, a partnership owned a tract of land, and one of the partners, Cavaliere, mortgaged this property without the required approval of the partnership for a personal loan. The other partner, Bluh, learned that the mortgage had been entered without his consent. Despite the fact that he was aware that the mortgage executed by Cavaliere would have first priority and that the mortgage could be claimed to be invalid, he allegedly did nothing to enforce the rights of the partnership. Instead, he entered into a subsequent partnership agreement with Cavaliere and continued to use Cavaliere as his attorney in two of his other mortgage transactions. Bluh later sought to have the mortgage discharged. The trial court ruled the mortgage was void *ab initio*, as Cavaliere was not authorized to place the mortgage on the property.

The Appellate Court reversed, holding that the mortgage was not void *ab initio*, as Bluh may have ratified Cavaliere's actions in granting the mortgage by failing to repudiate the transaction upon learning of it. The court then remanded the case on this issue for a determination as to whether Bluh ratified the transaction, given his alleged acquiescence and participating in negotiating a new partnership agreement concerning the mortgage.

Espinosa v. Martin

Espinosa v. Martin provides a recent example of a how a court determined that the doctrine of ratification did not protect a bank. 520 S.E.2d 108, 111 (N.C. Ct. App. 1999), *cert. den.* 543 S.E.2d 126 (N.C. 2000). There, a bank brought action for foreclosure against putative mortgagors Cheri and Jamie Espinosa, who were deeded property from Ms. Espinosa's sister, but did not obtain a mortgage loan in connection with the transaction and disavowed making a mortgage. The trial court found that Cheri Espinosa's father forged their signatures and received the loan proceeds. In response to the putative mortgagors' claim that they did not sign the mortgage, the

bank argued that the borrowers ratified the transaction by retaining the property after they learned of a forgery. The court held that the borrowers did not ratify the transaction because there was no evidence that they received the loan proceeds or that they had knowledge of the loan transaction.

Reformation and Recording *Nunc pro Tunc*

The doctrine of reformation applies when parties intend to form a contract, but "the resulting writing does not accurately reflect the intention of the parties." See 7 CORBIN ON CONTRACTS § 28.45 (1998). The purpose of the doctrine is to allow a contract to be reformed so that "[t]he reformed [document] corrects the language used so that it reads as it should have read all along." 14 POWELL ON REAL PROPERTY, § 901[3] (1998). Reformation of a contract cannot modify the intention of the parties. See *Lederman v. Prudential Life Ins. Co. of Am. Inc.,* 897 A.2d 373, 385 (N.J. Super. Ct. App. Div. 2006). "The reformation of an instrument relates back to the time the instrument was originally executed and simply corrects the document's language to read as the instrument should have read all along." 66 AM. JUR. 2D *Reformation of Instruments* § 9 (2010).

Although specific standards vary from state to state, broadly stated, the "grounds for the reformation of an instrument are generally limited to: (1) mistake; or (2) fraudulent or inequitable conduct." 66 AM. JUR. 2D *Reformation of Instruments* § 10 (2010); see also 76 C.J.S. *Reformation of Instruments* § 25 (2010) ("It has thus been recognized that "relief will be granted without regard to the cause of the failure to express the contract as actually made of the intent of the parties, whether due to fraud, mistake in the use of the language or any other thing which prevented the expression of the true intention of the parties, and that if by reason of fraud, inequitable conduct, mistake, inadvertence accident or surprise the instrument fails to express the true intent and meaning of the parties, equity will on satisfactory evidence reform it."); *St. Pius X House of Retreats, Salvatorian Fathers v. Diocese of Camden,* 443 A.2d 1052, 1055 (N.J. 1982) ("The traditional grounds justifying reformation of an instrument are either mutual mistake or unilateral mistake by one party and fraud or unconscionable conduct by the other.").

When seeking to reform a document based on mistake, it generally must be established that the mistake is mutual by both parties. See id.; *Matter of Enstar Corp.*, 604 A.2d 404 (Del. 1992). Where fraud or inequitable conduct is established, a mutual mistake by the parties need not be shown. When seeking to obtain reformation based on fraud, however, it must generally be established that a party made a material representation or concealed a material fact on which the other party relied. See 66 AM. JUR. 2D *Reformation of Instruments* §§ 23-24.

The doctrine of reformation has been repeatedly held to apply to deeds by states across the country. See 66 AM. JUR. 2D *Reformation of Instruments* § 30 (citing *Palmer v. Palmer*, 390 So. 2d 1050 (Ala. 1980); *City of Fargo v. D.T.L. Props. Inc.*, 564 N.W.2d 274 (N.D. 1997); *O'Donnell v. O'Donnell*, 202 S.W.2d 999 (Ky. Ct. App. 1947); *Fisher v. Standard Inv. Co.*, 15 N.W.2d 355 (Neb. 1944)). It has also been widely applied to mortgages. *See id.* (citing *Sunshine Bank of Ft. Walton Beach v. Smith*, 631 So. 2d 965 (Ala. 1994); *Grappo v. Mauch*, 110 Nev. 1396 (1994); *Hopkins v. Mills*, 156 So. 532 (Fla. 1934); *Bruenn v. Switlik*, 447 A.2d 583 (N.J. Super. Ct. App. Div. 1982); *Busey v. Moraga*, 62 P. 1081 (Cal. 1900); *Thompson v. Estate of Coffield*, 894 P.2d 1065 (Okla. 1995)). A lender who is faced with loan fraud should carefully determine whether it could preserve the validity of its mortgage or deed by relying on the doctrine of reformation. Situations in which reformation may be able to aid a lender include those in which a borrower involved in a fraud attempts to disclaim responsibility based on technicalities in the documents.

Sample Cases Showing Reformation in Action

Sunshine Bank of Fort Walton Beach v. Smith

In *Sunshine Bank of Fort Walton Beach v. Smith*, defendant lent a third party, Kemp, $56,000 to purchase certain real property. 631 So. 2d 965 (Ala. 1994). In exchange, Kemp obtained a purchase-money mortgage on the property. However, because of a scrivener's error, the mortgage listed the incorrect address of the property, instead containing the neighbor's address. Thereafter, plaintiff obtained a judgment against Kemp. The court ultimately permitted reformation of the mortgage to gain priority over plaintiff's judgment where "the clear intention, as manifested by all the

parties to the contract and the mortgage, was that Kemp purchase the real estate [with the correct address], and that [defendant] provide the purchase money and receive in return a purchase money mortgage covering that real property."

Holiday Hospitality Franchising Inc. v. State Resources Inc

Holiday Hospitality Franchising Inc. v. State Res. Inc. provides another illustrative case of the application of the doctrine of reformation. 232 S.W.3d 41 (Tenn. Ct. App. 2006). There, the Tennessee Court of Appeals evaluated the competing interests in restoring a mortgage lien, which had mistakenly been discharged, and the priority of intervening judgment creditors. Tennessee is a "race notice" state. *See* TENN. CODE ANN. §66-26-101 (West 2010). *Nunc pro tunc* recordation was granted. In *Holiday*, a developer secured a construction loan to improve two lots, 13 and 30. The lender recorded the mortgage, which encompassed both lots. After the completion of construction of lot 13, the developer sold it and used the proceeds to pay off a portion of the mortgage. The original mortgage, which encompassed both lots, was still unsatisfied, and the lender should have maintained a recorded lien on lot 30. After the closing, however, the lender recorded a release of both. The conveyance of the deed to lot 13 from the developer to a third-party purchaser was then recorded. After recording the release, two judgments were entered against the developer and entered as liens against lot 30. The lender petitioned the court and argued that: (1) an erroneous release had been executed and filed because of mutual mistake; (2) the judgment creditor did not rely on the recorded title information in asserting its judgment lien; and (3) equitable principles justified a reformation of the release to reinstate the original deed of trust.

The *Holiday* court permitted a corrective filing canceling the erroneous release. It reasoned that the release or satisfaction of a mortgage resulting from fraud should not benefit a party that acquired an interest in the property but did not rely on the notice of discharge. Because a judgment lien creditor has no duty to inspect title records, its rights will not ordinarily preclude relief sought by a deed holder. The court noted that the judgment lienor's interest attaches upon the filing of the judgment and that record notice does not affect the lienor's rights. Id.; see also *Sunshine Bank*, 631 So. 2d at 968. (finding that where purchase money mortgage is reformed, the

judgment creditor is in no worse place than it would have been had the mortgage been recorded with the correct address). Thus, the restoration of a mortgage to its priority of lien does not place the judgment creditor in a worse position than he should have been in. The court concluded that it was equitable to balance the "benefit of absolution from record notice with the risk of deed reinstatement," where such restoration places the judgment lien creditor in no worse position. *See Holiday*, 232 S.W.3d at 53.

Once a deed or mortgage has been reformed to protect a lender's lien status, the lender should seek to have the instrument recorded *nunc pro tunc*. Recordation *nunc pro tunc* refers to the recording of a reformed instrument at the direction of a court designed to correct a previously recorded incorrect instrument. BLACK'S LAW DICTIONARY (6th ed. 1991); *In re Marriage of Hirsch*, 482 N.E.2d 625, 632 (Ill. App. Ct. 1985) ("nunc pro tunc order is an entry now for something previously done, made to make the record speak now for what was actually done then"). When a reformed document is recorded *nunc pro tunc*, the effective date of its recording is the date of recordation of the original instrument.

Equitable Lien/Equitable Mortgage

Another equitable tool on which a lender can rely if it does not have a valid mortgage because of fraud is that of the doctrine of equitable lien/ mortgage. (See Appendix B for a Sample Equitable Lien/Mortgage and Reformation Nunc pro Tunc Pleading.) "An equitable lien is the right to have property subjected, in a court of equity, to the payment of a claim. It is neither a debt nor a right of property but a remedy for a debt. It is simply a right of a special nature over the property which constitutes a charge or encumbrance thereon...." *Hargrove v. Gerill Corp.*, 464 N.E.2d 1226, 1231 (Ill. App. Ct. 1984) (quotation omitted) (cited by 59 CJ.S. *Mortgages* § 12). An equitable mortgage is a specific type of equitable lien created "where money is loaned or credit given in reliance upon the security of property of the debtor, but pledged by him in such manner as not to be enforceable as a mortgage at law." *Id.* at 1230; *Hamilton Trust Co. v. Clemes*, 57 N.E. 614 (N.Y. 1900) ("'an equitable mortgage may be constituted by any writing from which the intention so to do may be gathered, and an attempt to make a legal mortgage, which fails for the want of some solemnity, is valid in equity; ... a specific lien upon the land, ... and that an equitable mortgage

thus created is entitled to a preference over subsequent judgment creditors.'"); see also *FDIC v. Five Star Mgmt. Inc.*, 258 A.D.2d 15, 21 (N.Y. App. Div. Jun. 17, 1999). 4 *Pomeroy's Equity Jurisprudence* § 1235 at 696 (5th ed. 1941) ("An equitable lien may be imposed where there exists an agreement in which: the contracting party sufficiently indicates an intention to make some particular property, real or personal, or fund, therein described or identified, a security for a debt or other obligation, or whereby the party promises to convey or assign or transfer the property as security ..."). When the transaction is the lending of money, to be secured by a mortgage, but the "mortgage .... is so defective or informal, as to fail in effectuating the purpose of its execution, equity will impress upon the land ... a lien in favor of the creditor." *Sprague v. Cochran*, 38 N.E. 1000 (N.Y. 1894). The equitable lien arises from the loan, rather than from the formality of the instrument, and it continues in effect until satisfied or waived. 258 A.D.2d at 21.

Courts across the country have recognized the existence of equitable mortgages where parties intend to create a mortgage or lien on a property. *Boyarsky v. Froccaro*, 125 Misc. 2d 352 (N.Y. Sup. Ct. 1984); *Holmes v. Dunning*, 133 So. 557 (Fla. 1931). The essential element is the intent by the parties to create a lien on specific property. 59 CJ.S. *Mortgages* § 12. Significantly, the form of agreement that creates an equitable lien or mortgage is not dispositive because equity looks at the intent and purpose. "If an intent to give, charge or pledge property, real or personal, as security for an obligation appears, and the property or thing intended to be given, charged or pledged is sufficiently described or identified, then the equitable lien ... will follow as of course." *Rutherford Nat'l Bank v. H.R. Bogle & Co.*, 169 A. 180, 182 (N.J. Super. Ct. Ch. Div. 1933); see also *Ulrich v. Ulrich*, 1 N.Y.S. 777 (N.Y. App. Div. 1888) (enforcing an equitable mortgage against a wife's interest in land that husband's actions created an equitable mortgage.); *In re Loring*, 301 A.2d 721, 723 (N.J. 1973) (assertion of attorney's equitable lien for a fee claim out of sale proceeds of house); *Cohen v. Estate of Sheridan*, 528 A.2d 101, 104 (N.J. Super. Ct. Ch. Div 1987) (real estate brokers have equitable lien for their commissions on proceeds of sale due vendor at closing). That said, it is important to realize that most courts hold that, in light of the statutes of fraud on agreements, the pledge to give a mortgage must be in writing to constitute an equitable mortgage. 59 C.J.S. *Mortgages* § 48.

"While the terms 'equitable lien' and 'equitable mortgage' are closely related, equitable lien is a more inclusive term than equitable mortgage, which in all instances requires an affirmative pledge of property as security for a debt." 59 C.J.S. *Mortgages* § 32. Often courts will use the two terms interchangeably. *Id.* (citing *Red River State Bank v. Reirson*, 533 N.W.2d 683 (N.D. 1995)). Both concepts arise from the well-settled maxim that "equity regards as done that which ought to be done. …" *Hadley v. Passaic Nat'l Bank & Trust Co.*, 168 A. 38, 40 (N.J. Super. Ct. Ch. Div. 1933).

An equitable mortgage can be enforced between the original parties to the transaction or against a third party who has notice thereof. See 59 C.J.S. *Mortgages* § 51 (citing *Owens v. Cont'l Supply Co.*, 71 F.2d 862, 863 (10th Cir. 1934) ("Equity treats that as done which ought to be done. A valid agreement to execute a mortgage will be enforced in equity against the maker or third persons who have notice thereof, or who are volunteers."). An equitable mortgage can also be enforced against a person or entity who obtains an interest only by operation of law and not for valuable consideration. See 1 N.Y.S. 777 (enforcing an equitable mortgage against a wife's interest in land that husband's actions created an equitable mortgage.).

The ability to impose equitable liens and mortgages on property can be a valuable tool for lenders who have been defrauded—especially when the lender does not have a valid mortgage on which it can rely. Lenders who have been defrauded in connection with transactions involving real property can claim to have an equitable lien on all property held by those who have defrauded it. Moreover, in situations where a putative borrower agreed to make a lien on a particular property for the lender's benefit, the lender can seek to impose an equitable mortgage on the property.

Demonstrating Equitable Mortgage:

F.D.I.C. v. Five Star Management Inc.

An illustrative case of the application of an equitable mortgage is *F.D.I.C. v. Five Star Management Inc.*, 258 A.D.2d 15 (N.Y. App. Div.1999). In *Five Star*, plaintiff was seeking to foreclose on a mortgage that was in default. The defendant debtor, however, asserted an affirmative defense that the mortgage was a nullity insofar as there was a scrivener's error in the deed

conveying the premises to the mortgagee. Defendant moved for summary judgment on these grounds and the plaintiff cross-moved seeking, among other things, an equitable mortgage. In reversing the trial court, the Appellate Division granted summary judgment in favor of the plaintiff for an equitable mortgage, finding that "[t]he documentary evidence in this case, notwithstanding a glitch in a deed, sufficiently establishes the existence of the loan, the intent that it be secured by certain premises, and [defendant's] obligation ... to satisfy the debt by a date certain." The court therefore permitted the plaintiff to foreclose on the property.

Notary Curative Statutes

Often the mortgage documents executed in connection with a fraudulent transaction have not been acknowledged properly, rendering them invalid under state law. See *In re Buckholz*, 224 B.R. 13, 23 (Bankr. D.N.J. 1998) (finding that mortgage that was not properly acknowledged because of a false notarization was not sufficient to perfect mortgagee's interest as to a subsequent bona fide purchaser for value). Many states, however, have curative provisions rendering improperly acknowledged mortgage instruments valid under certain circumstances. In particular, certain states provide that if a document has been recorded for a certain period of time, even if the acknowledgment is defective, it will still serve as notice to any subsequent bona fide purchaser for value. For example, in New Jersey, N.J. STAT. ANN. § 46:21-2 (West 2003), provides in relevant part that:

> When any deed or instrument of the nature or description set forth in section 46:16-1 of this title shall, for a period of six years or more, have stood on record in any of the lawful books of record in this state appropriate for such deed or instrument, the record of such deed or instrument shall, after the lapse of such period, be and become valid for every purpose of notice as provided by section 46:21-1 of this title, and such deed or instrument, the record and certified copy thereof, shall be received in evidence in every court and be as effectual as if the original deed or instrument had been produced and proved, notwithstanding the absence of, or any informality, defect, imperfection or uncertainty in, the acknowledgment or proof or the certificates thereof, but only when such deed

> or instrument shall be corroborated by evidence of corresponding enjoyment or other equivalent or explanatory proof.

Similarly, California has a curative statute providing that a document that has been recorded for one year or more serves as notice to a subsequent purchaser for value despite a defect in the acknowledgment. See CAL. CIV. CODE § 1207 (West 2007) ("Any instrument affecting the title to real property, one year after the same has been copied into the proper book of record, kept in the office of any county recorder, imparts notice of its contents to subsequent purchasers and encumbrancers, notwithstanding any defect, omission, or informality in the execution of the instrument, or in the certificate of acknowledgment thereof, or the absence of any such certificate; but nothing herein affects the rights of purchasers or encumbrancers previous to the taking effect of this act."). Florida has a similar law curing a defective acknowledgment where an instrument has been recorded for at least seven years. See FLA. STAT. ANN. § 694.08 (West 2010). These statutes, however, "cannot apply to change rights that have vested in innocent purchasers for value before the act went into effect." 2 PATTON AND PALOMAR ON LAND TITLES § 366 (3d. ed. 2009).

Lenders should be familiar with the curative statutes of the states in which they do business. In states where such curative statutes exist, a lender may sustain its priority despite a defective acknowledgment, as long as the statutorily required time period has elapsed.

Conclusion

The legal tools discussed above are powerful tools lenders have to maintain the priority of their liens even when undisputed fraud has occurred. Lenders should be familiar with the specific provisions of the laws and case law in the states in which they do business regarding these topics. Thus, when faced with a mortgage fraud scheme, the lender should not automatically assume that its lien is void. Instead, a thorough factual and legal analysis must be conducted as to: (1) how the lender's loan benefited others as to enhancing their priority position; (2) the benefit conveyed to the borrower from the loan; (3) the borrower's actions during and after the fraud was uncovered or known to him; and (4) whether their state has any curative statutes applicable to their situation.

Michael R. O'Donnell is a partner at Riker Danzig Scherer Hyland & Perretti LLP and specializes in representing title companies and financial institutions in a variety of disputes. He has handled mortgage fraud claims ranging from claims in hundreds of thousands of dollars to those in excess of $30 million.

Acknowledgment: *I would like to extend my appreciation and thanks to Ronald Ahrens and Jonathan Sandler, associates at Riker Danzig Scherer Hyland & Perretti LLP, who provided invaluable assistance in researching and writing this chapter and without whom this chapter would not have been possible.*

APPENDIX A

SAMPLE EQUITABLE SUBROGATION PLEADING

I. THE FIRST MORTGAGE

1. On or about January 1, 2003, Borrower executed a mortgage for the benefit of First Lender (the "First Mortgage"). Among other things, the First Mortgage encumbered and constituted a lien on property located at Block 1, Lot 2 on the official Tax Map of City, commonly known as Property.
2. The First Mortgage was recorded in the County Clerk's office on January 15, 2003 in Mortgage Book 1, Page 2.
3. On February 1, 2003, the Tax Collector of the City issued Tax Sale Certificate No. 03 in connection with delinquent taxes that were due to the City for the Property.
4. Tax Sale Certificate No. 03 was recorded in the County Clerk's office on February 20, 2003 in Mortgage Book 1, Page 2.
5. Upon information and belief as to Second Lender's lien, the taxes owed on the Property constituted first-position liens.

II. THE SECOND MORTGAGE

6. On October 1, 2003, the Borrower gave an "Equity Source Account Mortgage" to Second Lender (the "Second Mortgage"). The Second Mortgage secured a $40,000 line of credit given by Second Lender to the Borrower pursuant to an "Equity Source Account Agreement and Disclosure" between Borrower and Second Lender (the "Second Lender Agreement").
7. The Second Mortgage was recorded in the County Clerk's office on January 15, 2004 at Mortgage Book 2, Page 2.

III. THE THIRD MORTGAGE

8. On or about January 16, 2004, the Borrower refinanced the Property (the "Refinance").
9. In connection with the Refinance, the Borrower obtained a loan from Third Lender in the amount of $150,000 (the "Third Lender

Loan"). The Third Lender Loan was secured by a mortgage given by the Borrower to Third Lender on January 16, 2004 in the amount of $150,000 (the "Third Mortgage").

10. The Third Mortgage was recorded in the County Clerk's office on March 12, 2004 at Mortgage Book 2, Page 10.

IV. THE PAY-OFF OF THE PRIOR LIENS WITH THE PROCEEDS OF THE THIRD LENDER LOAN

11. In connection with the Refinance, $120,000 of the proceeds of the Third Lender Loan was used to payoff the First Mortgage on or about January 16, 2004. The pay-off funds were transferred by means of a check made payable to First Lender that was prepared and sent via UPS by the closing agent.
12. The First Mortgage was subsequently discharged by means of a Mortgage, Release, Satisfaction, and Discharge, dated January 27, 2004, which was recorded in the County Clerk's office on March 17, 2004 at Discharge Mortgage Book 1, Page 2.
13. In connection with the Refinance, $10,000 of the proceeds of the Third Lender were used to payoff Tax Sale Certificate No. 03. The pay-off funds were transferred by means of a check made payable to Collector, Township of City, that was prepared and sent via UPS by the closing agent.
14. Tax Sale Certificate No. 03-116 was subsequently cancelled of record on or about March 19, 2004, and recorded by the County Clerk.
15. In connection with the Refinance, $5,000 of the proceeds of the Third Lender Loan were used to payoff outstanding municipal taxes on the Property. The taxes owed on the Property constituted first-position liens. The pay-off funds were transferred by means of a check made payable to Collector, Township of City, that was prepared and sent via UPS by the closing agent.
16. The First Mortgage, taxes owed pursuant to Tax Sale Certificate No. 03 and taxes paid in connection with the Property each constituted liens on the Property superior in position to that of the Second Mortgage.

17. Third Lender did not know of the existence of the Second Mortgage at the time that the First Mortgage, Tax Sale Certificate No. 03-116 and taxes were paid off.
18. The first time Third Lender learned of the existence of the Second Mortgage was when it was served with the Complaint in this matter.
19. Second Lender will be unjustly enriched if it is allowed to foreclose on the Property without regard to the prior liens on the Property that were paid off with the proceeds of the Third Lender Loan, including the First Mortgage, Tax Sale Certificate No. 03 and other taxes paid on the Property.
20. As the proceeds of the Third Lender Loan were used to payoff the First Mortgage, Tax Sale Certificate No. 03 and, upon information and belief, other taxes paid on the Property, Third Lender stands in the shoes of the lien holders that it paid off and is entitled to priority position over the Second Mortgage to the extent of the amount of those liens.

WHEREFORE, Third Lender demands judgment against Second Lender declaring that, by virtue of the doctrine of equitable subrogation, that Third Lender holds a priority position on the Property superior to that of the Second Mortgage to the extent that liens prior to the Second Mortgage were paid off, and awarding attorneys' fees, costs of suit, and such other relief as this Court deems just and equitable.

APPENDIX B

SAMPLE EQUITABLE LIEN/MORTGAGE AND REFORMATION NUNC PRO TUNC PLEADING

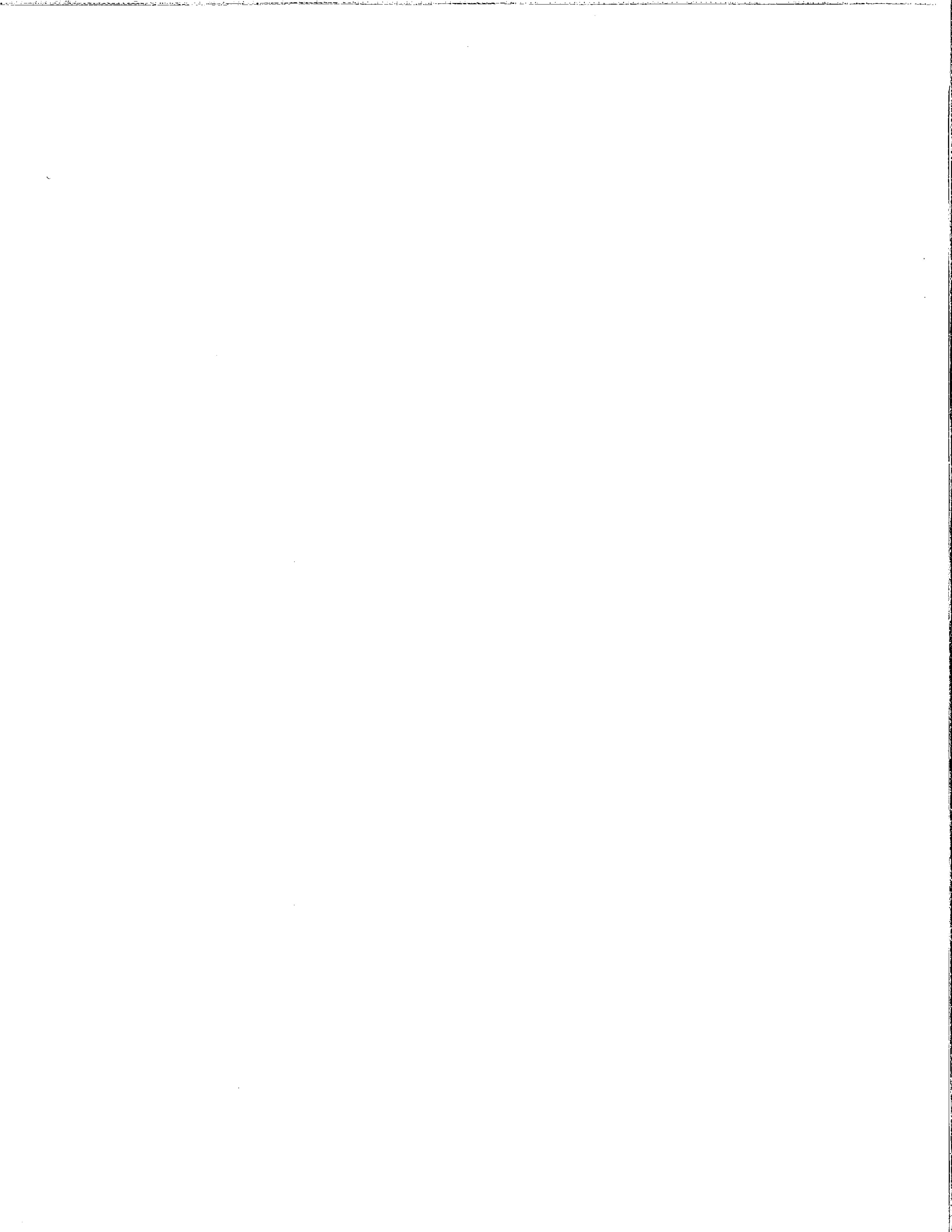
1. On or about April 1, 2009, Lender made a loan to Borrower, in the principal sum of $500,000 (the "$500,000 Loan").
2. On or about April 1, 2009, to evidence the $500,000 Loan, Defendant, as an officer of Borrower and on behalf of Borrower, executed and delivered to Lender a Promissory Note in the original principal amount of $500,000 ($500,000 Note").
3. Pursuant to the $500,000 Note, interest on the $500,000 Loan accrued at a variable initial rate of seven point seven five percent (7.75%) per annum. The $500,000 Note is payable in (i) three hundred (300) consecutive monthly installments of principal and interest in the amount of $2,680.80 commencing on May 1, 2009 and thereafter on the first (1st) day of each succeeding calendar month, and (ii) a balloon payment of all outstanding principal and accrued interest due on April 1, 2039.
4. Pursuant to the terms of the $500,000 Note, Borrower is required to pay a late charge equal to five percent (5%) of any payment that Lender does not receive within ten (10) calendar days of its due date thereunder.
5. Also, pursuant to the terms of the $500,000 Note, Borrower agreed to Lender's costs and expenses, including but not limited to attorneys' fees, in connection with enforcing its rights under the $500,000 Note and the Borrower Mortgage (as defined below).
6. On or about April 1, 2009, Borrower executed and delivered to Lender, as collateral security for Borrower's obligations under the Loan Documents, including the $500,000 Loan, a Mortgage ("Borrower Mortgage"), pursuant to which Borrower granted to Lender a second-lien mortgage on the real property located at 1 Valley Street, Orange, New Jersey 07079 (the "Mortgaged Premises"). Upon information and belief, the Mortgaged Premises is a commercial property.
7. However, at the time of the commencement of this foreclosure action, Lender discovered that the Mortgaged Premises, in fact, was not owned by Borrower. At the time of the closing of the $500,000 Loan, the

Mortgaged Premises was purchased by Defendant, individually, as opposed to the Borrower of which the Defendant is the sole principal.

8. The Borrower Mortgage was recorded on April 10, 2009, in the County Clerk's office in Mortgage Book 100, page 1, and is revealed by a title search with respect to the Mortgaged Premises.
9. At all relevant times, Lender intended and contractually agreed to receive a mortgage lien as collateral security for the $500,000 Loan, as evidenced by the Borrower Mortgage.
10. Defendant obtained the benefit and use of the proceeds of the $500,000 Loan and ownership of the Mortgaged Premises free of record lien in favor of Lender.

Wherefore, Lender respectfully requests that this Court enter judgment against Defendant for the following relief:

a. adjudging that Lender has an equitable mortgage lien nunc pro tunc until date of closing (April 1, 2010) on the Mortgaged Premises;
b. directing that Lender be paid the amount due on the Borrower Mortgage together with interest and costs; and
c. such other relief as the Court may deem to be just, proper and equitable.



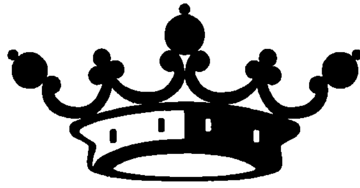
ASPATORE

www.Aspatore.com

Aspatore Books, a Thomson Reuters business, exclusively publishes C-Level executives (CEO, CFO, CTO, CMO, Partner) from the world's most respected companies and law firms. C-Level Business Intelligence™, as conceptualized and developed by Aspatore Books, provides professionals of all levels with proven business intelligence from industry insiders—direct and unfiltered insight from those who know it best—as opposed to third-party accounts offered by unknown authors and analysts. Aspatore Books is committed to publishing an innovative line of business and legal books, those which lay forth principles and offer insights that when employed, can have a direct financial impact on the reader's business objectives, whatever they may be. In essence, Aspatore publishes critical tools for all business professionals.

Inside the Minds

The *Inside the Minds* series provides readers of all levels with proven legal and business intelligence from C-Level executives and lawyers (CEO, CFO, CTO, CMO, Partner) from the world's most respected companies and law firms. Each chapter is comparable to a white paper or essay and is a future-oriented look at where an industry, profession, or topic is heading and the most important issues for future success. Each author has been selected based upon their experience and C-Level standing within the professional community. *Inside the Minds* was conceived in order to give readers actual insights into the leading minds of top lawyers and business executives worldwide, presenting an unprecedented look at various industries and professions.



ASPATORE