New York Law Journal
Real Estate Update
Wednesday, February 10, 2010

Split Between Departments Muddies Subrogation Doctrine

BY ADAM LEITMAN BAILEY AND DOV TREIMAN

In an era when this nation's economic stability depends, in part, on stable and unfettered real estate transfers, equitable subrogation provides a solution to some of the cracks in the system. However, as evidenced by a split between two departments of the Appellate Division, these cracks need some additional caulking to make sure that the right lien obtains priority.

During 2009, the Second and Third departments of the Appellate Division split regarding when and how equitable subrogation should be applied in prioritizing mortgages. (The First and the Fourth departments have been silent on the issue.) The varying interpretations have created calls for further clarification by the state's highest court or the passage of legislation.

An Obscure Doctrine

Equitable subrogation, an obscure enough doctrine silently lurking at most title closings, allows a lender whose funds are being used to extinguish an older debt to step into the priority position held by the original creditor. The new lender thus leapfrogs in priority over other lenders of junior priority to the original creditor, should the property be sold at foreclosure. However, the question arises whether the lender can be allowed this privilege if it knows of other liens on the property older than its own, but younger than the one it seeksto pay off.

This word "knows" is the crux of the divide between the Second and Third departments.

To understand equitable subrogation, one must be fully familiar with the idea that recordation of an item imparts constructive knowledge to the whole world not only of the actual contents of the recorded instrument, but of matters set forth in it that indicate other things exist that could cloud title.1

According to the Second Department, this constructive notice of an intermediate lien is enough to disqualify the subrogation. According to both the Court of Appeals and the Third Department, it is not.

To further complicate things, there have been no rulings from any of the Departments or the Court of Appeals speaking to whether or not actual knowledge of the intermediate lien disqualifies the subrogation.

Adam Leitman Bailey

Dov Treiman

The Leading Case

The leading New York case is King v. Pelkofski,2 standing for the idea that equitable subrogation lies in New York at least where the junior liens are not actually known to the lender seeking subrogation. The quote most extracted from the case is:

This principle has been applied to situations… where the funds of a mortgagee are used to satisfy the lien of an existing, known incumbrance when, unbeknown to the mortgagee, another lien on the property exists which is senior to his but junior to the one satisfied with his funds. In order to avoid the unjust enrichment of the intervening, unknown lienor, the mortgagee is entitled to be subrogated to the rights of the senior incumbrance…3

In Pelkofski, the lienor did have constructive notice of a junior lien. The property was originally bought with a bank mortgage. Then the owner executed an unrecorded deed of trust in favor of his wife. Then he took out two additional bank mortgages, after which the trust deed was finally recorded. Borrowing privately from someone new who did not find the trust in a title report, the owner then used the funds to discharge the various mortgages and some other debts. Thus the court had to deal with whether the last lien had the priority position of the mortgage whereby the property was bought in the first place or was junior to the trust. The court gave the youngest lien the most senior position.

Pelkofski therefore stands for the proposition that mere constructive notice did not disqualify the subrogation.

However, the Court did not say what many assume the court meant: "Had the lienor had actual knowledge of the junior lien, the subrogation would not lie." The court only says that it is enough that there was actual ignorance of the junior lien; the court never said such ignorance was needed. One should note that Pelkofski approvingly quotes from the Restatement of Restitution, the leading authority for the idea that actual knowledge would itself be irrelevant, but Pelkofski never addresses that issue.

This enough/needed dichotomy is often expressed in formal logic as respectively a discussion of "sufficient" and "necessary" conditions. In just such language, Ohio Savings Bank v. First Island Realty Corp.,4 applying Pelkofski, found lack of actual knowledge "sufficient" without considering whether it was "necessary," again leaving open the question of whether actual knowledge will kill the subrogation.

In United States v. Baran,5 property was sold to a third party who financed the deal by obtaining a mortgage, the proceeds of which were used to satisfy the first mortgage on the property, but apparently not to satisfy a tax lien recorded after that first mortgage. The lender at the sale had no actual knowledge of the tax lien. The Second Circuit, applying New York law stated:

The purpose of subrogation is to prevent a junior lienor from converting the mistake of the lender "into a magical gift for himself." …In effect, subrogation erases the lender's mistake in failing to discover intervening liens, and grants him the benefit of having obtained an assignment of the senior lien that he caused to be discharged…. Although other states may take a different view, New York does not require the lender to offer an excuse for his failure to discover the intervening lien.6

Thus, the new mortgage was put in a more senior position than the older recorded tax lien. Notably, Baran also never addressed the question of actual knowledge.

The Second Department

The Second Department first addressed this issue in 1997. In R.C.P.S. Assoc. v. Karam Developers,7 that court, citing to Pelkofski denied equitable subrogation, saying "The…doctrine of equitable subrogation should not be applied here inasmuch as the evidence established that the plaintiff had knowledge of the [intervening] lien."

Although not reported as such, the briefs made it clear that the so-called knowledge was in fact mere constructive notice.8

That the Second Department explicitly held mere constructive notice adequate to disqualify the subrogation became clear in Bank One v. Mui,9 in which there were four mortgages involved. The proceeds of the youngest were used to pay off the debt of the eldest. One of the two mortgages in the middle had been recorded, but the other not. The Second Department held that the subrogation lifted the fourth mortgagee to the most senior spot with respect to the unrecorded intervening mortgage, but not with respect to the recorded one. No one claimed that the fourth mortgagee had actual knowledge of any but the most senior of the mortgagees, the one into whose shoes it was hoping fully to step.

The Second Department reiterated that view in Roth v. Porush,10 a case not about lending money but about conveyancing.

The Third Department

However, the Appellate Division, Third Department in Elwood v. Hoffman11 wrote:

[W]hile Delta had constructive notice of the recorded notice of pendency, it did not have actual notice of the same. Based on the Court of Appeal's decision in King…the presence of constructive notice does not render the doctrine of equitable subrogation inapplicable…. We decline to follow those cases holding otherwise inasmuch as they depart from the Court of Appeals' decision in King v. Pelkofski. (citations to Karam, Mui, and Porush omitted.)12

Thus, the Third Department has staked out its territory, directly contradicting the Second Department's view that constructive notice disqualifies the subrogation. The Third Department bluntly says "No. We disagree with the Second Department."

Since Pelkofski was explicitly a case about constructive notice, it seems impossible to agree with the Second Department. The Third Department seems to have all authority on its side. The Second Department indeed seems to be violating the fundamental rule of stare decisis by contradicting the Court of Appeals.

The Second Responds

The Third Department's Elwood criticism is solely of the Second Department, the source of the only cases in New York to disqualify equitable subrogation on the basis of constructive notice. Elwood was an implicit invitation to the Second Department to change its view. However, the Second Department ended 2009 reasserting its position in Countrywide Home Loans v. Dombek13 without mentioning Elwood.

In Dombek, the owner gave a mortgage to the plaintiff. The mortgage was recorded on Aug. 25, 2005, nine days after he gave another mortgage to the defendant (which mortgage was recorded on Sept. 14, 2005). The proceeds of the plaintiff's mortgage were used to satisfy a prior and more senior purchase money mortgage. The court denied summary judgment to the plaintiff, finding issues of fact as to whether the plaintiff had "mere notice" of the earlier mortgage.

Thus the Second Department adhered to its position that "mere notice" could disqualify an equitable subrogation. And, it did so without mentioning Elwood's disapproval of its earlier cases.

Practical Effects

The split between the Second and Third department and most courts' silence on the effect of actual knowledge have effects on real life. The first thing we have to realize is that at any real estate closing where a mortgage is being used to buy already mortgaged property, the proceeds of the newer mortgage are indeed being used to pay off the senior one. Without acknowledging it as such, the parties are expecting equitable subrogation.

If it doesn't matter what the most junior lender knew about earlier liens, the only thing that it would have to prove would be whether the funds were indeed being used to discharge older liens.14 This view encourages the use of title searches so the lienor can be certain that all of the older liens are being wiped out in refinancing. Under this theory, the funds' use determines how reliably they can be recovered by a lender/lienor.

If only actual knowledge disqualifies an equitable subrogation, the purchase of title insurance becomes even more crucial. Once a lender receives a title report, anything in that report upgrades from mere constructive notice to actual knowledge. On one level that would seem to argue against ordering a title report. However, that knowledge is not only critical in ascertaining whether the loan is a good risk in the first place, but it enables the lender to ensure that the funds are indeed being used to discharge the elder liens, and that therefore the lender will qualify for the subrogation from the use-of-funds point of view. Fortunately for the lender, any mistakes in the title report will not harm the lender or its title company. Other liens that eluded the title report cannot unseat the subrogation.

If mere constructive notice disqualifies subrogation, title insurance for the lender is absolutely essential. The lender will want all the benefits previously described, but also to require the borrower to pay the requisite insurance premium to ensure that any errors in the title report do not deprive the lender's recovery of the proceeds.

In the current atmosphere of plentiful over-financed properties and foreclosures, the rules for lien priority may make all the difference in determining how many loan defaults cause lenders to have to default on their debts as well.

Conclusion

With this split in authority between the Second and Third departments, not knowing which sides the First and Fourth departments will take, and not having any word on the effect of actual knowledge, it is time for the Court of Appeals to speak again or the legislature to act and let the State know what the rules of equitable subrogation are to be. In truth, any rule definitely stated is better than confusion as to what the rules are. Ideally one of the contradictory cases from 2009 should go up to the Court of Appeals to resolve the problem, but lacking that, it would be wise for the Legislature to speak. The forgiveness for error implicit in the rule allowing the subrogation in spite of constructive notice makes that rule the one most appetizing from the point of view of fundamental fairness. It is also the rule most likely to support an active real estate transfer industry as it makes secured transactions vastly more secure.

In the mean time, junior lenders discharging elder liens had better make sure they insist on paid-up title insurance.

Adam Leitman Bailey is the founding partner and Dov Treiman is a partner of Adam Leitman Bailey, P.C. Vladimir Mironenko contributed to this article.

Endnotes:

1. Fairmont Funding, Ltd. v. Stefansky, 301 AD 2d 562 (2d Dept. 2003).
2. 20 NY 2d 326 (1967).
3. Id. at 333.
4. 836 NYS 2d 501 (Sup. Kings 2007)
5. 996 F.2d 25 (2d Cir. 1993).
6. Id. at 29
7. 656 NYS 2d 666 (2d Dept. 1997).
8. 1996 WL 34423113 (Appellate Brief) Brief for Plaintiff-Appellant (May 24, 1996). Actually the title report showed the defect, but the lender's lawyer did not communicate it to the lender. The Second Department never resolved whether this was actual knowledge imputed to the agent's principal or mere constructive notice. Later cases where there was pure constructive notice made the answer to that question unnecessary.
9. 38 AD 3d 809 (2d Dept. 2007).
10. 281 A.D.2d 612 (2d Dept. 2001).
11. 61 AD3d 1073 (3d Dept. 2009).
12. Id. at 1074.
13. 68 AD 3d 1041.
14. Pelkofski, supra note 2, also dealt with what other kinds of payments would qualify for subrogation treatment, but analysis of that is beyond the scope of this article.