

Fall 2015
Vol. 11 No. 4



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No “Leap-Frog” in Refinancing

Delaware Supreme Court
Embraces Delaware’s Pure Race
Priority Status



by
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A recent Delaware Supreme Court opinion reinforced Delaware’s “pure race” approach to lien status in the context of mortgage refinancing transactions. In *Eastern Savings Bank, FSB v. CACH, LLC*, CA No. N13A-09-008 (Sept. 28, 2015), the Delaware Supreme Court held that the doctrine of equitable subrogation (see discussion below) does not apply to a mortgage refinancing absent other equitable circumstances. In other words, lenders that provide funds to refinance existing mortgage liens will have to rely upon their record status in the Recorder of Deeds Office; they cannot step into the shoes of the existing lienholder that is being taken out of the transaction and enjoy the lien priority of such existing lender’s mortgage lien. So, what is the takeaway for mortgage lenders? Given the holding in *Eastern Savings Bank*, second mortgage lenders—indeed, all mortgage lenders—should require a policy of lender’s title insurance, dated as of the date of closing, with particular emphasis on having the title insurance company cover any gap between signing and recording. And while no standardized forms of mortgage lender due diligence checklists are used throughout the state, the opinion also demonstrates the

value to mortgage lenders of establishing best practices such as using a mortgage lender's closing checklist to guide it through the closing practice, as discussed more fully below.

As stated in *Eastern Savings Bank*, Delaware is a "pure race" state, meaning that lien priority is determined exclusively by the time of recording.¹ In the "pure race" to file, the stakes are high: the first to record wins, no matter what. Creditors are therefore incentivized to act quickly in recording their liens. Any delays in filing could result in huge losses to a creditor in the event of foreclosure. With respect to mortgage liens (excluding seller take-back mortgage financing, for which special rules apply), in Delaware "[t]he rule is first in time, first in right."² The fact that a lienholder knows of the potential for another lien that has not yet been filed is irrelevant. Delaware courts will only consider such "notice" knowledge in determining priority where it is impossible to determine who in fact was the first to record.³

To prevent such harsh results, courts across the country have adopted equitable principles that provide reprieve for some lenders under the pure race and other statutes. One such principle is the doctrine of equitable subrogation. Under the doctrine, "[o]ne who fully performs an obligation of another, secured by a mortgage, becomes by subrogation the owner of the obligation of the mortgage to the extent necessary to prevent unjust enrichment."⁴ As an analogy, it is helpful to think of subrogation as "substitution." The new lender "steps into the shoes" of the former creditor and takes that creditor's priority lien position. The doctrine "acts as an exception to ... recording statutes and enables a later-filed lienholder to leap-frog over an intervening lien-holder."⁵

"Leap-Frog" in the Pure Race: Equitable Subrogation in Delaware

Delaware courts have recognized the doctrine of equitable subrogation for over a century, such as in connection with payment and performance bonds, but until the *Eastern Savings Bank* opinion, the courts had not applied the doctrine in the context of a mortgage loan refinancing, and case law addressing the matter in Delaware had been sparse.⁶ The Court of Chancery enumerates five elements required for a claim of equitable subrogation:

- (1) payment must have been made by the subrogee to protect his or her own interest;
- (2) the subrogee must not have acted as a volunteer;
- (3) the debt paid must have been one for which the subrogee was not primarily liable;
- (4) the entire debt must have been paid; and
- (5) subrogation must not work any injustice to the rights of others.⁷

Eastern Savings Bank: Equitable Subrogation Does Not Apply to Refinancing Mortgage Lender Absent Equitable Circumstances

The controversy in *Eastern Savings Bank* began in 2006, when a borrower defaulted on a car loan. Creditor CACH, LLC obtained a judgment against the borrower in the amount of \$16,000 on December 7, 2006, and transferred its judgment to the Superior Court on December 21, 2006. The judgment became a judgment lien on the borrower's New Castle County property

on that latter date. Two days prior, on December 19, 2006, the borrower closed a residential mortgage loan refinancing with Eastern Savings Bank and executed a mortgage for \$168,000. The borrower used the loan proceeds to discharge five debts and their respective liens, including two mortgages (the earliest of which was from 1999). It did not discharge CACH's debt. All five discharged liens, which totaled approximately \$148,500, had been recorded prior to CACH's lien. Eastern Savings then recorded its mortgage on December 29, 2006. Satisfactions of the prior mortgages were recorded in the beginning of 2007.

The housing bubble burst, the borrower defaulted, and, in August 2008, Eastern Savings Bank foreclosed on the mortgage. A Sheriff's Sale of the property yielded \$133,000. The sheriff sent Eastern Savings Bank the entirety of the sale proceeds, less the costs of the sale. CACH requested payment from Eastern Savings Bank, arguing that since all prior liens had been extinguished, it was entitled to first priority in the proceeds from the sale; as after all, it recorded its judgment lien on December 21, 2006, eight days before Eastern Savings recorded its mortgage lien against the borrower's New Castle County property. Eastern Savings refused to pay CACH, and litigation ensued. The dispute eventually went to the Delaware Supreme Court, where it was determined that CACH had first priority. The case then made its way back to the Supreme Court specifically on reconsideration of the issue of whether the doctrine of equitable subrogation applied.

The Delaware Supreme Court concluded that Eastern Savings Bank was not entitled to protection under the doctrine of equitable subrogation. It rejected two prior cases cited by Eastern Savings Bank in which the Delaware Court of Chancery had allowed equitable subrogation in a mortgage loan context. The distinction the Court found was that in those cases, there had been equitable reasons to apply the doctrine (reasonable mistake or unjust enrichment); in this case, there was no such reason to allow Eastern Savings Bank to have priority.

First, the Court noted that if the mortgage had been timely recorded, with a proper bring-down title search, the lien priority fight "would have been avoided, or revealed, and addressed." The Court found that Eastern Savings Bank had an adequate remedy at law against the title insurer and therefore refused to "apply the doctrine of equitable subrogation to cure the failure of Eastern Savings' title insurer or settlement agent to ensure that Eastern Savings was placed in a first lien position before completing the settlement process."

Second, the Court found that applying subrogation in this context would "work ... injustice to the rights of others." Eastern Savings Bank argued that CACH would not be disadvantaged by application of subrogation, because it would put the priority of CACH's judgment lien in no worse a position than it had been in before the application of subrogation. The Court held that this argument ignored the fact that the Eastern States loan actually diminished the debtor's equity from its lien position before that lien was incurred, as the debt incurred under the Eastern States loan exceeded the debts extinguished by the proceeds of that loan.

(continued on p. 12)

(continued from p. 11)

Finally, the Court found that CACH did not bargain for its subordinate position. CACH was not an intervening lienholder that had agreed to be third or fourth in priority; it had received a judgment and properly recorded it. It would not receive an “unearned windfall” if it was paid back that judgment amount, because it had never agreed to be subordinate to a mortgage lien. It would simply receive the money that it was entitled to when it obtained its judgment.

The Lessons of Eastern Savings Bank for Mortgage Lenders Refinancing Existing Secured Liens

In the wake of *Eastern Savings Bank*, Delaware mortgage lenders involved in refinancing transactions of existing mortgage liens should proceed under the assumption that the payment of prior mortgages with the proceeds from their new loan will not result in the refinancing lender assuming the priority position of those paid mortgages. Absent equitable considerations to the contrary, a court will strictly follow Delaware’s pure race recording statute. In most cases, a refinancing mortgage lender will have priority as of the date it records its new mortgage, and not before.

However, the implications of *Eastern Savings Bank* for refinancing lenders are not nearly as troubling as they appear. The initial decision of whether to provide a refinancing loan already requires review of previously existing liens on the property as disclosed through a thorough title search. Refinancing lenders should therefore ensure that their attorneys and title search companies are utilizing best practices throughout the course of the transaction. This is where outside counsel’s loan closing mortgage checklist can serve as a significant tool to protect lenders.

A loan closing checklist helps the attorney, client, and borrower identify each due diligence task and the responsible party, and includes a description of the status of each such task. As a best practice, counsel’s loan closing checklist should have a detailed title requirements section; this acts as one of many tools against lien priority fights between creditors. In particular, a bring-down search of liens within at least one day of closing helps ameliorate the result in *Eastern Savings Bank*. Should a search fail to spot and report that newly filed lien, as in the case of *Eastern Savings Bank*, requiring a lender’s policy of title insurance, dated as of the closing, provides the lender with an indemnity policy insuring the bank when mistakes are made.

In Delaware, the review of title is considered to be the practice of law in the state and therefore exclusively performed by Delaware attorneys. Lien search or title search reports and abstracts are typically prepared by a title or abstracting company for review by the Delaware attorney. Title abstracters are usually, although not always, affiliated with a title insurance company. All title insurance in Delaware is issued through a Delaware attorney acting as either an issuing agent or an approved attorney for a title insurance company licensed to conduct business in Delaware. Standard forms of title insurance policies and endorsements promulgated by the American Land Title Association are

approved for use in Delaware, and lenders typically require the borrower to provide title insurance acceptable to the lender at closing.

It is unclear from review of *Eastern Savings Bank* the date on which the title search of the borrower’s property occurred and whether a bring-down search was performed in the eight days between CACH’s recording of its judgment lien and closing of the mortgage loan. Had the title search company uncovered the lien, it is clear from the facts that Eastern Savings could have repaid the lien with the financing proceeds and still satisfied other liens. A refinancing lender should therefore ensure that both its attorney and title searcher are narrowing the gap between the time that the title search is conducted and the mortgage is recorded. A title search should be completed before the transaction and again just prior to recording—this is commonly called the “bring-down” search in Delaware practice.

Still, there is potential for liens to show up even if the gap between searching and recording has been narrowed. Fortunately, gap coverage from title insurance provides a remedy for these missed liens. Title insurers generally bear the risk of these liens, and a lender will be compensated in the event a lien or judgment is filed or indexed between the time of the search and time of recording. With such a narrow gap in the time from title search to recording, there will likely be little dispute between the title insurer and the refinancing lender about the gap coverage’s applicability to the missed lien.

Disputable title insurance claims, however, will make obtaining compensation from title insurers more difficult. A refinancing mortgage lender with priority issues would not want to spend time litigating with its insurer. This is why it is absolutely crucial for lenders and title searchers to follow best practices and narrow the gap between searching and recording.

Conclusion

The Delaware Supreme Court has held that absent any kind of equitable circumstances, refinancing loans made in the normal course of business will generally not be entitled to a “leap-frog” in lien priority under equitable subrogation. *Eastern Savings Bank* therefore constricts the doctrine of equitable subrogation, but this constriction should not trouble refinancing lenders. Refinancing lenders should continue to ensure that their attorneys, settlement agents, and title searchers utilize best practices when performing a title search and recording, as they will likely not be able to rely on a prior mortgage’s lien position in the event of a priority dispute.





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The views expressed in this article are those of the authors and not necessarily those of Richards, Layton & Finger or its clients.

Notes:

1- 25 Del C. § 2106

2- Guarantee Bank v. Magness Construction Co. 462 A.2d 405 (Del. 1983).

3- Winchester v. Parm, 141 A. 271 (Del.Ch. 1928).

4- RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES, § 7.6.

5- 73 Am. Jur. 2d § 58.

6- See Stoeckle v. Rosenheim, 10 Del. Ch. 195 (1913); Oldham v. Taylor, No. CIV.A. 18800-NC, 2003 WL 21786217, at *1 (Del. Ch. Aug. 4, 2003).

7- Eastern Savings Bank, supra, at *4 (quoting Reserves, Dev. LLC v. Severn Sav. Bank, FSB, 2007 WL 4054231, at *17 (Del. Ch. Nov. 9, 2007)).