



FINANCIAL RESTRUCTURING & BANKRUPTCY PRACTICE

ALERT

LOOK OUT FOR UNRECORDED VENDEE'S LIENS IN NEW JERSEY

By Michael J. Viscount, Jr.

Two recent cases in New Jersey establish that contract vendees of real estate have liens that, even though unrecorded, can and often do prime the rights of after recorded mortgage liens where the mortgage holder had notice of the pending contracts and deposits. The two cases arise out of the bankruptcy of New Jersey home builder Elliott Building Group.

Elliott and various of its development affiliates voluntarily filed bankruptcy on June 10, 2007. The priority dispute arose in connection with a refinancing construction loan made by RBC Bank to the debtor affiliate that owned a project called "Sea Pines Estates." At the time the construction loan was made and before the mortgage was recorded, the Sea Pines project was already under development and prospective home purchasers had signed contracts under which they handed over deposits to the debtor. To resolve the dispute over who was entitled to the proceeds of a sale of the project out of the bankruptcy, the debtor initiated an adversary proceeding in the bankruptcy case against the bank and the contract vendees. See *Elliott Residential, et al. v. RBC Centura Bank*, Adversary No. 08-01091. In that case, both the debtor as mortgagor and the contract vendees alleged that the contract vendees had lien rights under New Jersey law that arose when deposits had been paid and the debtor/seller had defaulted by failing to perform. It was also alleged that, even though unrecorded, the vendee's liens had priority over the after recorded mortgage of the bank, because the bank had actual

knowledge of the existence of the contracts and the deposits at the time of the mortgage loan closing. The priority issue was never decided in the bankruptcy case, because the parties entered into a settlement that acknowledged the priority of the vendees' liens. At the hearing to approve the settlement, the bankruptcy judge stated that had she been asked to rule on the issue, she would have ruled in favor of the vendee claimants, citing *Cox v. RKA Corp.*, 164 N.J. 487, 753 A.2d 1112 (2000). In *Cox*, New Jersey's highest court analyzed and compared the law in New Jersey to holdings in other states and concluded that in New Jersey the vendee has priority over a subsequent mortgage recorded with notice of the existence of a contract and paid consideration, but that once the mortgage is recorded, the vendee has constructive notice so that future advances to the property owner are made subject to the mortgage lien.

In large part because of the outcome in the *Elliott* case, the bank sued its former law firm in the federal district court of New Jersey for malpractice in connection with representation on the construction loan refinancing. The bank alleged that it retained the law firm "to procure a first lien on the lots, free and clear of all other encumbrances." The law firm filed a motion to dismiss, which it lost. The district court held that the bank had sufficiently pled facts to support its claim that the mortgage was primed by the unrecorded vendees' liens. See *RBC Bank (USA) v. Riley*, 2009 U.S. Dist. LEXIS 73359.

The obvious lessons and practice pointers: (1) the mortgage lender needs to not only ask for but read and understand pending contracts and the rights of those who have paid deposits and other forms of consideration, and (2) the lender's counsel needs to be aware of and understand the nature of the real estate collateral, even on a construction project. When the collateral is subdivided lots, special attention needs to be given to whether all of the lots remain available and whether some or all are already under contract for sale to third parties. If the contracts reveal the payment of deposits or other consideration, both lender and counsel need to determine whether the funds are in escrow or have been turned over to and employed by the borrower. In New Jersey at least, the maxim may be *lender beware*, and if deposits or other consideration have been turned over to the borrower, the mortgage lender needs subordination or postponement agreements or some other affirmative assurance that its mortgage lien priority will not be primed.

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Michael Viscount is a commercial lawyer with extensive experience representing public and private businesses and creditors' groups on corporate debt restructuring, workouts, bankruptcies and other complex commercial matters. From manufacturers, suppliers and service providers to public and private funding sources, Michael has a long track record of developing creative solutions to meet the needs of financially distressed companies and creditors.

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