THE SUFFOLK LAWYER
THE OFFICIAL PUBLICATION OF THE SUFFOLK COUNTY BAR ASSOCIATION
DEDICATED TO LEGAL EXCELLENCE SINCE 1908
www.scba.org Vol. 28, No. 1 – November 2012

The Diligence That is Due

By Lance R. Pomerantz

Many practitioners view land record systems as a cut-and-dried method of garnering information about title to real estate, similar to automobile registration. Because land records are deemed to provide constructive notice or inquiry notice, the additional implications of recorded instruments, or even *unrecorded* instruments, can dramatically affect the rights of those who rely on the recording system.

Due Diligence of the junior lender (and the lender's attorney)

In *Capital Stack Fund, LLC v. Badio, et al.,* 2012 NY Slip Op 51481(U) (Sup. Ct., Rockland Cty., July 15, 2012), Capital Stack Fund, the senior lender, had refinanced an earlier mortgage, and the satisfaction was recorded soon after the new loan closed. For some reason, Capital Stack's mortgage was not recorded for several months. In the interim, Colin, the junior lender, closed its loan and recorded its mortgage. Capital Stack sought to foreclose and named Colin as a defendant. Of course, Colin asserted priority under RPL §291. Capital Stack countered, *inter alia,* that Colin was on constructive notice of Capital Stack's loan because of the recorded satisfaction (*i.e.*, that a reasonable person would have realized that the earlier mortgage could not have been satisfied *but for* the existence of an intervening loan and mortgage, albeit unrecorded).

In connection with the junior mortgage transaction, Colin's real estate counsel had "hired the title company to search the title, and obtained title insurance for [Colin]...." The title company "did not convey to [Colin] or their lawyer any information about the recently-satisfied ... Mortgage." Colin submitted an expert witness affidavit from the principal of an uninvolved title agency stating that "extraneous information that does *not* reveal the existence of any *open* title encumbrance against real property, such as mortgages that have already been satisfied, ... is not turned over to a title company's client" [emphasis in original]. Capital Stack submitted no affidavit to the contrary.

Based on this testimony, the court found that "by doing a title search and acquiring title insurance, [Colin] did make a 'reasonably diligent inquiry' into whether they should 'question the transaction'.... They should not be charged with constructive notice of [Capital Stack Fund's] later-recorded mortgage." Capital Stack Fund's foreclosure action was dismissed![1]


Lance Pomerantz

It is axiomatic that constructive notice arises merely from the properly recorded instrument, regardless of whether the public records are actually searched. The court, however, sidestepped the delicate question of whether a recorded satisfaction, in and of itself, is sufficient to constitute constructive (or at least "inquiry") notice to the lender of the existence of an unrecorded mortgage.

The decision also blurs the distinction between a search and report prepared for the client's use and information on the one hand, and a search performed by the insurer for its own use in making underwriting decisions on the other. Read literally, the decision says that the title search made in connection with writing the title policy was done by Colin, or on their behalf. The more likely scenario is that the title company was engaged to provide a lender's policy and conducted the title search for its own benefit before preparing a "commitment." The expert testimony made clear that the satisfaction was discovered of record, but not turned over to the client. This approach is consistent with underwriting practice.

Nevertheless, the court appears to hold that a title company search and issuance of insurance is *per se* sufficient to shield a lender from constructive notice that might otherwise be imputed to the lender directly from the public record.

Due Diligence of the title agent

While the holding in *Capital Stack Fund* is good news for junior lenders who purchase title insurance, title agents are being held to a higher standard. In *United General Title Insurance Company v. RC Abstract, Inc., d/b/a Triborough Land Services,* (Westchester County Supreme Court #6620/09) (unreported), the insurance underwriter sought indemnification from its own policy-writing agent.

As part of a fraudulent scheme, the seller had taken a loan from Bank A to pay off an earlier mortgage. The satisfaction of the earlier mortgage was recorded, but the Bank A mortgage was not. The buyer took a loan from Bank B to purchase the property. Unbeknownst to RC Abstract, Inc. (the title agent), the Bank A mortgage was recorded the same day as the closing on the sale. As a result, Bank B's mortgage was subordinate to the Bank A mortgage and the title insurer had to pay off the Bank A mortgage pursuant to Bank B's lender's policy.

The gravamen of the action was that the agent should have inquired into the source of funds used to satisfy the prior mortgage when there was no newer mortgage of record. Here, the duty arose from the agency agreement between the underwriter and the agent. The agreement provided that the agent would indemnify the underwriter for

> "[e]rrors or omissions which are disclosed by the application for title insurance, examiner's report, searcher's report or other defects, liens encumbrances or matters affecting title to real property which were known to the Agent or, in the exercise of ordinary care and due diligence, should have been known to the Agent."

In the decision, "the Court concludes that in the exercise of ordinary care, a title agent is obligated to make inquiry as to the source of funds of a satisfied mortgage." (Lefkowitz, J., decision dated May 25, 2011). By failing to make such an inquiry, the court observed that several different methods of avoiding or mitigating the loss (*i.e.*, adjourning the closing, escrowing adequate funds, or seeking the insurer's direction) were rendered unavailable.

Heightened vigilance

The collapse of the real estate market during the past five years exposed many instances of shoddy recording practice, as well as outright fraud. In addition, the collapse itself has spawned many "mortgage rescue" scams that employ illegitimate techniques. Fighting back, some title insurers have provided guidance to their agents in the form of underwriting bulletins. These bulletins outline the various methods utilized by imposters, forgers and fraudsters to exploit the vulnerabilities of local land recording systems. They also warn of "red flags" for which an agent should be on alert, including a recorded mortgage satisfaction with no concurrent refinance or arms-length sale. Sellers and refinancing owners alike

should be prepared to explain the source of funds for a recently satisfied mortgage.

1. The opinion does not state why dismissal was warranted. It appears that Capital Stack should have been allowed to proceed to foreclose on its (now) subordinate mortgage.

Note: Lance R. Pomerantz is a sole practitioner who provides representation, expert testimony, consultation and research in land title disputes. He is also the publisher of the widely-read land title newsletter Constructive Notice. For more information, please visit www.LandTitleLaw.com.