

SYLLABUS

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Rosenthal & Rosenthal, Inc., v. Vanessa Benun, et al. (A-6-15) (076266)

Argued April 26, 2016 -- Decided July 21, 2016

CUFF, P.J.A.D. (temporarily assigned), writing for a unanimous Court.

The issue in this appeal is the priority of mortgages securing optional future advances when a factor has advance notice of an intervening lien but nonetheless proceeds to make optional advances to a commercial entity.

On July 12, 1995, Jazz Photo Corp., one of several commercial entities (collectively referred to as the Jazz Entities), entered into a factoring agreement with Rosenthal & Rosenthal, Inc. (Rosenthal). Jazz Photo sold Rosenthal its accounts receivable in return for cash. The agreement contemplated the disbursement of additional advances. Five years later, Vanessa Benun (Benun), the daughter of Jack Benun, a principal of the Jazz Entities, guaranteed Jazz Photo's obligations under that agreement. Benun also executed a mortgage on real property she owned in Monmouth County as security for her personal guaranty. The mortgage secured "all sums due or that may become due under this Mortgage, the Guaranty and other Loan Documents (and all extensions, renewals, restatements, substitutions, amendments and modifications of any or all of the foregoing), up to a maximum principal amount of One Million (\$1,000,000) Dollars[.]" The mortgage also contained anti-subordination clauses. It was recorded in the Monmouth County Clerk's Office on August 21, 2000.

In March 2005, another of the Jazz Entities, Ribi Tech Products, LLC (Ribi Tech), entered into a factoring agreement with Rosenthal. This factoring agreement also provided for discretionary capital advances from time to time, if Ribi Tech so requested and certain conditions were met. Benun personally guaranteed Ribi Tech's obligations to Rosenthal. Benun executed another mortgage on the same Monmouth County real property to secure her guaranty, containing the same provisions as the 2000 mortgage. This mortgage was recorded in the Monmouth County Clerk's Office on April 12, 2005.

In March 2007, Riker, Danzig, Scherer, Hyland & Perretti, L.L.P. (Riker), a law firm providing legal services to Jack Benun and the Jazz Entities, obtained a third mortgage from Benun on the same real property. This mortgage was executed in favor of Riker to secure Jack Benun's personal debt under a letter agreement dated March 20, 2007. When Benun executed the mortgage, Jack Benun owed Riker \$1,679,701.33 in unpaid legal fees, and the letter agreement reflected his obligations to Riker and Riker's promise to provide continuing legal representation. Riker's mortgage was recorded on April 13, 2007.

Rosenthal received actual notice of the Riker mortgage, as reflected in an August 2007 email from Rosenthal's counsel to Riker stating that the "title on the daughter[']s properties show[s] liens in favor of your firm. Those liens will need to be fully subordinated to any new [Rosenthal] mortgages on the daughter[']s properties related to the new loan to Mona Benun." Even with notice of the Riker mortgage, Rosenthal continued to make advances to the Jazz Entities that totaled millions of dollars. In September 2009, Jazz Products filed for bankruptcy. The Jazz Entities defaulted on their obligations to Rosenthal, owing Rosenthal close to \$4 million. Benun, in turn, defaulted on her personal guaranty to secure the debt.

After Riker recorded its mortgage on the Monmouth County property, it continued to perform legal services for Jack Benun, and his unpaid legal fees ballooned to over \$3 million. Jack Benun and the Jazz Entities defaulted on their obligation to Riker, and Benun defaulted on her guaranty. The debt secured by the three mortgages totaled close to \$7 million, far in excess of the value of the mortgaged property. Rosenthal filed a foreclosure complaint against Benun, her husband, and Riker. Benun and her husband did not respond, and Rosenthal requested that a default judgment be entered against them. Riker answered, disputing the priority of Rosenthal's mortgages. Later, both Rosenthal and Riker filed cross-motions for summary judgment regarding the priority of their respective mortgages.

The trial court granted Rosenthal's motion for summary judgment. It held that Riker's argument that its mortgage displaced the two Rosenthal mortgages was legally flawed because the firm accepted a mortgage on the property with knowledge of two prior mortgages, each securing an obligation of up to \$1 million, and with knowledge of the anti-subordination clauses. The court concluded that there was no convincing justification for rewarding Riker -- a subsequent mortgagee -- a superior priority.

Riker appealed, and the Appellate Division reversed in a published opinion. 441 N.J. Super. 184 (App. Div. 2015). The Appellate Division concluded that the common law rules of priority placed Riker ahead of Rosenthal. The panel relied on the long-standing New Jersey rule governing future advance mortgages: when the future advance is optional, actual notice of an intervening lien will subordinate advances made after such notice is received.

The Supreme Court granted Rosenthal's petition for certification. 223 N.J. 281 (2015).

HELD: When a lender holds a mortgage that secures optional future advances, the prior lien loses priority for advances made after actual notice of an intervening mortgage, in this case Riker's intervening lien.

1. There are, broadly speaking, two considerations that bear on the priority issue: (1) whether the first mortgagee's subsequent advances were optional or obligatory; and (2) whether the first mortgagee had notice, either actual or constructive, of the intervening mortgage. Under the traditional common law rule, if the advances are obligatory, the first mortgagee retains priority for all advances over all subsequent mortgagees, regardless of whether the first mortgagee had notice of an intervening lien. But if the advances are optional, then the first mortgagee retains priority only for advances made before the mortgagee had notice -- usually actual notice -- of the second, intervening mortgage. (pp. 13-15)
2. For the most part, New Jersey law tracks the optional/obligatory and notice/no-notice common law distinctions governing future advance mortgages. In Ward v. Cooke, 17 N.J. Eq. 93, 99 (Ch. 1864), the court held that a future advance mortgage "is entitled to priority over subsequent encumbrances, for all advances made prior to notice of the subsequent encumbrance." Only actual notice, not record or constructive notice, would suffice. Ibid. The Ward rule has been continuously recognized as the general rule in this State. In Lincoln Federal Savings & Loan Ass'n v. Platt Homes, Inc., 185 N.J. Super. 457, 466-67 (Ch. Div. 1982), the trial court permitted subordination of optional future advances secured by a prior mortgage to an intervening mortgage based on constructive rather than actual notice of the intervening lien, but limited the rule to construction loans. Lincoln Federal has been roundly criticized; nonetheless this Court cited the case with approval in Cox v. RKA Corp., 164 N.J. 487 (2000), albeit in a different context from the traditional advance money mortgage. (pp. 15-24)
3. New Jersey's mortgage-priority statute, N.J.S.A. 46:9-8 to -8.5, preserves priority only for future advances made under a line-of-credit agreement, which are by definition mandatory, thereby denying priority to discretionary principal advances. Because the common law rule protected the priority of mandatory future advances, the statute does little to change the future advance priority common law rule. In other words, optional future advances made with actual knowledge of an intervening lien are subordinated to the intervening lien. (pp. 24-29)
4. The general rule that a mortgage given to secure future advances retains its priority over a subsequent encumbrance only if the future advance is mandatory or if the prior mortgagee did not have actual notice of the intervening lien was established in Ward, supra, 17 N.J. Eq. at 99. That rule remains in effect except as altered by Lincoln Federal for construction loans. Rosenthal's reliance on the Lincoln Federal exception, however, is misplaced. The common law rule -- that actual notice of an intervening lien subordinates a mortgage securing optional future advances -- remains in effect in New Jersey, at least outside the construction-loan context. Lincoln Federal and Cox, supra, did nothing to cast doubt on the common law rule's continuing vitality as to financing vehicles such as factoring agreements or the optional/obligatory distinction regarding future advances. (pp. 29-35)
5. The common law rule grew out of a concern that a prior lender could preclude a borrower from obtaining capital to meet the needs of its business. The circumstances attendant to the execution of the mortgage in favor of Riker in this case are akin to the need for financing to continue business operations under more favorable terms. Once Rosenthal had actual notice of Riker's intervening mortgage and continued to make advances to the Jazz Entities, it subjected itself to the common law priority rules. The amount that Rosenthal now claims has priority over the Riker mortgage was not only advanced at Rosenthal's discretion but also advanced after actual notice of Riker's mortgage. Those sums are therefore subordinated to the Riker mortgage. (pp. 35-36)

The judgment of the Appellate Division is **AFFIRMED**.

CHIEF JUSTICE RABNER and JUSTICES LaVECCHIA, FERNANDEZ-VINA, and SOLOMON join in JUDGE CUFF's opinion. JUSTICES ALBIN and PATTERSON did not participate.

SUPREME COURT OF NEW JERSEY
A-6 September Term 2015
076266

ROSENTHAL & ROSENTHAL, INC.,

Plaintiff-Appellant,

v.

VANESSA BENUN (a/k/a VANESSA
BROOCHIAN and ELAN
BROOCHIAN),

Defendants,

and

RIKER, DANZIG, SCHERER,
HYLAND & PERRETTI, L.L.P.,

Defendant-Respondent.

Argued April 26, 2016 - Decided July 21, 2016

On certification to the Superior Court,
Appellate Division, whose opinion is
reported at 441 N.J. Super. 184 (App. Div.
2015).

Joshua A. Zielinski argued the cause for
appellant (McElroy, Deutsch, Mulvaney &
Carpenter, attorneys; Mr. Zielinski and
Peter Saad, of counsel; Mr. Zielinski,
Andrew Gimigliano, and Young Yu, on the
briefs).

Matthew H. Lewis argued the cause for
respondent (Riker, Danzig, Scherer, Hyland &
Perretti, attorneys; Mr. Lewis, Gerald A.
Liloia and Nicholas Racioppi, Jr., of
counsel).

Mark Salah Morgan argued the cause for amicus curiae New Jersey Bankers Association (Day Pitney, attorneys; Mr. Morgan, Christina A. Parlapiano, and Alba V. Aviles, of counsel and on the brief).

Edward C. Eastman argued the cause for amicus curiae New Jersey Land Title Association (Davison, Eastman & Munoz, attorney; Michael J. Fasano, on the brief).

JUDGE CUFF (temporarily assigned) delivered the opinion of the Court.

This appeal addresses the priority of mortgages given to secure financing for a group of related commercial entities. A factor purchased accounts receivable, advanced funds to the commercial entities, and agreed to make optional future advances. The financing was secured by personal guaranties and mortgages on the home of a guarantor. Each mortgage was capped at \$1 million.

Before the factor made additional advances to the commercial entities, it received actual notice that a law firm representing the principal of the commercial entities had obtained a mortgage on the home of the personal guarantor to secure payment of current and future legal fees.

Notwithstanding actual notice of the intervening mortgage, the factor advanced additional funds. Eventually, the commercial entities defaulted and filed a bankruptcy petition. The guarantor also defaulted. At that time, the amount of

indebtedness to the factor and to the law firm far exceeded the value of the security.

The factor commenced an action to foreclose on the mortgages it held. Although the guarantor did not appear in the foreclosure action, the law firm appeared to contest the priority of the liens on the secured property. The law firm contended that the factor's prior liens securing any funds advanced by the factor after receipt of actual notice of the law firm's intervening lien were subordinated to the law firm's mortgage.

The law governing mortgages securing optional, sometimes referred to as discretionary, future advances in this State is well-settled. When a lender holds a mortgage that secures optional future advances, the prior lien loses priority for advances made after actual notice of an intervening mortgage. Although the common law rule and the mortgage-priority statutory scheme adopted by the Legislature have been criticized by commentators and differ from the law in other states, any fundamental alteration of the law governing the priority of mortgages is best addressed by the Legislature.

Here, it is undisputed that the factor had advance notice of the law firm's intervening lien but nonetheless proceeded to make optional advances to the commercial entities. Having done so, its mortgages securing those optional future advances were

subordinated to the law firm's intervening lien. Accordingly, we affirm the judgment of the Appellate Division, holding that the law firm's intervening lien takes priority over optional advances made by the factor after it received actual notice of the intervening lien.

I.

On July 12, 1995, Jazz Photo Corp., one of several commercial entities (collectively referred to as the Jazz Entities), entered into a factoring agreement with Rosenthal & Rosenthal, Inc. (Rosenthal). Jazz Photo sold Rosenthal its accounts receivable in return for cash. The agreement contemplated the disbursement of additional advances and provided as follows: "If you require funds from time to time, we will advance to you, at our discretion, up to seventy percent (70%) of the net amount of receivables purchased by us and not yet collected."

Five years later, Vanessa Benun (Benun), the daughter of Jack Benun, a principal of the Jazz Entities, guaranteed Jazz Photo's obligations under that agreement. At that time, Benun also executed a mortgage on real property she owned in Monmouth County as security for her personal guaranty. The mortgage secured "all sums due or that may become due under this Mortgage, the Guaranty and other Loan Documents (and all extensions, renewals, restatements, substitutions, amendments

and modifications of any or all of the foregoing), up to a maximum principal amount of One Million (\$1,000,000) Dollars[.]” Benun’s mortgage also contained “dragnet” and anti-subordination clauses. The dragnet clause provided that the mortgage would secure not only the present guaranty but also “all obligations and indebtedness of every kind” that Benun would incur to Rosenthal in the future. The anti-subordination clause prevented Benun from further mortgaging or encumbering the property. The mortgage was recorded in the Monmouth County Clerk’s Office on August 21, 2000.

In March 2005, another of the Jazz Entities, Ribitech Products, LLC (Ribitech),¹ entered into a factoring agreement with Rosenthal. This factoring agreement also provided for discretionary capital advances from time to time, if Ribitech so requested and certain conditions were met. Benun personally guaranteed Ribitech’s obligations to Rosenthal. Benun executed another mortgage on the same Monmouth County real property to secure her guaranty. This mortgage contained the same provisions as the 2000 mortgage, and it was recorded in the Monmouth County Clerk’s Office on April 12, 2005.

In March 2007, Riker, Danzig, Scherer, Hyland & Perretti, L.L.P. (Riker), a law firm providing legal services to Jack

¹ Ribitech later changed its name to Jazz Products.

Benun and the Jazz Entities, obtained a third mortgage from Benun on the same real property. This mortgage was executed in favor of Riker to secure Jack Benun's personal debt under a letter agreement dated March 20, 2007. When Benun executed the mortgage, Jack Benun owed Riker \$1,679,701.33 in unpaid legal fees, and the letter agreement reflected his obligations to Riker and Riker's promise to provide continuing legal representation. Riker's mortgage was recorded on April 13, 2007.

Rosenthal received actual notice of the Riker mortgage, as reflected in an August 2007 email from Rosenthal's counsel to Riker. Sent in connection with a contemplated new loan from Rosenthal to the Benuns or the Jazz Entities, the email stated that the "title on the daughter[']s properties show[s] liens in favor of your firm. Those liens will need to be fully subordinated to any new [Rosenthal] mortgages on the daughter[']s properties related to the new loan to Mona Benun."

Even with notice of the Riker mortgage, Rosenthal continued to make advances to the Jazz Entities that totaled millions of dollars.² In September 2009, Jazz Products filed for bankruptcy.

² The outstanding balances on advances made by Rosenthal to the Jazz Entities following actual notice of the Riker mortgage are as follows:

August 2007	\$ 388,921.33
September 2007	\$1,567,387.00

The Jazz Entities defaulted on their obligations to Rosenthal, owing Rosenthal close to \$4 million. Benun, in turn, defaulted on her personal guaranty to secure the debt.

After Riker recorded its mortgage on the Monmouth County property, it continued to perform legal services for Jack Benun, and his unpaid legal fees ballooned to over \$3 million. Jack Benun, and the Jazz Entities defaulted on their obligation to Riker and Benun defaulted on her guaranty. Thus, the debt secured by the three mortgages totaled close to \$7 million, far in excess of the value of the mortgaged property.

October 2007	\$2,048,442.37
November 2007	\$ 872,521.17
December 2007	\$ 797,364.00
January 2008	\$ 513,000.00
February 2008	\$ 996,400.00
March 2008	\$ 191,381.93
April 2008	\$3,907,817.76
May 2008	\$1,276,499.00
June 2008	\$1,312,275.33
July 2008	\$1,794,399.76
August 2008	\$ 797,200.73
September 2008	\$1,723,758.64
October 2008	\$1,841,312.25
November 2008	\$1,049,230.33
December 2008	\$ 960,844.60
January 2009	\$ 393,300.00
February 2009	\$ 474,915.65
March 2009	\$ 611,702.84
April 2009	\$1,226,885.00
May 2009	\$ 612,421.33
June 2009	\$1,319,019.28
July 2009	\$ 312,000.00
August 2009	\$ 75,933.13
September 2009	\$ 3233.33
October 2009	\$ 1125.83

Rosenthal filed a foreclosure complaint against Benun, her husband, and Riker. Benun and her husband did not respond, and Rosenthal requested that a default judgment be entered against them. Riker answered, disputing the priority of Rosenthal's mortgages. Later, both Rosenthal and Riker filed cross-motions for summary judgment regarding the priority of their respective mortgages.

The trial court granted Rosenthal's motion for summary judgment. The trial court determined that the dragnet clauses in the Rosenthal mortgages were fully enforceable. Turning to the priority issue, the trial court held that Riker's argument that its mortgage displaced the two Rosenthal mortgages was legally flawed because the firm accepted a mortgage on the property with knowledge of two prior mortgages, each securing an obligation of up to \$1 million, and with knowledge of the anti-subordination clauses. The court concluded that there was no convincing justification for rewarding Riker -- a subsequent mortgagee -- a superior priority.

Riker appealed, and the Appellate Division reversed in a published opinion. See Rosenthal & Rosenthal, Inc. v. Benun, 441 N.J. Super. 184 (App. Div. 2015). The Appellate Division concluded that the common law rules of priority placed Riker ahead of Rosenthal. The panel relied on the long-standing New Jersey rule governing future advance mortgages: when the future

advance is optional, actual notice of an intervening lien will subordinate advances made after such notice is received. Id. at 190 (citing Ward v. Cooke, 17 N.J. Eq. 93, 99 (Ch. 1864)).

This Court granted Rosenthal's petition for certification. 223 N.J. 281 (2015). We also permitted the New Jersey Bankers Association (NJBA) and the New Jersey Land Title Association (NJLTA) to appear as amici curiae.

II.

A.

Rosenthal focuses on the bargained-for contractual expectations of it, Benun, and the Jazz Entities. According to Rosenthal, those parties entered into the factoring agreements with the expectation that Rosenthal would maintain a senior interest in the mortgaged property. By granting Riker priority, Rosenthal contends that the Appellate Division's holding allowed Riker, a stranger to the factoring agreements, to upend those bargained-for expectations.

Recognizing the common law rule, and acknowledging that it is the majority rule, Rosenthal urges, however, that it should not apply here. Rosenthal emphasizes that the mortgages secured Benun's personal guaranty, not a direct advance money loan. The Appellate Division, Rosenthal claims, failed to consider that critical distinction.

Rosenthal also contends that the Appellate Division failed to consider and give effect to the dragnet clauses contained in the mortgages. Rosenthal argues that all parties to the Jazz Entities' factoring agreements specifically intended that the dragnet clauses would secure Rosenthal's future credit advances up to a specified amount and would keep Rosenthal's priority position for all advances up to that amount. Moreover, Benun never contested the validity of the dragnet clauses, and the Appellate Division granted Riker priority without addressing the effect that such clauses have on the common law priority rules.

Finally, Rosenthal argues that the legislative history of the mortgage-priority statute, N.J.S.A. 46:9-8.1 and -8.2, plainly indicates that the Legislature intended to vest all future advances with priority. Rosenthal contends that a literal reading of the statute may produce the harsh, "inequitable," and "absurd" result of an intervening lien holder taking priority based on constructive notice alone.

B.

Riker asserts that the Appellate Division simply applied a rule that has been the law in New Jersey for the past 150 years: when a lender holds a mortgage that secures discretionary future advances, those advances lose priority when they are made after actual notice of an intervening mortgage. That rule, according

to Riker, stands on strong policy footing and has been codified in the mortgage-priority statutes.

Finally, Riker argues that Rosenthal's focus on the dragnet clauses is misplaced and mischaracterizes the Appellate Division's opinion. Rather, the issue before the trial court, the Appellate Division, and this Court has always centered on the well-settled rules governing the priority of recorded mortgages, not the validity of the factoring agreements.

C.

NJBA highlights the important role that future advances play in the financial industry. It asserts that the Appellate Division's opinion will defeat the primary purpose behind the use of future advances in the banking industry -- allowing "lenders to lend money at the pace often required in commercial transactions, i.e., at the point of economic necessity."

NJBA contends that the Appellate Division's focus on Rosenthal's actual notice of Riker's mortgage overlooks that Riker had actual notice of the Rosenthal mortgage. NJBA argues that Riker should have expected its lien to be subordinate to Rosenthal's two earlier-recorded liens.

NJBA expresses concern about three possible outcomes that could follow from the Appellate Division's decision: (1) lenders may avoid future advance transactions because of the risk that intervening liens will destroy their bargained-for

