

legal

First in Time – First in Right

By MARK A. KABLACK

Every so often a court decision tests the standards of what most in the legal community consider to be black-and-white law.



When this happens it shakes and rattles the foundation that people in the legal community have come to rely upon. It is common in

human nature for people to want firm standards and predictable results. This trait is magnified in the business world, particularly as it relates to lending practices. With this backdrop, it is understandable how the recent Massachusetts Appeals Court decision in *Queeno v. Colonial Co-Operative Bank* (63 Mass. Appeals Court 392, 2005) has the attention and concern of lenders, members of the conveyancing bar, and builders.

The *Queeno* case tests the common principle in Massachusetts, driven by statute, common law and real estate conveyance practice, that first in time equals first in right. When documents are recorded throughout the Massachusetts registry system, priority in the recording date and time equates to priority in interest. A buyer, lender or other party acquiring interest in real property takes the interest subject to all prior matters of record. A party is

presumed to know about and be bound by matters on the registry record. This is the black-and-white rule, and for the most part it is applied universally.

Of course there are numerous exceptions to the black-and-white rule, and these exceptions tend to be well-documented and time-honored standards. There are express provisions for subordinating specific documents to others, regardless of the recording time preference. There are conveyancing practices with respect to institutional lenders, whereby title is transferred and deeds are recorded with the full expectation and legal obligation that mortgagees will promptly discharge a prior mortgage lien based upon the tendering of funds at a closing in accordance with a payoff letter. There are also situations where the priority of recording, or the implication of not recording a document at all, is governed by what a party actually knows rather than what the registry record shows. This latter point is the main focus of the *Queeno* case.

In *Queeno*, a husband and wife entered into a purchase-and-sale agreement with a builder/developer for construction of a single-family home in Westminister. The agreement provided for a certain purchase price for the construction of the home and the land, and a portion of the purchase price was paid upfront in the form of a deposit. As is common for most purchase-and-sale agreements, the agree-

ment was not recorded with the Worcester County Registry of Deeds.

Subsequent to signing the purchase-and-sale agreement, the builder/developer sought and received a construction loan from Colonial Co-Operative Bank. The loan application submitted by the builder/developer included a copy of the purchase-and-sale agreement, and Colonial issued the loan based upon underwriting criteria that the home was "pre-sold." Colonial promptly recorded a mortgage on the subject property at the Worcester County Registry of Deeds, believing it was getting a first mortgage lien on the property, based upon the rule that first in time equates to first in right.

In the months that ensued, the relationship between the buyers and the builder/developer deteriorated. The construction was delayed and there were arguments over construction quality and cost overruns. The closing date under the purchase-and-sale agreement lapsed, and in a bizarre set of circumstances, the husband and wife eventually negotiated a temporary certificate of occupancy for the home and were allowed to take occupancy without closing on the property. These events were followed by a sale of the property to a realty trust for nominal consideration, and attempts by various creditors of the builder/developer to assert ownership interest in the property for purposes of debt collection. It was at this time

that Colonial moved to foreclose its mortgage lien on the property, only to be rebuffed by the husband and wife buyers. The buyers asserted legal claims against Colonial, claiming that Colonial's interest was subject to the purchase-and-sale agreement and that Colonial should be restricted from selling the property to anyone other than the husband and wife. This is the crux of the Queeno case, and it pits the black-and-white theory of recording priority in the registry record against the actual knowledge of Colonial with respect to the purchase-and-sale agreement.

In a lower court decision, *Queeno v. Cote* (Massachusetts Superior Court, 2000), Judge Francis R. Fecteau ruled in favor of Colonial. In a preliminary ruling on a motion for summary judgment, Fecteau ruled that Colonial's mortgage lien interest was not subject or subordinate to the purchase-and-sale agreement or other rights of the husband and wife. The judge's decision was based in part on the following: First, the judge acknowledged the actual knowledge exception to the recording rule, but found that the statutory framework of the exception did not apply to this case. The exception applies when someone has actual knowledge of another's actual real estate interest (such as actual ownership, a life estate, a tenancy or an assignment of rents or profits). In the judge's opinion, the exemption does not apply when the interest is merely contractual (such as in a purchase agreement). Second, the judge was not convinced that Colonial had actual knowledge of all the details of the purchase-and-sale agreement. Third, the judge reasoned that the husband and wife buyers must have understood that a construction loan was required in order for the builder/developer to

complete the home, and that Colonial, or any other lender for that matter, would not have made the loan if it believed that the loan was subordinate or subject to the purchase-and-sale agreement. Additional issues noted by Fecteau include: the husband and wife never sought to record the purchase-and-sale agreement; the Colonial mortgage was recorded well in advance of the scheduled closing date under the purchase-and-sale agreement; and the husband and wife waited too long to enforce the terms of the purchase-and-sale agreement, allowing the original closing date to lapse without extension, amendment or other action.

This May, the Massachusetts Appeals Court overturned the lower court decision. In a decision authored by Judge Smith, the Appeals Court took an entirely different approach on the statutory requirements for actual notice. Contrary to the lower court case, the Appeals Court decided that a purchase agreement bestows a significant real estate interest upon a buyer. The husband and wife acquired an equity interest in the property as soon as the purchase-and-sale agreement was executed, and such equity interest is sufficient under Mass. General Law chapter 183, section 4, to circumvent the black-and-white rule of first in time equals first in right. When a bank has actual knowledge of a purchase agreement, it does not matter whether the agreement is recorded at the registry.

The Appeals Court also took a harder look at what Colonial actually knew at the time it issued the construction loan and recorded the mortgage. Contrary to the lower court case, the Appeals Court found that Colonial not only had actual knowledge of the purchase-and-sale agreement, it also knew the details. The Ap-

peals Court was convinced that Colonial had a copy of the signed purchase-and-sale agreement and that they clearly underwrote the construction loan to the builder/developer based upon the "pre-sold" aspects of the deal.

Based upon Colonial's actual knowledge of the husband and wife's equitable interest in the property, the Appeals Court was convinced that Colonial made the construction loan at its peril. Colonial could have, but failed, to request a subordination agreement from the husband and wife. Summary judgment for Colonial was reversed in favor of the husband and wife, and the case has been remanded for trial on remaining counts in the complaint. Further appellate review of this decision is pending, at the time of this writing, before the Supreme Judicial Court.

The impacts of this case are far-reaching, and my expectation is that pending appeals will result in further judicial review and debate on the finding of the Appeals Court case. The immediate impact places a burden on lenders and members of the conveyancing bar to carry out additional due-diligence review to ensure that all non-record matters are attended to correctly and that subordinations are properly obtained. In addition, builder/developers who enter into purchase agreements for future construction should make specific mention of the right and intent to obtain construction financing, and the buyer should be asked to subordinate to such financing within the text of the agreement. ♦

Mark A. Kablack is a principal of M.A. Kablack and Assoc., practicing real estate law in Framingham. He is also counsel of Whittemore & Wallace in Framingham.