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Rights of Parties to a Subordination Agreement

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In *Troidle* v. *Adirondack P. & L. Corporation*[10] the plaintiff, in order to erect a radio aerial wire, threw one end over the defendant's wires, twenty feet above the ground, carrying a heavy voltage of electricity. As the aerial came into contact with defendant's wires, that part which remained on the ground uncoiled and struck plaintiff, causing a current of electricity to pass through his body and to injure him. The defendant was held to have owed no duty to the plaintiff so to insulate his wires that in a perilous situation of plaintiff's own creation, in which he voluntarily placed himself, he might suffer no harm. Five judges concurred; Cardozo, *Ch. J.*, concurred in result on the ground that the defendant was not proved to have been negligent in that the insulation was not shown to be inadequate in view of the contingencies reasonably to be foreseen.

And finally in the very recent case of *Van Leet* v. *Kilmer*[11] the plaintiff's intestate, while standing upon a ladder placed against a building, was fishing for a baffle plate inside a blower with an iron rod. This rod came into contact with the defendant's low voltage wires strung along the side of the building, shocking the deceased, causing him to fall, from which he sustained a fractured skull and died. The plaintiff was denied recovery since the defendant was not bound to foresee and to make provision against such an accident.

So it will be seen that no liability for the creation of a dangerous situation exists where it could not reasonably be foreseen that in the ordinary course of events such situation would be fraught with danger to anyone rightfully and customarily in the vicinity. Liability does arise when there is a failure to provide the necessary safeguards where the danger is reasonably to be anticipated.

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RIGHTS OF PARTIES TO A SUBORDINATION AGREEMENT.

The recent decision of the Court of Appeals in the case of the *Brooklyn Trust Co.* v. *Fairfield Gardens, Inc.*,[1] reversing the decision of the Appellate Division[2] has again caused much discussion among attorneys concerning the policy of the Courts and the Legislature concerning building loan mortgages, the rights of prior and subsequent lienors, and the rights of mortgagees who subordinate their liens to such a building loan mortgage.

The ruling of the Court in the instant case is, that where a mortgagee, at the instance of the owner of the property, agrees to

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[10] Troidle v. Adirondack P. & L. Co., *supra* note 6.
[11] *Supra* note 3.

[1] 260 N. Y. 16, 182 N. E. 231 (1932).
[2] 235 App. Div. 768, 256 N. Y. Supp. 719 (1st Dept. 1932).

subordinate his lien to a building loan mortgage to be executed between said owner and a lender, even though the subordination runs directly to the lender, there is no duty owing by such a lender to a party so subordinating his lien beyond making the advances called for in the building loan mortgage. Upon a cursory glance the decision seems to be in accord with the apparent intention of the parties, but upon closer examination the result of this decision may well be questioned in the light of other rulings by this same Court, as well as in the light of the practical result whereby a very valuable first lien is eliminated by a second mortgagee without the real purpose and intent of the maker of the subordination agreement being observed. The net practical result, if this decision is not limited, will be to place an effective barrier before owners of real property subject to encumbrances who wish to improve said property and cannot arrange a building loan mortgage which will permit them to pay off prior encumbrances, for under this decision no mortgagee would dare subordinate his lien unless he received a covenant to build from the mortgage company, which covenant could not be obtained for no mortgage company will assume such an onerous duty.

Under a prior decision this Court took judicial notice "that it is the ordinary and usual course when a party agrees to make a building loan on real estate that existing encumbrances whether mortgages, taxes, assessments * * * are paid out of the new loan as far as practical and the Court will take judicial notice thereof." [3]

The Lien Law [4] defines cost of improvement to include in its meaning of said term expenditures incurred by the owner to discharge mortgages and other encumbrances existing prior to the time when the lien provided for in this chapter (building loan lien) may attach.

Thus we have a course of dealing in building loan mortgages recognized first by the courts and then by the legislature. When this recognized system is varied by contract, the written instrument, if the source of conflicting claims by disputants, should be closely scrutinized so as to arrive at true intent of the parties. This a Court of Equity has power to do.[5]

The major question herein, as well as in similar cases is, and will be, does the lender owe any duty to a subordinating party beyond the mere advancing of the money under the mortgage. It may be noted here that the Lien Law [6] expressly frees the lender

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[3] Penn Steel v. T. G. T., 193 N. Y. 37, 85 N. E. 820 (1908).

[4] N. Y. LIEN LAW, art. 1, §2, added by L. 1929, c. 515, §1, amended by L. 1930, c. 859, §1.

[5] Smith v. Cross, 90 N. Y. 549 (1882); Zeiser v. Cohen, 207 N. Y. 407, 101 N. E. 184 (1913); People *ex rel.* Brachist v. Kaiser, 209 App. Div. 722, 205 N. Y. Supp. 317 (3rd Dept. 1924); Silverstein v. Taubenkimmel, 209 App. Div. 710, 205 N. Y. Supp. 241 (3rd Dept. 1924).

[6] N. Y. LIEN LAW §13, subd. 3, as amended by L. 1929, L. 1930, L. 1932.

from any duty as to the proper application of the funds advanced, but this merely applies as between lender and lienors under the owner and contractor and not to disputes under subordination agreements.

The familiar maxim "Equity will look through the mere form of a transaction to the substance and determine the equities" [7] will permit us to determine what was the real intention of the subordination agreement, and since "that the motive and intent with which an act is done may and often is ascertained and determined by inferences drawn from proof of facts and circumstances connected with the transaction and the parties to it" [8] that the intention and purpose of the first mortgagee hereinafter called the defendant, was to subordinate his lien to a mortgage of $700,000 00,[9] to be used for the erection of a particular building as per certain specifications known to both parties [10] and that he had a right to rely on the good faith of the mortgage company hereinafter called the plaintiff in insisting on strict compliance by the borrower with all the terms of the building loan mortgage so that an adequate security for both the building loan mortgage and the now subordinate first mortgage would arise. This is so because the plaintiff knew that the defendant had no right, nor could in any way control the erection of the said building. The plaintiff may be deemed to have understood and known that the first mortgagee was only subordinating on condition that $700,000.00 be advanced to erect a certain type of building, for anything else would not meet the purpose of the subordination. Any change in either would result in a *failure of consideration.*

This is a normal inference to be drawn from the surrounding facts, nature, and type of subordination agreement executed by the first mortgagee, for a man ordinarily does not surrender a very valuable superior lien without some assurance of protection by the person receiving the benefits thereby, and if same is not expressly stated, it may be implied.[11] In short, the Court may, and should, rule that this agreement was in the nature of a unilateral contract offered by the defendant to the plaintiff and as such requiring an unequivocal acceptance.[12] The plaintiff denies such and claims that if it is an offer, it goes to the owner, but the facts repudiate such a claim. The subordination on its face describes the defendant as party of the first part, and the plaintiff as party of the second part.[13]

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[7] *Supra* note 5.

[8] Hennequin v. Naylor, 24 N. Y. 139 (1861); Adams v. Gillig, 199 N. Y. 314, 92 N. E. 670 (1910).

[9] *Supra* note 1, at 20.

[10] *Supra* note 1, at 23.

[11] *Supra* note 8, 2 BISHOP, CONTRACTS (1907) §241.

[12] Stanley v. Gannon, 109 Misc. 611, 180 N. Y. Supp. 602 (1919); 17 West 50th St. Corp. v. Tollerton, 107 Misc. 609, 177 N. Y. Supp. 89 (1919).

[13] *Supra* note 1, at 20.

The mere fact that plaintiff did not sign such agreement is immaterial.

What is important is that it accepted such offer by entering into the agreement by advancing money thereunder. An agreement subordinating a prior mortgage to a junior mortgage lien runs to the holder of the junior mortgage.[14] The Court, in its own opinion,[15] states, that if the holder of the mortgage subordinated by agreement to the plaintiff's mortgage has any defense, it must be because by language of the agreement or *through the relation created thereby,* some duty to protect the interest of the holder of the subordinated mortgage was placed upon the lender. The mortgage company having accepted the full benefit of the subordination in the nature of a unilateral contract and well knowing, by inference at least, that the intention of the holder of the first mortgage was to subordinate to a mortgage, the proceeds of which were to be used to build a *certain specified type of building essential to accomplish the desired improvement* as per the terms of the building loan mortgage, could such a lender by virtue of a general waiver clause aimed not at this defendant, because there was nothing left for this defendant to do, but rather towards the breaches by the owner, deny any liability or duty to report to the first mortgage holder any material change in the plans, the result of which was to end in the construction of a different type of building than was intended, and perhaps defeat or endanger the security of the holder of the first mortgage. The Trial Court found as a fact that the garages were an essential part of the building, and necessary to the type of building contemplated. Even the type, size, and number of garages were specified in the building loan mortgage. A failure to perform an essential part of the contract goes to the heart of the agreement and *results in a failure of consideration,* for the changed building did not secure the improvement intended and thus defeated the purpose and consideration of the subordination.

The Court in *Lewis* v. *Gollner*[16] said, "to warrant relief in case of an infraction of an agreement, it is not essential that said agreement be binding at law, or any privity of estate or contract exist between the parties". Even if plaintiff's plea of no privity of contract be upheld, the above rule may well apply to prevent a fraud inasmuch as the plaintiff had actual notice of this defendant's intention and purpose to subordinate to a building loan mortgage contemplating a certain specific type of building, costing a certain set sum, since the subordination arose actually out of the demand by the plaintiff for a first lien for its mortgage, when it knew of this defendant's existing first lien.

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[14] Londoner v. Perlman, 129 App. Div. 93, 113 N. Y. Supp. 420 (1st Dept. 1908); Rose v. Provident Loan Society, 28 Ind. App. 25, 62 N. E. 293 (1901); Leibers v. Plainfield Spanish Homes, 108 N. J. Eq. 391, 155 Atl. 270 (1931).

[15] *Supra* note 1, at 22.

[16] 129 N. Y. 227, 29 N. E. 81 (1891).

And to show plaintiff's bad faith and a complete failure of consideration for the contract, it must be borne out that this plaintiff well knew in advance or is deemed to know, since ignorance of the law is no excuse, that such a building as contemplated could not be constructed because it was in violation of the Zoning Law in force, which prohibited the construction of garages in that area. Even conceding the plaintiff's plea of ignorance, for the time being, the plaintiff did receive actual notice, and so admits, sometime in April of 1929, after having advanced the sum of $275,000.00. Can the plaintiff now be heard to claim protection of no duty owing to this defendant in order to protect the advances thereafter made when it actually knew that any advances thereafter made would go into the construction of a building not at all in the contemplation of the security desired by this defendant in return for its subordination. It may be noted here that this building was subsequently sold under foreclosure for $600,000.00 and at most this plaintiff could claim protection only for the advances of $275,000.00. In the opinion of the writer, the contract of subordination was void [17] inasmuch as the purpose was to accomplish an illegal act, namely to erect a prohibited type of building within a restricted area. Can the plaintiff now be heard to claim the rights of a contract which it is deemed to know to have been illegal [18] or can it disregard the illegal part and claim the benefits of the legal part.

The plaintiff took an unfair advantage of this defendant inasmuch as by virtue of its own form of subordination it caused the defendant to rely on an implied promise to perform as per the building loan agreement. It is well known that mortgage companies always use their own legal forms and it is fair to presume that such is the case herein. And the defendant had a right to rely upon the presumption that the plaintiff would not take an unfair advantage over him, in view of the nature of the transaction, the full knowledge of the plaintiff, and the fact that *no present consideration* passed to the defendant. While Equity will not relieve a party from loss due to mistake of law, it will analyze with care any evidence that may indicate an unfair advantage taken of one seeking relief.[19] The obligation of good faith, which is an implied condition in every contract, required plaintiff not to exercise its right to the detriment of the defendant without notice. It should not have modified the building plans so as to imperil the contemplated security of the

[17] Sage v. Hampe, 235 U. S. 99, 35 Sup. Ct. 94 (1914); Mills Novelty Co. v. Dupouy, 203 Fed. 254 (C. C. A. 7th, 1913); Cleveland Ry. v. Hirsh, 204 Fed. 849 (C. C. A. 6th, 1913).

[18] Sternaman v. Met. Life Ins. Co., 170 N. Y. 13, 62 N. E. 763 (1902); Coverley v. Terminal Warehouse Company, 82 App. Div. 488, *aff'd*, 178 N. Y. 602, 70 N. E. 1097 (1904); Hart v. City Theatre Co., 250 N. Y. 322, 109 N. E. 497 (1915); Kloberg v. Teller, 103 Misc. 641, 171 N. Y. Supp. 947 (1918); Atterbridge v. Pennbroke, 235 App. Div. 101, 256 N. Y. Supp. 257 (4th Dept. 1932).

[19] Ryan v. John Wanamaker, 116 Misc. 91, 190 N. Y. Supp. 250 (1921).

defendant, in reliance upon which (and of which conduct the plaintiff did know) it subordinated.

So we may well imply a duty on the part of the plaintiff to notify the defendant of a change in plans in the mortgage to which the defendant subordinated his lien, since a change in plans meant a change in the security impliedly demanded by this defendant for his subordination. The plaintiff could not of its own will or notion alter or change the terms of the contract, which included in its entirety the subordination and the building loan mortgage, and all the terms of the latter, including the plans.

If there was any doubt as to the rights and liabilities of the parties, the duty was on the mortgage company to show that there was no fraud. "He who benefits by a contract or a transaction has the burden of showing the integrity and fairness of the transaction, that it was fully understood, and that there was no fraud or mistake." [20] The defendant herein secured no return for his act, and he surrendered a first lien in contemplation of the construction of a certain specified improvement which would be an adequate security for the building loan mortgage and his now subordinated lien.

The plaintiff practiced a fraud on the defendant in that it failed to perform a duty owing to said defendant. Constructive fraud consists of an act or omission which is contrary to legal or equitable duty, or trust or confidence justly reposed, and which is contrary to good conscience, and operates to the injury of another.[21]

The plaintiff seeks equity with unclean hands in that he violated a duty justly owing to this defendant in failing to notify him of the change in an essential part of the plans and hence should be denied the relief sought for herein.

Equity will not aid in bringing about inequitable results, and he who seeks equity must do equity,[22] and further, Equity will not assist those who by indirection violate their agreements * * *.[23] Here the plaintiff, having violated a duty owing to the defendant, resulting in a failure of consideration and thus restoring his first lien seeks to accomplish a grave injustice on this defendant by eliminating said lien through a foreclosure of plaintiff's junior mortgage due to a default by the borrower.

Still more, Equity will not permit a party having a legal right, to avail himself of it for purposes of injustice or oppression.[24]

Here plaintiff had a right to waive a breach of the building loan mortgage by the borrower. As to this waiver clause, the parties

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[20] Barnard v. Gantz, 140 N. Y. 249, 35 N. E. 430 (1893); Ten Eyck v. Whitbeck, 156 N. Y. 341, 50 N. E. 963 (1898); Allen v. La Vaud, 213 N. Y. 322, 107 N. E. 570 (1915).

[21] *In re* Dority's Will, 118 Misc. 725, 194 N. Y. Supp. 573 (1922).

[22] Johnson-Kahn v. Thompson, 73 Misc. 103, 130 N. Y. Supp. 216 (1911).

[23] McGrath v. Normer, 221 App. Div. 804, 223 N. Y. Supp. 288 (2d Dept. 1927).

[24] Lougherty v. Catalona, 207 App. Div. 895, 201 N. Y. Supp. 919 (1st Dept. 1923).

never intended this to apply to this defendant who could commit no breach inasmuch as there was nothing left for him to do, but rather was intended to apply to the borrower who had many obligations resting on him under the contract. This is all right as between those parties but where such waiver is taken advantage of to secure an unfair position over, or to defeat the purpose of, this defendant, who could in no way interfere with or govern the performance of the building contract, and cause a great loss to him, such is inequitable and ought not to be permitted.

Since the question in a Court of Equity is not what the Court must do, but rather what the Court ought to do, in view of all the circumstances in each case, in order to further justice and prevent oppression,[25] it certainly is not the doctrine of a Court of Equity to enforce by its peculiar mandate, every contract in all cases, even where a specific execution is found to be its legal intention and effect. A Court of Equity gives or withholds such decree according to its discretion, in view of the circumstances of the case, and the plaintiff's prayer for relief is not answered, when under the circumstances the relief he seeks would be inequitable.[26]

Therefore defendant's subordination agreement should be cancelled and his lien declared a valid first lien, or, at most, subject only to a first lien of $275,000 00, as above mentioned.

This discussion would be further justified in view of the dangerous situation likely to be incurred under the apparent policy of protecting the investments and contracts of building loan mortgage companies, and which may occur in similar cases in the future where a holder of a first lien is asked to subordinate his lien to a building loan mortgage. He could have no protection against a breach by an owner, or any act of such a mortgage company advancing such a loan, save an indemnity bond or completion bond which would be next to impossible to get in view of the freedom of a waiver clause as is interpreted under this decision. And certainly no insurance company will issue an indemnity bond or completion bond to such a subordinating mortgagee who, in order to subordinate, would have to subordinate to all the terms of a building loan mortgage.

It may be noted here in passing, as a matter of information, that one direct result of this case has been to cause one large title company in this state to relax its strict scrutiny and inspection of construction jobs under their building loan mortgages, taking the view that so long as they are satisfied as to how the construction plans are being followed, they need not worry as to any claims of any other interested parties.

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[25] Fish v. Lesser, 69 Ill. 394 (1874); Plummer v. Keppler, 26 N. J. Eq. 481 (1875).

[26] Mathews v. Terwilliger, 3 Barb. 51 (N. Y. 1848); Peters v. Delaplaine, 49 N. Y. 362 (1872); Margraf v. Muir, 57 N. Y. 155 (1874); Trustees v. Thatcher, 87 N. Y. 311 (1882).

Thus we can see as an apparent result of the above discussed decisions and the Lien Law mentioned by section, that if an owner desires to improve property that has a large lien on it, or such a lien that a mortgage company refuses to consolidate with its first lien, unless he can get a subordination to such a building loan mortgage, which in the light of this decision, he will not get, then the property will have to stay as it is, unimproved—thus achieving the very thing that the brief of the *amicus curiae* in the instant case feared, but not from his point of view, that of danger to a title or mortgage company investment, but rather from the viewpoint of the holder of a first lien who wants to aid in improving the property but fears the results of this case.

A subordination agreement is nothing more than a contract between the party giving and the party receiving, and the ordinary, well established rules of contract should apply where a court of equity is called upon to determine the issues raised between contesting parties.

SAMUEL A. LOCKER.

THE CONVERSION OF STOCK.

In a recent New York case [1] the plaintiff was awarded damages to the full extent of the value of the stock for the conversion of an unindorsed certificate. The case presents problems which are fundamental both in the law of conversion and in the law of corporate stock.

By disregarding the doctrine: "In order that conversion of a certificate of stock may constitute a conversion of the stock, which it represents, the owner must be thereby deprived of the stock, and not merely of the certificate;" [2] the Court of Appeals has ignored precedent set in several other states.[3] These irreconcilable decisions are based on the theory that acquisition of use and title by the converter is the test of conversion, and the rule that a certificate of stock is not the stock or share itself, but mere evidence of the holder's rights as a stockholder.[4] The latter is a logical deduction from the former unsound premise.

The natural meaning of converting property to one's own use has long since been left behind. Conversion, in the modern view, manifests itself in the exercise of unlawful dominion over the plain-

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[1] Pierpoint v. Hoyt, 260 N. Y. 26, 182 N. E. 235 (1932).

[2] 11 FLETCHER, CYCLOPEDIA OF CORPORATION LAW (1932) §5114.

[3] Daggett v. Davis, 53 Mich. 35, 18 N. W. 548 (1884); Pardee v. Nelson, 59 Utah 497, 205 Pac. 332 (1922).

[4] *Ibid.*