Deferred Mortgage Recording: Weighing the Risks and Benefits

Robert J. Fryman
DEFERRED MORTGAGE RECORDING: WEIGHING THE RISKS AND BENEFITS

INTRODUCTION

In the study of real property law and real estate transfer the concept of recording and its consequences is at first difficult to grasp. Inevitably, the concept of recording does become foundational in the understanding and appreciation of this area of the law. It would seem that all conveyances or encumbrances of real property would certainly be recorded, absent any desire to perpetrate a fraud. Yet, arrangements are often made involving the deferral or avoidance of recording mortgages. These arrangements seem risky to some, downright foolish to others, but are used nevertheless. Referred to as a deferral or avoidance arrangement because the ultimate goal is usually to avoid paying the mortgage recording tax, it is likely that such arrangements will be cast as deferrals of recording, to allow the mortgagees to record if necessary.

In New York the tax on recording mortgages can be as high as 2.25% on the amount of the note. Thus the avoidance of this tax on a large mortgage loan can result in a substantial savings to the mortgagor. However, the risks and consequences to the mortgagee are equal to if not greater than the potential monetary savings. This note will focus on these consequences and the means used to lessen the negative effects. In order to examine this practice or arrangement of deferring or avoiding the recording of the instrument, this note will examine, in some detail, the recording act and the mortgage recording tax.

I. THE RECORDING ACT

The recording act in New York State is codified in the New York Real Property Law §§ 291-336. The act provides that “[a] conveyance of real property . . . may be recorded . . . . Every such conveyance not so recorded is void as against any person who subse-

quently purchases the same real property in good faith and for a valuable consideration and whose conveyance is first duly recorded.” The act has several related purposes, all supporting the goal of an orderly, efficient system for the transfer of interest in real property. The act is “intended to protect the rights of innocent purchasers who acquire an interest in property without knowledge of prior encumbrances.” The act has no application to the relationship between the two original parties to the instrument. An unrecorded instrument as between the original parties to that instrument (or their distributees or assignees) is valid and binding on the ordinary principles of contracts. It is to the third party interest that the recording act becomes applicable.

The mechanics of the New York State recording system are set forth in § 291 of the New York Real Property Law, which provides that the conveyance of property, when duly acknowledged, may be recorded in the office of the clerk of the county in which the property is located, upon the request of any party, and upon the tender of the appropriate fees (most notably the mortgage recording tax). As defined, the term “conveyance” includes written instruments which create an interest or estate in real property; written instruments which transfer, mortgage or assign real property; and written instruments which may affect the title to any real property.

New York’s recording system is of the type known as a race-notice system. The act provides that the subsequent bona fide purchaser, who purchases the interest for valuable consideration,

7. N.Y. REAL PROP. LAW § 291.
8. N.Y. REAL PROP. LAW § 290(3) (McKinney 1989). The statute reads as follows:

The term “conveyance” includes every written instrument, by which any estate or interest in real property is created, transferred, mortgaged or assigned, or by which the title to any real property may be affected, including an instrument in execution of a power, although the power be one of revocation only, and an instrument postponing or subordinating a mortgage lien; except a will, a lease for a term not exceeding three years, an executory contract for the sale or purchase of lands, and an instrument containing a power to convey real property as the agent or attorney for the owner of such property.

Id.
prevails over the prior purchaser if the bona fide purchaser has no notice of the prior purchase and is the first to record. The subtleties that enter into the analysis at this point primarily involve the question of what constitutes notice for the purpose of this statute.

The issue of notice is not only involved in the question of how the statute works, but also in the question of what the act of recording actually does. The recording of the conveyance serves to protect the purchaser and to provide notice to any subsequent purchaser of the interest or encumbrance upon that property. Thus, the act of recording revolves around the concept of providing notice to the entire world of the interest in the property. The recording of a conveyance is a form of constructive notice to subsequent purchasers, who are thereafter charged with the knowledge provided in the record, whether or not they have actual knowledge of the record. "It matters not whether [the subsequent purchaser] checks the records but does not find the deed or neglects to check the records [at all]—he is unprotected in either case."

There are cases in which an unrecording prior purchaser may prevail over a subsequent purchaser, as the subsequent purchaser may have some other form of constructive notice which would deprive him of the statute's protection. A purchaser may have knowledge of facts concerning the property, such as possession by a party other than the vendor, which puts him on notice of the possibility of another interest in the property. This type of notice, known as inquiry notice, is sufficient to give constructive notice to the purchaser, regardless of whether he investigated further. Thus, because he had inquiry notice of another interest, he is not afforded the protection of the recording act.

The key question regarding the deferral or avoidance of recording is: What are the effects of not recording? According to principles of contract law, a conveyance is still binding between the original

10. See Miglino, supra note 4, at 33; Colavito, supra note 4, at 38.
12. Id. at 143.
13. See, e.g., Wardell v. Older, 70 A.D.2d 1008, 418 N.Y.S.2d 196 (App. Div. 1979); see also Colavito, supra note 4, at 38.
parties to the agreement, whether or not it was recorded. However, if the purchaser does not record, he is not protected against a subsequent bona fide purchaser who records first. This point will be analyzed further infra, with particular attention paid to questions of notice and status as a bona fide purchaser, and whether or not the subsequent purchaser prevails with the protection afforded to him by the recording act. Other effects of not recording, including lack of protection by the recording act, will also be discussed infra in the discussion of the mortgage recording tax.

II. The Mortgage Recording Tax

The mortgage recording tax is codified in Article 11 of the New York State Tax Law. The statutes provide for the payment of a tax imposed upon the privilege of recording a mortgage instrument; it is not a tax on the mortgage itself, but rather a tax on the recording of the mortgage. This tax on recording can amount to as much as 2.25% of the amount secured by the mortgage note. Avoiding this tax can bring a substantial savings to the borrower and this is one of the primary reasons to seek this type of arrangement.

New York State has had some form of tax upon the recording of a mortgage since 1905. The following year, the law was revised to a form more similar to the present law. In 1909, the tax on recording mortgages was reenacted as Article 11.

In its early stages, the mortgage recording tax was attacked on the grounds of unconstitutionality. In Franklin Society for Home Building and Savings v. Bennett, the mortgage recording tax was challenged as being violative of the state constitution's prohibition that "[i]ntangible personal property shall not be taxed ad valorem nor shall any excise tax be levied solely because of ownership or pos-

14. Castelli v. Burns, 158 A.D. 913, 143 N.Y.S. 755 (1913); see also Colavito, supra note 4, at 38.
15. N.Y. Real Prop. Law § 291.
21. Id.
In *Franklin*, the Court of Appeals held that the mortgage recording tax (as provided for in Article 11) was a tax upon the *recording* of the instrument and not upon the mortgage itself and as such it was not violative of the state constitutional provision nor of the due process clause of the Fourteenth Amendment of the Federal Constitution.24

The mortgage recording tax has not been seriously challenged since the disposition of these cases. Therefore, an analysis of the imposition of the tax is appropriate to see how and where the mortgage recording tax applies.

The statutory basis for the tax on mortgage recording is found in the New York Tax Law,25 and in New York City in the Administrative Code of the City of New York.26 The State Tax Law27 provides for the imposition of an additional mortgage recording tax in cities having a population of one million or more. The State tax, in a worst case scenario, can amount to one dollar on each 100 dollars (or one percent) of the debt which is or may be secured by the recorded mortgage.28 The tax law, in section 253, has several contingent provisions for the imposition of the tax. Section 253(1) provides for a tax of fifty cents per 100 dollars of the debt secured by the mortgage with a minimum tax imposed of fifty cents.29 Section 253(1-a) imposes an additional tax of twenty-five cents per 100 dollars of the principal debt.30 However, the tax imposed in this section has an interesting twist as compared to the other taxes imposed by the other sections of the tax law. In some instances this tax must be paid by the mortgagee and may not be passed along to the mortgagor to pay.31 If the property secured is improved or is to be improved by one or more structures comprising together a total of not more than six residential dwellings, the tax imposed by section 253(1-a) shall be paid by the lender and cannot be passed along to the borrower (with a few technical exceptions that are outside the scope of this

23. *Id.* at 84 (quoting N.Y. Const. art XVI, § 3).
31. *Id.*
In section 253(2), a tax of twenty-five cents per 100 dollars is imposed in addition to the levies of sections 253(1) and 253(1-a). However, if the property secured by the note is improved or will be improved by a one or two family dwelling the first ten thousand dollars of the principal debt is excluded from the calculation of the tax imposed in this subdivision. Section 253-a authorizes the adoption of an additional tax by cities having a population of one million or more. The state statute sets forth the tax amounts and procedure. In New York City, this additional tax is codified in Title 11, Chapter 26 of the New York City Administrative Code and Charter.

The authorization by the state, reflected by the city statute, gradually increases the tax imposed over time. The tax imposed on mortgages recorded on or after July 1, 1982 in cities having a population of one million or more is determined by reference to the type of property secured and/or the extent of the indebtedness. If the debt secured is $500,000 or less a tax of fifty cents per 100 dollars of the debt is imposed; if the mortgage is for one-, two- or three-family houses, cooperative apartments or condominium units and the principal debt is $500,000 or more, the tax imposed is sixty-two and one-half cents per 100 dollars of the debt secured. As to all other real property, the tax imposed will be one dollar and twenty-five cents per 100 dollars of the debt.

In light of the statutory bases for the imposition of the mortgage recording tax, the following quote from Lawrence B. Lipschitz's article on the New York State mortgage recording tax appears to be well founded: "New York State has created a labyrinth in the area of mortgage recording taxes. What was at one time a simple tax . . . has now become . . . [a] maze of laws . . . ." The basic premises behind the tax system are simple enough. First, the tax is payable only upon the recording of a mortgage that is taxable as provided by the statute. Secondly, the amount of the tax is determined by reference to the amount of the debt secured by the re-
corded mortgage. While this seems straightforward, there are a number of twists and exceptions that can arise under the statutory enactments of these basic premises. The main questions that arise here are: Is the writing in question a mortgage (or an instrument) to which the Article 11 tax applies? And if so, what is the amount secured thereby?

Section 250 of the tax law defines mortgage (as used in connection with Article 11) as being "every mortgage or deed of trust which imposes a lien on or affects the title to real property." The determination of whether an instrument falls within the statute's definition of mortgage depends not only on the label attached to the instrument, but also on the actual situation involved. Thus, the question really is "whether the instrument imposes a lien on real estate." Instruments that impose a lien on real property do fall under the auspices of the Article 11 tax. There are situations, however, where legitimate questions may arise as to whether or not an instrument imposes a lien against the property and thus may be exempt from the recording tax.

Instruments which raise questions as to their applicability under section 250 include instruments that increase the amount secured, spreader agreements, instruments that deal with existing liens, and mortgages which replace an existing mortgage. Instruments which increase the amount loaned and secured, commonplace devices, are normally offered for recording in conjunction with a consolidation agreement, which combines the liens secured by both notes. The new loan, or the increased amount, is clearly a mortgage under § 250 and is thus taxed when offered for recording. However, the consolidation agreement merely consolidates the liens of both notes and as such is not regarded as a mortgage for recording tax purposes.

A spreader agreement spreads the lien imposed by the previously recorded instrument extending the lien onto additional prop-

---

41. Miller, supra note 20, at 40.
42. N.Y. Tax Law § 250 (McKinney 1986).
43. Miller, supra note 20, at 42; N.Y. Tax Law § 250.
44. Miller, supra note 20, at 42 (emphasis added).
45. Id. at 42-43.
46. Id. at 43-51.
47. Id. at 43-44. However, Miller's article notes a holding of the appellate division which is contrary to this view of the consolidation agreement. In Jeweler's Bldg. Corp. v. State Tax Comm'n, 214 A.D. 99, 210 N.Y.S. 263 (App. Div.), aff'd 241 N.Y. 524, 150 N.E. 539 (1925), the court held that the consolidation agreement explicitly cancelled the old lien and thereafter established a new lien of an increased amount. The tax applied to the entire new loan, which included the prior existing loan. The original loan was thus taxed twice.
erty. Thus a spreader agreement, in creating a new lien, is obviously an Article 11 mortgage.\textsuperscript{48} However, the recording of this new lien is not taxed pursuant to section 255 of the Tax Law as it is deemed a supplemental mortgage.\textsuperscript{49} The statute provides:

[An instrument which] is recorded for the purpose of correcting or perfecting any recorded mortgage . . . or an additional mortgage . . . imposing the lien thereof upon property not originally covered by or not described in such recorded primary mortgage, . . . shall not be subject to taxation . . . unless it creates or secures a new or further indebtedness . . . .\textsuperscript{50}

Thus, so long as the spreader agreement does not increase the amount of the loan secured, no new tax is imposed upon recording. It is important to note that the supplemental mortgage exception necessarily arises only when there exists a prior recorded mortgage (that was taxed accordingly).\textsuperscript{51}

Questions can also arise regarding instruments that are recorded and affect liens already existing while not imposing a lien themselves. Examples include a discharge of a lien, which although affecting a lien clearly does not impose a lien and therefore is not an Article 11 mortgage.\textsuperscript{52} Hence, so long as the instrument does no more than "reinforce, extend the duration of, consolidate, divide and/or otherwise modify . . . an existing lien," there will be no tax imposed.\textsuperscript{53}

Another example of a dispute that might arise as to the applicability of the Article 11 tax is where an instrument is offered for recording which replaces a pre-existing mortgage. If the parties have allowed, or have caused, the old lien to be extinguished and create a new one with the new instrument, then the instrument creates a lien and is thus an Article 11 mortgage.\textsuperscript{54} However, it is possible for the parties to avoid this result by recasting the transaction. If the parties only desire to amend the original agreement, the recording of such an amendatory document would not by itself create a lien, and it would therefore not be an Article 11 mortgage. Thus, the form in which the transaction is cast is critical in the determination of

\begin{itemize}
\item \textsuperscript{48} Miller, supra note 20, at 46.
\item \textsuperscript{49} N.Y. \textsc{Tax Law} § 255 (McKinney Supp. 1989).
\item \textsuperscript{50} Id.
\item \textsuperscript{51} Miller, supra note 20, at 47.
\item \textsuperscript{52} Id.
\item \textsuperscript{53} Id. at 48.
\item \textsuperscript{54} Id. at 49.
\end{itemize}
whether the tax applies.\textsuperscript{55}

Another exemption to the payment of the recording tax exists in the section 255 supplemental mortgage exemption.\textsuperscript{56} Section 255 provides that although an instrument offered for recording imposes a lien, there shall be no tax due upon the recording as it is the supplemental mortgage that imposes a lien.\textsuperscript{57} This is really an oversimplification of the principle behind the supplemental mortgage exemption. The rationale behind the enactment of this section is that the relationship between the new lien and the prior lien is so close as to make the legislature warrant treating the new lien as not being an Article 11 mortgage.\textsuperscript{58} One would not attempt to qualify an instrument as an exempt supplemental mortgage unless it appears that the instrument is or may be taxable under Article 11.\textsuperscript{59}

After an instrument has been determined to be an Article 11 mortgage (thus not qualifying for an exemption) one must determine the amount of the tax imposed by reference to the amount of the debt secured. "[T]he taxable amount is the maximum amount of principal indebtedness that can be secured by the lien under any circumstances."\textsuperscript{60} Thus, any future advances which may be made at the option of the parties is included in calculating the amount of the tax imposed.\textsuperscript{61} However simple the basic rule may seem, it is easy to hypothesize situations in which the rule does not apply smoothly. For example, where a mortgage does not set an upper limit to the amount that may be advanced, the rule seems to have no clear cut, logical application. In such a case, the mortgage will be taxed as being in an amount equal to the value of the property secured by the note, which may be a surprisingly harsh burden to the party offering the instrument for recording.\textsuperscript{62} Furthermore, in the case of a mort-


\textsuperscript{56} N.Y. TAx Law § 255.

\textsuperscript{57} Miller, supra note 20, at 51-60.

\textsuperscript{58} Id. at 51-52.

\textsuperscript{59} Id. at 52.

\textsuperscript{60} Id. at 60.

\textsuperscript{61} See N.Y. Tax Law § 253.

\textsuperscript{62} N.Y. Tax Law § 256 (McKinney 1986); Miller, supra note 20, at 61.

To prevent hardship to those who might have been unaware of the consequences of recording an Article 11 "mortgage" that on its face is unlimited in amount, the statute provides that the mortgagee can limit the taxable amount by filing "a sworn statement of the maximum amount secured or which under any contingency may be secured by the mortgage."

Id. at 62.
gage with no upper limit (as well as in the case of a mortgage under which future advances may be made), the tax imposed (based upon the total amount of indebtedness that may be undertaken) is due in total at the time of recording, regardless of the actual amount advanced under the instrument at that time.\textsuperscript{63}

Another problem in determining the amount of the tax liability that can have great impact is seen in the situation presented in the (first-time) recording of a mortgage that has already been partially paid down.\textsuperscript{64} In this situation, the question is whether the tax liability is computed with reference to the amount secured in the mortgage instrument or by reference to the current outstanding principal debt. It has been held that in such a situation, the amount outstanding at the time the instrument is offered for recording is the correct reference with which to compute the tax liability.\textsuperscript{65}

The questions involved in calculating the amount of tax liability become more complex as the transactions giving rise to them become more complicated. For example, the recording of a subordinate mortgage that is unlimited in amount, or transactions involving wrap-around mortgages, can pose difficult questions.\textsuperscript{66} In the case of the wrap-around mortgage transaction, the issue involved concerns the fact that the instrument offered for recording (the wrap-around mortgage) includes the amount of the underlying prior mortgage (which continues to exist). Is the new instrument to be taxed on its full face amount or only upon the additional amount advanced, subtracting the amount of the outstanding prior mortgage? The New York Court of Appeals has held that the tax shall be calculated without reference to the amount of the underlying mortgage.\textsuperscript{67} While seemingly not clear cut, it must be remembered that new questions arise in greater degrees of complexity as the transaction itself in-

---


64. This will be of more significance after the discussion of triggering stimuli, infra pp 402-04.


66. Miller, supra note 20, at 65-66. A wrap-around mortgage is a "[m]ethod of refinancing whereby a new mortgage to cover a new loan is placed in a secondary position to the existing mortgage on the original loan. The entire loan is treated as a single obligation." BLACK'S LAW DICTIONARY 912 (5th ed. 1979).

67. Id. at 66 (citing to First Fiscal Fund Corp. v. State Tax Comm'n, 40 N.Y.2d 940, 358 N.E.2d 1037, 390 N.Y.S.2d 412 (1976)).
creases in complexity (such questions go beyond the scope of this note).

Where the recording tax has not been paid, no record shall be entered of the instrument offered for recording.\(^68\) Section 258 also explicitly provides that when the recording tax assessed has not been paid, no discharge of the mortgage may be recorded, the mortgage may not be received as evidence in any judicial proceeding, and no modification, extension or assignment of the mortgage involved may be recorded.\(^69\) Furthermore, the statute also provides that "[n]o judgment or final order . . . shall be made for the foreclosure or the enforcement of any mortgage . . . subject to any tax imposed by this article . . . unless the taxes . . . shall have been paid."\(^70\)

Judge Lehman, in his opinion in *Franklin Society for Home Building and Savings v. Bennett*, stated:

Lest the inducement to record offered by the Real Property Law should in some cases be nullified by reluctance to pay a recording tax, the Legislature, in section 258 of the Tax Law, has provided an effective form of economic compulsion to supplement the inducement by restricting, if not, indeed, prohibiting, the use of an unrecorded mortgage for any practical purposes.\(^71\)

Judge Lehman points out what should now be clearly recognizable as the question crucial to this note: Why enter into a deferred recording arrangement in the first place?

### III. Deferring or Avoiding Recording

As the starting point in the analysis of the deferred recording arrangement, the threshold question must inevitably be: Why not record? Most obviously, there can be a great tax savings where no recording is made, especially when dealing with large mortgages. Furthermore, within New York City, it appears that many properties are revalued for property tax purposes upon significant financings (or re-financings) as well as upon transfer, therefore offering an inducement not to record so as to avoid an increase in property value.\(^72\)

\(^{68}\) N.Y. Tax Law § 258 (McKinney 1986).

\(^{69}\) Id.; see, e.g., People v. Ruoff, 159 A.D. 919, 145 N.Y.S. 80 (App. Div. 1913) (court held that the satisfaction of a mortgage cannot be recorded as the recording tax on the mortgage was never paid); see also Moore v. Lindsay, 61 Misc. 176, 114 N.Y.S. 684 (Sup. Ct. 1908).

\(^{70}\) N.Y. Tax Law § 258; see, e.g., Rowland v. Vars, 241 A.D. 780, 270 N.Y.S. 1005 (1934).

\(^{71}\) *Franklin Soc'y*, 282 N.Y. at 83, 24 N.E.2d at 856.
There are other reasons, dependent upon and resultant of the mortgagor's own position, that might influence him to try to structure a financing arrangement that avoids recording, leaving aside any fraudulent intent he might have. Avoiding a recording of a mortgage may, for example, leave intact the mortgagor's credit line so as to enable him to secure loans for other purposes. Clearly, then, there are things to be gained by deferring. The next question that must be considered is: Is the deferred recording arrangement legal?

New York Real Property Law section 291 provides that "[a] conveyance of real property . . . may be recorded . . . ." In 1910, the Appellate Division of the New York State Supreme Court, in looking to recording statutes as far back as the late 1700's, found the language of the statutes, essentially similar to section 291, to indicate that recording was permissive and not mandatory. It would thus appear, from the language of the statute, that the privilege of recording an instrument is left to the discretion of the parties. Yet, this is not entirely true. State chartered banking institutions in New York, for example, are required in most instances to immediately record mortgages taken by them for security. This reduces the scope of the availability of the deferred recording arrangement dramatically, as a major source of mortgage lending is statutorily prohibited from engaging in this practice. However, this deferred recording arrangement is itself a break from the traditional form of mortgage financing and therefore lends itself more readily to less traditional sources of mortgage financing than local savings and loan institutions.

In considering the use of this deferred recording arrangement, it is crucial to consider with the utmost regard the effects of not recording. While the conveyance of interest would still be valid as between the parties to the note, the mortgagee would lose all protection offered by the recording act as to third parties. The mortgagee will not be able to bring any action to enforce the mortgage, nor will he be able to pursue an action to foreclose without first recording the mortgage. Furthermore, the mortgage may not be offered

73. N.Y. REAL PROP. LAW § 291 (emphasis added).
75. See N.Y. BANKING LAW §§ 96(4), 235(6)(g), 380(5) (McKinney 1971).
76. See supra notes 14-15 & 68-71 and accompanying text.
77. See supra note 14.
78. See supra note 70.
as evidence in any proceeding without having been properly recorded. In addition, various problems arise should the mortgagor become insolvent and file for bankruptcy.

In a bankruptcy situation, the deferred recording arrangement can yield grave results. Without recording the instrument, the mortgagee's status is reduced to that of an unsecured creditor. In that case, if the mortgagor were to file for bankruptcy, the mortgagee's lien against the property would be ineffectual since it was not perfected by recording. Even if the mortgagee were to record prior to the mortgagor's filing for bankruptcy protection (which will be discussed further infra), there are other problems that arise under the Federal Bankruptcy statutes. If the mortgagee were to record the mortgage within ninety days prior to the mortgagor's filing for bankruptcy, the mortgage lien might be invalidated as a preferential transfer. Section 547 of the Bankruptcy Code provides for the avoidance of a transfer of property made within ninety days of the filing for bankruptcy. Thus, the key issue arising under the preferences provision of the Federal Bankruptcy Code is the determination of when the transfer was made. If the transfer is perfected by being recorded within ten days after the transaction takes effect, it is deemed, for the purposes of this section of the Bankruptcy Code, to have been made at the time the transfer took effect. If the transfer has not been perfected by recording within ten days of the transfer taking effect, the transfer is deemed to have been made as of the date of the perfection of the transfer of interest. If the transaction has not been perfected once the petition for bankruptcy has been filed, the transfer will then be deemed to have been made immediately before the commencement of the bankruptcy proceeding. Thus, if the transfer is not perfected, such as by recording, before the ninety day period, the deferred mortgage recording arrangement may cause the avoidance of the transfer of interest by the mortgage and relegate the mortgagee to the position of unsecured creditor. However, it may be possible for the mortgagee to show perfection of

79. See supra note 69.
80. Kuntz & Schreiber, supra note 72, at 19.
86. Id.
the transfer without recording. The statute provides that the transfer of real property is perfected when applicable state law provides that a bona fide purchaser who takes from the debtor would not be able to perfect title against the unrecorded interest of the transferee. This approach was used by the U.S. Court of Appeals for the Ninth Circuit in denying a bankruptcy trustee's petition to avoid a transfer of a house by a debtor to his son. In this case, the Court, using the applicable California state law, determined that because the transferees were in actual possession, constructive notice was created even though the transfer to them was not recorded. Thus, sufficient notice (inquiry notice, at least) existed so as to allow the transferees to prevail over the subsequent bona fide purchasers (in a bankruptcy, the trustee stands in the shoes of a bona fide purchaser of real property). The bankruptcy trustee lost his bona fide status due to the constructive notice. It is conceivable that as long as a mortgage falls into the category of "a transfer of real property," as used for the purpose of the bankruptcy statutes, sufficient notice of the mortgagee's interest may be enough for the mortgagee to avoid having his interest voided as a preference under section 547, as the notice may lead to the evaporation of the subsequent purchaser's (or the bankruptcy trustee's) bona fide purchaser status.

Of further concern in the bankruptcy situation is the possibility that the deferred recording of the mortgage will be avoided on the grounds of being a fraudulent transfer if made within one year before the filing of the bankruptcy petition. In this situation, the inquiry would focus on the intent of the parties in the arrangement involved. It is also noteworthy that in a bankruptcy proceeding the bankruptcy trustee is vested with the powers of a bona fide purchaser of real property. With such status the trustee is able to avoid any transfers of the property that a subsequent bona fide purchaser would have been able to prevail on, absent the bankruptcy. Similar issues may also arise under applicable state law.

When coupled with the risks a mortgagee faces when holding a

88. In re Gulino, 779 F.2d 546 (9th Cir. 1985); see Rifkin, supra note 82, at 21.
89. Id.
95. Id.
mortgage without the benefit of recording (as discussed supra), the risks associated with deferred recording in a bankruptcy situation point even more clearly to the danger of deferred recording. Yet these risks may still be reduced to a manageable, if not an acceptable, level.

The arrangement involved here has been described as a deferral or avoidance (of recording) arrangement. In other words, in the best of situations, no recording will be necessary, thus no mortgage recording tax will be incurred. However, it is more likely that, while the avoidance of recording may be the goal, the deferral of recording is the concept maintained throughout the structuring of the arrangement. By this it is meant that the deal is structured so as to avoid the recording (if possible), but if at some point the mortgagee feels insecure, he can then record the mortgage. After receiving some stimuli, or information, the mortgagee would record the instrument to perfect the lien against the property. This stimulus has been called a "triggering device." The concept behind triggering devices is that they are indicia of an increased chance of default. These triggering devices could include: the creation or existence of any other lien or encumbrance that was not specifically identified and provided for in the agreement between the parties; any decrease in the loan-to-value ratio of the property; any decrease in the cash-flow coverage of the debt service; a decrease in the net worth of any parties acting as personal guarantors on the loan; or any prospective losses of revenue to the mortgagor such as lease defaults, terminations or expirations. The production of the triggering device is a creative endeavor in the drafting of the agreement. Any type of provision could be tailor-made to fit the unique details of the situation involved. Furthermore, the agreement could go so far as to provide the mortgagee with the unilateral right to record at any time. The mortgagee might record upon default by the mortgagor, but this might be too late. However, despite the existence, contractually provided for, of the triggering stimuli, one must always remember the risks incurred by not recording contemporaneously with the execution of the mortgage loan, especially those associated with a bankruptcy situation. It should also be noted that use of this triggering device method is not without other negative aspects, most notably the high tax cost of

96. Kuntz & Schreiber, supra note 72, at 19.
97. Id.
98. Id. at 21.
99. See supra notes 81-93 and accompanying text.
If the situation triggering the recording of the instrument arises, the costs (that were the cause of the deferral arrangement in the first place) of the mortgage recording tax will now be incurred. It is therefore important for the parties to realize and plan for this contingency. For the mortgagee to record and pay these costs himself would increase his credit exposure as well as increase his transaction related cost, and thus reduce his profit. The mortgagee would request more than just the mortgagor’s promise to pay for these costs. Two methods for providing for adequate assurance that the mortgagor will bear the costs of recording, should recording become necessary, would be for the mortgagee to reserve part of the loan advance for payment of these costs or to provide for a cash or credit collateral account to be established to bear the costs of recording. Furthermore, it is important to realize (as mentioned supra) that the monitoring of the various indicia that could trigger or stimulate the recording of the instrument is in itself a large task, and, if not done efficiently, would not provide for the security afforded by the inclusion of the triggering stimuli in the arrangement.

In entering this deferral arrangement it is likely that various forms of security or credit enhancement will be sought by the mortgagee and offered by the mortgagor to alleviate the risks (as well as the skepticism) incurred by not recording. As with the different types of stimuli that can lead to the recording of the instrument, the credit and security arrangements involved are also highly creative and situationally dependent. Some of these security enhancements could include any combination of the following: personal recourse to the mortgagor or its principals; personal guarantees by the principals or other credit-worthy parties; the use of additional collateral in the loan arrangement; and, in the case of a corporate mortgagor, securing control, or at least some form of restraint, over the mortgagor, either by the holding of undated resignation letters or other forms of corporate control.

100. Kuntz & Schreiber, supra note 72, at 21.
101. Id.
102. See supra note 65 and accompanying text.
103. Kuntz & Schreiber, supra note 72, at 21.
104. Id.
105. Id.
106. Interviews with various practitioners from all aspects of the real estate field in the New York-New Jersey area (September 1988 through January 1989).
It is important to note that no court case has arisen to date concerning the use of the modern type of deferred recording arrangement in New York State. It is almost certain to reach the courts if this type of arrangement spreads beyond its current, very limited scope. If and when such arrangements are scrutinized by the courts, it is highly likely that the key issues involved will include questions of (constructive and inquiry) notice, questions of priority involving any possible interceding encumbrances and/or conveyances, and the possibility of barring actions due to late payment or non-payment of the mortgage recording tax. It is likely that the courts will not view such arrangements favorably, as they rely strongly on precedent, as well as a tradition of respect for the recording system. This deference exists in the legislative branch as well, as the courts are doubtless well aware: “In providing such an extensive and detailed system for the recording and indexing of instruments affecting real property, the State Legislature has acknowledged the importance of an orderly system of recording for transfers of real property . . . .” Such legislative attitudes have been known to influence judicial behavior.

It can be seen that there are many obvious, as well as subtle, risks involved in the deferred recording arrangement. It is clear that there are many obvious and subtle benefits as well. It remains very much a question whether or not to engage in this type of arrangement in any given situation. In interviews with various practitioners involved in different aspects of the real estate field, most, if not all, expressed a cautious attitude toward the deferred recording arrangement. Some thought it outright dangerous and foolish, except in the most exigent of situations; even then they would only consider the arrangement with a few very special borrowers. It was further indicated, by most of the practitioners, that they would only consider this type of arrangement where a special relationship existed between the parties involved. Therefore, the consensus is that this practice, being in contravention to the traditional norm, is one to be viewed with the utmost scrutiny and caution.

It also appears that presently no legislative initiative is in the process of closing this apparent loophole in the law. It is conceded that any new real estate related tax meets with stiff opposition, and even in light of New York State’s current deficit position, it does not

108. See supra note 105.
appear that any attempt is about to be made to make recording mandatory across the board in order to garner more tax revenue.\(^{109}\)

**CONCLUSION**

In summation, it appears that while this practice exists, and may, under certain market conditions, even prosper and increase in use;\(^{110}\) for the most part the practice of deferring or avoiding the recording of mortgages is not extremely widespread. The risks involved may or may not, in any given situation, outweigh the cost benefits involved and thus it is up to mortgagees and their counsel to determine the pros and cons on a case-by-case basis. At this point it would seem that there can be no blanket application of this type of arrangement, nor would it appear that it will become commonplace any time soon. It will most likely remain a rarity which most practitioners will hear about or deal with once or twice; it is far from becoming, or even approaching, the norm.

Robert J. Fryman

---

\(^{109}\) Interviews with various New York State legislative assistants (January 1989).

\(^{110}\) "It appears that as long as the current competitive market for mortgage loans on prime Manhattan properties continues, lenders will be asked to refrain from recording mortgages." Kuntz & Schreiber, supra note 72, at 21.

Apparently a competitive market would introduce ideal situations for bargaining that might result in the deferral of recording, but it is possible (although less likely) that the deferral arrangement could occur in other markets, with a less competitive atmosphere.