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First Lien Recorded May Not Always Win

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There is a tradition in the law that things are not always as they seem. We think of liens as simply "which came first" when determining which lien controls; but lien priorities are not always as straightforward as they appear. A creditor may find that what he assumed was a senior lien may in fact be junior to another creditor's lien. Such was the conclusion reached in a case decided by the North Carolina Court of Appeals in September of 2006.

Typically with regard to real property, the priority of liens is determined by the order in which they are recorded. First recorded wins; last recorded loses. If, for example, a Lender sues a Borrower and obtains a judgment against the Borrower, that judgment is a lien on any real property that Borrower owns in each county in which that judgment is recorded. If the Borrower then later takes out a loan with a Bank using the same real estate as collateral, and the Bank records a deed of trust to secure that loan, the Bank's lien is normally junior to the Lender's judgment because it was recorded afterward. The North Carolina Court of Appeals' recent ruling, however, demonstrated that things sometimes turn out differently than expected.

In the case of [West Durham Lumber Company v. Meadows](#), the Court was presented with a fairly common dispute: the priority of competing liens on real property. Meadows was a homebuilder who purchased a tract of land in Wake County using money he borrowed from National Bank of Commerce (NBC), which did business as Central Carolina Bank. The loan from NBC was a typical construction loan, allowing for regular draws as the construction proceeded, with a maximum loan amount established at \$560,000.00.

West Durham Lumber provided supplies and materials for the improvement of the property, first furnishing those materials on March 18, 2003. A few days later, on March 26, 2003, the deed to Meadows and the construction deed of trust to NBC were recorded with the Register of Deeds. Meadows borrowed an initial \$112,000.00 and used that money to purchase the property. The remaining available funds were used during the construction of the house on the property.

Meadows defaulted on the loan and NBC initiated foreclosure under its deed of trust. At the time of the foreclosure, NBC had advanced \$524,000.00 to Meadows under the loan. The property was sold at foreclosure, with NBC becoming the high bidder at

\$425,000.00. The law provides that a foreclosure “wipes out” any junior liens on the property such that the high bidder at the foreclosure takes title to the property free and clear of any junior liens. Only superior liens on the property will remain after foreclosure.

Several months later, West Durham filed a Claim of Lien which attached to the real property and which reflected that West Durham had not been paid for the materials it had supplied to improve the property. Under North Carolina law, if a Claim of Lien is properly filed and perfected, that lien “relates back” to the date of the first furnishing of labor or materials to the property. In other words, if the lien is determined to be a valid lien upon the property, it is treated as having been filed on the date that the materials were first furnished on the property — in this case, March 18, 2003. The deed of trust to NBC was not recorded until March 26, 2003. Since West Durham’s lien was recorded first, a logical result would dictate that West Durham’s lien take priority over NBC’s deed of trust. Somewhat surprisingly, this is not how the Court ruled.

Many legal doctrines and theories seem to not apply in the “real” world. But, many actually do play a part in determining issues such as lien priorities. One such theory is the “doctrine of instantaneous seisin.” Simply speaking, this doctrine provides an exception to the otherwise generally accepted principle that the first lien filed has priority. Under this doctrine, if a lender loans money to a borrower in order for the borrower to purchase property, and the Lender takes a deed of trust in order to secure that loan (known as a “purchase money deed of trust”), then so long as the deed to the property and the deed of trust to the lender are recorded in one transaction, the lender’s lien has priority over any lien already existing on the property.

Thus, the Court held that because the deed to Meadows and the deed of trust from Meadows to NBC were recorded in one transaction, NBC’s deed of trust took priority over the lien of West Durham, even though that lien was deemed to have been filed prior to the recording of the NBC deed of trust.

Despite this ruling, however, West Durham was still able to claim a partial victory. Under an exception to the doctrine of instantaneous seisin, the Court found that the doctrine only provides lien priority if the proceeds of the loan are used to “purchase” the property. In this case, Meadows borrowed only the first \$112,000.00 to purchase the property. At the time of NBC’s foreclosure, over \$500,000.00 had been drawn down on the deed of trust. NBC took the position that the entire debt secured by the deed of trust was superior to the lien of West Durham. The Court disagreed. It found that only that portion of the debt actually used to “purchase” the property was given priority, not the entire debt.

The West Durham case also proved to be an interesting interrelation of issues dealing with the application of surplus proceeds in foreclosure. While a discussion of all aspects of this case is beyond the scope of this article, it is worthy of review by lenders, contractors and suppliers.

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