Equitable Subrogation

A Timely Old Remedy To Salvage Lien Priority

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With increasing frequency in today's troubled real estate environment, mortgage lenders find themselves competing for lien priority over one another in the face of declining property values. The stakes in this lien priority competition are high, where lower lien priority can result in a mortgage lender being under-secured, or worse, unsecured altogether. Fortunately, California courts can apply the time-honored doctrine of equitable subrogation to ensure that lienholders who lose priority through no fault of their own are treated fairly.

During foreclosure proceedings or when negotiating a "short sale," it is not uncommon for a mortgage lender to be surprised to learn that what it thought was a first priority loan used to pay off pre-existing senior liens is or may be subordinate to one or more other mortgages, tax liens, mechanics liens or encumbrances that recorded against the property prior to the mortgage lender's deed of trust.

The intervening lien may not have been discovered prior to the mortgage lender funding its loan because of the total absence of title insurance, reliance on an outdated title report, or a search error by the title company insuring the mortgage lender's deed of trust. However, when the intervening lien is discovered, there is sure to be confusion, concern and controversy. The intervening lienholder may enjoy or at least assert a step-up in priority and a possible windfall at the expense of the subsequent mortgage lender.

Under the right circumstances, however, the mortgage lender (or its title insurer, if the mortgage loan was insured) may be able to salvage all or a portion of its loan by establishing lien priority to the extent of the paid-off senior liens based upon the doctrine of "equitable subrogation." The concept underlying equitable subrogation is to place all parties in the relative lien priority positions that the parties expected. The goal is to avoid an inadvertent loss of priority to the new lender and prevent a windfall step-up in priority to the intervening lender.

Equitable subrogation made its debut in California law before 1900. See *Martzen v. Shaeffer*, 65 Cal. 81 (1884). Since then it has been utilized with increasing frequency over the years to avoid strict, and at times harsh, application of California's "first in time, first in right" rule of lien priority. California Civil Code Section 2897. The doctrine was well-articulated by the California Supreme Court in *Simon Newman Co. v. Fink*, 206 Cal. 143 (1928) as follows:

> "One who advances money to pay off an encumbrance on realty at the instance of either the owner of the property or the holder of the encumbrance, either on the express understanding, or under circumstances from which an understanding will be implied, that the advance made is to be secured by a first lien on the property, is not a mere volunteer; and in the event the new security is for any reason not a first lien on the property, the holder of such security, if not chargeable with culpable and inexcusable neglect, will be subrogated to the rights of the prior encumbrancer under the security held by him, unless the superior or equal equities of others would be prejudiced thereby, and to this end equity will set aside a cancellation of such security, and revise the same for his benefit."

In determining whether to apply equitable subrogation, courts usually determine whether the mortgage lender is guilty of culpable and inexcusable neglect and balance the relative equities of the intervening lender and the mortgage lender. The very recent case of *JP Morgan Chase Bank, N.A. v. Banc of America Practice Solutions, Inc.*, 209 Cal. App. 4th 855 (2012), is illustrative.

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Chase refinanced first and second mortgages on the property of Jon and Julie Siems relying, in part, on a title report dated over two months previously.. Unbeknownst to Chase at the time of funding and recording, a third mortgage in favor of Sky Bank (later acquired by Banc of America Practice Solutions) had recorded against the Siems property a few days after issuance of the title report. In making its third mortgage loan, Sky Bank knew of and intended to be subordinate to the first and second mortgages subsequently paid off by Chase. Eventually, the Siems defaulted on the Sky Bank loan and foreclosure was commenced. Only then did Chase discover the intervening Sky Bank lien. Asserting the doctrine of equitable subrogation, Chase sought and obtained declaratory relief that it was entitled to an equitable lien with priority over the previously recorded Sky Bank mortgage to the extent of the first and second mortgages it paid off.

On appeal, the trial court's determination was upheld. The appellate court rejected Sky Bank's argument that Chase was guilty of culpable and inexcusable neglect as it had constructive notice (as opposed to actual notice which was not alleged) of Sky Bank's lien due to the recording of its lien and unreasonably relied upon an outdated title report. The appellate court then weighed the lienholders' relative equities and found that there was no prejudice to Sky Bank by granting Chase its requested relief, as Sky Bank would be in exactly the same lien position as it had intended all along.

The case demonstrates equitable subrogation's strong salvage potential available to refinance lenders (and their title insurers) who find their record lien position to be unintentionally subordinate to previously unknown liens. Equitable subrogation, as an equitable remedy, is never a sure thing and requires time, effort, money and judicial sanction. Although costly, uncertain and slow, it may be the only practicable solution to remedy the mortgage lender's failure to achieve its intended lien priority. Of course, the situation at issue in this case might have been avoided altogether had Chase obtained a "date down" of its title report closer to the date the loan was funded and its deed of trust recorded.

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