# EQUITABLE SUBROGATION: CAN A REFINANCING MORTGAGEE ESTABLISH PRIORITY OVER INTERVENING LIENS?*

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*Editors' Synopsis: In this Article, the Author examines the uncertain and unpredictable approaches to determining whether actual or constructive notice of an intervening lien serves as a bar to raising the equitable-subrogation doctrine. The Author discusses the limited case law supporting the use of the doctrine by a mortgagee to take priority over federal tax liens and the impact of title insurance on equitable subrogation claims. This Article concludes by suggesting several strategies for preventing a refinanced mortgage from losing priority.*



## I. INTRODUCTION

With respect to mortgage loans, the doctrine of equitable subrogation generally provides that when loan proceeds from a new loan are used to satisfy a prior lien, the new lender stands in the shoes of the prior lienholder if there is no prejudice to other lienholders. The doctrine rests on the equitable

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maxim that no one's loss shall enrich another and may be invoked when justice demands its application. The doctrine is designed to prevent an unjust forfeiture on the one hand and a windfall amounting to unjust enrichment on the other.[1] The courts have adopted three different jurisdictional

[1] *See, e.g.*, Burgoon v. Lavezzo, 92 F.2d 726, 733 (D.C. Cir. 1937) (finding issue of whether equitable subrogation should be liberally or strictly applied very difficult and stating that principles of "benevolent or natural justice" were pitted against policy of law favoring consistency and predictability); Rachal v. Smith, 101 F. 159, 164–66 (5th Cir. 1900) ("Since the equitable doctrine of equitable subrogation was ingrafted on the English equity jurisprudence from the civil law, it has been steadily growing in importance, and widening in its sphere of application. It is a creation of equity, and is administered in the furtherance of justice."). The party asserting the equitable mortgage doctrine bears the burden of proving its applicability. *See* Citizens State Bank v. Raven Trading Partners, Inc., No. A08-1560, 2009 WL 1515585, at *2 (Minn. Ct. App. June 2, 2009). For a discussion of the applicability of the equitable subrogation doctrine in general, see Equity Bank, SSB v. Chapel of Praise A.L.D.C.M., Inc., No. 06-0460-CG-B, 2007 WL 2236886 (S.D. Ala. July 31, 2007). In this case, the court held that the bank lender was "entitled to equitable subrogation to the extent the proceeds from its loan were used to pay off the prior . . . indebtedness" because there was no evidence that the bank lender had actual (as opposed to constructive) knowledge of the intervening mortgage and there was no material prejudice to the intervening lienholder. *Id.* The court stated as follows with respect to the definition and scope of equitable subrogation:

> The Court of Civil Appeals of Alabama has described the doctrine as follows: The doctrine of equitable subrogation provides that one who voluntarily loans money to a debtor to discharge a debt will "step into the shoes" of the former creditor. Subrogation is appropriate to prevent unjust enrichment if the person seeking subrogation pays the obligation with the reasonable expectation of receiving a security interest in the property that has the same priority as the debt being discharged and if subrogation will not materially prejudice the holders of intervening interests in the property.
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> In order to be entitled to equitable subrogation, Alabama courts have historically held that one must meet the following requirements: (1) the money must be advanced in order to extinguish a prior encumbrance, (2) the money must be used for that purpose with the payor's expectation of obtaining a security interest of equal priority with the prior encumbrance, (3) the entire debt must be paid, (4) the payor must be ignorant of the intervening lien, and (5) the intervening lienor must not be "burdened or embarrassed."
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> In addition, our Supreme Court has stated that "'when a purchaser pays off a prior incumbrance as part of the purchase price without actual notice of a junior lien . . . equity will treat him as the assignee of the original incumbrance, and will revive and enforce it for his benefit.'" In order to qualify for relief under the doctrine of equitable subrogation, one "need not exercise the highest degree of care to discover an intervening incumbrance of the title, and mere constructive notice . . . is not sufficient

approaches to equitable subrogation: (1) the position taken by the *Restatement (Third) of Property: Mortgages*[2] *(Restatement)* that actual or constructive knowledge of the intervening lien is irrelevant and is not a bar to equitable subrogation;[3] (2) the majority position that a party with actual knowl-

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> to preclude [one] from invoking the doctrine of equitable subrogation in the absence of culpable negligence."

*Id.* at *6 (quoting Whitson v. Metropolitan Life Ins. Co., 142 So. 564, 567 (Ala. 1932) (citations omitted)). With respect to the basic meaning of equitable subrogation as adopted by Michigan courts, the Michigan Supreme Court stated as follows:

> Equitable subrogation is a legal fiction through which a person who pays a debt for which another is primarily responsible is substituted or subrogated to all the rights and remedies of the other. It is well-established that the subrogee acquires no greater rights than those possessed by the subrogor, and that the subrogee may not be a "mere volunteer."

Hartford Accident & Indem. Co. v. Used Car Factory, Inc., 600 N.W.2d 630, 632 (Mich. 1999) (quoting Commercial Union Ins. Co. v. Med. Protective Co., 393 N.W.2d 479, 482 (Mich. 1986) (citations omitted)); *see also In re* Duel, 594 F.3d 1073, 1079 (9th Cir. 2010) ("Equitable subrogation traditionally enables '[o]ne who pays, otherwise than as a volunteer, an obligation for which another is primarily liable,' to be 'given by equity the protection of any lien or other security for the payment of the debt to the creditor,' and to 'enforce such security against the principal debtor or collect the obligation from him.' California has adopted the traditional doctrine." (quoting HENRY L. MCCLINTOCK, MCCLINTOCK ON EQUITY 332 2d ed. 1948)).

[2] RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6 (1997). Section 7.6 states as follows with respect to equitable subrogation:

> (a) One who fully performs an obligation of another, secured by a mortgage, becomes by subrogation the owner of the obligation and the mortgage to the extent necessary to prevent unjust enrichment. Even though the performance would otherwise discharge the obligation and the mortgage, they are preserved and the mortgage retains its priority in the hands of the subrogee.
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> (b) By way of illustration, subrogation is appropriate to prevent unjust enrichment if the person seeking subrogation performs the obligation:
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> (1) in order to protect his or her interest;
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> (2) under a legal duty to do so;
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> (3) on account of misrepresentation, mistake, duress, undue influence, deceit, or other similar imposition; or
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> (4) upon a request from the obligor or the obligor's successor to do so, if the person performing was promised repayment and reasonably expected to receive a security interest in the real estate with the priority of the mortgage being discharged, and if subrogation will not materially prejudice the holders of intervening interests in the real estate.

[3] At least one court has expressly characterized the *Restatement* approach as being the most liberal of the three approaches. In *Lamb Excavation, Inc. v. Chase Manhattan*

edge of the intervening lien cannot seek equitable subrogation, while one with constructive notice can; and (3) the minority position that a party with either actual or constructive knowledge of the intervening lien cannot seek equitable subrogation.

Although many cases and much of the commentary on this issue favor the *Restatement* position, the *Restatement* approach is still not the majority position. The most recent cases in this area have not favored complete adoption of the Restatement position, but instead use a fact-intensive analysis of the equitable-subrogation issue. As a result of this uncertainty, litigation is often necessary to determine whether a mortgage lender who has paid off a prior lien is entitled to the priority of the earlier recorded lien. Unfortunately, mortgage priority disputes can be both time-consuming and expensive for mortgage lenders to resolve and can create major headaches for title insurers. The resolution of these disputes often depends on off-the-record facts that are difficult to determine and prove—meanwhile, title to the property remains uncertain and in limbo until the litigation is concluded. This Article will discuss and analyze recent case law in this area as well as the concerns of title insurers, and suggest drafting strategies for refinancing lenders to employ that may reduce the risk of being precluded from utilizing the equitable subrogation doctrine.

## II. THE RESTATEMENT POSITION: *BANK OF AMERICA V. PRESTANCE CORP.*

The *Restatement* seeks to expand the right of equitable subrogation and provides that a refinancing lender is equitably subrogated to the priority of the first mortgage even in cases in which the lender has actual knowledge of

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*Mortgage Corp.*, 95 P.3d 542 (Ariz. Ct. App. 2004), the court "held that the doctrine of equitable subrogation entitled current lender to be placed in the same primary lien position which had been occupied by" the first priority lender whose loan was paid from the proceeds of the refinancing loan and stated that "The Restatement sets forth an even more liberal rule concerning equitable subrogation than that of the majority of jurisdictions." *Id.* at 542, 545. The court held that the refinancing lender could successfully assert equitable subrogation over intervening mechanic's lien claimants, reasoning that "[1] there existed at least an implied agreement to subrogate, reflected in the loan documents and escrow closing instructions, [2] current lender was not acting as a volunteer, and [3] there was no prejudice to mechanic's lienholders . . . ." *Id.* at 542. The court stated that "Arizona's approach to equitable subrogation appears consistent with the Restatement." *Id* at 546. For a discussion of the *Lamb* case and the application of the equitable-subrogation doctrine generally with respect to mechanic's lien priority, see Gregory Thorpe and Jeannie Ridings, *Equitable Subrogation—Mechanic's Lien Priority*, ILL. ST. B. ASS'N REAL PROP. NEWSL., Aug. 2006, at 11. *See also* 56 C.J.S. MECHANIC'S LIENS § 253 (2010).

the intervening lien.[4] Therefore, no need to "balance the equities" exists. The *Restatement* states the following:

> Under this Restatement, however, subrogation can be granted even if the payor [the refinancing lender] had actual knowledge of the intervening interest; the payor's notice, actual or constructive, is not necessarily relevant. The question in such cases is whether the payor reasonably expected to get security with a priority equal to the mortgage being paid. Ordinarily lenders who provide refinancing desire and expect precisely that, even if they are aware of an intervening lien. . . . A refinancing mortgagee should be found to lack such an expectation only where there is affirmative proof that the mortgagee intended to subordinate its mortgage to the intervening interest.[5]

In a case clearly adopting the *Restatement* position, *Bank of America v. Prestance Corp.*,[6] the question before the Washington Supreme Court was whether a refinancing mortgagee must be precluded from equitable subrogation to a first-priority lien if the mortgagee has actual or constructive no-

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[4] *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6 (1997). Interestingly, section 7.6 comment e states as follows:

> Obviously subrogation cannot be involved unless the second loan is made by a different lender than the holder of the first mortgage; one cannot be subrogated to one's own previous mortgage. Where a mortgage loan is refinanced by the same lender, a mortgage securing the new loan may be given the priority of the original mortgage under the principles of replacement and modification of mortgages; see § 7.3. The result is analogous to subrogation, and under this Restatement the requirements are essentially similar to those for subrogation.

*Restatement* section 7.3 comment b states that "a senior mortgagee that discharges its mortgage of record and records a replacement mortgage does not lose its priority as against the holder of an intervening interest unless that holder suffers material prejudice."

The language in section 7.3 comment b thus protects the priority of the original lender who refinances the existing loan with a new mortgage, as long as no changes in the refinancing loan are materially prejudicial to the holder of an intervening interest, such as a higher interest rate, an increase in the principal amount of the loan, or a longer amortization period, in which event the replacement mortgage is subordinate to the holder of an intervening interest to the extent of such prejudice. Section 7.3 comment b notes that "[t]here is a strong presumption under this section that a time extension on a senior mortgage or obligation, standing alone, is not materially prejudicial to intervening interests."

[5] *See* § 7.6 cmt. e.

[6] 160 P.3d 17 (Wash. 2007).

tice of a junior lienholder. The court, noting that this particular issue was one of first impression, held that the answer was no.[7]

The facts in this case are somewhat complicated:

> On August 8, 1994, Sakae and Yuko Sugihara [borrowers] received a thirty-year home loan of $543,150 from Washington Mutual, which Washington Mutual secured with a deed of trust on the property. . . . In August 1999, Bank of America made a loan of $400,000 to Prestance Corporation, a . . . corporation owned by Sugihara [the borrowers]; the loan was secured, in part, by the Sugihara's [the borrowers] deed of trust on their home.[8]

Bank of America (B of A) later furnished Prestance an additional line of credit for $1 million, secured by Mr. Sughihara's personal guarantee and an amendment to the existing B of A deed of trust.[9]

In 2001, the borrowers approached Wells Fargo Bank West (WFB West) for a loan in the amount of $1 million to be secured by a deed of trust on the borrowers' property.[10] The court noted that "[o]ne purpose of the loan was to pay off the first-position Washington Mutual [home] loan" in the amount of approximately $500,000.[11] "WFB West expected it would then have priority over the other loans for the amount used to pay Washington Mutual. A preliminary title commitment showed the Bank of America loans, secured by the Bank of America deed of trust and its amendment."[12]

B of A sued the borrowers, Prestance, and WFB West, seeking a money judgment and foreclosure of the defaulted B of A loan.[13] The trial court, relying on the *Restatement* position, ruled that "WFB West should be equitably subrogated to the first-priority lien position of Washington Mutual in the payoff amount of $499,477, leaving Bank of America 'in no worse position than it would have been [in] had [WFB West] never made its . . . loan.'"[14] The appellate court reversed, holding that "WFB West's

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[7] *See id.*
[8] *Id.* at 18–19.
[9] *See id.* at 19.
[10] *See id.*
[11] *Id.*
[12] *Id.*
[13] *See id.*
[14] *Id.* (quoting Clerk's Papers at 600) (alterations in original).

actual knowledge of Bank of America's lien barred the application of equitable subrogation."[15]

The Washington Supreme Court, upon appeal from the appellate court's decision, noted that "[t]he only issue before us is a legal one: should we adopt § 7.6 of *Restatement (Third)* to hold a refinancing mortgagee's actual or constructive knowledge of intervening liens does not automatically preclude a court from applying equitable subrogation."[16]

The court first discussed the origins and purpose of equitable subrogation: to seek to maintain the status quo and preserve the proper priorities "by keeping the first mortgage first and the second mortgage second."[17] The court also noted that, despite initial resistance, many courts now liberally apply the doctrine of equitable subrogation.[18] The Washington Supreme Court then approved and adopted the *Restatement* position that subrogation occurs even if the refinancing lender has actual or constructive notice of the intervening lien.[19]

In its discussion of the majority rule, the court dismissed the argument that applying the *Restatement* position "would obstruct the predictability and stability of the recording act and the rule 'first in time, first in right.'"[20] The court stated that "while the recording act provides stability and notice to lenders (both vital elements to any successful real estate lending scheme), we cannot rigidly adhere to its strictures where it works an injustice."[21]

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[15] *Id.*

[16] *Id.*

[17] *Id.* at 20.

[18] *See id.*

[19] *See id.* at 29. The *Prestance* court noted that "[i]t is not clear whether a majority of jurisdictions still require a plaintiff not have actual knowledge of intervening interests. Since the *Restatement's* publication in 1997, numerous jurisdictions have adopted [the *Restatement* position]." *Id.* at 21 n.5.

[20] *Id.* at 22–24.

[21] *Id.* at 23. According to the court, the majority rule "is followed by many, but by no means all, jurisdictions." *Id.* at 22. In a recent case, *Joondeph v. Hicks*, 235 P.3d 303 (Colo. 2010), the Colorado Supreme Court followed the majority rule and rejected application of the doctrine of equitable subrogation under the facts of the case, stating that "because the petitioners had actual knowledge of the . . . [intervening] lien and were not operating under the mistaken assumption that they would obtain a senior priority position, the doctrine of equitable subrogation is inapplicable." *Id.* at 305. The court also declined to recognize the doctrine of derivative equitable subrogation asserted by the petitioners that the court described as follows:

> [D]erivative equitable subrogation would allow a subrogee to convey his senior priority through a warranty deed to a buyer regardless of whether junior lienholders had released their lien, whether junior

The court also dismissed the minority rule, stating that while the "rationale for this rule is a party should not profit by its negligence in failing to check the [public] records[,] . . . [f]or practical purposes, this rule swallows the doctrine and is widely criticized."[22] The court reasoned that if parties who confer a benefit on others due to the parties' negligence were disqualified from equitable relief even where no other party is harmed, "then the law of restitution, which was conceived in order to prevent unjust enrichment, would be of little or no value."[23] The court quoted, with approval, a

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> lienholders had contractually agreed to remain subordinate, or whether the buyer could itself meet the requirements for equitable subrogation. We decline to expand our definition of equitable subrogation in this fashion.

*Id*. at 308.

In *United States v. Avila*, 88 F.3d 229, (3rd Cir. 1996), the "United States sought to foreclose a federal tax lien, based on the property owner's failure to pay employment taxes . . . . *Id.* at 229. The property owner had transferred his interest in the subject property to his wife (who was not personally liable for the nonpayment of taxes), who thereafter sold the property to the first purchasers, who paid off liens prior to the tax lien with a portion of the proceeds. *See id.* at 231–32. The first purchasers had secured title insurance, and the title insurer "was aware of the IRS lien [ ] but omitted it from its list of title exceptions." *Id.* at 231. The first purchasers then sold the property to the subsequent purchasers, who were the parties named in the federal government's foreclosure action. *See id.* at 232. The Third Circuit held that the subsequent purchasers' actual knowledge of the tax lien was irrelevant and that the only knowledge the court should consider was that of the original subrogee, whose position the subsequent purchasers sought to assume. *Id.* at 238. The court determined that equitable subrogation is controlled only by the equities as between the original parties to the transaction and that the subsequent purchasers were derivatively equitably subrogated to the senior lienholders whose liens were satisfied with the first purchaser's purchase money. With respect to the doctrine of derivative equitable subrogation, the court stated the following:

> [T]he [subsequent purchasers'] knowledge that the IRS lien was valid when they acquired the property, and the fact that their money was not used to satisfy the prior liens, simply are not germane with respect to whether they should be allowed to equitably subrogate. In short, principles governing the right to *direct* subrogation cannot be applied in this case which involves *derivative* subrogation.

*Id*. at 237–38. The court stated further: Overall we . . . conclude that once the district court reached the correct result that the . . . [original subrogee] could equitably subrogate, the court should have permitted the . . . [subsequent purchasers] to exercise those same rights derivatively. Thus, we hold that the court's failure to allow the . . . [subsequent purchasers] to exercise the right to equitably subordinate was an error . . . ."

*Id*. at 239.

[22] *Id.* at 21 (citing cases from other jurisdictions and academic commentary rejecting the minority rule).

[23] *Id.* (quoting *Ex Parte* Am. South Mortgage, 679 So.2d 251, 255 (Ala. 1996)).

law review article by Grant S. Nelson and Dale A. Whitman,[24] in which the authors vigorously criticized the minority rule, arguing that equitable subrogation "in this situation harms no one, leaving the intervening lien exactly where it started."[25]

Finally, the court stated that the following economic policy considerations support its position that the *Restatement* position should prevail: (1) "facilitating more refinancing," thereby helping "to stem the threat of foreclosure;" and (2) affording significant financial benefits for many homeowners by significantly reducing title insurance premiums and costs.[26] The court concluded, after examining the existing case law, that "[t]his trend is clearly toward the more liberal [*Restatement*] approach, and we would be wise to follow it."[27]

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[24] Grant S. Nelson & Dale A. Whitman, *Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners*, 2006 BYU L. REV. 305.

[25] *Id.* at 315–16; *see* Bank of Am. v. Prestance, Corp., 160 P.3d 17, 22 (Wash. 2007).

[26] *Prestance*, 160 P.3d at 28.

[27] *Id.* at 26. Many of the footnotes in *Prestance* contain excellent references to and summaries of the conflicting decisions on equitable subrogation in various other jurisdictions. *See also In re* Greer, No. 36611-8-II, 2008 WL 2655805, (Wash. Ct. App. July 8, 2008). In *Greer*, with facts and circumstances nearly identical to those in *Prestance*, the court agreed with the purpose and policy considerations of equitable subrogation in the mortgage context as set forth in *Prestance*. The court stated the following:

> Here, justice supports the application of equitable subrogation because the junior lienholder (Citibank) was not prejudiced when CitiMortgage took the first lien position from Source One by lending Greer the funds to pay off the Source One loan. We hold that Citibank was the junior lienholder under the doctrine of equitable subrogation . . . .

*Id.* at *7; Ameriquest Mortg. Co. v. Land Title Ins. Corp., 216 P.3d 597, 602 (Colo. App. 2007) (stating that "[w]e are . . . guided by the reasoning of *Bank of America v. Prestance Corp.*," the court held that equitable subrogation of lender to higher position as deed-of-trust beneficiary would not prejudice the prior beneficiary and was permissible) *rev'd on other grounds*, 207 P.3d 141 (Colo. 2009); *In re* Stevenson, No. 06-00306, 2008 WL 748927 (Bankr. D.C. Mar. 17, 2008), at *7–9 (citing with approval the court's decision in *Bank of America v. Prestance* and stating that "[o]n balance, if the objective is accomplishing equity and not preventing the application of subrogation based on technicalities, the *Restatement* approach appears better suited to the task"); Eastern Sav. Bank, FSB, v. Pappas, 829 A.2d 953, 956–57, 961 (D.C. 2003) (granting equitable subrogation based on *Restatement* analysis, even though replacement mortgage had far higher interest rate, but granting subrogation only to extent of amount required to satisfy existing debt); Byers v. McGuire Properties, Inc., 679 S.E.2d 1, 7–8 (Ga. 2009) (holding purchase-money mortgagee was entitled to equitable subrogation with respect to prior construction mortgage where it advanced funds to pay off prior encumbrances with the express understanding that it would be secured by senior lien on property, and purchase-money mortgagee and title examiner had no actual knowledge of existence of intervening lien due to lengthy delay between filing and

Judge Owens, in a vigorous dissent, argued that WFB West's actual knowledge of B of A's lien barred application of the equitable-subrogation doctrine.[28] Judge Owens reasoned that "in my view a commercial lender who undertakes no title search will be unable to demonstrate, as the *Restatement (Third)* requires, that it '*reasonably expected* to receive a security interest in the real estate with the priority of the mortgage being discharged.'"[29]

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indexing of the lien, even though there was no actual or constructive fraud by construction mortgagee, the entire amount of construction mortgage was not paid off, and the loan agreement did not provide for purchase-money mortgagee to be equitably subrogated); Bank of New York v. Nally, 820 N.E.2d 644, 653–54 (Ind. 2005) (showing that although prior Indiana Court of Appeals opinions had declined to adopt the *Restatement* position, the Indiana Supreme Court disagreed and noted that the purpose of equitable subrogation is "to avoid an unearned windfall." The court agreed with *Restatement*'s position on actual or constructive notice "at least in the context of a conventional refinancing," but noted that "application of the doctrine of equitable subrogation depends on the equities and attending facts and circumstances of each case."); JPMorgan Chase Bank v. Howell, 883 N.E.2d 106, 111 (Ind. Ct. App. 2007) (basing its opinion on Indiana Supreme Court's holding in *Nally*, the Indiana appellate court found that where (1) the plaintiff bank refinanced mortgage that was senior to defendant's mortgage, (2) the defendant would not be disadvantaged because its position as junior lienholder would remain unchanged, and (3) the refinancing bank was not culpably negligent; doctrine of equitable subrogation would apply to make refinancing bank lender's mortgage superior to plaintiff's mortgage); Gibson v. Neu, 867 N.E.2d 188, 200 (Ind. Ct. App. 2007) (finding that Indiana appellate court did not limit equitable subrogation to refinancing situations and stating that "while it is clear from *Nally* that a lender's knowledge is irrelevant in the context of a traditional refinancing, *Nally* also implies that knowledge may be irrelevant in other contexts;" the court further noted that, even though plaintiff and new lender had constructive knowledge of existing mortgage, they would be entitled to equitable subrogation); E. Bos. Sav. Bank v. Ogan, 701 N.E.2d 331 (Mass. 1998) (quoting with approval RESTATEMENT § 7.6(a) and stating that "knowledge is not necessarily fatal to a claim of subrogation"); Golden Delta Enters. v. U.S. Bank, 213 S.W.3d 171, 176 (Mo. Ct. App. 2007) (adopting *Restatement* position with respect to refinancing creditor and stating that "[t]he Restatement of Property [Section 7.3] concisely states the rule of law applied in Missouri case law."); Sheppard v. Interbay Funding, LLC, 305 S.W.3d 102, 108 n. 6 (Tex. App. 2009) (permitting equitable subrogation of refinancing mortgage based on Restatement position, and stating that *Bank of America v. Prestance* case "has characterized Texas as one of several jurisdictions to have followed the more liberal *Restatement* approach on equitable subrogation, which considers 'actual or constructive knowledge of intervening interests [to be] irrelevant'" (citation omitted)). *See generally* Annotation, *Scope and Extent of Subrogation in Favor of One Entitled to be Subrogated to Mortgage Lien*, 107 A.L.R. 785, 787–90 (1937).

[28] *Prestance*, 160 P.3d at 29 (Owens, J., dissenting).

[29] *Id.* at 30 (quoting RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6(b)(11) (1997)). The dissent further argued that "a second lienholder who has *actual* knowledge of the prior

*unrecorded* lien cannot move up in priority simply by beating the first lienholder to the county auditor's office." *Id.* at 29; *see also* Lawson v. Brian Homes, Inc., 6 So. 3d. 1, 4–5 (Ala. Civ. App. 2006) (holding (1) purchase-money mortgages have priority over mechanic's liens; (2) mere constructive notice without culpable negligence, as opposed to actual notice, is insufficient to preclude applicability of the equitable subrogation doctrine; and (3) state's mechanics lien statutes do not guarantee such liens will not be subject to equitable subrogation if certain factual and equitable circumstances exist) *rev'd on other grounds*, *Ex Parte* Lawson, 6 So.3d 7 (Ala. 2008).

Some courts have held that a refinancing lender is not entitled to invoke the equitable subrogation doctrine because it is a "volunteer." *See*, e.g., 1313466 Ontario, Inc. v. Carr, 954 A.2d 1, 4–6 (Pa. Super. Ct. 2008), *reargument denied* Aug. 26, 2008 (court held it was bound by existing precedent, which imposes different rules than Restatement, and refinancing lender was not entitled to equitable subrogation since it was mere volunteer and was negligent because of an error in title search in failing to discover an intervening mortgage lien.); First Commonwealth Bank v. Heller, 863 A.2d 1153, 1157–58 (Pa. Super. Ct. 2004) (holding that refinancing lender was mere volunteer under no obligation to pay existing debt and stating that, "While we find . . . the Restatement to be compelling and very persuasive, we are bound by principles of *stare decisis* and accordingly, must find the trial court properly determined . . . [the refinancing lender] is not entitled to the remedy of equitable subrogation"); Ameriquest Mortg. Co. v. Alton, 731 N.W.2d 99, 107 (Mich. App. 2006) ("Ameriquest [the refinancing lender] is a mere volunteer because it had no preexisting interest in the property and did not attempt to protect its interest in the property or to revive or obtain an assignment of the original mortgage"); *cf.* Wyo. Bldg. & Loan Ass'n v. Mills Constr. Co., 269 P. 45, 48-49 (Wyo. 1928) ("One instance in which legal subrogation is applied is in connection with the protection of a lien, and the rule is universal that one who has an interest in property by lien or otherwise, in making payment of prior liens, including taxes, is not a mere volunteer, and that he will be entitled, upon payment of a superior lien in order to protect his own lien, to be subrogated to the rights of the superior lienholder." (citations omitted)); U.S. Bank Nat'l Ass'n v. Lame, No. F056380, 2009 WL 4022275, at *5 (Cal. Ct. App. Nov. 23, 2009) (unpublished opinion) ("the doctrine of equitable subrogation may apply to a lender that refinances existing obligations secured by deeds of trust on real property, even though the lender lacks a pre-existing interest in the property; the refinancing lender, who acted at the request of the debtor, is not a mere volunteer"); Lamb Excavation, Inc. v. Chase Manhattan Mortgage Corp., 95 P.3d 542, 545 (Ariz. Ct. App. 2004) (holding that refinancing lender could successfully assert equitable subrogation over intervening mechanic's lien claimants and was not acting as mere volunteer).

In Matrix Financial Services Corp. v. Frazer, No. 26859, 2010 WL 3219472 (S. C. Aug. 16, 2010), the South Carolina Supreme Court ruled that the lender, Matrix Financial Services Corporation, which refinanced its own mortgage with the Frazers, as borrowers, was not entitled to equitable subrogation because it "cannot prove that it was secondarily liable on the initial mortgage, . . . [and because it] was a mere volunteer when it disbursed the funds . . ." *Id.* at *2. The court also held that an equitable remedy was not available because Matrix closed the loan unlawfully and with "unclean hands" under South Carolina law, which requires that all loan closings be supervised by an attorney. *See id.* at *1–3. In a

## III. CASES NOT APPLYING OR REJECTING THE RESTATEMENT POSITION

The *Restatement* position on equitable subrogation, although gaining in popularity, is still not the majority rule in the United States. For example, in *Citizens State Bank v. Raven Trading Partners, Inc.*,[30] the Minnesota appellate court held that the trial court's adoption of the equitable subrogation doctrine was an abuse of discretion and reversed the trial court's ruling that the later-recorded mortgage of Citizens State Bank's (Citizens) mortgage took priority over Raven Trading Partners, LLC (Raven).[31] "The mortgage [recorded by Raven] acknowledged the existence of two prior mortgages."[32] Ten days after the Raven mortgage was recorded, Citizens recorded its mortgage on the same property.[33] As the appellate court noted, "Citizens entered into its mortgage 50 days prior to execution of the Raven mortgage, and Citizens paid the balances on the prior [two] mortgages. It is undisputed that Raven had no notice of Citizens' mortgage."[34] Unfortunately for Citizens, its "first attempt to record its mortgage failed due to an incorrect amount for the mortgage-registration tax," and Citizens then waited approximately thirty-eight days after learning of the error to correct it and return the mortgage to the recorder's office.[35]

The court held that Citizens did not act under a "justifiable or excusable mistake" of fact and was not entitled to application of the equitable-subrogation doctrine because of its negligent delay in filing the mortgage

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concurring opinion, Justice Kittredge argued that he would rule against the lender on the basis of unclean hands and not reach the argument on the merits of equitable subrogation. *See id.* at *3 (Kittredge, J. concurring). In a vigorous (and well-reasoned) dissent, Justice Pleicones argued that equitable subrogation should be available to the lender because "Matrix was not a volunteer but was directly interested in the discharge of the original mortgage, and was secondarily liable for its discharge by virtue of its agreement to make a new loan to the Frazers [the borrowers] conditioned on the payoff of the first mortgage." *Id.* at *5 (Pleicones, J., dissenting). Justice Pleicones argued further that the doctrine of unclean hands should not apply to the mortgage between Matrix and the Frazers because "the Court is altering the requirement that only a party to the transaction may assert the bar [of unclean hands])." *Id.* at *5. He further noted that "many closings are conducted unlawfully, often without the knowledge of the lender. To hold that equity will not aid the lender in such a situation, will deny it the right to foreclosure." *Id.* at *6 n.3 (citation omitted).

[30] No. A08-1560, 2009 WL 1515585 (Minn. Ct. App. June 2, 2009).

[31] *See id.* at *1.

[32] *Id.* Neither mortgage was in favor of Citizens. *See id.*

[33] *See id.*

[34] *Id.*

[35] *Id.*

for a total period of eighty days after the mortgage had been executed.[36] Although the court stated that "[w]e recognize that Raven is not injured by the application of equitable subrogation in this case," it noted that "[l]osing priority by failing to timely record a mortgage or other conveyance of an interest in real property is a predictable consequence well known to commercial lenders."[37]

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[36] *See id.* The appellate court rejected Citizens' argument that it should be entitled to equitable subrogation to give its mortgage priority over the Raven mortgage based on a prior Minnesota appellate court decision, *see* Ripley v. Piehl, 700 N.W.2d 540 (Minn. Ct. App. 2005), and its reasoning that "a professional lender, such as a bank, is held to a higher standard than an unsophisticated individual," *Citizens State Bank*, 2009 WL 1515585 at *2.

[37] *Citizens State Bank*, 2009 WL 1515585 at *2; *see* Osterman v. Baber, 714 N.E. 2d 735, 738–39 (Ind. App. 1999) (citing the *Restatement* but declining to follow its approach regarding irrelevance of actual knowledge), *overruled by* Bank of N.Y. v. Nally, 820 N.E. 2d 644 (Ind. 2005); Bankers Trust Co. v. United States, 25 P.3d 877, 882–83 (Kan. Ct. App. 2001) (acknowledging the *Restatement*'s approach but declining to follow it); *see also* Casstevens v. Smith, 269 S.W.2d 222, 229–31 (Tex. App. 2008) (ruling that a victim of fraud who advanced money to pay senior mortgage was not entitled to equitable subrogation as against subsequent purchaser of property at foreclosure of junior mortgage); Sygitowicz v. United States, No. C06-962Z, 2007 WL 2496095 (W.D. Wash. Aug. 30, 2007), at *7 (citing with approval the *Restatement* position on equitable subrogation and the court's holding in *Bank of America v. Prestance*, but concluding that in this case "the doctrine of equitable subrogation does not apply because the . . . [subordinate lender] loaned the . . . [borrowers] $225,000 without any expectation of taking the priority position of the . . . [first lender]."); Countrywide Home Loans, Inc. v. First Nat'l Bank of Steamboat Springs, N.A., 144 P.3d 1224, 1230 (Wyo. 2006) ("We have not . . . applied the doctrine of equitable subrogation as set forth in the *Restatement* to allow a refinancing mortgagee to step into the shoes of a prior mortgagee for purposes of obtaining lien priority.").

In a case involving a complicated fact situation, UPS Capital Business Credit v. Abbey, 975 A.2d 548 (N.J. Super. Ct. 2004), the court held that because the proceeds of the new mortgage were used to enable the new mortgage to take the place of the original mortgage, which was a superior lien to the first mortgagee's mortgage by virtue of a recorded subordination agreement, the new mortgage retained a superior position even though the replaced mortgage was not modified and did not mature or expire and was replaced by the new mortgage. *See id.* at 553–54. The court found that the new mortgage was in effect a modification as well as a renewal of the replaced mortgage because the new mortgage contained a lower interest rate and an extended maturity date. *See id.* at 551. While not specifically adopting or applying (or even mentioning) the *Restatement* rule, the court held that equitable subrogation would be available even though the lack of knowledge on the part of the new mortgagee resulted from negligence (or, as acknowledged by the parties, "mistake and inadvertence"). *See id.* at 553–54. The title commitment did not show the intervening mortgage despite the fact that it was properly indexed and recorded, and an affidavit signed by the borrower did not disclose the existence of the mortgage. *See id.* at 550. In a recent case, Aurora Loan Services v. Senchuk, 36 So.3d 716, 720 (Fla. Dist. Ct. App. 2010), the

The concurring opinion in this case, by Judge Crippen, is interesting not only because of its length (it is approximately three times as long as the actual decision by Judge Stoneburner) but also because of Judge Crippen's reluctance to concur in order to "to avoid inconsistent opinions" based on prior Minnesota case law regarding the equitable-subrogation doctrine.[38] Judge Crippen argued vehemently that Raven, in fact, had received a windfall that "erodes a principle of real estate law and practice that has been with us throughout most of Minnesota's history."[39] Although he acknowledged that Citizens was a sophisticated party and made a mistake that it could not adequately explain, he noted that Raven knew it already had a subordinate lien and stated that "[n]othing in its circumstances suggests an equitable right to a first lien. That right arises only by reason of the recording act, which has long been subject to the doctrine of equitable subrogation."[40]

Judge Crippen argued that Citizens was not an interloper "who had no legitimate reason to pay a prior encumbrance" or whose actions would cause harm to an intervening lienholder and that "Raven [wa]s not an innocent victim" and would receive an undeserved windfall.[41] He also argued that, historically, "the Minnesota Supreme Court has applied the equitable subrogation doctrine despite a variety of mistakes—some very serious—on the part of claimants of the doctrine."[42] Finally, he argued that the *Restatement* position was consistent with prior Minnesota law because the interven-

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court, without mentioning the *Restatement*, held that Florida follows the modern, liberal view in determining what constitutes prejudice when the equitable-subrogation doctrine is applied, and therefore constructive notice of the intervening lien does not preclude application of the doctrine.

But in another recent Florida case involving unusual facts, *Velazquez v. Serrano*, No. 3D09-609, 2010 WL 2925402 (Fla. Dist. Ct. App. July 28, 2010), the court ruled that a new mortgagee who, in accordance with a sale of the property to its mortgagor, paid off two prior mortgage loans but not a third mortgage, was not entitled to equitable subrogation as to the third mortgage. The new mortgagee was unaware of the third mortgage because "the endorsement to the title insurance commitment did not note the [third] mortgage." *Id.* at *1. The court refused to apply equitable subrogation because there was a surplus of funds after the payment of the first two mortgages, which surplus the new mortgagee should have paid to the third mortgagee who had properly recorded its mortgage, and not to the seller of the property who violated the due-on-sale clause in the third mortgage. *Id.* at *2. According to the court, the third mortgagee was "deprived of a legal right—the payment of her mortgage upon the sale of the property pursuant to the due-on-sale clause." *Id.* at *3.

[38] *Citizens State Bank*, 2009 WL 1515585 at *3 (Crippen, J., concurring).

[39] *Id.*

[40] *Id.*

[41] *Id.* at *5.

[42] *Id.*

ing lienholder would be "no worse off than before the senior obligation was discharged,"[43] and that "this emphasis on preventing a windfall to an intervening mortgagee is reflected in Minnesota case law."[44]

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[43] *Id.* at *8 (quoting RESTATEMENT (THIRD) OF PROPERTY) § 7.6 cmt. b (1999)).

[44] *Id.* With respect to the amount recoverable by the party seeking equitable subrogation and determination of the amount of prejudice to the intervening lienholder, in *Countrywide Home Loans, Inc. v. Schmidt*, 742 N.W.2d 901 (Wis. Ct. App. 2007), the court held that balance of equities prevented mortgagee from obtaining equitable subrogation to the extent it exceeded purchaser's bargained-for purchase price of $300,000, where contract purchaser had filed *lis pendens* on property before lender made loan of $360,000 to seller. *See id.* at 905–07. The court allowed lender to recoup $260,000 paid to satisfy two prior mortgages, but not interest on paid-off mortgages, or taxes and insurance that it paid, adding up to $320,000. *See id.* The court noted that lender could sue seller personally for difference between $300,000 purchase price and $260,000 that court awarded lender. *See id.*

In *Aurora Loan Services v. Senchuk*, 36 So. 3d 716 (Fla. Dist. Ct. App. 2010), the court stated that "the determination of what constitutes prejudice to a second lien holder must be confined to what would constitute prejudice in the event of a foreclosure." *Id.* at 721. The court held that the refinancing lender, who increased the principal amount of the loan, did not as a matter of law prejudice the existing second mortgage lender where the refinancing lender's request for equitable subrogation was only equal to the amount paid to satisfy the original first mortgage. *See id.* at 722. In *Provident Co-operative Bank v. Talcott*, 260 N.E.2d 903 (Mass. 1970), the court stated that the equitable subrogee obtained priority to the extent of "whatever amount would not be payable . . . had that mortgage not been discharged by mistake." *Id.* at 909. The court held that the equitable subrogee was entitled to priority as to ongoing interests and costs, to extent of: (1) amount of senior liens paid off; (2) less payments thereafter made by borrower subrogee, each payment to be applied first to interest and then to outstanding principal; (3) plus interest accrued on principal balance, as reduced; and (4) any real estate taxes paid by mortgagee. *See id.* at 908–09. In summarizing the *Provident Co-operative Bank v. Talcott* decision, Giles L. Krill states that:

> If tax payments may be added to the equitable subrogee's position, then it stands to reason that any escrow deficiency for other expenses covered by mortgage covenants, such as property insurance payments, may be added to the equitable subrogee's priority position. Another unanswered question is whether foreclosure costs may be added to the equitable subrogee's priority position. The *Provident* decision suggests that any costs incurred by the equitable subrogee by reason of the mortgagor's breach of covenants appearing in the discharged mortgage, including costs incurred in exercise of the statutory power of sale, are properly added to the equitable subrogee's priority position according to the theory that it constitutes "whatever amount would no[t] be payable . . . had that mortgage not been discharged by mistake." Where the discharged mortgage and the equitable subrogee's new mortgage contain identical mortgage covenants, the argument is strengthened.

Giles L. Krill, *Does the Doctrine of Equitable Subrogation Include Mortgage Priority as to Ongoing Interest and Costs?*, LAW OFFICES OF EDWARD A. GOTTLIEB (July 1, 2008),

On July 22, 2010, the Minnesota Supreme Court affirmed the holding of the appellate court.[45] The Minnesota Supreme Court stated the following: "Raven did not have actual, implied, or constructive notice of the Citizens mortgage, and Raven recorded its mortgage on the property prior to Citizens. It is undisputed that Raven was a good faith purchaser . . . . The only question is whether we should apply equitable subrogation to reverse that priority."[46]

The court noted that because Citizens was the party seeking subrogation, Citizens had the burden of proving that the equities in this case weighed in its favor.[47] The court ruled that the equities did not favor Citizens because it "neglected to act in a timely manner" by waiting thirty-eight days to submit the mortgage for recording after the mortgage had been initially returned to Citizens unrecorded, during which time the Raven mortgage was properly recorded.[48] The delay by Citizens, according to the court, "is not justifiable or excusable, regardless of the sophistication of the mortgagee."[49] The dissent argued that "the district court did not clearly abuse its discretion when it applied equitable subrogation to Citizens' mortgage."[50]

In an unpublished Indiana appellate court case, *Roswell Properties, LLC v. Mullins*,[51] the court decided the issue of priority on the basis of contract law and an applicable Indiana statute and did not need to reach (and did not mention or discuss) the *Restatement* position. In this case, the borrowers executed a mortgage, which did not contain a dragnet clause,[52] on their property to the predecessor of Roswell, LLC (the plaintiff bank) (Roswell) in 1996.[53] "[A] series of additional notes [was executed] for the principal loan balance of $230,000" from 1997 to 2004.[54] In between those dates, "on June 25, 2001, the [b]orrowers executed a mortgage note to U.S. Bank's predecessor for the sum of $725,000, secured by the . . . [same] property.

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http://www.gottliebesq.com/pdf/Equitable-Subrogation.pdf (quoting *Provident*, 260 N.E. 2d at 909) (citations omitted).

[45] *See* Citizens State Bank v. Raven Trading Partners, Inc., No. A08-1560, 2010 WL 2852289 (Minn. July 22, 2010).

[46] *Id.* at *3.

[47] *See id.* at *10.

[48] *Id.*

[49] *Id.* at *11.

[50] *Id.* at *12 (Page, J., dissenting)..

[51] 872 N.E.2d 707 (Ind. Ct. App. 2007) (mem.).

[52] The term *dragnet clause* refers to a "provision in a mortgage in which the mortgagor gives security for past and future advances as well as present indebtedness." *In re* Bass, 44 B.R. 113, 114 (Bankr. D. N.M. 1984).

[53] *See id.* at *l.

[54] *Id.*

Prior to closing the loan, U.S. Bank's attorney requested and received mortgage payoff information from Roswell."[55] According to the court, the balance due on the Roswell loan as of June 25, 2001 had been "'paid to $0.00'. . . . In addition to a check for the payoff amount . . ., U.S. Bank sent Roswell a closing letter" asking for a release of the existing mortgage; "[h]owever, the mortgage was never released."[56] The borrower subsequently borrowed additional funds from Roswell and defaulted under the Roswell loan as a result of borrowing these additional funds, and Roswell filed a foreclosure action.[57] U.S. Bank counterclaimed for foreclosure of its own mortgage, and the trial court ruled in favor of U.S. Bank.[58]

The appellate court upheld the trial court's decision, rejecting Roswell's argument that "its 2004 note is a renewal of a revolving line of credit secured by the 1996 mortgage" and "its 1996 mortgage takes priority over U.S. Bank's 2001 mortgage."[59] The court noted that Indiana has a specific statute[60] that requires that a lender discharge and release its mortgage of record when payment in full has been lawfully tendered.[61] The court also referred to one of its previous decisions, *Dreibelbiss Title Co. v. Fifth Third Bank*,[62] in which the appellate court "held that the lender was not required to release its mortgage after receiving payoff funds because the lender had not received written notification from the borrower to close the account, as required by the loan agreement."[63] The court in *Roswell* distinguished its prior holding in *Dreibelbiss* however, stating that "[h]ere there was no such additional requirement in order to 'discharge' the lender's obligation to release the mortgage."[64] The court further noted that the Roswell mortgage "clearly provides '[u]pon payment of all sums secured by this Security Instrument [the mortgage], Lender shall release this Security Instrument 'without charge to the borrower.'"[65] Therefore, the court held that Roswell was required as a matter of law, upon receiving the payoff amount from

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[55] *Id.*
[56] *Id.* (quoting Appellant's Appendix at 82) (alteration in original).
[57] *See id.*
[58] *See id.*
[59] *Id.* at *1–*2.
[60] *See* IND. CODE § 32-28-1-1(b) (2002).
[61] *See Roswell*, 872 N.E.2d at 707.
[62] 806 N.E.2d 345 (Ind. Ct. App. 2004).
[63] *Roswell*, 872 N.E.2d at 707.
[64] *Id.*
[65] *Id.* (alteration in original).

U.S. Bank in 2001, to release the mortgage under both the language in its mortgage and the applicable Indiana statute.[66]

In an article on the application of the equitable-subrogation doctrine under Michigan law,[67] the author discusses recent Michigan equitable-subrogation cases and argues that they have severely limited—or even eviscerated—application of the *Restatement* position to commercial loan refinances in Michigan, even though the current lengthy recording gap in Michigan is especially suited to application of the equitable-subrogation doctrine.[68] The author notes that until recently Michigan cases generally followed the *Restatement* but that "at least with respect to commercial refinance lenders . . . Michigan no longer embraces any aspect of the Restatement, the majority or any other view of equitable subrogation."[69]

The author of that article also states that "equitable subrogation is no longer available to a commercial lender solely by virtue of the fact that it is a sophisticated business entity."[70] The author cites and analyzes recent Michigan appellate court cases on equitable subrogation that support this conclusion,[71] including *Ameriquest Mortgage Co. v. Alton*[72] and *Deutsche Bank Trust Co. Americas v. Spot Realty, Inc.*[73]

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[66] *See id.*

[67] *See* Thomas A. Kabel, *Equitable Subrogation: Why the Refinance Lender's Security Interest May Not be as Secure as it Thinks*, 34 MICH. REAL PROP. REV. 134 (2007).

[68] *See id.* at 135–37.

[69] *Id.* at 135.

[70] *Id.*

[71] *See id.*

[72] 731 N.W.2d 99 (Mich. Ct. App. 2006). In this case the court held that a conventional lender is properly classified as a "mere volunteer" in all instances and thus, may not avail itself of equitable subrogation. *See id.* The court in *Ameriquest* stated that:

> [W]e are unaware of any authority regarding the application of the doctrine of equitable subrogation to support the general proposition that a new mortgage, granted as part of a generic refinancing transaction, can take the priority of the original mortgage, which is being paid off, giving it priority over intervening liens. . . . Such bolstering of priority may be applicable where the new mortgagee is the holder of the mortgage being paid off or where the proceeds of the new mortgage are necessary to preserve the property from foreclosure or another action that would cause the intervening lien holders to lose their security interests.

*Id.* at 104 (quoting Washington Mut. Bank, FA v. ShoreBank Corp., 703 N.W.2d 486, 496 (Mich. Ct. App. 2005)). The *Ameriquest* court held that if there are intervening liens, equitable subrogation "'cannot be used to avoid the dictates of'" MICH. COMP. LAWS section 565.25 to allow "'a new mortgage, granted as part of a generic refinancing transaction, [to] take the priority of the original mortgage,'" unless the new mortgagee can establish that an intervening lien holder acted fraudulently. *Id.* at 106 (quoting from both Burkhardt v. Bailey,

## IV. CONVENTIONAL V. EQUITABLE SUBROGATION

The *Prestance* decision has almost no discussion of the distinction that some other cases make between conventional[74] and equitable (or legal) subrogation. In this regard, the court in *Prestance* may have been confused by (or unconcerned with) the distinction and stated only the following: "[W]e agree with the Restatement at least in the context of a conventional refinancing. A lender providing funds to pay off an existing mortgage expects to receive the same security as the loan being paid off."[75]

Many courts continue to apply the doctrine of conventional subrogation, a fraternal—but not identical—twin of equitable subrogation, and allow claimants to bypass equitable defenses that have operated to defeat subrogation claims in the past. The Illinois Appellate Court discussed this supposedly distinct doctrine in *Aames Capital Corp. v. Interstate Bank of Oak Forest*,[76] stating the following:

> There are two broad categories of subrogation rights: contractual or conventional rights, and common-law or equitable rights. Equitable subrogation is a creature of chancery that is utilized to prevent unjust enrichment. There is no general rule that can be laid down to determine whether a right of equitable subrogation exists, since the right depends upon the equities of each particular case. Conventional subrogation, on the other hand, arises from an agreement between the parties [the refinancing mortgagee and the mortgagor] that the subrogee [the refinancing mortgagee] pay a debt on behalf of a third

680 N.W.2d 453, 465 (Mich. Ct. App. 2004); Ameriquest Mortg. Co. v. Alton, 726 N.W.2d 424 (Mich. Ct. App. 2006)).

[73] 714 N.W.2d 409 (Mich. Ct App. 2005) (holding that equitable subrogation simply is not available to commercial lenders absent fraud, mutual mistake, or other unusual circumstances).

[74] "Conventional subrogation is . . . contractual, occurring where one having no interest or any relation to the matter pays the debt of another, and by agreement is entitled to the rights and securities of the creditor so paid." Bancinsure, Inc. v. BNC Nat'l Bank, 263 F.3d 766, 773 (8th Cir. 2001).

[75] Bank of Am. v. Prestance, 160 P.3d 17, 25 (Wash. 2007) (quoting Bank of N.Y. v. Nally, 820 N.E.2d 644, 653 (Ind. 2005)).

[76] 734 N.E.2d 493 (Ill. App. Ct. 2000).

> party and, in return, be able to assert the rights of the original creditor.[77]

Noting that "[t]here are no Illinois cases of recent vintage that explain when subrogation will apply to a mortgage refinancing," the *Aames* court nonetheless observed that "[t]here are numerous policy reasons to apply the doctrine of conventional subrogation to a case involving a refinancing mortgage."[78]

In *Financial Federal Credit, Inc. v. LaSalle Bank National Ass'n*,[79] the Illinois Circuit court ruled that the first-in-time rule, as codified in Illinois,[80] creates a presumption that a lien that is recorded ahead of others has priority relative to such other liens. The court also noted that Illinois is a race-notice jurisdiction because "the first person to record is entitled to claim priority only if he also is 'without notice' of any prior, unrecorded lien, a circumstance that does not exist in this case."[81] Further, the court stated:

> [C]onventional subrogation . . . results from an equitable right springing from an express agreement with the debtor, by which one advances money to pay a claim for the security of which there exists a lien, by which agreement

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[77] *Id.* at 498 (citations omitted); *see also* Bankers Trust Co. v. United States, 25 P.3d 877, 880 (Kan. Ct. App. 2001) ("conventional subrogation . . . arises from an agreement between the parties"). In *In re Flamingo 55, Inc.*, 378 B.R. 893 (Bankr. D. Nev. 2007), the court stated that:

> There are different "flavors" of subrogation, each with somewhat different qualities. The Ninth Circuit has categorized these types as "conventional" or "contractual" subrogation, "legal" or "equitable" subrogation, and statutory subrogation. "Conventional" or "contractual" subrogation rights arise from an express or implied agreement between the subrogor and subrogee. "Equitable subrogation is a legal fiction, which permits a party who satisfies another's obligation to recover from the party 'primarily liable' for the extinguished obligation." The right of "legal" or "equitable" subrogation arose as a "creature of equity" and "is enforced solely for the purpose of accomplishing the ends of substantial justice." Statutory subrogation, as one might expect, occurs by virtue of a right created by statute.

*Id.* at 906 n.15 (citations omitted) (quoting Hamanda v. Far East Nat'l Bank (*In re* Hamanda), 291 F.3d 645, 649 (9th Cir. 2002)).

[78] *Id.* at 500.

[79] Nos. 05 CH 3936, 06 CH 2385, 2008 WL 4565905 (Trial Order) (Cir. Ct. of Ill., April 29, 2008).

[80] *See* 765 ILL. COMP. STAT. ANN. 5/30 (West 2001).

[81] *LaSalle*, 2008 WL 4565905, at *4 n.5.

> he is to have an equal lien to that paid off, whereupon he is entitled to the benefit of the security which he has satisfied with the expectation of receiving an equal lien.[82]

The court reasoned that in this case, the lender who intended to leap frog the intervening lienor's judgment lien did not argue for equitable subrogation—nor could it—because "the lien claims here are garden-variety."[83] The court rejected the refinancing lender's claim based on conventional subrogation because the lender did not meet its burden of coming forward with evidentiary facts to support its position—an agreement to discharge the prior mortgages and the actual discharge of those mortgages.[84] Based on the same reasoning, the court also rejected the lender's claim that it was entitled to priority as a purchase money mortgagee because the lender provided no evidence to demonstrate that such was the case; furthermore, the boilerplate language in the mortgage regarding the conditional removal of prior liens was insufficient to prove the requisite express agreement required to establish equitable subrogation.[85]

But the doctrine of equitable subrogation has ancient origins, and the law in this area is well developed. Both the conventional subrogation and

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[82] *Id.* at *4.

[83] *Id.* at *4–*5.

[84] *See id.* at *7.

[85] *See id.* at *8; *see also* Union Bank v. Thrall, 872 N.E.2d 542, 547 (Ill. App. Ct. 2007) (holding that subrogation is not really an exception to the first-in-time rule in Illinois and stating "it simply holds that, under certain circumstances, equity requires that a subsequent lienor be considered the same as if he were the original lienor."); Detroit Steel Prod. Co. v. Hudes, 151 N.E.2d 136, 140 (Ill. App. Ct. 1958) (holding mortgagee was entitled to position of building-material providers who had been paid out of mortgage-loan proceeds where it was clear that mortgagee had required known mechanic's lien claimants to be paid out of loan proceeds and had expected to be subrogated); Barbara A. Gimbel & Edward J. Andersen, *Lender Leap-Frog: Conventional Subrogation in Lien Priority Disputes*, 94 ILL. B.J. 494, 494–98 (Sept. 2006) (discussing the first-in-time rule and conventional subrogation in Illinois); *cf.* Decaro v. M. Felix, Inc., 864 N.E.2d 890 (Ill. App. Ct. 2007). In this case, Genaro Felix (Felix) owned the property at issue, which was encumbered by two preexisting mortgages. *See id.* at 1104–05. Lakeshore Decaro (Lakeshore) subsequently obtained an $80,000 arbitration award against Felix and recorded a memorandum of judgment against the property. *See id.* at 1105. Felix then entered into a contract to sell the property to Burke Chaney Builders (Burke Chaney). *See id.* In connection with the sale, the First National Bank of Brookfield (Bank) lent Burke Chaney $104,800 and received a mortgage on the property for that amount. *See id.* The Bank used a portion of the proceeds to pay off two prior mortgage liens and Cook County real estate taxes. *See id.* The Illinois appellate court held that under principles of equitable subrogation, the Bank's mortgage lien on the property was superior to Lakeshore's judgment lien. *See id.* at 1109.

equitable subrogation doctrines are creatures of equity, and the court may be creating a distinction without a meaningful difference.[86]

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[86] *See* Aames Capital Corp. v. Interstate Bank of Oak Forest, 734 N.E.2d 493, 501 (Ill. App. Ct. 2000). In addition to Illinois, the *Aames* court lists other state and federal jurisdictions that recognize the conventional subrogation doctrine. *See id.*

The following cases contain a discussion of the difference between conventional and equitable (or legal) subrogation: (1) In *LaSalle Bank, N.I. v. First American Bank,* 736 N.E.2d 619 (Ill. App. Ct. 2000), the Illinois appellate court expressly affirmed the doctrine of conventional subrogation. According to the court:

> [I]n terms of real property, the doctrine of conventional subrogation holds that when a refunding mortgage is made, the lien of the old mortgage continues in effect without interruption and the refunding mortgage does not become subordinate to an intervening lien or interest attaching between the time the old mortgage was recorded and the effective date of the refunding mortgage, even though the old mortgage has been released.

*Id.* at 625 (citations omitted). (2) In *Welch Foods, Inc. v. Chicago Title Insurance Co.*, 17 S.W.3d 467 (Ark. 2000), the Arkansas Supreme Court stated:

> "Conventional subrogation, as the term implies, is founded upon some understanding or agreement, express or implied, and without which there is no 'convention.'" Legal or equitable subrogation, on the other hand, is a creature of equity, and not dependent upon contract, but rather dependent upon the equities of the parties. It arises by operation of law.

*Id.* at 470 (quoting Courtney v. Birdsong, 437 S.W.2d 238, 241 (Ark. 1969)). (3) In *Wyoming Building & Loan Ass'n v. Mills Construction Co.*, 269 P. 45 (Wyo. 1928), the Wyoming Supreme Court stated:

> The right of subrogation may arise and sometimes must arise from contract. This is conventional subrogation. The right is sometimes given in the absence of contract, is then a creation of the court of equity, and is given when otherwise there would be a manifest failure of justice. This is legal subrogation. It is a mode which equity adopts to compel the ultimate payment of a debt by one who in justice, equity, and good conscience ought to pay it, though it is not exercised in favor of a mere intermeddler. This principle, adopted from the Roman law and at first sparingly exercised, has come to be one of the great principles of equity of our jurisprudence, and courts incline to extend it rather than restrict it. One instance in which legal subrogation is applied is in connection with the protection of a lien, and the rule is universal that one who has an interest in property by lien or otherwise, in making payment of prior liens, including taxes, is not a mere volunteer, and that he will be entitled, upon payment of a superior lien in order to protect his own lien, to be subrogated to the rights of the superior lienholder.

*Id.* at 48–49 (citations omitted). (4) In *Van Dyk Mortgage Corp. v. United States*, 503 F. Supp. 2d 876 (W.D. Mich. 2007), the U.S. District Court for the Western District of Michigan stated:

> Michigan courts have recognized two forms or types of subrogation, as explained in *French v. Grand Beach Co.*: "The doctrine of subrogation rests

## V. PRIORITY OF EQUITABLY SUBROGATED MORTGAGE WITH RESPECT TO FEDERAL TAX LIENS

If a mortgagee seeks to establish priority via application of the equitable-mortgage doctrine, will such priority be effective against an intervening federal tax lien? The existing case law on this point generally indicates that the answer to this question is yes.

For example, in *The Sum of $66,839.59 Filed in Registry of Court v. United States Internal Revenue Service*,[87] the U.S. District Court in Georgia granted summary judgment to The Sunshine House, Inc. (Sunshine House), which was the purchaser of the assets of Americare Child Enrichment Centers (Americare). Sunshine House claimed it was entitled to equitable subrogation with respect to the rights of Americare's secured creditor, First National Bank of Griffin (First National), because Sunshine House paid First National's loan in full at the time of closing.[88] Sunshine claimed it was entitled to equitable subrogation with respect to an Internal Revenue Service tax lien filed but not yet recorded at the time of the purchase transaction and loan payoff.[89] The court agreed, stating:

> Sunshine House became equitably subrogated to First National's position as senior lienholder when it paid off the First National loan to Americare as part of the asset purchase agreement without knowledge of the IRS' filed

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> upon the equitable principle that one, who, in order to protect a security held by him, is compelled to pay a debt for which another is primarily liable, is entitled to be substituted in the place of and to be vested with the rights of the person to whom such payment is made, without agreement to that effect. This doctrine is sometimes spoken of as "legal subrogation," and has long been applied by courts of equity. There is also what is known as "conventional subrogation." It arises from an agreement between the debtor and a third person whereby the latter, in consideration that the security of the creditor and all his rights thereunder be vested in him, agrees to make payment of the debt in order to relieve the debtor from a sacrifice of his property due to an enforced sale thereof. It is wholly independent of any interest in the property which the lender may have to protect. It does not, however, inure to a mere volunteer who has no equities which appeal to the conscience of the court."

*Id.* at 880 (quoting French v. Grand Beach Co., 215 N.W. 13, 14 (Mich. 1927)) (internal citations omitted).

[87] 119 F. Supp. 2d 1358 (N.D. Ga. 2000).

[88] *See id.* at 1360.

[89] *See id.* "[W]hile the IRS' tax lien was filed [with the Superior Court of Dekalb County] . . . , it had not yet been indexed in the Dekalb County public indices by the date of the closing . . . ." *Id.*

> but not yet publicly available tax lien. Where the IRS does not dispute that First National's interest was prior in time and therefore superior to the federal tax lien, the Court finds that Sunshine House's security interest has priority over the IRS' lien, and summary judgment is GRANTED in favor of Sunshine House.[90]

In *Van Dyk Mortgage Corp.*,[91] the U.S. District Court for the Western District of Michigan held that under Michigan law a mortgagee who discharged its original mortgage because of a loan refinancing did not lose priority over intervening tax liens recorded before the refinancing mortgage was recorded.[92] The court upheld the mortgagee's priority even though it noted that the mortgagee did not act under compulsion in cancelling the original mortgage.[93] The court applied the equitable-mortgage doctrine to protect the priority of the mortgagee even though the court acknowledged that the mortgagee could have taken other steps to protect itself, because this was not a prerequisite to application of the doctrine, and the government would be no worse off since its lien was the junior lien at the time it was filed.[94] Furthermore, the court found that the mortgagee was not a volunteer because it had made the original loan and had a direct interest in paying off the original loan and placing a substitute refinancing loan on the property.[95]

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[90] *Id.* at 1362 (footnote omitted).

[91] 503 F. Supp. 2d 876 (W.D. Mich. 2007).

[92] *See id.* at 879–81, 886–87.

[93] *See id.* at 886.

[94] *See id.* at 886–87.

[95] *See id.* at 886; *see also* Dietrich Indus., Inc. v. United States, 988 F.2d 568, 570 (5th Cir. 1993) (stating "'Where, under local law, one person is subrogated to the rights of another with respect to a lien or interest, such person shall be subrogated to such rights for purposes of any [federal tax lien].'" (quoting I.R.C. § 6323(i)(2)) (alteration in original)). Federal law ultimately determines the priority of competing liens. *See* United States v. McDermott, 507 U.S. 447, 453–54 (1993) (stating "the filing of notice renders the federal tax lien extant for 'first in time' priority purposes regardless of whether it has yet attached to identifiable property"); *In re* Spearing Tool & Mfg. Co., 412 F.3d 653, 655 (6th Cir. 2005) ("Federal law controls whether the IRS's lien notice sufficed.") *cert. denied*, 549 U.S. 810 (2006); *cf. Van Dyk Mortg. Corp.*, 503 F. Supp. at 879 (acknowledging that "[w]hen the priority of competing federal and state liens is at issue, federal law controls," but noting that "as between a state law lien and a federal tax lien, the first perfected lien is entitled to priority"); Progressive Consumers Fed. Credit Union v. United States, 79 F.3d 1228, 1236–38 (1st Cir. 1996) (ruling that, in a case of first impression under Massachusetts law, application of equitable subrogation would leave intervening recorded IRS tax liens in no worse position than they would have been prior to refinancing lender's mortgage).

## VI. CONCERNS OF TITLE INSURERS

Title insurers have legitimate and understandable concerns regarding court rulings on equitable-subrogation claims. Whenever a title insurer pays a claim, it will ask the claims handler to consider possibilities for recovery from someone who may have been unjustly enriched. Often this inquiry begins and ends with consideration of the title insurance company's rights under the legal doctrine of equitable subrogation. When it works as intended, this doctrine allows the insurer to stand in the shoes of the injured party, the insured, and sue for recovery from any other party who, in equity and fairness, ultimately should pay for the loss.[96] But some courts have proven themselves inhospitable to such suits for various reasons—particularly where the claim is seen as resulting from some mistake by the title company's employee or agent.

This approach was clearly demonstrated in a case from the State of Washington Supreme Court, *Kim v. Lee*.[97] Mr. Kim, a judgment lienholder, recorded his judgment lien with the county where the Lees' property was located in order to execute on his judgment, and the title insurer intervened

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If the mortgage is a purchase money mortgage, and the lien is against the borrower, there may not be a priority problem in the first place. *See* Rev. Rul. 68-57, 1968-1 C.B. 553 ("In view of the legislative history of the Federal Tax Lien Act of 1966, the Internal Revenue Service will consider that a purchase money security interest or mortgage valid under local law is protected even though it may arise after a notice of Federal tax lien has been filed.").

Also, if the tax lien identified the debtor by a former name or a maiden name, and the lender had no knowledge of the former name/maiden name, this may be another basis to establish lien priority by invoking the equitable subrogation doctrine. However, a filed tax lien does not have to perfectly identify the taxpayer as long as an abbreviated or erroneous name sufficiently identifies the taxpayer such that a reasonable and diligent search would have revealed the existence of the notices of the federal tax lien. *See In re Spearing Tool & Mfg. Co.* 412 F.3d at 656–67; *see also* BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 48.03, (3d ed. 2002) (discussing all aspects of federal tax liens, including priority and methods of discharge). *See generally* Lawrence P. Heffernan, *Equitable Subrogation Unsettled*, TITLE NEWS, Jan.-Feb. 1998, *available at* http://www.alta.org/publications/titlenews/98/9801_07.cfm (analyzing case law regarding priority of intervening tax liens with respect to refinancing mortgages).

[96] Given the conflicting case law in this area, title insurers must be especially careful when deciding whether to issue an endorsement protecting against any loss as a result of an intervening recorded lien. *See* Joondeph v. Hicks, 235 P.3d 303,305 (Colo. 2010) (ruling against application of equitable-subrogation doctrine because the Joondephs clearly had actual knowledge of the intervening lien, including the fact that "the Joondephs' title policy included an endorsement protecting against any loss caused by Hicks' claim").

[97] 31 P.3d 665 (Wash. 2001), *distinguished by* Bank of Am. v. Prestance Corp., 160 P.3d 17, 19–20 (Wash. 2007).

to protect its insured lender.[98] The title company had failed to discover the judgment lien when it searched title, and even though Kim made the company aware of this lien prior to closing the new mortgage, the title company closed without paying off Kim's judgment lien.[99] This new mortgage involved a modification of the existing mortgage, which was senior to the judgment lien.[100] The majority opinion adopted the following approach to subrogation in regards to mortgage loans:

> Under the *Restatement* a modification of a mortgage will ordinarily cause it to lose priority to junior interests to the extent that the modification is materially prejudicial to those interests. . . . Absent an increase in the principal amount or the interest rate of the mortgage, such modifications normally do not jeopardize the mortgagee's priority as against intervening interests.[101]

The court found that the modification of the loan repayment term from six years to thirty years, and the fact that this was a new mortgage, were materially prejudicial to Kim as the junior lienholder.[102] As a result, the court found that the new mortgage was junior to Kim's judgment lien.[103]

The court refused to allow equitable subrogation where, as in this case, the party seeking subrogation, the title insurer, had actual knowledge of the intervening interest.[104] The court then described the role of the title insurer, stating:

> Generally, the role of the title insurer is relied upon by the lender, judgment creditor, and other lienors. Just as a lender relies on the title insurer to commit that title is vested in its borrower, subject only to known exclusions, judgment creditors and other lienors rely on title insurers to prevent a debtor from conveying real property without first satisfying a perfected lien. In the instant case, legal remedies and equity suggest that the loss should fall on the title company rather than the innocent judgment creditor.[105]

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[98] *See id.* at 667–68.
[99] *See id.*
[100] *See id.*
[101] *Id.* at 670 (citing RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.3 1997).
[102] *See Kim*, 31 P.3d at 670.
[103] *See id.*
[104] *See id.* at 671.
[105] *Id.*

The court concluded that "equitable subrogation should not apply in favor of a title company which guaranteed title while on constructive or actual notice of a prior judgment."[106] Interestingly, the appellate court in *Prestance* (whose decision was subsequently reversed by the Washington Supreme Court) held that under the guidance of the *Kim* decision, WFB West's actual knowledge of B of A's lien prevented the application of the equitable-subrogation doctrine.[107] The Washington Supreme Court disagreed and distinguished its prior decision in *Kim* on the basis that

> *Kim* addressed whether a refinancing mortgagee's *title insurer* could benefit from equitable subrogation if the *insurer* had actual knowledge of intervening liens. The facts before us today are different and concern whether a refinancing mortgagee, not a title insurer, must be

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[106] *Id.* at 92. *See also* First Fed. Bank v. United States, 118 F.3d 532, 534 (7th Cir. 1997) (refusing to apply equitable subrogation under Indiana law where doing so would benefit the title insurer who was negligent in failing to discover federal tax lien and stating that "Indiana courts have been more reluctant to invoke the doctrine of equitable subrogation in cases where to do so would benefit a negligent title insurer"); Centreville Car Care, Inc. v. N. Am. Mortg. Co., 559 S.E.2d 870, 872–74 (Va. 2002) (refusing to equitably subrogate lender's claim to prior properly recorded mortgage where title examiner and title insurer were negligent in failing to discover prior recorded lien; court stated that "any 'windfall' in this case as a result of granting subrogation would inure to the benefit of the negligent title examiner and the party that insured the title. . . . Thus, the equities in this case favor [the prior mortgagee], the innocent party who would be prejudiced if subrogation were granted"). Virginia has a specific statute, VA. CODE ANN. § 55-58.3 (1950), which applies irrespective of a title company's involvement and states in part, at § 55-58.3(B):

> Upon the refinancing of a prior mortgage encumbering or conveying an interest in real estate containing not more than one dwelling unit, a subordinate mortgage shall retain the same subordinate position with respect to a refinance mortgage as the subordinate mortgage had with the prior mortgage, provided that:
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> 1. Such refinance mortgage states on the first page thereof in bold or capitalized letters: "THIS IS A REFINANCE OF A (DEED OF TRUST, MORTGAGE OR OTHER SECURITY INTEREST) RECORDED IN THE CLERK'S OFFICE, CIRCUIT COURT OF (NAME OF COUNTY OR CITY), VIRGINIA, IN DEED BOOK ___, PAGE ___, IN THE ORIGINAL PRINCIPAL AMOUNT OF _____ AND WITH THE OUTSTANDING PRINCIPAL BALANCE WHICH IS _____.";
>
> 2. The principal amount secured by such refinance mortgage does not exceed the outstanding principal balance secured by the prior mortgage plus $5,000; and
>
> 3. The interest rate is stated in the refinance mortgage at the time it is recorded and does not exceed the interest rate set forth in the prior mortgage.

[107] *See* Bank of Amer. v. Prestance Corp., 160 P.3d 17, 20 (Wash. 2007).

> precluded from equitable subrogation if he has actual knowledge of intervening liens.[108]

But the allegation by the Washington Supreme Court in *Kim* that a title company guarantees title is incorrect. A title insurer does not guarantee title; it contractually indemnifies an insured's title to the property subject to the terms, conditions, exceptions and exclusions contained in the policy.[109] Furthermore, the insured lender, not the title insurer, had a lien on the property (such that the lender's prior knowledge of the lien, if any, should be controlling) and would be the direct beneficiary of any right to equitable subrogation.[110] An assertion that title insurers owe duties to third parties with whom they are not in privity or bound by any contractual relationships is misguided. The court's ruling effectively prevents any lien holder, judgment lien creditor, or any other party with an interest in the property from being entitled to the benefits of equitable subrogation whenever that party has obtained title insurance, while those parties that do not have title insurance will be allowed such benefits.[111]

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[108] *See id.*

[109] *See* Lawyers Title Ins. Co. v. Synergism One Corp., 572 So. 2d 517, 518 (Fla. Dist. Ct. App. 1990) ("A title policy indemnifies rather than guarantees the state of the insured title."); Cavalaris v. Youmans, No. 2000-CP-10-001475, 2001 WL 36000146, (S.C. Cir. Ct., Feb. 20, 2001) ("Title insurance is not liability insurance. Professor Spitz has written that we must '[k]eep in mind that a title insurance policy is *not* intended to reflect or guarantee the status of title. It is not a 'guaranteed abstract.' Rather, it is intended to be a contract by which the insured is indemnified against specified losses,'" (quoting STEVE SPITZ, INTRODUCTION TO TITLE INSURANCE, REAL ESTATE TRANSACTIONS, CASES AND MATERIALS, 490 (S.C. Bar Continuing Legal Education Div. 1998))); *see also* 43 AM. JUR. 2D INSURANCE § 528 (2003) ("The liability of an insurer under a title insurance policy is for loss or damage by reason of defects in the title to the property or by reason of liens or encumbrances thereon. As a general rule, a title insurer does not guarantee the state of title, but agrees to indemnify the insured for any loss; thus, the mere existence of liens or defects covered by a title policy in and of itself is not sufficient to justify recovery." (Footnotes and citations omitted)).

[110] *See Kim*, 31 P.3d at 667–68.

[111] *But cf.* Houston v. Bank of Am., 78 P.3d 71, 73–74 (Nev. 2003), (seemingly countering the reasoning, noting that "precluding equitable subrogation when a mortgagee discovered or could have discovered a junior lien holder runs contrary to the purposes underlying the [equitable subrogation] doctrine."); *see also* Foster v. Porter Bridge Loan Co., 27 So.3d 481 (Ala. 2009) (holding that even though title company did not discover intervening judgment lien, refinancing lender had no actual knowledge of lien and constructive notice of intervening lien was not sufficient to preclude equitable subrogation under Alabama law); Hicks v. Londre, 125 P.3d 452, 460 (Colo. 2005) (holding that refinancing lender had no actual knowledge of intervening judgment lien and there was no negligence in failing to discover it, even though lender had obtained title commitment that failed to show the lien, and stating that "reliance upon a title insurance company is not

Interestingly, in *Gibson v. Neu*,[112] the subordinate mortgagee argued that the property purchaser and the purchaser's lender (who paid off the first mortgage but not the subordinate second mortgage that the title insurer neglected to show on the title commitment or policy) would not be prejudiced by awarding it first priority because they had obtained title insurance.[113] But the court in *Gibson v. Neu* noted that Indiana has a statute[114] that provides that "a mortgagee seeking equitable subrogation with respect to a lien may not be denied equitable subrogation solely because . . . the mortgagee ob-

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evidence of negligence"); ABN Amro Mortg. Group, Inc. v. Kanagh, 906 N.E.2d 1195 (Ohio Ct. App. 2009) (ruling that equitable subrogation applied because refinancing mortgagee clearly intended to hold first lien on property and prior mortgagee had agreed to subordinate its security interest; court stated that "a title company's negligence is not material in cases in which the competing lienholder 'was not misled or injured, because it did not bargain for or expect a first lien position.'" (quoting Cadle Co. No. 2 v. Rendezvous Realty, Nos. 63565, 63724, 1993 WL 335444 (Ohio Ct. App. Sept. 2, 1993)); Eastern Sav. Bank v. Pappas, 829 A.2d 953, 955–56 (D.C. 2003) (refinancing mortgagee paying off first mortgage entitled to equitable subrogation even though title company's title search on property negligently failed to show existence of intervening lien). In *Bank of America v. Wells Fargo Bank*, 109 P.3d 863, 868–69 (Wash. Ct. App. 2005), the court, relying on *Kim v. Lee*, held that equitable subrogation was inappropriate where, as in this case, the refinancing lender had actual knowledge of the intervening mortgage liens based on a preliminary title commitment and final report and the loan officer acknowledged he was aware of the intervening liens but "thought they had been paid off and released." *Id.* at 868. The court also stated that "Simple solutions existed to address the intervening liens, including the proper use of the escrow agent and seeking subordination agreements. The [refinancing lender] did neither." *Id.* at 869. The court stated further that:

> We recognize that other jurisdictions have increasingly recognized the flaws in the actual knowledge prohibition, and although actual knowledge bars subrogation in the majority of jurisdictions, this dominant position is being rapidly eroded. But we conclude that the controlling precedent of Kim compels the conclusion that . . . actual knowledge of an intervening lien bars equitable subrogation.

*Id*. at 868–69. In *Universal Title Co. v. United States,* 942 F.2d 1311 (8th Cir. 1991), the court refused to permit a title insurance company to be equitably subrogated to the rights of a prior mortgagee, in part because of its failure as a sophisticated professional enterprise to discover an intervening IRS tax lien during its title search. The court stated that Minnesota courts "impose stricter standards on professionals than lay persons in assessing whether mistakes are 'excusable' for purposes of the doctrine of legal subrogation, especially when the professional relationship arises out of a commercial transaction involving consideration." *Id.* at 1317.

[112] 867 N.E.2d 188 (Ind. Ct. App. 2007).

[113] *See id.* at 201.

[114] *See* IND. CODE ANN. § 32-29-1-11 (LexisNexis 2006).

tained a title insurance policy."[115] The purchaser's lender argued that the existence of title insurance was irrelevant because the statute "reflects a broad policy determination that neither buyers nor lenders should be denied equitable subrogation simply because they obtained title insurance."[116] The court agreed, "[g]iven the 'liberal application' of equitable subrogation."[117]

## VII. PREVENTIVE STRATEGIES FOR REFINANCING LENDERS

As previously noted, the more liberal *Restatement* position is not yet the majority view in the United States, although many recent cases appear more willing to adopt the *Restatement* position.[118] But in any event, a real estate practitioner who represents mortgage lenders can take prudent steps to

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[115] *Gibson*, 867 N.E.2d at 201–02 (quoting IND. CODE ANN. § 32-29-1-11 (LexisNexis 2006)).

[116] *Id.* at 202 (quoting Brief of Appellee at 22).

[117] *Id.* (quoting Bank of New York v. Nally, 820 N.E.2d 644, 652 (Ind. 2005)); *see* Wilshire Servicing Corp. v. Timber Ridge P'ship, 743 N.E.2d 1173, 1179 (Ind. Ct. App. 2001) (stating the fact that "a title insurer was paid to perform precisely the function that would have revealed the [junior] judgment lien is a factor within the purview of a determination of the equities"); *In re* Bill Heard Enters., Inc., 420 B.R. 553, 564 n.30 (Bankr. N.D. Ala. 2009) ("The Court cannot help but noticing the irony involved in HSBC's equitable subrogation and equitable lien theories in as much as it is actually the title insurance company that is defending this action and will bear the ultimate loss while it was their agent/attorney that created the problem in not recording the Warranty Deed in the first place."); *see also* Heffernan, *supra* note 95 (arguing that "the existence of title insurance should not bar the application of equitable subrogation or any other equitable remedy"). But in *Neu v. Gibson*, 928 N.E.2d 556 (Ind. 2010), the Indiana Supreme Court affirmed the holding of the trial court and ruled that the purchasers and the purchasers' lender, as equitable subrogees without actual notice of the intervening recorded mortgage lien nonetheless, (1) were not entitled to step into the shoes of the paid-off prior mortgagee and foreclose the mortgage of which they assumed the first lien position, because that mortgage had been paid off and discharged, (2) were not equitably entitled to interest or attorneys' fees under the paid-off mortgage, and (3) were not proper parties under Indiana law to force a sheriff's sale under the intervening mortgage. *See id.* at 560–64. The court noted that the closing agent for the transaction had performed a title search on the property, which failed to disclose the intervening mortgage. *See id.* The purchasers argued that foreclosure or forcing a foreclosure sale were the only viable options to protect their interests. *See id.* But the Indiana Supreme Court reasoned that the purchasers had other remedies available, i.e., either the purchasers could sell their home and pay off the new lender and the remainder of the other mortgage liens, if sufficient proceeds remained, or else "they can take the matter up with their title insurance company which is also the party who failed to find [the intervening mortgage] lien." *Id.* at 564. *See generally* J. BUSHNELL NIELSEN, TITLE AND ESCROW CLAIMS GUIDE Ch. 5, Recoupment (2nd ed. 1996, rev. Dec. 11, 2009) (discussing main sources of recoupment of a loss payment by a title insurer, including subrogation, and analyzing case law and policy language in connection with such subrogation right).

[118] *See supra* notes 19–22.

avoid the loss of priority of a refinancing mortgage, in which some or all of the proceeds from the mortgage are intended to be disbursed to pay off a prior recorded mortgage.

Obviously, the refinancing mortgage loan documents should—and almost always do—clearly state the intention of both the mortgagor and the mortgagee that the mortgagee is to receive a properly perfected first mortgage lien against the property and receive the priority of any existing first mortgage being paid off (irrespective of whether the mortgage is released). The refinancing mortgagee's attorney also should obtain a title commitment to ascertain the status of title and to determine if there are any presently existing mortgage liens or other encumbrances against the property (other than the existing first mortgage) and should determine the title insurer's willingness and ability to issue a title policy, insuring the new mortgagee's security interest as a prior, valid, and enforceable first mortgage lien on the property.[119]

The refinancing mortgagee's attorney also may find it beneficial to have the existing first-mortgage lienholder, whose loan is to be paid off from the proceeds of the new loan, assign the existing mortgage to the refinancing mortgagee, in those situations where there are intervening lienholders or encumbrancers, instead of releasing the mortgage from record (or perhaps leave the existing mortgage of record until the new mortgagee's loan is paid in full). Additionally, the existing mortgage could be assigned if the new lender enters into a modification agreement regarding the existing mortgage. Another prudent action would be to require (where feasible), as a condition to the new mortgage loan, that any known or identified lienholder execute and agree to have recorded an intercreditor or subordination agreement, whereby the existing mortgagee and any intervening lienholder would consent to the new mortgage lien and confirm that their respective liens would be subordinate to the new refinancing mortgage (at least to the extent of the outstanding amount of the prior lien being paid from the proceeds of the new loan).[120]

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[119] The availability, extent, and scope of such coverage will be available only on a case-by-case determination by the title insurer based on: (1) the facts and circumstances of each transaction; (2) the title insurer's underwriting considerations based on the documentation and other factors; (3) applicable statutory and case law; and (4) regulatory prohibitions and restrictions.

[120] *See* Lawyers Title Ins. Corp. v. Feldsher, 49 Cal. Rptr. 2d 542 (Ct. App. 1996). "[The new lender's] actual knowledge of the crucial facts, combined with his negligence in allowing the transaction to close despite the absence of a subordination agreement, is the type of 'culpable and inexcusable neglect' which justifies denial of . . . equitable subrogation under the overall circumstances of this case." *Id.* at 550. The court also noted, "[The lender]

As to the key issue of the scope of equitable subrogation (and its offspring, conventional subrogation), litigation often is necessary to determine whether a mortgage lender who has paid off a prior lien is entitled to the priority of the earlier recorded lien. The goal of the actions mentioned above is to avoid, if at all possible, a court challenge to the priority of the new refinancing mortgage. Decisions in this area of the law generally are highly fact specific and uncertain, and mortgage priority disputes can be time-consuming and expensive for mortgage lenders to resolve. The resolution of such litigation may depend on off-the-record facts and matters that are difficult to determine and prove—meanwhile, the lien priorities with respect to the property remain undetermined and in limbo until the litigation is concluded.[121]

## VIII. CONCLUSION

It appears that in many of the cases involving equitable subrogation, the court is trying to avoid any fact-intensive weighing of the equities by setting up conventional subrogation as a rule to be followed. However, many state courts rely on equitable arguments to justify the rule.

Although the cases discussed in this Article involve different fact situations, it seems reasonable that a court should be able to find a method sufficient to invoke conventional subrogation whenever a refinancing lender can show: (1) it intended to pay off the senior debt (whether it had actual or constructive knowledge of the intervening lien); (2) the intervening lienholder would suffer no harm; and (3) in exchange the refinancing lender intended to obtain a first mortgage.

The doctrine of equitable subrogation, which different courts interpret differently, fosters uncertainty and unpredictability with respect to mortgage priority issues and clouds real property records (and, as mentioned earlier, creates headaches for title insurers). Most real estate practitioners and title

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knew his trust deed would be junior to the . . . [sellers'] trust deed unless . . . [the sellers] agreed to-as well as executed and recorded an agreement to subordinate his trust deed to . . . [the lender's] trust deed." *Id.* at 549.

[121] *See generally* David H. Cox and Vernon W. Johnson III, *State Equity Doctrine Helps Title Insurers*, NAT'L L.J., Feb. 7, 2000, at B17; Matthew Lilly, *Subrogation of Mortgages in California: A Comparison with the Restatement and Proposals for Change*, 48 UCLA L. REV. 1633, 1654, 1667 (2001) (stating that "The California rule is that if a payor satisfies an obligation at the request of a debtor, and the payor is expected to hold a senior lien on the property, then the payor is entitled to be subrogated to the paid-off mortgagee so long as he did not have actual notice of any intervening liens, and so long as subrogation will not result in injustice to third parties," and arguing that"[t]he Restatement rule . . . differs from California's in several respects and should be partially adopted").

insurers would prefer real-property priority and recording rules that are clear and consistent. The only certainty at present may be that there still is uncertainty as to how state courts, and bankruptcy and other federal courts construing applicable state law,[122] will rule on this issue.

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[122] With respect to recent bankruptcy court rulings on the doctrine of equitable subrogation, see Gordon v. Navastar Mortgage, Inc. (*In re* Hedrick), 524 F.3d 1175, 1182–91 (11th Cir. 2008) (ruling that a lender who refinanced debtors' first mortgage outside the ninety-day preference period (as provided under section 547 of Bankruptcy Code) but recorded its security interest within that ninety-day period, while prior mortgage was still of record, was entitled to rely on doctrine of equitable subrogation so that perfection of its security interest occurred outside the ninety-day preference period; that continued existence of senior lien of record would have put any hypothetical subsequent purchaser on notice; declining to equate "contemporaneous exchange" with the time limits set forth in section 547(e)(2)(A) of Bankruptcy Code finding that "substantially contemporaneous" defense, under section 547(c)(1) of Bankruptcy Code, requires consideration of circumstances surrounding delayed perfection); *In re* Bill Heard Enters., 420 B.R. 553, 564–65 (Bankr. N.D. Ala. 2009) (holding that under Texas law: (1) bona fide purchaser without notice prevails over holder of prior equitable interest; (2) party claiming equitable subrogation was negligent "in failing to ensure that its mortgage interest had been properly perfected;" (3) because deed transferring ownership interest to property was not recorded it was not deemed to have put mortgagee on "constructive notice" of any document outside its own chain of title; (4) party that qualifies as hypothetical bona fide purchaser under section 544(a)(3) of the Bankruptcy Code prevails over alleged contractual subrogation interest); First Am. Title Ins. Co. v. Stevenson (*In re* Stevenson), No. 06-00306, 2008 WL 748927, at *7–9, 11 (Bankr. D.C. Mar. 17, 2008) (citing with approval the court's decision in *Prestance*, 106 P.3d 17 (Wash. 2007) and stating: "On balance, if the objective is accomplishing equity and not preventing the application of subrogation based on technicalities, the Restatement approach appears better suited to the task."); *In re* Berg, 387 B.R. 524, 555-56 (Bankr. N.D. Ill. 2008) (ruling that bankruptcy trustee, as bona fide purchaser without notice, prevails over mortgagee's contractual subrogation rights); Deuel v. Taxel (*In re* Deuel), 594 F.3d 1073, 1079–80 (9th Cir. 2010), at *4 (holding that, based on bankruptcy trustee's strong arm avoiding power under section 544(a) of the Bankruptcy Code, a trustee, as bona fide purchaser for value without notice, can avoid refinancing mortgage that was unrecorded even though deed of reconveyance from previous loan was paid in full). The court rejected the refinancing lender's argument that the lender was entitled to equitable subrogation, ruling that the doctrine did not apply in this case because of the following:

> [F]irst, the creditor whose debt it paid off, itself has no lien, having discharged it by a recorded deed of reconveyance. . . . Second . . . [e]quitable subrogation cannot operate here, because . . . [a] bona fide purchaser for value of the [subject property] would learn from a title search that [the refinancing lender] had discharged its lien, not that it still had one. . . . Third, California courts give priority to a bona fide purchaser over one claiming equitable subrogation.

*Id.* at *4. *See generally* Nancy C. Dreher, *Eleventh Circuit Rules That a Lender Who Refinances Debtors' First Mortgage Outside the 90-day Preference Period but Records Its*

*Security Interest within That 90 Days Is Entitled to Rely on the Doctrine of Equitable Subrogation to Place Perfection of Its Security Interest Outside the 90-day Preference Period and Further Declines to Equate Contemporaneous Exchange With the Time Limits Set Forth in § 547(e)(2)(A)*, 2008 BANKR. SERVICE CURRENT AWARENESS ALERT 5, June 2008, *available at* Westlaw Database BSV-BCA as 2008, No. 6 BSV-BCA 5; Dan Schechter, *Belated Recording of Refinancing Mortgage Is Not Preferential Because Lien Relates Back to Prior Mortgage Due to Equitable Subrogation; "Substantially Contemporaneous" Defense Requires Consideration of Circumstances Surrounding Delayed Perfection* [*In re Hedrick (11th Cir.).*], 2008 COM. FIN. NEWSL. 38, May 5, 2008, *available at* Westlaw Database COMFINNL (arguing that "the refinancing lender's interest was always 'perfected' for purposes of § 547 [of the Bankruptcy Code], and there was no preference at all (since there was no transfer on account of an antecedent debt)," and stating that "[w]ith reference to the equitable subrogation portion of this opinion, I think that this is a case of 'right result, wrong reason'"); Dan Schechter, *Trustee's Status as Bona Fide Purchaser Defeats Co-Obligor's Claim of Equitable Subrogation [In re Flamingo 55, Inc. (Bankr. D. Nev.).]*, 2007 COM. FIN. NEWSL. 95, Dec. 10, 2007, *available at* Westlaw Database COMMFINNL (discussing Nevada bankruptcy case, *In re* Flamingo 55, Inc., 378 B.R. 893 (Bankr. D. Nev. 2007), which held that when co-obligor asserts lien against bankrupt's real property by invoking doctrine of equitable subrogation, doctrine is not available and cannot prevail over trustee's status as hypothetical subsequent bona fide purchaser).