NO. 71544-5-1

COURT OF APPEALS, DIVISION I
OF THE STATE OF WASHINGTON

BEL AIR & BRINEY, A General Partnership; NICK BRINEY, A Single Man; and ROGER BELAIR, A Married Man,

Appellants,

and

CITY OF KENT,

Respondent.

APPEAL FROM THE SUPERIOR COURT
FOR KING COUNTY
THE HONORABLE ANDREA DARVAS

BRIEF OF APPELLANTS

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I. INTRODUCTION

Equitable subrogation typically comes into play when a third party pays a debtor's outstanding debt to his lender without any formal agreement between the third party and the debtor. That third party will be equitably subrogated to the lender's interest if and to the extent that the debtor would otherwise be unjustly enriched.

Here, Appellants Bel Air & Briney were owed $134,000, secured by a second deed of trust encumbering the debtor's real property. Respondent City of Kent ("City") purchased that property for $392,000, of which approximately $197,000 was used to satisfy the first deed of trust. The escrow company involved in the transaction disbursed the remainder to the owner, including the $134,000 that should have been distributed to Bel Air & Briney, due to the City's title insurer's failure to detect Bel Air & Briney's deed of trust.

The Trial Court erred when it granted the City's Motion for Summary Judgment and denied Bel Air & Briney's Motion for Summary Judgment, because the latter were not unjustly enriched by the City's purchase payment, did not receive a windfall, were materially prejudiced by the grant, and the City would be compensated by its title insurer for any damage it might have

suffered by the denial of its application for equitable subrogation.

II. ASSIGNMENT OF ERROR

1. The trial court erred in granting the Respondent's Motion for Summary Judgment and denying the Appellants' Motion for Summary Judgment. The Respondent was not entitled to the application of equitable subrogation because the Appellants were not unjustly enriched by the Respondent's payment of the senior secured debt, were materially prejudiced by granting equitable subrogation, and any damage suffered by the Respondent from such a ruling would be paid by its title insurer, whose error caused the problem in the first place.

III. ISSUES REGARDING THE ASSIGNMENTS OF ERROR

A. Was it not error for the Trial Court to grant the remedy of equitable subrogation to the City of Kent when Bel Air & Briney was materially prejudiced as a result?

B. Was it not error for the Trial Court to refuse to consider that the City of Kent was likely to be compensated by its title insurer for damages it would have suffered had its claim for equitable subrogation been denied?

IV. STATEMENT OF THE CASE

A. Bel Air & Briney Were the Holders of a Second Deed of Trust Against the Tran Property.

Bel Air & Briney ("B&B") is a general partnership between Roger L. Bel Air and Nick Briney ("Briney"). (CP 98) Mr. Briney worked for SeaFirst Bank (later acquired by Bank of America) for 20 years, becoming a Vice President of Operations and Personnel. (CP 98-99) He met Mr. Bel Air when they both worked for SeaFirst and formed B&B over 35 years ago, initially fixing up and selling real estate, then purchasing discounted contracts, and ultimately making direct loans. (CP 99)

Hiep Nguyen, Hoang Tran, and Dun Tram ("Tran") gave a promissory note ("the Promissory Note") to B&B dated June 13, 2007, in the principal amount of $134,000. (CP 99) The Promissory Note matured on December 13, 2007, with monthly interest-only payments due beginning July 13, 2007. (CP 99)

Tran made each of the five monthly payments on the Promissory Note between July and November 2007. (CP 99) Rather than pay the $134,000 due B&B in December 2007, Tran obtained B&B's consent to extend the balloon payment deadline for another six months to June 13, 2008, in return for which the

principal amount of the Promissory Note was increased by $9,500 to $143,500 and the monthly payments to $1,435. (CP 99)

The Promissory Note was secured by a deed of trust dated June 13, 2007 ("the B&B Deed of Trust"), which encumbered four properties, identified in the B&B Deed of Trust and here as Parcels A through D. (CP 99) Parcel C, which was the subject of the lawsuit involved in this appeal, is located in Kent, Washington. (CP 99)

When B&B accepted the Promissory Note and Deed of Trust, it knew that each of the four parcels encumbered by its Deed of Trust was already serving as collateral for one or more loans as of June 2007 and, consequently, the Deed of Trust would be in a junior position on each parcel. (CP 99) It was in second position in parcels A (behind a deed of trust securing a $550,000 debt) and C (behind a $189,000 deed of trust in favor of MortgageIt, Inc.), and in third position in parcels B (behind a total of $241,500) and D (behind a total of about $260,000 in secured debt). (CP 99)

Like so many other Americans in the mid-2000's, Tran had purchased these properties and used their increasing valuations as collateral to borrow more money to buy more property, assuming the parcels' values would continue to go up. (CP 100)

The City of Kent decided to develop an Aquatic Center on the block where Parcel C is located and began the process of acquiring the properties necessary to do so in 2006. (CP 100)

During negotiations with Tran, the City of Kent received a preliminary commitment for title insurance from Pacific Northwest Title Company of Washington, Inc. ("PNWT"), dated March 14, 2007. (CP 100) The preliminary commitment offered a title policy that would include a special exception for the first deed of trust to MortgageIt. (CP 100) It did not include, and could not have included, an exception for the B&B Deed of Trust because that instrument was not recorded until June 15, 2007, three months after the Preliminary Commitment was issued. (CP 100)

B. Parcel C Was Sold to the City of Kent for $392,500. The First Deed of Trust was Paid Off At Closing But the $143,000 From the Remainder That Was Supposed to be Paid to Bel Air & Briney to Satisfy its Deed of Trust Instead Went to the Owner Due to the City's Title Insurer's Error.

The sale of Parcel C closed on January 31, 2008 with the cash payment of $392,500 from the City of Kent to Tran through the PNWT escrow department. (CP 100) MortgageIt received $196,894.17 from the sales proceeds in satisfaction of its outstanding loan and reconveyed its deed of trust. (CP 100)

As of January 31, 2008, the amount owing to B&B under the Promissory Note and secured by the B&B Deed of Trust was $143,305.42. (CP 100) After the MortgageIt loan and closing costs were paid, Tran received $168,499.50 at closing, and another $25,000 later after release of a holdback, for a total of $193,499.50. (CP 100) Had B&B's debt been paid at closing, Tran would have still received approximately $50,000 in net sale proceeds. (CP 100) However, B&B received no funds: the entire $143,305 that was supposed to have been paid to B&B was instead disbursed to Tran. (CP 100)

B&B received no money from the closing because PNWT apparently did not discover and thus did not disclose to the escrow agent the existence of the B&B Deed of Trust. (CP 101) Consequently, the PNWT escrow agent was unaware of the existence of the Tran debt to B&B and did not disburse any of the sales proceeds to them. (CP 101) The title insurance policy PNWT issued to the City of Kent dated January 31, 2008 does not contain any exception for the B&B Deed of Trust. (CP 101)

C. Tran Defaulted on the Promissory Note to Bel Air & Briney Shortly After He Pocketed Their Money from the Sale, and Bel Air & Briney Soon Had No Collateral From Which to Collect Any of the Money It was Owed by Tran.

Tran never informed B&B of the Parcel C sale, let alone that he had pocketed $194,000, $143,300 of which should have gone to B&B in return for the reconveyance of its Deed of Trust. (CP 101) B&B was not aware of the sale of Parcel C until July of 2012, over four and one-half years later. (CP 101)

Following the December 2007 extension agreement of the Promissory Note, Tran made the next six monthly payments to B&B on time. (CP 101)

In June 2008 Tran asked for and obtained another six month extension to December 2008, in return for which the principal balance of the Promissory Note was increased by $10,000 to $153,500, and the monthly payment was increased to $1,535. (CP 101)

Tran made one additional payment -- $1,535 in July 2008 -- and one, final one in October 2008 for $1,835, following Mr. Briney's requests for payment, but B&B never received any more money from Tran despite Briney's attempts to contact him. (CP 101)

Because of the suddenly declining values of real property in the Seattle area and all over the country beginning in late 2008, the equity in the other three parcels securing the Promissory Note vaporized, and Tran defaulted on his debts on the other three parcels. (CP 101-102)

D. In 2012 Bel Air & Briney Discovered the 2008 Sale and the Error Made By Kent's Title Insurer, and Litigation Ensued.

In early July 2012 after Mr. Briney was contacted by the real estate agent regarding Parcel B, he again tried to contact Tran, initially unsuccessfully. (CP 102) He then reviewed the King County recorded documents website to attempt to see what, if anything, was going on with Parcel C. (CP 102) He discovered, to his astonishment, that on January 31, 2008 Tran had sold the parcel to the City of Kent for $392,500. (CP 102) Mr. Briney knew that the B&B deed of trust was in second position, behind a first deed of trust for $189,500 (as of November 2005, when it was recorded). (CP 102)

Mr. Briney located Hoang and Tram and met with them on July 14, 2012, becoming convinced that they had no money to pay B&B. (CP 102) Following that conversation Mr. Briney contacted the City of Kent and had numerous discussions with

representatives of both the City and PNWT, which he learned had issued the title insurance policy regarding the Tran transaction. (CP 102) The contact from Mr. Briney was the first time the City of Kent had actual knowledge of the Deed of Trust. (CP 102)

The City of Kent gave notice under its title policy of B&B's claim. (CP 103) First American Title Insurance Company, as successor to PNWT, has acknowledged the claim and is providing the defense on behalf of the City of Kent, including paying the City of Kent's costs incurred in connection with this litigation. (CP 103)

The City of Kent obtained an appraisal of Parcel C indicating that its as-is fair market value on October 30, 2012 was $110,000. (CP 103)

E. The Trial Court Granted the City of Kent's Motion for Summary Judgment Awarding It a Lien Senior to the Bel Air & Briney Deed of Trust in the Amount of $196,894.17, and Denied the City's Right to Foreclose on It.

After agreeing on a stipulated set of facts (CP 65-97), both parties filed Motions for Summary Judgment. (CP 15-64 and 151-165 for Respondent; CP 98-116, 117-150, and 166-220 for the Appellants) On January 21, 2014 the Trial Court entered its Order on Cross Motions for Summary Judgment, granting the Respondent's and denying the Appellants' Motions (CP 221-226).

The Appellants filed a Motion for Reconsideration of Order (CP 235-242), which was denied on April 9, 2014 (CP 282-284). At the same time, the Trial Court entered a Judgment in favor of the Respondent (CP 285-288), although it had never been presented to the Court (CP 295-302). The Judgment not only ordered that the Appellants' deed of trust "is subordinate to City of Kent's lien on the Property" but that the Respondent's lien be sold by the King County Sheriff "in the manner provided by law for foreclosures and in accordance with the practice of this Court", that the Respondent "may credit-bid at such Sheriff's Sale up to a maximum of $196,894.17", and that the first $196,894.17 from the proceeds from said sale after deducting costs of sale would be paid to the Respondent. (CP 286-287)

The Appellants filed a Motion for Reconsideration of Judgment contending that there was no legal basis for the foreclosing of the Respondent's equitable lien. (CP 289-294) The Trial Court agreed that "[t]here is no apparent legal authority for the City to foreclose on its equitable subrogation", and granted the Appellants' second Motion for Reconsideration. (CP 346-348) The Respondents have filed a Motion for Reconsideration of that Order. (CP 349-361)

V. ARGUMENT

A. Standard Of Review And Burden Of Proof: This Court Reviews the Order Granting Respondent's Motion For Summary Judgment De Novo.

CR 56(c) sets forth the conditions for granting a summary judgment motion: "[T]he judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law."

A material fact is a fact upon which the outcome of the litigation depends, in whole or in part. The burden is on the moving party to demonstrate there is no genuine dispute as to any material fact, and all reasonable inferences from the evidence must be resolved against the movant. *Morris v. McNicol*, 83 Wn.2d 491, 494, 519 P.2d 7 (1974). Here, the parties agree there are no disputed material facts: which party is to prevail is solely a matter of law.

Of course, this Court reviews de novo the summary judgment order. *Estate of Bracken*, 175 Wn.2d 549, 562, 290 3d 99 (2012).

B. Equitable Subrogation is Appropriate Where it Would Avoid the Unjust Enrichment of a Junior Lien Holder.

As the Washington Supreme Court recently stated in *Columbia Community Bank v. Newman Park, LLC*, 177 Wn.2d 566, 573-574, 304 P.3d 472 (2013):

> Equitable subrogation allows one party to step into the shoes of a second party who is owed a debt or obligation and to receive the benefit of that debt or obligation, in the absence of any contractual agreement or assignment of rights between those two parties or the debtor. Subrogation is permitted without assignment in order to prevent unjust enrichment. Unjust enrichment is an equitable doctrine; thus this sort of subrogation is called equitable subrogation.
>
> In its simplest form equitable subrogation comes into play when a third party pays a debtor's outstanding debt to his lender without any formal agreement between the parties. Under certain circumstances, equity would permit that third party to take over the lender's interest and receive the continuing payments from the debtor. In other words, the third party would be subrogated to the lender's interest to avoid a windfall to the debtor, who would otherwise be unjustly enriched.

As a general rule, a mortgage (which is now almost always in the form of a deed of trust in non-agricultural Western

Washington but the generic term "mortgage" will be used throughout this brief) must be recorded against the real property it encumbers to secure the debt in order to be enforceable. In *Bank of America, N.A. v. Prestance Corp.*, 160 Wn.2d 560, 564-565,160 P.3d 17 (2007), the Washington State Supreme Court explained the interplay between the state statutory scheme for the recording of mortgages and equitable subrogation, especially as it involves refinancing:

> For example, suppose A, a homeowner, has two mortgages: one recorded first by bank *B* and one recorded second by bank *C*. Our recording act says *B* has a higher priority because it recorded first, putting the world on notice as to its interest in *A's* land. RCW 65.08.070. If *D* fully discharges [first deed of trust holder] *B*'s debt, then equitable subrogation substitutes *D* for *B*, so *D* has a higher priority than [second deed of trust holder] *C*, even though *D* recorded after. See *Jackson Co. v. Boylston Mut. Ins. Co.*, 139 Mass. 508, 510, 2 N.E. 103, 104 (1885). At first blush, equitable subrogation conflicts with the recording act because it is an exception to the general rule "first in time, first in right." But no new lien or interest is created: *D* simply takes over *B*'s interest and that interest came first in time. *C* never expected his priority to be promoted simply because *A* refinanced the mortgage with a new

> company. *C* bargained with *A* to have a second-priority mortgage; it is immaterial who has priority before *C*. See RESTATEMENT (THIRD) §7.6 cmt. A, at 510.

In Washington, mortgage priority is important. If the holder of the first mortgage forecloses, "the second-priority mortgagee knows he can recover any surplus remaining only after the first-priority mortgagee has been fully satisfied." *Id.* at p. 565, fn. 4 If a foreclosure sale is conducted regarding the first mortgage, all junior mortgages and other liens are erased from the encumbered property and the second mortgagee receives only the sale proceeds remaining, if any, after the first mortgage and expenses pertaining to the foreclosure are paid in full. RCW 61.24.080

The Supreme Court noted in *Prestance* that "[d]espite an initial resistance to equitable subrogation, many courts now apply it liberally". *Id.*, page 565 It cited with approval Restatement (Third) of Property: Mortgages ¶7.6 (1997), which encourages that more liberal approach,

> (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.

(b) By way of illustration***, subrogation is appropriate to prevent unjust enrichment*** if the person seeking subrogation performs the obligation

(1) in order to protect his or her interest;
(2) under a legal duty to do so;
(3) on account of misrepresentation, mistake, duress, undue influence, deceit, or other similar imposition; or
(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.*** *Id.*, page 580 (emphasis added)

In *Prestance,* the Court discussed the windfall usually reaped by a second lienholder when the first lienholder's debt is satisfied, enabling the second lienholder to move up the priority ladder. Because of the risks of foreclosure of the first-priority mortgagee, ". . . second – priority mortgages often include terms to help alleviate this risk, such as higher interest rates. It is unfair then to allow a second-priority mortgagee to take a first-priority but still enforce the previously bargained-for terms. He gains the security of a first-priority loan, while keeping the favorable conditions of a second-priority loan." *Id.*, p. 565, fn. 4

Nevertheless, the Supreme Court in *Prestance* emphasized the importance of protecting the junior lienholder if it would be harmed by the proposed subrogation instead of receiving an unearned windfall. "Equitable subrogation ***should never be allowed*** if a junior interest is materially prejudiced, but if the junior interests are unaffected, then there is no reason to deny it." *Id.*, page 572 "Equitable doctrine is a broad doctrine and should be followed whenever justice demands it ***and where there is no material prejudice to junior interest**." Id., page 581* (emphasis added in both)

In *Prestance* Washington Mutual had the first mortgage and

Bank of America's mortgage was in second position. The property owner applied to Wells Fargo Bank for a loan, a portion of which was to pay off Washington Mutual's debt. Wells Fargo was aware of Bank of America's second mortgage because it was disclosed on the preliminary title commitment issued by a title insurance company. Wells Fargo nevertheless made the loan to the property owner, expecting the proceeds to pay off both debts, thus establishing its mortgage in first position. Washington Mutual's mortgage was paid off and removed from the title but Bank of America's debt was not paid. Consequently its mortgage advanced to the first position.

Wells Fargo sued to equitably subrogate its mortgage ahead of Bank of America's mortgage. Bank of America contended that Wells Fargo's mortgage should not step into first position because it was aware of Bank of America's junior deed of trust when it made the loan. The Supreme Court disagreed and granted equitable subrogation, since "Bank of America offers no principled reason why it should receive an unearned windfall at [Wells Fargo's] expense. . ." *Id.*, page 582

The Supreme Court returned to equitable subrogation last summer in *Newman Park, supra*. Newman Park, LLC owned real

estate that was encumbered by a first mortgage in favor of Hometown National Bank ("Hometown") in the amount of $400,000. One of Newman Park's principals borrowed $1.5 million from Columbia Community Bank ("Columbia Community"), $400,000 of which was used to pay off the Hometown debt, so Columbia Community's mortgage securing the $1.5 million loan was in first position. Columbia Community was unaware that the borrower did not have the authority to use Newman Park's property as collateral (he presented the bank with forged documents ostensibly demonstrating that authority). When the borrower defaulted on the loan, Newman Park sued to invalidate Columbia Community's mortgage.

Columbia Community contended that its mortgage was valid or, alternatively, it should at least be awarded an equitable lien against the Newman Park property in the amount – $400,000 – that it paid Hometown since (1) Newman Park received that benefit by having its debt to Hometown paid by Columbia Community; and (2) Columbia Community was defrauded into making the loan by one of Newman Park's principals. The Supreme Court agreed with Newman Park that the mortgage was invalid but granted Columbia Community a $400,000 equitable lien to prohibit Newman Park's

windfall.

In so doing the Supreme Court applied, and extended, its discussion of equitable subrogation in *Prestance*, stating "We now explicitly adopt *Restatement (Third)* ¶7.6 in full".

The current status of the law of equitable subrogation in the state of Washington, therefore, appears to be that any lender who pays money that is used to satisfy a mortgage under the reasonable belief that it has acquired a mortgage having the same priority as the interest it satisfied is entitled to step into the shoes of that mortgagee, as long as by doing so no junior lien holder is materially prejudiced and "equity demands it".

Appellants also agree that the liberal application of equitable subrogation in the state of Washington applies to owners -- although not yet to purchasers -- of property. *See, for example, Coy v. Raabe*, 69 Wn.2d 346, 418 P.2d 728 (1966) and *Olson v. Chapman*, 4 Wn.2d 522, 104 P.2d 344 (1940).

C. Equitable Subrogation Must, However, Be Denied Where It Would Materially Prejudice the Interests of a Junior Lien Holder.

The two basis tenets of the law of equitable subrogation established and applied by the Washington State Supreme Court in *Prestance* are:

“The doctrine of equitable subrogation is an equitable one, having for its basis of complete and perfect justice between the parties without regard to form, and its purpose and object is the prevention of injustice . . . " *Prestance* at 565-566 (quoting an Arkansas case); and

"Equitable subrogation should never be allowed if a junior interest is materially prejudiced, but if the junior interests are unaffected, then there is no reason to deny it." *Id.* at 572

The law in the state of Washington is therefore quite simple: if the application of equitable subrogation would materially prejudice the junior lien holder it will be denied, and it must be granted if that junior lien holder would otherwise receive an undeserved windfall. If the facts of a particular case do not dictate a clear answer one way or the other, the court should grant the relief that is most equitable to both parties.

In every published opinion in the state of Washington where equitable subrogation was granted, the junior lien holder would have received an unearned windfall and the plaintiff would have been unfairly damaged had the request been denied.

In *Prestance* the Supreme Court upheld the trial court's conclusion that Wells Fargo (the refinancing lender) should be

equitably subrogated to the first lien position in the amount of the $499,477 it paid to satisfy that debt, which would leave Bank of America (the junior lienholder) "in no worse position than it would have been [in] had [Wells Fargo] never made its . . . loan." *Prestance* at 563

In *Newman Park,* the Newman Park, LLC property was encumbered by a deed of trust secured by a $400,000 deed of trust. Columbia Community Bank lent one of the LLC's principals $1.5 million, $400,000 of which was used to paid off the deed of trust. The loan was fraudulently obtained, so Columbia Community Bank lost its secured interest in the property owned by Newman Park, LLC which, incredibly, opposed the Bank's request that it at least get credit for its $400,000 payment of the LLC's debt by being in first lien position. It would have been an outrage had equitable subrogation been denied.

In *Coy v. Raabe*, *supra,* at 69 Wn.2d 346 (1966), the owner leased property to Coy who had an option to buy it. The owner instead sold the property to Raabe, who as part of the purchase satisfied an IRS lien owed by the owner that encumbered the property. Coy successfully sued to enforce his option to purchase, but Raabe was appropriately equitably subrogated to the IRS lien

he paid off for the benefit of the owner.

In *Olson v. Chapman*, *supra,* at 4 Wn.2d 522 (1940), a one-third co-tenant of the property (and his estate after he died) paid all of the real property taxes for 14 years. The Supreme Court had no difficulty foreclosing a lien for the two-thirds share of the taxes he paid that were owed him by the co-tenants.

It makes perfect sense for equitable subrogation to be awarded in each of those cases.

Conversely, the Washington Supreme Court has provided an example of a replacement loan whose terms materially prejudiced the junior lien holder. In *Kim v. Lee,* 145 Wn.2d 79, 31 P.3d 665 (2001), in 1995 the Changs purchased a home for their daughter and son-in-law (the Lees) for $165,000, $130,000 of which was financed by a loan from Sterling Trust Company secured by a deed of trust. The loan terms included a 10.5% interest rate and a six year balloon payment.

In 1998 the Changs quit claimed their interest in the house to the Lees, who borrowed money from Pioneer Bank -- with a 6.75% interest rate, maturing in 30 years -- to pay off the loan from Sterling. Yakima Title issued a title insurance policy insuring Pioneer Bank's deed of trust in first position, failing to discover or

disclose that in 1997 -- after the Changs' purchase and before the Pioneer Bank loan -- Mr. Kim obtained a judgment against the Lees for over $83,000.

Kim attempted to execute on his judgment, claiming that it was in first position since Sterling's deed of trust had been paid in full. The Supreme Court held in favor of Kim over Yakima Title, which had accepted a tender of the defense of Pioneer Bank's lien position, holding that "legal remedies and equity suggest that the loss should fall on the title company rather than the innocent judgment creditor." *Id.* at 91

Kim is highly relevant to this case for two reasons. First, it supports Bel Air & Briney's contention that PNWT, not Bel Air & Briney, should bear the damages caused by its negligence. Second, the Supreme Court held that because the Lees' obligation to repay the Sterling note in six years was replaced by the 30 year maturity date of the Pioneer note, junior lien holder Kim was materially prejudiced because the later loan amortized much more slowly and 24 years longer than the one it replaced. *Id.* at 90

As an equitable remedy, equitable subrogation is "founded in the facts and circumstances of each particular case. *Credit Bureau Corp. v. Beckstead,* 63 Wash.2d 183, 186, 385 P.2d 864 (1963)."

Newman Park, at 581 The facts and circumstances of this particular case compel the reversal of the grant of the City of Kent's request for equitable subrogation, since junior lien holder Bel Air & Briney did not receive a windfall from the City's purchase of Parcel C and would be materially prejudiced if the request were granted; and the City will be otherwise fully compensated for its loss through its title insurance policy.

D. The Trial Court Erred In Concluding that the City of Kent was Entitled to the Equitable Subrogation of a Lien Senior to Bel Air & Briney's Junior Deed of Trust.

1. Bel Air & Briney Did Not Receive a Windfall From the City's Purchase of the Tran Property.

Here, Bel Air & Briney had a second deed of trust in Parcel C which moved into first position because the purchase price paid by Kent included the full satisfaction of the debt secured by the first deed of trust. At first blush it would thus appear that Bel Air & Briney received an undeserved windfall because when the sale was completed its $143,000 debt became secured by a first, not a second, deed of trust with collateral worth $392,500, the amount the City of Kent paid for Parcel C.

That would have been true except that, unlike all of the aforementioned cases in which equitable subrogation has been

granted in the state of Washington, Bel Air & Briney's debt would have been paid in full but for the mistake made by the City's title insurer. All of the net proceeds instead went to the sellers who shortly thereafter stopped paying their debt to Bel Air & Briney. To make matters much worse, long before Bel Air & Briney discovered what happened four years later, the $392,500 collateral had diminished to $110,000 through no fault of their own.

The facts in this case are startlingly similar to those in *Centreville Car Care, Inc. v. North American Mortgage Co.*, 262 Va. 339, 559 S.E. 2d 870 (2002) and *William B. Gregory et al. v. Revenue Service*, 2012 WL 5426533 (W. D. Va.), which denied the application of equitable subrogation.

In *Centreville,* Lynch owned property secured by a $195,000 first deed of trust to Fleet Mortgage and a $150,000 second deed of trust to B & B Car Care which later became Centreville Car Care ("Centreville").

Lynch later sold the property to buyers for $210,000, who borrowed $208,250 from North American Mortgage ("North American") to be secured by a first mortgage. From the purchase price Fleet Mortgage received about $190,000 in full satisfaction of its first mortgage and the remaining $4,000 was paid to Lynch, the

seller, just as Tran received the remainder of the sale proceeds. The title insurer had failed to discover and disclose the mortgage in favor of Centreville, just as PNWT had missed the Bel Air & Briney mortgage when the City of Kent bought the property from Tran. *Id.*, page 344

When the buyer stopped paying North American, the bank began foreclosure proceedings and sued the buyer and Centreville, claiming that its mortgage should be equitably subrogated to the Centreville mortgage in the amount of the $190,000 it paid to satisfy the Fleet Mortgage debt, just as the City of Kent is requesting here. The trial court agreed with North American because Centreville "remains in the same position that it has knowingly been in since it made its loan". *Id.*, page 344

The Virginia Supreme Court reversed and dismissed North American's claim for equitable subrogation for several reasons, all of which apply to the instant case:

Centerville had the right to anticipate its secured interest would be improved and/or paid. The Virginia Supreme Court held that although the Centerville second mortgage was initially under-secured:

> Centreville had the right to anticipate that the obligors would ultimately satisfy these loans to extinguish the liens upon their interests in the property. Centreville also had the right to anticipate that when Fleet Mortgage's lien was extinguished Centreville's lien would advance to the position of priority of a first lien on the property. ***Morever, under the events that actually occurred, Centreville was entitled to receive the balance of funds from North American Mortgage's loan to the [buyers] that was paid to [the seller] after the promissory note was held by Fleet Mortgage was satisfied from those funds. To this extent, Centreville was prejudiced.*** *Id.*, pp. 346-347 (emphasis added)

Centreville would get virtually nothing if equitable subrogation were ordered. The Virginia Supreme Court noted that the obligors on the note to Centreville (Lynch, who sold to the buyers) no longer had an interest in the property and thus had no incentive to continue paying that debt, and the current owners had defaulted on their debt to North American. The Court found that if North American were allowed to take first position ahead of Centreville, the latter would likely recover little or nothing in a foreclosure, obviously prejudicing it. *Id.*, page 347

There is no windfall for Centreville, especially compared

to the windfall received by the negligent title insurer if North American prevailed. The Court held that

> . . . any windfall Centreville may have obtained from its deed of trust advancing to first position would inure to the benefit of the negligent title examiner and the party that insured title for North American Mortgage and the [buyers]. While [they] have recourse against those parties for the loss in this case, Centreville has no such recourse. Thus, the equities in this case favor Centreville, the innocent party who would be prejudiced if subrogation were granted. *Id.*, page 348

Replace "Lynch" with Tran, "Centreville" with Bel Air & Briney and "North American" with the City of Kent and *Centreville* is on all fours with this case, except that here the seller received all $143,300, not a mere $4,000, that was supposed to be paid to the junior lien holder.

Centreville involved a request for equitable subrogation by a lender. In *Gregory*, its successor, it was the property owner who asked for the relief.

In *Gregory*, the Watsons' property was encumbered by a first mortgage to Highlands Union Bank ("Highlands") and a junior IRS tax lien of around $200,000 against Mr. Watson's one-half interest in the property. The Watsons later sold the property to the

Gregorys for $225,000, $105,000 of which went to Highlands to pay off its first mortgage. The rest went to the Watsons, because the IRS lien was missed by the title insurer. To finance the purchase the Gregorys borrowed $92,000 from TriSummit Bank, secured by a mortgage.

The Gregorys entered into a contract to sell the property for $380,000. The IRS insisted on receiving one-half of that amount, as its lien encumbered a one-half interest in the property and its lien was now in first position. The Gregorys claimed they should be equitably subrogated to all but $60,000 of the IRS lien, the amount the IRS would have received from the Watsons' earlier sale. The Gregorys completed the sale and posted a $190,000 bond to address the IRS' lien claim.

The Court rejected the Gregorys' complaint for equitable subrogation, applying *Centreville* to find that "[t]he facts of this case are far different from the situations in which this equitable doctrine has been applied" in at least four ways:

The Highlands mortgage "was not paid in order that the Gregorys be substituted as lien creditors; it was paid as a condition of the sale . . . Similarly, it is not TriSummit Bank that is seeking subrogation in this case; it has been paid out of the proceeds of the

Gregorys' sale of the property." *Id.*, page 348

As in *Centreville*, "when the IRS filed its notice of federal tax lien, it was second in priority to the existing mortgage, but had the right to expect to advance in priority as the more senior lien was extinguished." *Id.*, page 348

As in *Centreville,* "the IRS was prejudiced when the balance of the purchasing funds that remained after paying the first mortgage was paid to [the seller] rather than to the IRS." *Id.*, page 348

As in *Centreville,* granting relief "would allow a simple claim of mistake, where there were no other equitable considerations, to endanger the position of junior lienors." *Id.*, page 348

As in *Gregory*, the MortgageIt debt was not paid in order that the City of Kent be substituted as lien creditors; it was paid as a condition of the sale. As in *Gregory*, when Bel Air & Briney filed its mortgage, it was second in priority to the existing mortgage to MortgageIt but had the right to expect to advance in priority as the more senior lien was extinguished. As in *Gregory*, Bel Air & Briney was prejudiced when the balance of the purchasing funds that remained after paying the first mortgage was paid to the seller instead of them. In fact, the entirety of the Bel Air & Briney debt

was to be paid from the purchasing funds. And, as in *Gregory*, granting relief to the City of Kent would allow a simple claim of mistake, where there were no other equitable considerations, to endanger the position of a junior lienor.

The facts in this case are similar to those in *Kim, Centreville,* and *Gregory*, instead of those in *Prestance* and *Newman Park*.

2. Bel Air & Briney Was Materially Prejudiced by the Satisfaction of the Senior Deed of Trust.

On the day of the sale, January 31, 2008, Parcel C was worth what it sold for: $392,500. It was encumbered by two mortgages securing about $340,000 in debt: $197,000 to MortgageIt and $143,000 to Bel Air & Briney. After payment of those debts and $2,000 in closing costs, about $50,000 would have been disbursed to Tran.

Bel Air & Briney had lent Tran $134,000 seven months earlier, to be paid in full in December 2007. Tran made each of his six monthly payments, but in mid-December 2007 he asked for, and received, Bel Air & Briney's consent to extend the deadline for an additional six months.

Tran then made the monthly payments for December 2007 and January 2008. He was current on his payments through the

day the sale closed, January 31, 2008, for good reason: he did not want to default and potentially jeopardize his claim for the $50,000 he was going to receive from the sale.

Once the sale closed Tran was supposed to no longer be obligated to Bel Air & Briney because that debt would have been paid in full. Instead, Tran still owed Bel Air & Briney $143,000. However, his motivation to continue making monthly payments on that debt had vanished, because (1) the debt was no longer secured by Tran's equity in Parcel C, which had been converted into $50,000 cash in his pocket; (2) the three other parcels secured by that debt were encumbered by a total of seven other mortgages securing debt of over $850,000 ahead of the Bel Air & Briney mortgage; and (3) due to PNWT's negligence Tran had received the $143,000 that was supposed to go to Bel Air & Briney.

Tran stopped payments after July 2008, made one last one in October 2008 in response to Mr. Briney's pressure, but then stopped completely, as his other properties slipped into foreclosure and the entire $143,000 disappeared.

The likelihood that Bel Air & Briney would ever get the $143,000 they were owed by Tran was not only reduced, it disappeared, on January 31, 2008, the day Tran received the

$143,000 that was supposed to be paid to Bel Air & Briney. They were far more materially prejudiced than judgment creditor Kim, whose judgment was junior to a loan whose amortization rate had only been extended.

3. Moreover, the City of Kent Had Title Insurance to Cover Its Losses.

The Washington State Supreme Court instructs us that "[t]he doctrine of equitable subrogation is an equitable one, having for its basis of complete and perfect justice between the parties without regard to form, and its purpose and object is the prevention of injustice . . ." *Prestance* at 565

"Complete and perfect justice" is not possible between these parties or, probably, between any parties in most any case, but injustice can be prevented by denying the City of Kent's equitable subrogation claim.

It is undisputed that (1) the City of Kent obtained title insurance coverage from PNWT regarding its purchase of Parcel C; (2) PNWT inexplicably failed to discover the Bel Air & Briney deed of trust; and as a result (3) instead of owning Parcel C free and clear the City's property is still encumbered by Bel Air & Briney's deed of trust and (4) Bel Air & Briney has received none of the

$143,305 it would have been paid from the sale.

The City will receive the same compensation whether its equitable subrogation claim is upheld or reversed, just in different forms: if it is upheld the City will receive the value of the property (because its $197,000 first deed of trust would, according to the City, exceed its value) and if the claim is denied the City will receive a check from First American Title, PNWT's successor, for the same amount.

This Court's ruling, however, will be vitally important to Bel Air & Briney and First American Title. If the grant of equitable subrogation is upheld PNWT -- which created this fiasco -- will pay nothing and Bel Air & Briney, its victim, will likely receive little or nothing: although it can foreclose on its deed of trust the property will be encumbered by a lien of almost $200,000. If it is reversed, First American Title will have to pay the City what its title insurance policy obligates it to pay, and Bel Air & Briney can at least keep the proceeds from its foreclosure sale.

The latter results in incomplete and imperfect justice, but at least it will prevent the injustice that would result from the former.

Bel Air & Briney agree that the loss should not fall on the negligent title company if they had gained a windfall as a result of

that negligence: equitable subrogation should instead be granted the innocent third party. That is why equitable subrogation was appropriately upheld in *Prestance, Newman Park, Coy, and Olson.*

However, unlike the junior lien holder or in every one of those cases, Bel Air & Briney did not "receive an unearned windfall at the expense of another", *Prestance* at 567, quoted in the recent Division 3 opinion in *Worden v. Smith,* ___ Wn. App., 314 P.3d 1125, 1135 (2013). And, the Washington courts' embrace of a "long and robust tradition of applying the doctrine of equity" that the Supreme Court emphasized in *Newman Park* at 569 and was quoted by the Court of Appeals in *Worden* at 1135, compels the denial of equitable subrogation in this case.

In its Order granting Kent's Motion for Summary Judgment the Trial Court stated that "one reason cited by the Supreme Court for adopting the Restatement's position on equitable subrogation is that 'when a jurisdiction adopts the liberal view of equitable subrogation, the insurance premium is greatly reduced. These savings eventually benefit homeowners because title insurance premiums are mostly passed on to them.' *Bank of America, N.A. v. Prestance Corp.*, 160 Wn.2d 560, 581, 160 P.3d 17, 28 (2007) (internal citations omitted)."

That benefit is likely no longer recognized by Washington appellate courts, whose decisions actually mandate the denial of equitable subrogation in this unique case.

The Supreme Court retreats in Newman Park. The first equitable subrogation case decided by the Washington Supreme Court after *Prestance* was *Columbia Bank v. Newman Park, LLC, supra, 177* Wn.2d 566 (2013) which explicitly adopted the liberal application of equitable subrogation in *Restatement (Third)* ¶7.6. It acknowledged that in *Prestance* it stated that the second of two policy reasons in favor of a liberal application of equitable subrogation[1] was that it "can save billions of dollars by reducing title insurance premiums and that those premiums would be passed on to homeowners. *Id.* at 580-81, 160 P.3d 17." However, it meekly acknowledged in the next sentence that "[m]aybe the effect of liberalizing equitable subrogation on promoting these policies was overstated." *Ibid.*

The most likely reason why the Supreme Court abandoned this fanciful notion was that there was no evidence to support it, either before or after *Prestance.*

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[1] The other policy reason, to provide an incentive for one to advance sums to help a property owner avoid forfeiture, *Prestance* at 580, does not apply to this case.

The BYU Law Review Article does not apply to this case. Even if it were true, the alleged potential savings to consumers would not be applicable to the facts of this case. The comment in *Prestance* was based on a 2006 Brigham Young University Law Review article that discussed the benefits of adopting the *Restatement (Third)* only with respect to *refinancing* of loans while here, the transaction involved a *cash purchase* of Parcel C by the City of Kent. The following is the section from the BYU Law Review article that provides the context for the sentence cited in *Prestance:*

> We have illustrated how adoption of the Restatement sections dealing with subrogation and related priority issues would virtually eliminate the risk of loss of mortgage priority *for refinancing lenders.* We have also described how two simple additions to *mortgage documents* would serve to enhance this protection by strongly increasing the likelihood that courts would apply the subrogation doctrine and would grant priority to *refinancing lenders* even when the *new mortgage* exceeds the amount of its predecessor. These latter steps could largely be accomplished by Fannie Mae and Freddie Mac incorporating the appropriate language in their standard *residential mortgage* forms. We also considered the technique of direct assignment to *new lenders of mortgages being refinanced* as an alternative to subrogation but concluded

> that the adoption of such an approach would be impractical at this time.
>
> Ultimately, the Restatement approach should be enacted by Congress. Such federal legislation, buttressed by the two drafting techniques described above, would represent a package of protections *for lenders* that would largely obviate the major reason for title insurance *in refinancing transactions.* In such an environment, we believe that title insurers would either substantially reduce premiums in *home mortgage refinancings* or run the risk that major institutional lenders would eliminate the need for title insurance completely by becoming self-insurers. Either way, American homeowners would be the major beneficiaries. The potential savings quite literally amount to billions of dollars. *Id.* at 19 (emphasis added) (CP 196)

The authors make it clear they are not talking about the application of equitable subrogation to owners or new purchasers: "We do not advocate here the application of subrogation to mortgages on properties that have been sold to new owners. *Case authority supporting it is extremely limited, and it lies outside the ordinary scope of the subrogation doctrine.*" *Id.* at 11 (emphasis added) (CP 188)

Nor do the authors of the BYU article suggest that the

Restatement would allow a title insurance company to avoid having to pay for its negligence when the junior lien holder was not unjustly enriched.

Third, the authors provide examples where junior lienholders were sufficiently prejudiced by the terms of a mere refinancing to prohibit the application of equitable subrogation, including loans with either a higher interest rate or greater loan balance than the initial loan secured by the first deed of trust, including *Kim v. Lee*, *supra*. *Id.* at 5 and 6 (CP 182-183)

Granting the City's Motion for Summary Judgment not only significantly harmed Bel Air & Briney, it was an extraordinary and unjustified gift to the title insurer and to the entire title insurance industry in the state of Washington. The only reason to purchase title insurance is to protect the insured from exactly what happened here: lending or purchasing money based on incorrect information regarding ownership of or encumbrances against real property. In the rare instance that the insurer makes an error it is contractually obligated to compensate its insured for its error.

Bel Air & Briney understand that they are not entitled to be compensated for PNWT's negligence since they were not the latter's insured. However, the Trial Court was obligated to reach an

equitable result under the peculiar facts of this case. The only way to accomplish that was to allow the two innocent victims of PNWT's negligence to be compensated: Bel Air & Briney to foreclose on its deed of trust to recover a small portion of what it lost, and the City of Kent to recover its losses from the company to whom it paid a substantial insurance premium.

VI. SUMMARY

Equitable subrogation is "founded in the facts and circumstances of each particular case. *Credit Bureau Corp. v. Beckstead,* 63 Wash.2d 183, 186, 385 P.2d 864 (1963)." *Newman Park*, at 581 The "facts and circumstances" of <u>this</u> particular case are unique: no case found by either party or the Trial Court involved a situation where, as here, the junior lienor did not get a windfall from the payment of a third party of a senior secured debt, let alone one where, as here, the party seeking equitable subrogation would be fully compensated for its loss from its negligent title insurer.

Whether equitable subrogation is granted or denied, the City of Kent will suffer no loss; if it is granted Bel Air & Briney loses everything, while if it is denied their damages caused by the title insurer's negligence will only be marginally reduced. Every

appellate opinion issued by the Washington Court of Appeals and Supreme Court calls for equitable subrogation to be allowed when it is, in fact, equitable and denied when its application would materially prejudice a junior lien holder. The only ***equitable*** outcome here, therefore, would be for this Court to reverse the Court's Order denying the City of Kent's summary judgment motion.

DATED this 13th day of June, 2014.

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<u>**DECLARATION OF SERVICE**</u>

The undersigned declares under penalty of perjury, under the laws of the State of Washington, that the following is true and correct:

That on June 16, 2014, I arranged for service of the foregoing Brief of Appellants to the Court and to opposing counsel to this action as follows:

Office of Clerk Court of Appeals – Division I One Union Square 600 University Street Seattle, WA 98101	VIA MESSENGER

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DATED this 16th day of June, 2014, at Seattle, Washington.

CAMILLE CAMPBELL MILLS

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