

No. 87087-0

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SUPREME COURT OF THE STATE OF WASHINGTON
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STEWART TITLE GUARANTY COMPANY,
a Texas Corporation

Appellant,

v.

WITHERSPOON, KELLY, DAVENPORT & TOOLE, PS,
a Washington corporation; DUANE M. SWINTON and
JANE DOE SWINTON, and the marital community
comprised thereof,

Respondents.

BRIEF OF APPELLANT

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INTRODUCTION

In the case below, title insurer Stewart Title Guaranty Company (“Stewart Title”) brought a claim for legal malpractice against the attorneys it had retained to represent its insured¹ for having failed to recognize and assert the insured’s complete defense of equitable subrogation in the underlying mechanic’s lien action against the insured. Witherspoon’s error forced Stewart Title to pay \$1.3 Million to protect the insured. The trial court held that Witherspoon owed a duty of care to Stewart Title in defending the insured, but erroneously concluded that equitable subrogation was not available as a defense in the underlying action for the insured because: (1) the transaction wherein the insured paid off and satisfied prior liens did not constitute a refinance; and (2) in connection with issuing the title policy to the insured, Stewart Title’s agent failed to inspect the property thereby providing Stewart Title with constructive notice of the intervening lien. The trial court thus granted Witherspoon’s motion for summary judgment, and denied Stewart Title’s cross-motion for summary judgment and subsequent motion for reconsideration. Stewart Title appeals. Witherspoon cross-appeals on the issue of whether Witherspoon owed any duty to Stewart Title.

¹ Defendants Witherspoon Kelly Davenport & Toole and Duane M. Swinton are collectively referred to hereinafter as “Witherspoon.”

ASSIGNMENTS OF ERROR

1. The trial court erroneously held, as a matter of law, that equitable subrogation is limited in Washington to refinance transactions.

Issues Pertaining to Assignment of Error

- A. Whether *Prestance* or *Kim* limit equitable subrogation to refinance transactions.
- B. Whether the *Restatement* limits equitable subrogation to refinance transactions.

2. The trial court erroneously held, as a matter of law, that payment of Sterling Bank's loan proceeds to IFA and Brown did not constitute a refinance for purposes of equitable subrogation.

Issues Pertaining to Assignment of Error

- A. Whether the Sterling Bank loan transaction qualifies as a refinance for purposes of equitable subrogation because the borrowers' obligations were discharged with funds acquired through the creation of a new debt on which the borrowers were also obligated.
- B. Whether DAD, Milne, and JA were even more closely related than the Changs were to the Lees in *Kim*, for purposes of applying equitable subrogation.

3. The trial court erroneously held, as a matter of law, that no genuine issue of material fact remained relative to Witherspoon's cross-motion for summary judgment on equitable subrogation.

Issues Pertaining to Assignment of Error

- A. Whether the trial court erred when it refused to consider the testimony of Sterling Bank's witness, Lisa Irwin, which was properly before the Court.
- B. Whether the trial court erred when it denied Stewart Title's motion to reconsider on the basis that it was undisputed that Sterling did not expect to step into the shoes of the prior lenders on the property.
- C. Whether the trial court erred when it granted Witherspoon's motion for summary judgment without first ruling on Stewart Title's motion to strike expert testimony.

4. The trial court erroneously held, as a matter of law, that constructive knowledge of a lender's title insurance company is imputed to the lender and thus precludes the lender from asserting equitable subrogation.

Issues Pertaining to Assignment of Error

- A. Whether the existence of title insurance precludes application of equitable subrogation by a lender.

- B. Whether constructive knowledge of a title insurer precludes application of equitable subrogation by a lender.

STATEMENT OF THE CASE

A. **Statement of Facts**

1. **David Milne secures loans to develop the Cook Addition.**

David Milne (“Milne”) has been a developer in the construction industry since 1984. CP 1642:9-24. Milne typically buys a property and take it through subdivision, selling the lots to construction developers. *Id.* Milne has done 57 different developments. *Id.*

David Alan Development, LLC (“DAD”) is an Arizona limited liability company. CP 1643:1-1642:2. DAD has always been wholly owned by Milne. *Id.* Through DAD, Milne obtained the Cook Addition property from Eugene and Anna Marie Cook in May of 2005. CP 1686-1687. In connection with the purchase, DAD obtained a loan from Centrum Financial Services, Inc. (“Centrum”). CP 1645:13-1646:5. Milne personally guaranteed the Centrum loan. *Id.*

Milne began the project in partnership with George Brown, Jr. (“Brown”). CP 769. Notably, their agreement regarding the Cook Addition project was between Brown and Milne, and not DAD, even though DAD held title to the property. CP 769; 1686-1687. Milne

subsequently bought Brown out of the project, paying him \$1,000,000 and providing him a promissory note for an additional \$580,000, secured by a deed of trust against the Cook Addition. CP 1647:23-1648:24; 764-768. Although Milne was individually liable on the promissory note to Brown, DAD held title to the Cook Addition and provided the deed of trust securing the note.

To refinance the loan from Centrum, Milne (through DAD) obtained a \$2.35 million loan from Integrated Financial Associates (“IFA”). CP 1650:15-1651:1; 1688. Milne subsequently increased the IFA loan from \$2.35 million to \$6 million. CP 656:19-25; 657:25-658:4; 755-763. The promissory note and deed of trust to IFA were executed by Milne on behalf of DAD. CP 755-757. Milne personally guaranteed the \$6 million loan from IFA. CP 758-763. The IFA loan was a “hard money” loan, meaning it was high interest and short term, and not intended to be permanent financing. CP 664:24-665:22; 1651:11-1652:6.

Milne then partnered with Jim James (“James”) to continue the project. CP 1653:6-23. James was brought in to be the project manager in exchange for a minority membership interest in the newly formed James Alan, LLC (“JA”). *Id.* Thus, JA was owned by Milne and Jim James (through his wholly owned entity James Corp.). CP 558; 559; 568:7-8. James was not a decision-maker for JA, and Milne would have pursued

the project even without James' involvement. CP 1654:8-14. For his part, Milne was to secure financing, lend his considerable experience in helping to manage the project, provide construction support services, and was onsite at least once a week. CP 1676:5-1677:22.

2. **Milne secures a new loan from Sterling to replace the IFA and Brown loans.**

Milne transferred the Cook Addition from DAD to JA. CP 557. Milne's own company (Terra Consulting) acted as the agent. CP 1655:21-1656:8. In connection with the transfer, JA obtained a loan from Sterling (through its subsidiary, Action Mortgage), for the express purpose of refinancing the Brown loan and the IFA loan. CP 1658:23-1659:3; 1659:11-25; 1663:16-1664:6; 1669:18-1670:24. Accordingly, Sterling made a loan to JA in the amount of \$7,535,000. CP 575-576. The terms of the Sterling loan were more favorable than the terms of the IFA loan. CP 784-823 at ¶¶ 12 and 28.

Thus, although Milne attempted to develop the Cook Addition project with various partners (Brown and James) through different entities (DAD and JA), using a variety of different lenders (Centrum, IFA, and Sterling), Milne was the one constant throughout the Cook Addition project. CP 1649:15-25. Thus, although Stewart Title asserts that equitable subrogation does not require that the borrower remain the same

throughout the transaction (*i.e.*, that the transaction is a refinance), here the borrower was essentially the same both on the IFA and Brown loans, and the Sterling loan.

Indeed, Sterling would not have made the loan to JA without Milne and DAD's involvement. In fact, JA itself had no assets, no income, and no credit history. CP 559-566 (indicating that JA had no financial strength or credit history). Therefore, Milne personally guaranteed the loan. CP 577-579. Although not the borrower, DAD also guaranteed the Sterling loan. CP 580-582. In contrast, Sterling did not require a guaranty from James or James Corp. 1661:1-3; 1661:23-1662:5; 586:2-18; 587:19-24; 588:14-589:8; 571:1-4. Indeed, even though he was a member of JA, James never saw the Sterling loan documents (CP 569:11-15), was not involved in negotiating the Sterling loan terms and did not even know that Milne obtained the loan in the name of JA, rather than in Milne's own name or in the name of DAD (CP 570:5-10). James had no control or voice in how the Sterling loan proceeds were used. CP 1660:2-12.

Despite selling the Cook Addition property, DAD remained under a contract (which was recorded) to sell the finished lots to Sound Built Homes. CP 609-612. Even though Sterling relied heavily on the Sound Built Homes contract as the primary method of repayment of the loan, Sterling was not concerned that DAD, and not its borrower JA, would

receive the proceeds from the Sound Built Homes contract. CP 594:15-595:12; 1666:19-1668:13. Indeed, JA could not even pay the purchase price to DAD unless and until the project was finished and sold. CP 1678:20-1679:15.

Likewise, Sterling relied upon a construction contract between Mountain West Construction (“MWC”) and DAD, rather than its borrower JA, to develop the project. CP 597:15-598:8. Sterling approved draw requests and paid invoices from third-parties for work done on the project for the seller, DAD (CP 601:24-602:10), and was not concerned that the relevant permits for the project were in the name of the DAD, and not JA (CP 603:3-604:4). Furthermore, Sterling even relied upon DAD subordinating \$1,000,000 of the purchase price owed to it from JA to Sterling’s loan, in order to satisfy its equity requirement in making the loan to JA. CP 559-566. At the loan closing, DAD wanted to draw its equity out of the project, but Sterling would not allow it. CP 1665:4-18.

Milne and James also treated DAD and JA as one and the same. In connection with the transfer of the Cook Addition from DAD to JA, Milne executed a Real Estate Excise Tax Affidavit on behalf of both entities, claiming that the transfer of the Cook Addition property from DAD to JA was exempt from tax under WAC 458-61A-211 (2d) because the transfer was a “change of identity only.” CP 754. Although Milne later admitted

that the Excise Tax Affidavit may not have been entirely appropriate, James had no problem with it (CP 572:2-573:3), and Sterling relied on it by not allocating any loan proceeds for transfer taxes (CP 1673:16-1674:1; 667-672).

Because Milne was the driving force behind both DAD and JA, third-parties treated Milne and the two entities interchangeably. For example, MWC sent communications regarding the project to DAD (CP 621:19-622:21), sent its Notice of Commencement to both DAD and JA (CP 617:4-618:16), had contracts with both DAD and JA for the same project (CP 619:22-620:7), sent its change orders to DAD (CP 622:24-623:16), and provided all of its work on the project to both JA and DAD (CP 627:5-17). In addition, although JA was the owner of the property and the borrower under Sterling's loan, several third-parties invoiced DAD for their work, materials or services on the project, including Alkai Consultants, LLC (CP 629-631), Team4 Engineering (CP 632-637) Stewart Title of Kitsap County (CP 638), the Washington State Department of Ecology (CP 639), Williams, Kastner & Gibbs PLLC (CP 640-641), The Unity Group (CP 642), Sustainable Development Services (CP 643-644), the City of Poulsbo (CP 645), and N.L. Olson & Associates, Inc. (CP 646-654). Rather than merely processing these invoices as part of the construction support services provided by DAD to

JA, many of the foregoing had contracts directly with DAD on the project. CP 1680:15-1682:17.

As part of the transfer of the Cook Addition property from DAD to JA, the IFA loan and the Brown loan (the only liens on the property) were paid off and satisfied with proceeds from, and replaced by the Sterling loan. CP 659:16-24; 667-672; 663:12-17; 673; 676:9-20; 678-680. Specifically, IFA was paid \$5,566,273.05, and Brown was paid \$647,995.02. *Id.* Of the amount paid to IFA, \$77,719.83 constituted a credit for an unused interest reserve on the IFA loan, \$2,721,997.96 was returned as the unused portion of the IFA loan set aside for construction costs, and \$384,173.80 constituted loan proceeds from a separate IFA loan on an unrelated property owned by Milne. *Id.* Thus, \$3,030,916.48 of Sterling's loan proceeds were used to pay off and satisfy the IFA loan and the Brown loan, computed by taking the amount paid to Brown plus the amount paid to IFA minus the interest reserve, unused construction proceeds, and unrelated proceeds from a separate IFA loan. *Id.*

3. **All of the parties expected Sterling's loan to be in a first priority lien position and that MWC's mechanic's lien would be subordinate.**

All of the parties involved knew and expected that Sterling intended to discharge the IFA and Brown loans so that it would have a first position lien on the Cook Addition. Although the trial court now

describes the refinance of the IFA and Brown loans as merely a purchase and payoff, it is clear that Sterling understood and required that its loan proceeds were going to be used for the payoff of Milne's prior financing. Thus, in an Estimated Construction Loan Closing Statement provided to Milne, Sterling indicated that \$3,626,799.00 was "Avail[able] For Land Payoff," rather than describing the funds as purchase money. CP 1689; 1671:23-1672:15. Moreover, none of the Sterling loan proceeds ever went into a DAD account, DAD never had access to the funds, and Sterling conditioned its loan on payment of proceeds through escrow to IFA and Brown to retire their liens. CP 1683:11-1684:18.

Despite knowledge of the liens related to the IFA loan and Brown loan (CP 590:13-591:15), Sterling specifically conditioned the loan on being in a first lien position against the Cook Addition property. CP 587:7-18; 593:15-19; 596:7-15; 681-682; 683-690 at ¶¶ (1)(d) and (3)(b). Sterling required that the loan proceeds pay off and satisfy the existing liens. CP 607:1-6. In addition, Sterling's Deed of Trust on the loan specifically states that Sterling will be subrogated to any liens paid with its loan proceeds. CP 691-711 at § 3.09. Critically, Sterling's closing escrow instructions indicate that "any ... liens need to be paid at closing" and "NO MONIES ARE TO GO BACK TO THE BORROWER(S) AT CLOSING." CP 711 (emphasis in original). Indeed, in communicating

with the escrow company, Sterling asked about payoff amounts required by IFA and Brown because “we want to make sure we have adequate funds to payoff the under[ly]ing loans.” CP 1733.

Notably, Sterling has testified that it intended to be equitably subrogated into the positions of IFA and Brown. Specifically, Lisa Irwin, the loan officer with Action Mortgage (a wholly owned subsidiary of Sterling Savings Bank) who was primarily responsible for the JA loan, testified that (CP 434-435):

6. Sterling agreed to loan **Milne** \$7.535 Million for the construction and development project provided (1) that Sterling’s Deed of trust securing the loan was in **first position against all existing liens, other lenders and contractors**, and (2) **Milne** or his entities contributed substantial additional funds to the project and guaranteed the loan. With this intention and these conditions, Sterling approved the loan on May 9, 2007. At that time, no work had been done on the project and Sterling understood that none was to be done until after the loan closed.

7. In connection with the closing of the loan, **Sterling instructed the loan proceeds be first used to satisfy the underlying obligations secured by prior Deeds of Trust attached hereto as Exhibit A and B.**

8. The loan closed on June 11, 2007. As of the closing date, Sterling was unaware that [Mountain West Construction] had performed any lienable work on the project. Had Sterling known of such work, it would not have closed the loan or paid over \$2.2 Million to Mountain West subsequent to the closing.

9. By paying the prior Deeds of Trust and conditioning its loan on being in first position against all others, **Sterling**

intended and believed it would stand in the shoes of prior lienholders whose obligations it satisfied. Such obligations were all prior in time to all claims made by Mountain West. But for payment of these loans, Mountain West liens would be junior and would have been foreclosed upon the foreclosure of either of the prior Deeds of Trust. (emphasis added).

MWC's construction contract for development of the Cook Addition was for \$2,440,977.22. CP 713. MWC commenced work on the Cook Addition property on May 14, 2007. CP 118-127. At that time, the property was already encumbered by the IFA and Brown trust deeds. CP 743-747, 749-753. MWC's inchoate mechanic's lien rights were therefore in a third position on the property. MWC knew that Milne was obtaining a new loan to develop the project and admitted that it would not have started work if it had believed that the loan was not already in place. CP 614:21-615:15. Unsure of which of Milne's entities was obtaining the loan, MWC entered into contracts with both JA and DAD to do work on the Cook Addition project. CP 712-721. The first signed contract specifically states that "[w]ork shall not commence until Mountain West Construction LLC receive[s] written confirmation of project funding from the financial institution." CP 714. Further evidencing its expectation to be in a subordinate lien position, MWC bargained for a relatively high interest rate of 18% per annum on unpaid contract amounts. CP 714. MWC benefited from the Sterling loan by being paid approximately

\$2,285,918.60 of the loan funds for its work. CP 783. Eventually however, MWC claimed to have performed over \$800,000 in additional work on the project for which it was not paid. MWC therefore filed a mechanic's lien based on its commencement of work date of May 14, 2007, and filed suit to foreclose the lien in Kitsap County, styled *Mountain West Construction, LLC v. James Alan, LLC, et al.*, being Case No. 08-2-01804-2 (the "MWC Litigation"). CP 118-127. The trust deed securing Sterling's loan was not recorded until June 11, 2007. CP 1083-1099. Prior to recording the lien, MWC expected that Sterling's loan was in a first position on the property and was actually surprised when it discovered that its commencement date predated the recording of Sterling's trust deed. CP 616:8-16; 625:4-626:10.

Even Witherspoon belatedly acknowledged that equitable subrogation applied, based upon the fact that it later tried to add equitable subrogation as a defense on behalf of Sterling in the MWC Litigation by filing: (1) a Second Amended Answer, Affirmative Defense, Counterclaim, Cross-Claim, and Third-Party Complaint of Sterling Savings Bank; (2) an Amended Response of Sterling Savings Bank to Plaintiff's Motion for Summary Judgment; and (3) the Affidavit of Duane

M. Swinton in Support of Sterling Savings Bank's Response to Plaintiff's Motion for Summary Judgment.² CP 722-729; 730-733; 734-753.

B. Proceedings in the Lower Court

Plaintiff Stewart Title filed its First Amended Complaint for legal malpractice against Witherspoon in the King County Superior Court on July 1, 2010. CP 1-10. On cross-motions for summary judgment, the trial court granted Witherspoon's motion for summary judgment on the issue of whether equitable subrogation was available as a defense to Sterling in the MWC Litigation, and denied Stewart Title's cross motion for two reasons: (1) Washington law limits equitable subrogation to refinances and the underlying loan from the insured did not constitute a refinance as a matter of law; and (2) Washington law precludes equitable subrogation if the title insurer was on constructive notice of an intervening lien. CP 1753-1761 (attached as Appendix A). The trial court denied Stewart Title's motion for reconsideration (CP 1795-1796) (attached as Appendix B) and dismissed Stewart Title's Complaint. CP 1803-1805. Stewart Title timely appealed. CP1806-1831.

² Witherspoon's assertion of equitable subrogation in the MWC litigation was untimely and barred by a Stipulation drafted by Witherspoon which waived all defenses to MWC's lien priority. Thus, Witherspoon's belated assertion of equitable subrogation was never decided on its merits.

ARGUMENT

A. Standards of Review

Review of the trial court's summary judgment is de novo. *Elcon Constr., Inc. v. E. Wash. Univ.*, 174 Wn.2d 157, ¶ 10, 273 P.3d 965 (2012). Review of the trial court's denial of Stewart Title's Motion for Reconsideration under CR 59 is for abuse of discretion. *Teter v. Deck*, 174 Wn.2d 207, ¶ 14, ___, P.3d. ___, (2012). A trial court abuses its discretion when its decision is "manifestly unreasonable or based on untenable grounds or untenable reasons." *Id.* at ¶ 15.

B. Equitable Subrogation Generally

Bank of America, N.A. v. Prestance Corp., 160 Wn.2d 560, 160 P.3d 17 (2007) ("*Prestance*") adopted § 7.6 of the *Restatement* (Third) of Property: Mortgages (the "*Restatement*") regarding equitable subrogation. *Id.* at ¶ 35. The *Restatement* (attached as Appendix C) provides:

(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:

(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.

The purpose of equitable subrogation is to “maintain the proper order of [lien] priorities” (*id.* at ¶ 9), and to prevent an intervening lienholder from receiving a windfall by the unintended elevation of its lien priority (*id.* at ¶ 21). Thus, “[e]quitable 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 ¶ 21 (emphasis added). The doctrine achieves this goal by allowing a party who has discharged a lien on real property to succeed to the lien priority of the lien which that party has satisfied, thereby “keeping the first mortgage first and the second mortgage second.” *See id.* at ¶ 9. Were it not so, “any junior lender could effectively block any refinancing or restructuring between senior lenders and refinancing mortgagees and be unjustly enriched by their newfound higher priority.” *Id.* at ¶ 24. Courts should apply equitable subrogation to preserve bargained for lien priorities unless the terms of the replacement financing materially prejudice the intervening lienholder by putting it in a significantly worse position than it expected and bargained for. *See id.* at ¶ 34 (“Equitable subrogation is a broad

doctrine and **should be followed** whenever justice demands it and where there is no material prejudice to junior interest”).

Prestance further emphasizes that the equitable subrogation doctrine should be liberally applied, and has “for its basis the doing of complete and perfect justice between the parties **without regard to form** and its purpose and object is the prevention of injustice.... It rests upon the maxim that no one shall be enriched by another’s loss....” *Id.* at ¶10, (*quoting Cox v. Wooten Bros. Farms, Inc.*, 271 Ark. 735, 737-38, 610 S.W.2d 278 (1981)) (emphasis added).

In addition to preserving the proper order of bargained for lien priorities, the policy considerations underlying equitable subrogation include “facilitating more refinancing” to help “stem the threat of foreclosure” and reducing title insurance premiums. *Id.* at ¶¶ 32, 33. Indeed, “[e]quitable subrogation has been **steadily expanding and growing in importance and extent** in its application to various subjects and classes of persons.” *Id.* at ¶ 10 (internal citations and quotations omitted, emphasis added).

C. Equitable Subrogation is Not Limited to Refinance Transactions, and in Any Event, the Sterling Loan Constituted a Refinance Transaction.

In granting Witherspoon’s renewed motion for partial summary judgment, the trial court specifically held that equitable subrogation was

not available as a defense to Sterling because “the loan between JA and Sterling was not a refinance of the existing liens owed by DAD on the Cook’s Addition property, as required by *Restatement 7.6 . . .*” CP 1757:1-4. This conclusion was based on Witherspoon’s argument that Sterling’s loan funds were used by JA to purchase the Cook Addition, rather than refinance the existing liens; in other words, the trial court characterized the transaction as JA delivering the purchase proceeds to DAD, and then DAD using the purchase proceeds to discharge its own liens. *See, e.g.*, CP 836:12-16; 1278:2-7.

In fact, *Restatement §7.6* does not require that the transaction be a refinance for equitable subrogation to apply. The central requirement of the Restatement is not a refinance, but the payment of another party’s obligation. *See Restatement §7.6(a)*. The “refinance requirement” referred to in the trial court’s ruling was apparently drawn not from *Prestance* or *Restatement §7.6*, but from this Court’s earlier decision in *Kim v. Lee*, 145 Wn.2d 79, 31 P.3d 665 (2001). However, this ruling by the trial court ignores *Prestance*’s adoption of *Restatement §7.6* and unduly limits *Kim*’s broad definition of the term “refinance.” Similarly, the majority of other jurisdictions which have adopted the *Restatement* also apply equitable subrogation to non-refinance transactions. Moreover,

the *Restatement* explicitly extends equitable subrogation to the borrower's successor.

Thus, under either *Kim* or *Prestance*, the underlying facts of this case demonstrate that Sterling should have been equitably subrogated to the position of the liens discharged with its loan proceeds because MWC would have retained the same lien position it originally bargained for and suffered no prejudice from Sterling's loan being subrogated into a first lien priority position.

1. *Restatement* § 7.6 and *Prestance* do not limit equitable subrogation to refinance transactions.

Prior to adopting *Restatement* § 7.6 in *Prestance*, this Court previously adopted its companion provision, *Restatement* § 7.3, with some limitation. *See, Kim* 145 Wn.2d at 89. *Restatement* § 7.3 applies equitable subrogation when a lender "replaces" its own mortgage by making a new loan to satisfy and discharge obligations owed to that same lender. *See generally, Restatement (Third) of Property: Mortgages* § 7.3. *Kim* specifically dealt with a lender replacing its prior loan on a property with a new loan. *Kim, supra*, 145 Wn.2d at 87. In this context, the *Kim* court interpreted *Restatement* § 7.3 (without citing any additional authority), to mean that "[i]n order for the doctrine of equitable subrogation to apply,

the loan must be considered a refinance.” *Id.* The court then broadly defined “refinance” as follows (*Id.*):

To finance again or anew; to pay off existing debts with funds secured from new debt The discharge of an obligation with funds acquired through the creation of a new debt (citing Black’s Law Dictionary 1281 (6th ed. 1990)).

Notably, *Kim* specifically held that a lending transaction would be considered a refinance for purposes of applying equitable subrogation even when the borrowers under the original and replacement loans were different parties, if those parties were sufficiently related. *Id.* The holding of *Kim* itself therefore reinforces the broad definition of the court’s “refinance” requirement with a focus on the substance of the transaction rather than the form.

In contrast to *Restatement* § 7.3, *Restatement* § 7.6 as adopted by *Prestance* applies when a new lender makes a loan to satisfy and discharge an obligation of a previous, different, lender. While *Restatement* § 7.6 explains that the “most common context for this sort of subrogation is the ‘refinancing’ of a mortgage loan” (*Restatement* § 7.6., Comment e.), it specifically recognizes that the doctrine may apply in any variety of other transactions. For example, Comment d applies equitable subrogation to a buyer in a real estate sales transaction:

Although the grantee may have examined the title carelessly or may have made no title examination at all, if the cash price paid by the grantee included the second mortgage balance, subrogation to, rather than extinction of, the first mortgage will result in order to prevent unjust enrichment of the second mortgagee.

The *Restatement* contains several other non-refinance illustrations applying equitable subrogation. *See, Restatement* § 7.6, Illustrations 5, 15, 16, 17, 18, 19, 20 and 21 (purchase transactions), Illustration 22 (promissory note assignment), and Illustrations 1, 2, 6, 7 and 16 (various third party payment transactions). Contrary to the trial court ruling, neither *Restatement* § 7.6 nor *Prestance* contain a requirement that the loan be considered a refinance for equitable subrogation to apply – instead, *Prestance* specifically acknowledges that equitable subrogation may apply to non-refinance transactions. *Id.* at 577 fn.12 (“[e]quitable subrogation is also frequently applied in insurance, surety, and construction cases”). By adopting *Restatement* § 7.6 without limitation, the *Prestance* decision therefore has the effect of expanding equitable subrogation’s applicability beyond the already broad scope of refinance transactions encompassed by *Kim*.

The majority of other jurisdictions applying the *Restatement*’s principles have similarly applied equitable subrogation to non-refinance transactions. Indeed, the *Prestance* decision cites several such cases with

approval in its opinion. For example, in *East Boston Savings Bank v. Ogan*, 428 Mass. 327, 701 N.E.2d 331 (1998), the Supreme Court of Massachusetts applied equitable subrogation to a buyer in a purchase and sale transaction. *East Boston* involved a condominium owned by two tenants in common who jointly granted a first mortgage on the property. *Id.* at 328. Later, one cotenant granted a second mortgage on his one-half undivided interest to Ogan. *Id.* Five years later, the cotenants sold the property to Toner who discharged and paid off the first mortgage as part of the purchase price through a new mortgage he granted to East Boston Savings Bank. *Id.* The second mortgage was not discovered during closing and was not discharged as part of the sale. *Id.* The court affirmed a declaratory judgment in favor of Toner and East Boston Savings Bank and ruled that Ogan's mortgage was subordinate to Toner's equity interest and East Boston Savings Bank's mortgage. *Id.* at 334. In doing so, *East Boston* held that Toner and East Boston Savings Bank were both "equitably subrogated to the priority position of the original mortgage. . . ." *Id.* The court reasoned that because the "equities are substantially similar in refinancing and sales transactions," equitable subrogation also applies to real estate sales transactions. The court further noted that to hold otherwise would allow Ogan to "ascend to first priority through no act of her own" and thus be unjustly enriched. *Id.* at 334. Moreover,

under *East Boston*, Ogan remained in the same, or better, position than she was when she acquired her interest in the property. *Id.* at 333-34. *See also, Byers v. McGuire Props., Inc.*, 285 Ga. 530, 679 S.E.2d 1, 8 (2009) (“equitable subrogation applies even when a senior encumbrance is satisfied out of purchase money”).

Burgoon v. Lavezzo, 92 F.2d 726 (D.C. Cir. 1937), cited by *Prestance* with approval, similarly applied equitable subrogation to protect a buyer and prevent an unjust enrichment to a junior creditor. *See also, Gibson v. Neu*, 867 N.E.2d 188 (Ind. App. 2007) (applying *Restatement* § 7.6 to a real estate sales transaction to prevent a windfall to the junior creditor by not allowing him to ascend to a first priority position).

More recently, the Arizona Supreme Court specifically relied upon *Restatement* § 7.6 to apply equitable subrogation to a purchase transaction. *See generally, Sourcecorp, Inc. v. Norcutt*, 229 Ariz. 270, 274 P.3d 1204 (2012). In *Sourcecorp* the Norcutts bought a home for cash and satisfied an existing first mortgage. *Id.* at ¶ 1. The Norcutts subsequently learned the home was subject to a judgment lien. *Id.* The Arizona Supreme Court held that the Norcutts were equitably subrogated for the amount they paid to satisfy the mortgage. *Id.* In reaching its conclusion, *Sourcecorp* explained that “[t]he issue is only whether the payor expected that the payment would free the property; if this was the grantee’s understanding,

subrogation should be available.” *Id.* at ¶ 16 (citing 2 Grant S. Nelson & Dale A Whitman, *Real Estate Finance Law* § 1.7 (5th ed. 2012)).

Colorado has also applied equitable subrogation to buyers in a real estate sales transaction. In *Hicks v. Londre*, 125 P.3d 452 (Colo. 2005), Donald Hicks held a properly recorded judgment lien on Grubbs’ property. *Id.* at 454. The judgment lien was junior to three senior deeds of trust. *Id.* Grubbs sold the property to Kent Londre. *Id.* The buyer, Londre, used his own funds and a loan to pay the three senior deeds of trust as part of the purchase price. *Id.* at 454-55. However, Hicks’ judgment lien, though properly recorded, was not discovered and consequently it was not discharged. Thereafter, Hicks brought a foreclosure action against the property asserting priority over Londre’s warranty deed and the new mortgagee. *Id.* at 455.

The court held that Londre, as a purchaser, and the new mortgagee were both subrogated to the rights and interests of the first position lien holders that were paid off as part of the purchase price. *Id.* at 460. In doing so, the court noted that Colorado law is consistent with the *Restatement* §7.6. *Id.* at 458. Echoing *Prestance*, *Hicks* reasoned that its holding prevents unjust enrichment and does not prejudice Hicks because his priority position remains the same as it was before the sale. *Id.* at 457 and 460. Such applications of equitable subrogation to purchase

transactions predate *Restatement* § 7.6. *See*, 4 John Norton Pomeroy, *Pomeroy's Equity Jurisprudence* §1212, at 64-43 (5th Ed. 1941) (attached as Appendix D) (observing that “in many jurisdictions it is held that a purchaser who discharges . . . a specific superior lien on the land as part or full payment of the purchase price . . . is entitled to subrogation, in the absence of intervening equities, to the rights of the holder or the lien so discharged . . .”).

Equitable subrogation should apply here for the same reason it applied in all the foregoing cases: (1) the intervening lienholder (*i.e.* MWC) would suffer no prejudice in applying the doctrine and would retain the very same lien priority it bargained for; and (2) all of the parties expected Sterling’s loan to assume the first lien priority position. MWC expected that any lien it would have on the Cook Addition for unpaid work would be subordinate to a lien for the project financing (CP 616:8-16; 625:4-626:10); indeed, MWC explicitly relied on the third party financing for payment and would not even start work until it received proof of that financing. CP 614:21-615:15; CP 714. When MWC did start work, its inchoate lien rights were subordinate to the two DAD deeds of trust to IFA and Brown (CP 743-747; 749-753) and it was on notice that Milne was in the process of obtaining new financing from Sterling. CP 615:8-23. The terms of the Sterling loan were actually more favorable for

MWC than the terms of the IFA and Brown loans to which MWC was then subordinate. CP 784-823 at ¶¶ 12 and 28. When DAD conveyed title of the Cook Addition to Milne's new entity JA, MWC failed to make any meaningful distinction between the two entities and treated them interchangeably as project owners. CP 621:19-622:21; 617:4-618:16; 622:24-623:16; 627:5-17. MWC was paid over \$2 million out of Sterling's loan proceeds. When MWC eventually filed a lien on the Cook Addition and discovered that its commencement of work date preceded the recording of Sterling's trust deed, it was surprised, because it had expected to be in a subordinate position. CP 616:8-16; 625:4-626:10. MWC eventually received exactly what *Prestance* and *Restatement* § 7.6 seek to prevent – an unearned windfall due to an unexpected elevation in lien priority. MWC enjoyed both the favorable conditions of a second position lien holder (such as a high 18% interest on unpaid amounts (CP 714)), as well as the security of a first-priority lien. *Cf. Prestance* 160 Wn. 2d. ¶ 9, and n.4 (noting the inherent unfairness of such a result).

2. Equitable subrogation also extends to the successor of the borrower.

By its express language, the *Restatement* is not limited to the original borrower, but extends to the borrower's successor as well. The *Restatement* provides that equitable subrogation applies where the person

seeking subrogation performs the obligation “upon a request from the obligor **or the obligor’s successor...**” (*Restatement* § 7.6 (b) (4) (emphasis added)).

With respect to the Cook Addition project, JA is the successor of DAD and Milne. As noted above, DAD and Milne were obligated on loans against the project to IFA and Brown. The Sterling loan replaced the IFA and Brown loans. DAD and Milne remained liable on the project, now under the loan to Sterling. Although JA was the borrower under the Sterling loan, DAD and Milne were directly liable as guarantors. To the extent that JA is a separate and distinct entity from DAD and Milne, it is a successor, created specifically to allow Milne to continue his Cook Addition project. As such, the change of the obligor from DAD and Milne (under the IFA and Brown loans) to JA, DAD and Milne (under the Sterling loan) qualifies for equitable subrogation.

3. Equitable subrogation applies even under *Kim’s* refinance limitation.

To the extent that *Kim’s* “refinance requirement” survived the adoption of *Restatement* § 7.6 by *Prestance*, Sterling should still have been entitled to equitable subrogation in the underlying MWC Litigation. As mentioned above, *Kim* adopted the broad Black’s Law Dictionary definition of “refinance” which includes “the discharge of an obligation

with funds acquired through the creation of a new debt.” *Kim* 145 Wn.2d at 87. *Kim*’s facts further demonstrate the court’s broad interpretation of the term “refinance.”

In *Kim*, the Chang’s bought a home for their daughter and son-in-law, Sharon and Stanley Lee. *Id.* at 82. A large portion of the purchase price was financed by a loan secured by a first position deed of trust on the property. *Id.* Kim obtained a judgment against the Lees and had it recorded. After Kim’s judgment was recorded, the Chang’s quitclaimed an undivided one-half interest in the property to the Lees. Thereafter the Lees obtained financing in their own names and the parties agreed that the Changs would quitclaim the other half of their interest in the property to the Lees, and the Lees would use their new financing to pay off the Changs’ loan. Eventually, as a result of the transaction, Kim claimed that his judgment lien had been elevated to a first position and sought to foreclose. While *Kim* ultimately denied equitable subrogation because the title insurer had actual knowledge of the intervening lien and the terms of the new loan were prejudicial to Kim’s lien, it specifically held that the transaction still qualified as a refinance since the parties were family and the transfer of title from the Changs to the Lees was a gift. *Id.* at 87. Therefore, even *Kim*’s refinance requirement does not require that the

obligors of the loans at issue be the same party for equitable subrogation to apply, as the trial court required in this case.

With regard to the Sterling loan, equitable subrogation applies even under *Kim*'s refinance requirement for at least two reasons: (1) DAD's obligations were discharged with funds acquired through the creation of a new debt on which DAD was also obligated; and (2) DAD and JA were even more closely related than were the Changs to the Lees in *Kim*.

First, it is significant that although JA was the primary borrower of Sterling's loan, when it applied for the loan it had no credit, no assets, and no income. CP 559, 561, 565. Milne's only other partner in JA, Jim James, did not have sufficient credit to even offer a guarantee to Sterling. CP 586:2-18. Accordingly, Sterling would never have agreed to make the loan unless it was guaranteed repayment by Milne and DAD. Milne and DAD were therefore obligors on both the debts being discharged, and the new debt incurred to continue development of the project. This undisputed fact alone justifies characterization of the transaction as a "refinance," as per *Kim*'s definition of the same.

Second, the mere fact that DAD and JA are not the same borrowers should not preclude characterization of the transaction as a refinance when the two entities are so closely related. In *Kim*, this court found that a

parental relationship was sufficiently close to justify interpretation of the transaction as a refinance despite the fact that the borrowers were different parties. Here, the relationship between DAD and JA was even closer – they were essentially the same person – David Milne. Witherspoon argued, and the trial court agreed, that the court could not reach this conclusion without piercing the corporate veil to disregard the corporate form. CP 1759:4-6. However, *Prestance* and *Restatement* § 7.6 impose no such limitations on equitable subrogation. *See Prestance* 160 Wn.2d at 579 (“[equitable subrogation’s] basis is the doing of complete, essential, and perfect justice between the parties, without regard to form, and its object is the prevention of injustice.” (citations omitted)). Other jurisdictions interpreting *Restatement* § 7.6 have also made it clear that a change in the borrower’s identity does not affect application of equitable subrogation so long as the intervening lienholder is not prejudiced. *See Continental Lighting & Contracting, Inc. v. Premier Grading & Utilities, LLC*, 227 Ariz. 382, 258 P.3d 200, 207-208 (Ariz. App. 2011) (“other courts that follow the Restatement approach for assessing whether equitable subrogation should apply have applied the doctrine even where the borrowers in the initial and refinancing loans are different”); *Houston v. Bank of America Federal Saving’s Bank*, 119 Nev. 485, 78 P.3d 71, 75 (2003) (applying equitable subrogation despite the fact that the mortgagors

changed in a refinance because the intervening lienholders “did not offer any evidence that this change prejudiced them”); *accord Prestance* 160 Wn.2d at 582 (“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”); *Arnold v. Melani*, 75 Wn.2d 143, 152, 437 P.2d 908 (1968) (“equity has a right to step in and prevent the enforcement of a legal right whenever such an enforcement would be inequitable”) (*quoting Thisius v. Sealander*, 26 Wn.2d 810, 818, 175 P.2d 619 (1946)).

Witherspoon and the trial court also emphasized that whereas the Chang’s transfer of property to the Lee’s was a gift, DAD’s transfer of the Cook Addition to JA was a commercial transaction. Again, neither *Prestance* nor *Restatement* § 7.6 impose such a limitation on equitable subrogation. Moreover, to the extent *Kim* could be interpreted to impose a narrow limitation of “gift like” transactions, there is little practical distinction between parents gifting property to their children and DAD “selling” its property to JA when DAD and JA are controlled by the same person, JA had no other assets of its own, and DAD guaranteed repayment of JA’s loan. Indeed DAD’s only proceeds from the sale was a promissory note from JA to DAD which Milne could only pay himself once the project was completed and sold. CP 1678:20-1679:15. It is also

significant that Milne submitted a transfer excise tax affidavit claiming the transfer was a “change in identity only.” CP 754. Although Witherspoon disputed the propriety of such a characterization, it is apparent that Sterling endorsed it by its failure to allocate any loan proceeds for the payment of transfer excise tax. CP 1673:16-1674:1; 667-672.

D. The Trial Court Erred in Not Considering the Testimony of Lisa Irwin and Then Concluding that It Was Undisputed that Sterling Did Not Intend to be Equitably Subrogated.

Trial courts may only grant summary judgment if no genuine dispute remains concerning the material facts. *Young v. Key Pharmaceuticals*, 112 Wn.2d 216, 225, 770 P.2d 182 (1989). One factual element of equitable subrogation requires the claimant to show that it “expected to receive a first priority position.” *Prestance* 160 Wn. 2d at ¶ 13, fn.6. Under *Prestance* and the *Restatement*, there is a rebuttable presumption that the lender expected to have a first priority interest unless there is “affirmative proof that the mortgagee intended to subordinate its mortgage to the intervening interest.” *Id.* at ¶ 20; *Restatement* § 7.6, comment e.

In the underlying MWC Litigation, Sterling offered the affidavit of Lisa Irwin (“Irwin”) to confirm that Sterling intended its deed of trust to have a first priority interest against the Cook Addition, that it required Sterling’s loan proceeds to be used first to pay off the IFA and Brown trust

deeds, and that “Sterling intended and believed it would stand in the shoes of’ IFA and Brown. CP 433-447. Irwin is the loan officer who originated and closed the loan for Sterling (through a subsidiary, Action Mortgage) to JA. CP 434. In addition to her earlier affidavit, Stewart Title relied upon substantial deposition testimony of Lisa Irwin in this case, as further evidence of Sterling’s intention to have a first priority interest in the Cook Addition property. CP 583-608.

Witherspoon did not offer any evidence that Sterling intended to subordinate its deed of trust against the Cook Addition to MWC’s mechanic’s lien. Indeed, it could not have, as Irwin’s testimony and Sterling’s loan documents clearly affirmed that Sterling intended to have and bargained for a first priority interest. CP 433-447; 583-608; 691-711 at § 3.09. However, Witherspoon did offer a second affidavit of Irwin in support of its Reply in Support of Witherspoon’s Motion for Partial Summary Judgment in which Irwin disputed Stewart’s characterization of Sterling’s loan as a refinance. CP 1697-1701. At oral argument, the parties discussed whether Irwin’s affidavits and deposition testimony created material and disputed issues of fact.³ Stewart Title argued that the court could grant its motion for summary judgment without considering

³ Lisa Irwin’s second affidavit was filed in support of Witherspoon’s Reply in Support of Motion for Summary Judgment on November 14, 2011. CP 1697-1701. As a result, Stewart did not have the opportunity to respond to the Declaration prior to the November 18th oral argument.

Irwin's affidavits and deposition testimony because Witherspoon had not offered evidence to rebut the presumption established by *Prestance* and the *Restatement* that a lender intends to have first priority. Stewart also argued, however, that Irwin's testimony prevented the trial court from granting Witherspoon's motion for summary judgment because if the court were to rely on Irwin's second affidavit to rebut the presumption of *Prestance* and the *Restatement*, there would be a factual dispute as to the credibility of her statements given her first affidavit and also her deposition testimony. If the court is presented with conflicting affidavits giving rise to an issue of credibility, summary judgment must be denied. *See, e.g.,* 15A Tegland & Ende, *Wash. Prac., Handbook on Civil Proc.* § 69:16 (2011-2012 ed).

In its order denying Stewart Title's motion and granting Witherspoon's motion, the Court specifically stated that it "considered all evidence and materials for both motions except materials filed after argument and any testimony of Lisa Irwin." CP 1754 (emphasis in original). In a footnote to the decision the trial court further elaborated (CP 1756, footnote 1):

The only disputed facts are contained in the testimony of Lisa Irwin, the loan officer for Action Mortgage, the agent of Sterling bank in this case. But neither party argued that her testimony would preclude summary judgment, though Stewart argued that her testimony could not be used to

support a conclusion in favor of Sterling. Her testimony was not considered.

Instead of focusing on Sterling's expectation to have a first priority interest, the trial court then supported its ruling by concluding that although Sterling desired to have a first priority lien, it clearly did not intend for the loan to be a refinance and therefore equitable subrogation could not apply. CP 1784:1-2, 1782:1-2.

The trial court denied Stewart Title's motion for reconsideration on the sole basis that "[t]he undisputed facts in this case established that the loan was not structured to and **Sterling did not expect to step into the shoes** of the former lenders and the Cook's Addition liens." CP 1796 (emphasis added). Excluding Irwin's testimony that Sterling intended to step into the shoes of IFA and Brown when those loans were paid off, and then denying the motion to reconsider on the specific basis that it was undisputed that Sterling did not intend to step into the shoes of the prior liens which it paid off, constitutes an abuse of discretion. *See, Teter v. Deck*, 174 Wn.2d 207, ¶ 15, ___, P.3d. ___, (2012) ("A trial court abuses its discretion if its decision is manifestly unreasonable or based on untenable grounds or untenable reasons"). To the extent the trial court relied upon a conclusion of fact which remained in dispute to grant summary judgment, the Court's ruling should be reversed. Furthermore,

the Court's order on Stewart Title's motion to reconsider should be reversed as it relied exclusively on a supposed undisputed fact which actually was disputed, but which the trial court refused to consider in its original order.⁴

E. Whether Stewart Title Had Constructive Notice of the Intervening MWC Lien is Irrelevant

The trial court also erred in concluding that Washington precludes a lender from asserting equitable subrogation where the title insurer had constructive notice of an intervening lien. CP 1753-1761; 1795-1796. The trial court's conclusion is based upon the demonstrably incorrect belief that a title insurer warrants title information to be accurate. More importantly, equitable subrogation applies regardless of a party's constructive knowledge of an intervening lien, even when it is a title insurer. Indeed, whether the title insurer has knowledge of the intervening lien is irrelevant to the determination of whether its *insured* can claim equitable subrogation as a defense against the lien. Witherspoon's

⁴ In addition to the trial court's refusal to consider the testimony of Lisa Irwin, the trial court also erred in failing to rule on Stewart Title's Motion to Strike Declarations of Richard Skalbania and Michael F. Higgins. CP 1690-1696; 1748-1752. Although the motion was briefed and properly noted, the trial court never ruled on it. CP 1753-1761. It is unclear whether and to what extent the trial court relied on the expert opinions of Skalbania and/or Higgins in granting Witherspoon's motion for summary judgment and denying Stewart Title's cross-motion. The trial court erred in refusing to strike the expert declarations due to their non-compliance with ER 702 and 705. 15A Tegland & Ende, Wash Prac., *Handbook of Civil Proc.* § 69.9 (2011-2012 ed.); *Rothweiler v. Clark County*, 108 Wn. App. 91, 100, 29 P.3d 758 (2001); *Hash v. Hash*, 49 Wn. App. 130, 134, 741 P.2d 584 (1987), *aff'd*, 110 Wn.2d 912, 757 P.2d 507 (1988); *Lilly v. Lynch*, 88 Wn. App. 306, 320, 945 P.2d 727 (1997).

argument, and the trial court's conclusion that an insured cannot assert equitable subrogation if its title insurer was negligent is contrary to the law and policy of Washington statute, *Prestance*, *Restatement* § 7.6, and *Kim*.

1. Title insurers do not warrant information, they insure lien priority.

The trial court concluded that “Washington case law does not allow a title company to assert equitable subrogation where it failed to disclose the existence of a lien while on constructive notice of it, and where the parties to the transaction relied upon the title report in structuring their loan.” CP 1756. This conclusion by the trial court is premised upon the erroneous belief that “[i]n a loan transaction, the title company sells and warrants information to be accurate, the parties act upon the information, and then the insurance company insures the parties upon the information it provided.” CP 1760. The trial court's fundamental understanding of a preliminary commitment and title insurance policy is flawed, and contrary to the law in Washington.

Barstad v. Stewart Title Guar. Co., 145 Wn.2d 528, 536, 39 P.3d 984 (2002), explained that:

a preliminary commitment is a statement submitted to the potential insured establishing the terms and conditions upon which the title insurer is willing to issue a policy. See RCW 48.29.010(3)(c). The statement is merely an offer to issue the title insurance subject to the stated conditions. Significantly, the Legislature clearly

established that a preliminary commitment is *not* a representation of the condition of title, but a statement of terms and conditions upon which the issuer is willing to issue its title policy, if such offer is accepted. Furthermore, the statute explicitly states that reports are not abstracts of title, nor are any of the rights, duties, or responsibilities applicable to the preparation and issuance of an abstract of title applicable to the issuance of any report. (Internal citations and quotations omitted; emphasis in original).

Thus, while an “abstract of title imparts constructive notice with respect to the chain of title to the real property described,” a commitment or preliminary title report does not. *Id.*

Critically, Witherspoon did not and could not argue that Stewart Title or its agents ever provided Sterling with an abstract of title. Stewart Title did not. On the contrary, Stewart Title provided a commitment for title insurance (which matured into title insurance policy), which merely provides the conditions upon which Stewart Title was willing to insure title. *Barstad*, at 536; RCW 48.29.010(3)(c).

2. Equitable subrogation applies regardless of title insurance or the insurer’s constructive knowledge

Constructive knowledge of an intervening lien is irrelevant and does not prohibit application of equitable subrogation. Under *Prestance* and *Restatement* § 7.6 a lender is entitled to assert equitable subrogation regardless of its actual or constructive knowledge of an intervening lien. To the extent *Kim*’s holding that a title insurer with actual knowledge of

an intervening lien cannot assert equitable subrogation survives *Prestance* (it does not), Witherspoon could not argue, and the trial court did not conclude, that Stewart had **actual** knowledge of the intervening lien. The trial court should therefore be reversed.

The trial court agreed with Witherspoon's argument that the doctrine of equitable subrogation is not available where the lender was insured and its title insurer's agent was negligent in discovering the intervening lien. The trial court's conclusion is at odds with *Prestance*, *Restatement* § 7.6, and other jurisdictions which have adopted the *Restatement*. These authorities uniformly acknowledge that the lender's knowledge is irrelevant to application of equitable subrogation.

Witherspoon and the trial court nevertheless maintained that the knowledge of a lender's title insurer is relevant. CP 1759:11-1761:14. Such a conclusion severely undermines the policies set forth in *Prestance* and the *Restatement*, not the least of which is reducing title insurance premiums, as well as Washington's collateral source rule.

In this case, Witherspoon and the trial court relied heavily on two cases, *Kim and Coy v. Raabe*, 69 Wn.2d 346, 350-51, 418 P.2d 728 (1966) ("*Coy*"). *Kim* retains limited (if any) viability after *Prestance*. The Court of Appeals in *Prestance* applied *Kim*, but was reversed. *Prestance*, 160 Wn.2d at 564. The dissent in *Prestance* would also have followed *Kim*

(*id.* at 584), but the six justices in the majority carefully distinguished *Kim* by limiting the case to its facts wherein the party directly seeking equitable subrogation was a title company which had **actual** knowledge of an intervening lien. *Id.* at 564.

In *Kim*, the title company directly intervened to assert equitable subrogation on its own behalf. *Kim*, 145 Wn.2d at 85. In the underlying MWC Litigation, however, Stewart Title was not a party to the transaction and did not have actual knowledge of the intervening MWC mechanic's lien.

Coy has even less applicability and viability than *Kim*. *Coy* involved a bona fide purchaser—a truly innocent party who changed its position in reliance on another's mistake. *Coy* was not even cited by the majority or dissent in *Prestance*. Interpreting *Coy*, the Ninth Circuit has specifically distinguished its holding in cases in which the insured, not the insurer, is the named party asserting equitable subrogation – even when the insurer was negligent and was the real party in interest. *See, Mort v. United States*, 86 F.3d 890, 895 (1996) (applying the doctrine of equitable subrogation even though the buyer and its title company may have had constructive notice of an IRS tax lien); *In re: Tiffany*, 342 Fed. Appx. 303, 2009 U.S. App. LEXIS 17694, (9th Cir.) (“As we previously held in *Mort*, we will only consider the title insurance company's involvement for the

purposes of equitable subrogation when ‘the title company itself [is] seeking equitable subrogation.’ Here, [the lender] is the named party and our analysis does not change merely because [the title insurer] is fulfilling its contractual obligation to pay for the defense of its insured”) (internal citations omitted).⁵

The trial court’s denial of Sterling’s equitable subrogation claim based on Stewart’s alleged negligence is illogical and improper given this court’s embrace of *Restatement* § 7.6 in *Prestance*. If the trial court’s interpretation were correct, then the doctrine of equitable subrogation would rarely apply because nearly every loan transaction in which equitable subrogation may apply involves title insurance and constructive if not actual knowledge of the junior lien. As this court observed in *Prestance*, the minority rule which rejects equitable subrogation when the claimant has actual or constructive knowledge of an intervening lien “renders equitable subrogation nearly useless since a refinancing mortgagee will almost always have either actual or constructive knowledge of junior lienholders.” *Prestance*, 160 Wn.2d at 568-69; *see also id.* at 573. Indeed, if the buyer or its lender did not have actual or constructive notice of the competing lien, they would likely be protected

⁵ Citation of this unpublished opinion is authorized by GR 14.1 (b) and Ninth Circuit Rule 36-3(b). A copy of the opinion is attached as Appendix E. GR 14.1 (b).

by the bona fide purchaser doctrine and not need to invoke equitable subrogation.

To render equitable subrogation useless in cases involving title insurance would also conflict with the Court's articulated policy goal of reducing title insurance premiums:

[A] liberal equitable subrogation doctrine can save billions of dollars by reducing title insurance premiums. Title insurance primarily ensures there are no intervening liens, and 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.

Prestance, 160 Wn.2d at 580-81. The title industry thus supports the *Restatement's* equitable subrogation rule. *Id.* at 581, n.19. Witherspoon's contrary approach (adopted by the trial court) of denying application of the doctrine if one of the parties has title insurance, would have the opposite and undesirable effect of driving up title insurance premiums. It also leads to the illogical result that a party who lacks insurance has greater access to equitable subrogation as a legal defense than a party who is insured, thereby penalizing parties which obtain title insurance.

In addition to criticizing the minority of jurisdictions which consider whether the claimant has actual or constructive knowledge of the intervening lien, the *Prestance* opinion further observed that the doctrine "is also frequently applied in insurance . . . cases." *Id.* at 576, n.12. The

Restatement also expressly rejects the trial court's conclusion. "In many situations a mortgage obligation is discharged by one having a legal duty to do so. Common examples include **insurers**, sureties, and guarantors. Such persons are ordinarily given a right of subrogation." *Restatement* § 7.6, comment c (emphasis added).

Indeed, the doctrine of equitable subrogation was applied in *Prestance* even though the refinance lender had title insurance and had actual knowledge of the senior deed of trust. *Prestance*, 160 Wn.2d at 562-63 ("A preliminary title commitment showed the Bank of America loans, secured by the Bank of America deed of trust"). *Prestance* expressly and repeatedly held that knowledge and fault are irrelevant. *Id.* at 579 ("there is no reason to consider the subrogee's knowledge of intervening interests").⁶ Similarly, the doctrine applies regardless whether the lender or its title insurance company might have done something else

⁶ Numerous courts have held that a title insurance company is not the insured's agent and that the title company's knowledge is not imputed to its insured. *E.g.*, *Lewis v. Superior Court*, 37 Cal. Rptr. 2d 63, 76 (Dist. Ct. App. 1994) ("Another well-settled rule is that a title insurance company is not the agent of its insured, and the insurer's knowledge is not imputed to its insured."); *Soper v. Knaflich*, 26 Wn. App. 678, 613 P.2d 1209 (1980) (title insurance company's actual knowledge of earnest money agreement with other purchasers could not be imputed to insured because there was no agency relationship and subsequent purchaser took title as bona fide purchaser); *Lee v. Duncan*, 88 Conn. App. 319, 870 A.2d 1(2005) (title insurance company's activities in investigating condominium unit title prior to issuance of title insurance policy to unit purchasers did not create an agency relationship between insurance company and purchasers; company's knowledge of judgment could not be imputed to purchasers).

to protect against an intervening lien because the doctrine allows it to step into the shoes of the loan it has paid off.

In addition, these principles are consistent with the other jurisdictions which have adopted the *Restatement*, and apply the doctrine of equitable subrogation without regard to whether the lender was insured or its title company knew or should have known of the intervening lien. For example, in the recent *Sourcecorp* case, the Arizona Supreme Court specifically rejected an argument similar to Witherspoon's, that neither the borrower nor the insurer should benefit from the insurer's negligence in failing to discover an intervening lien. *Sourcecorp, Inc. v. Norcutt*, 274 P.3d 1204 at ¶ 22 (Az. 2012). *Sourcecorp* therefore applied equitable subrogation despite the insurer's negligent failure to discover a recorded judgment lien.

Similarly, in *Arbor Commercial Mortgage, LLC v. Associates at the Palm, LLC*, No. 2010-04658, ___ N.Y.S.2d. ___, 2012 N.Y. App. Div. LEXIS 3964 (May 23, 2012), the New York Appellate Division specifically held that equitable subrogation applies to erase the mistake of failing to identify an intervening lien, to prevent the junior lienor from converting the mistake "into a magical gift for himself." *Id.* at *5. The Appellate Division of the New Jersey Superior Court recently articulated the same policy: "the degree of [the title insurer's] negligence in failing to

discover [the intervening lienholder's] judgment is irrelevant in the absence of a showing that [the intervening lienholder] was prejudiced by [the title insurer's] refinancing of the [original first position] mortgage.” *Investors Savings Bank v. Keybank, N.A.*, 38 A.3d 638, 643 (N.J. Super. Ct. App. Div. 2011). In *Foster v. Porter Bridge Loan Co.*, 27 So.3d 481 (Ala. 2009), the Alabama Supreme Court concluded that even though a title company did not discover an intervening judgment lien, equitable subrogation still applied. In *In re Shavers*, 418 B.R. 589, 617 (Bankr. S.D. Miss. 2009), a Mississippi Bankruptcy Court determined that “title insurance is not a proper consideration in weighing the equities” between the parties regarding application of equitable subrogation. The Indiana Court of Appeals concluded that given the doctrine’s “liberal application,” “neither the buyers nor lenders should be denied equitable subrogation simply because they obtained title insurance.” *Gibson v. Neu*, 867 N.E.2d 188 (Ind. App. 2007). In *Hicks v. Londre*, 125 P.3d 452 (Colo. 2005) the Colorado Supreme Court applied equitable subrogation even though the title commitment failed to show an intervening lien, stating that “reliance upon a title insurance company is not evidence of negligence.” In *Eastern Savings Bank, FSB v. Pappas*, 829 A.2d 953 (D.C. 2003) the Court of Appeals for the District of Columbia applied equitable subrogation even though the title company’s title search on the relevant property negligently

failed to show existence of an intervening lien. In the recent case *Countrywide Home Loans, Inc. v. Korb*, 2011 Ohio 2094, 2011 Ohio App. LEXIS 1799⁷, an Ohio Court of Appeals allowed the lender to assert equitable subrogation despite the title company's negligence in obtaining a reconveyance of the lien to which the lender was seeking to be equitably subrogated. *Id.* at *11 (“Where a party did not expect to be in a first loan position but becomes first based on mistake or negligence on behalf of the party seeking application of the doctrine of equitable subrogation, such negligence is ‘immaterial’ and the doctrine of equitable subrogation applies” (citations omitted)). Thus, whether the lender or buyer had title insurance is simply irrelevant.

Moreover, the *Restatement* itself clearly indicates that the lender's knowledge is irrelevant. The *Restatement* indicates that “[u]nder this *Restatement*, however, subrogation can be granted even if the payor **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.” *Restatement* § 7.6, comment e (emphasis added).

⁷ Citation authorized by GR 14.1 (b) and Rule 4 of the Ohio Supreme Court Rules for Reporting Opinions. A copy of the opinion is attached as Appendix F. GR 14.1 (b).

Further, the law is well-settled that the fact that a party is insured is generally inadmissible because it is irrelevant and/or prejudicial. *See* ER 403, ER 411, and WPI 2.13 (“Whether a party does or does not have insurance has no bearing on any issue you must decide.”); 5A Teglund, *Wash. Prac., Evidence Law and Prac.*, ER 411 § 411 (5th ed. 2011). The denial of an insured’s legal defenses on the basis of an insurer’s conduct is also contrary to the collateral source rule. *Ciminski v. SCI Corp.*, 90 Wn.2d 802, 804, 585 P.2d 1182 (1978); *see also Criez v. Sunset Motor Co.*, 123 Wn. 604, 607, 213 P. 7 (1923) (“It is the settled law of this state that it is no defense to an action against a wrongdoer that the party seeking recovery was insured against the loss and had recovered the amount of the loss, or some part thereof, from the insurance company”). *Accord*, 22 Am. Jur. 2d Damages § 392 (attached as Appendix G).

CONCLUSION

Sterling’s loan proceeds paid off and satisfied the senior liens of IFA and Brown. Sterling should have been equitably subrogated into IFA and Brown’s first lien positions. MWC expected to be junior and inferior to Sterling’s lien and received a windfall in being elevated to a senior lien position. Either equitable subrogation applies to non-refinance transactions, or the Sterling loan qualifies as a refinance for purposes of

equitable subrogation. The knowledge of Stewart Title relative to the intervening MWC mechanic's lien is irrelevant.

Accordingly, Sterling could have successfully asserted equitable subrogation as a defense to the MWC lien claim, and Witherspoon's failure to recognize and timely assert the defense constituted malpractice. Alternatively, the testimony of Lisa Irwin establishes a genuine issue of material fact which precludes summary judgment.

This court should therefore reverse the trial court and conclude that equitable subrogation was available to Sterling as a complete defense in the MWC Litigation, and remand to the trial court to determine whether Witherspoon's failure to timely assert equitable subrogation constituted malpractice.

DATED this 11th day of June, 2012

/s/ David P. Hirschi
David P. Hirschi, WSBA # 35202
Hirschi Steele & Baer, PLLC
Attorney for Appellant

APPENDIX TO APPELLANT'S BRIEF

(hard copy submitted to Clerk by mail)

APPENDIX A – Order Denying Stewart's Motion for Summary Judgment Re Equitable Subrogation and Granting Witherspoon's Motion, dated December 22, 2011

APPENDIX B – Order Denying Plaintiff's Motion for Reconsideration of Order Denying Stewart's Motion for Summary Judgment Re: Equitable Subrogation and Granting Witherspoon's Motion

APPENDIX C – *Restatement (Third) of Property: Mortgages* § 7.6

APPENDIX D – 4 John Norton Pomeroy, *Pomeroy's Equity Jurisprudence* §1212, at 64-43 (5th Ed. 1941)

APPENDIX E – *In re: Tiffany*, 342 Fed. Appx. 303, 2009 U.S. App. LEXIS 17694, (9th Cir.)

APPENDIX F – *Countrywide Home Loans, Inc. v. Korb*, 2011 Ohio 2094, 2011 Ohio App. LEXIS 1799

APPENDIX G – Am. Jur. 2d Damages § 392

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Subject: RE: 87087-0 Stewart Title v. Witherspoon Kelly et al

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Subject: 87087-0 Stewart Title v. Witherspoon Kelly et al

Case No: 87087-0

Case Name: Stewart Title Guaranty Company v. Witherspoon, Kelley, Davenport & Toole, PS., et al.

Dear Court Clerk:

Attached please find the following pleading to be filed in the above referenced case:

- Appellant's Brief
- Declaration of Service

As per the clerk's instruction a hard copy of the appendix to Appellant's Brief is being sent via U.S. mail.

Best Regards,
David P. Hirschi, WSBA #35202
Phone: (801)990-0500
Email: dave@hsblegal.com

Thank you,

Kristen Child

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HIRSCHI STEELE & BAER
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APPENDIX TO APPELLANT'S BRIEF**(hard copy submitted to Clerk by mail)**

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APPENDIX F – *Countrywide Home Loans, Inc. v. Korb*, 2011 Ohio 2094, 2011 Ohio App. LEXIS 1799

APPENDIX G – Am. Jur. 2d Damages § 392

The Honorable Jim Rogers
Noted for Hearing: Friday, November 18, 2011, 2:00 p.m.
With Oral Argument

SUPERIOR COURT OF WASHINGTON IN AND FOR KING COUNTY

STEWART TITLE GUARANTY COMPANY,
a Texas corporation,

Plaintiff,

v.

STERLING SAVINGS BANK, a Washington
corporation; STERLING FINANCIAL
CORPORATION, a Washington corporation;
WITHERSPOON, KELLEY, DAVENPORT &
TOOLE, PS, a Washington corporation;
DUANE M. SWINTON and JANE DOE
SWINTON, and the marital community
composed thereof,

Defendants.

No. 10-2-23403-9SEA

~~PROPOSED~~ ORDER DENYING
STEWART'S MOTION FOR
SUMMARY JUDGMENT RE
EQUITABLE SUBROGATION

AND GRANTING
WITHERSPOON'S MOTION

This motion came on for hearing before the below-signed judge of the above-entitled court pursuant to plaintiff Stewart's Motion for Summary Judgment Re: Equitable Subrogation. The Court having considered the pleadings and papers filed in support and in opposition to said motion, including:

1. Stewart's Motion for Summary Judgment Re: Equitable Subrogation;
2. Declaration of Scott B. Osborne in Support of Stewart's Motion for Summary Judgment re Equitable Subrogation;
3. Declaration of David P. Hirschi in Support of Stewart's Motion for Summary Judgment re Equitable Subrogation;

~~PROPOSED~~ ORDER DENYING STEWART'S MOTION FOR
SUMMARY JUDGMENT RE EQUITABLE SUBROGATION - 1/9

BYRNIS • KELLER • CROMWELL LLP
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1000 SECOND AVENUE
SEATTLE, WASHINGTON 98104
(206) 622-2000

ORIGINAL

1 4. Witherspoon's Opposition to Stewart's Motion for Summary Judgment Re
2 Equitable Subrogation;

3 5. Declaration of Ralph E. Cromwell, Jr., in Support of Witherspoon's
4 Opposition to Stewart's Motion for Summary Judgment Re Equitable Subrogation;

5 6. Declaration of Richard H. Skalbania in Support of Witherspoon's Opposition
6 to Stewart's Motion for Summary Judgment Re Equitable Subrogation;

7 7. Declaration of Michael F. Higgins in Support of Witherspoon's Opposition to
8 Stewart's Motion for Summary Judgment Re Equitable Subrogation;

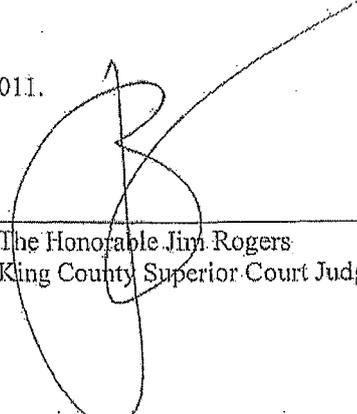
9 ~~the~~ Witherspoon's should. The Court considered
10 all evidence & materials for both motions ;
11 except materials filed after argument
12 and any testimony & live Deems ;

13 and deeming itself fully informed, the Court, finding that good cause exists to grant such
14 motion, now, therefore, it is hereby ORDERED:

- 15 1. Stewart's Motion for Summary Judgment re Equitable Subrogation is ^{DENIED} granted.
16 2. Equitable subrogation was not available as an affirmative defense to
17 defendants Sterling Savings Bank and/or Sterling Financial Corporation in the underlying lien
18 priority action: Mountain West Construction LLC v. James Alan, LLC, et al., Kitsap County
19 No. 08-2-01804-2.

20 DATED this 21st day of November, 2011.

21
22 3. Witherspoon shall
23 prepare a proposed order
24 listing proceedings for all
25 motions except as
26 specifically excluded
in this order.


The Honorable Jim Rogers
King County Superior Court Judge

[PROPOSED] ORDER DENYING STEWART'S MOTION FOR
SUMMARY JUDGMENT RE EQUITABLE SUBROGATION - 2 | 9

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1 Presented by:

2 BYRNES KELLER CROMWELL LLP

3 By /s/ Ralph E. Cromwell, Jr.

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5 Steven C. Minson, WSBA #30974

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13 WITHERSPOON, KELLEY, DAVENPORT

14 & TOOLE, P.S. and DUANE M. SWINTON

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26
[PROPOSED] ORDER DENYING STEWART'S MOTION FOR
SUMMARY JUDGMENT RE EQUITABLE SUBROGATION - 3/9

BYRNES • KELLER • CROMWELL LLP

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1 Stewart Title v. Sterling Savings Bank et. Al.
2 Summary Judgment on Equitable Subrogation

3 Stewart requests that this Court enter an order that equitable subrogation was a
4 viable defense available to Sterling Bank in the underlying lawsuit in this case.

5 Witherspoon asks that the Court rule that equitable subrogation was not available as a
6 defense. Both parties argue that undisputed facts allow this Court to enter a judgment
7 in favor of its position.¹
8

9 This Court concludes that equitable subrogation was not a defense available to
10 Sterling at the time of the Mountain West lawsuit for two separate reasons. First, the
11 loan with JA was not a refinance of DAD's liens on Cook's Addition. Second,
12 Washington case law does not allow a title company to assert equitable subrogation
13 where it failed to disclose the existence of a lien while on constructive notice of it, and
14 where the parties to the transaction relied upon the title report in structuring their loan.
15 The failure of the title company was an intervening factor that prevents Sterling from
16 asserting the defense. The Court does not reach the issue of whether the policies
17 underlying the mechanics lien statute would prohibit the application of equitable
18 subrogation.
19
20

21
22 ¹ The only disputed facts are contained in the testimony of Lisa Irwin, the loan officer for Action
23 Mortgage, the agent of Sterling Bank in this case. But neither party argued that her testimony would
24 preclude summary judgment, though Stewart argued that her testimony could not be used to support a
25 conclusion in favor of Sterling. Her testimony was not considered. The Court also did not consider any
 materials filed after the day of argument.

Hon. Jim Rogers
King County Superior Court
Dept. 45
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Seattle, Washington 98104
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1 First, the loan between JA and Sterling was not a refinance of the existing liens
2 owed by DAD on the Cook's Addition property, as required by *Restatement 7.6*,
3 adopted by our Supreme Court in Bank of America v. Prestance Corp., 160 Wn.2d
4 560, 565 (2007).
5

6 JA and DAD were corporate entities owned by developer David Milne. DAD
7 was a corporation solely controlled by David Milne and was used for many different
8 projects. As is common in the construction industry, JA was created as a single
9 purpose corporation that included another partner with Milne, the builder Jim James,
10 and was created for the Cook's Addition construction project. These two corporate
11 entities kept separate books, filed separate taxes, were incorporated in different
12 states, and as noted, JA included one additional member who was to receive profits
13 from the Cook's Addition development.
14

15 The loan documents for the sale of Cook's Addition from DAD to JA clearly
16 evidence a purchase and sale of real property from DAD to JA. There was an
17 appraisal done and JA paid market value. There is evidence that DAD, the seller,
18 paid off the Brown and IFA liens and the buyer JA did not. The HUD statement
19 supports this, as do other documents. DAD had to pay off the IFA and Brown liens as
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25

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Dept. 45
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Seattle, Washington 98104
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1 a condition of the sale of the property. There are no documents that support any other
2 view of the transaction.²

3
4 Stewart argues that the Supreme Court in Kim v. Lee, 145 Wn.2d 79 (2001),
5 expanded equitable subrogation to allow a substitution of borrowers to be considered
6 as a refinance if equitable under the circumstances. Stewart notes that *Restatement*
7 *of Mortgages* 7.6 states that the mechanics of a loan are not controlling. In Kim, the
8 eventual borrowers/property owners received their interest through a family gift, and
9 were not the initial borrowers. Here, JA bought the property through a commercial
10 transaction. Stewart argues that Milne and DAD stood on both sides of the
11 transaction as seller to JA and guarantor for JA, and this is true; he was required to
12 personally guarantee the JA loan and was required to have DAD guarantee it, as he
13 had assets in that corporation. Stewart also notes that third parties knew that David
14 Milne had an interest in both entities and looked ultimately to him for payment as the
15 developer. But Stewart specifically does not argue that Milne disregarded the
16 corporate forms of JA and DAD.³

17
18
19 The Court does not read the Restatement ("the mechanics of a loan transaction
20 are not controlling") to mean that the loan, bank and corporate documents should be
21

22
23 ² The HUD statement was originally cited by Stewart as prima facie evidence that JA had
refinanced the Brown and IFA liens, but apparently it was misread, and now the parties agree that it
evidences that DAD paid off the Brown and IFA liens on Cook's Addition.

24 ³ There is also a tax affidavit that records a "name change" only between DAD and JA. However, Milne
testified (in essence) that he lied on the tax affidavit to save \$4,500. Milne also called JA a "successor"

25
Hon. Jim Rogers
King County Superior Court
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1 disregarded. The loan documents and contracts are strong evidence of the intention
2 of the parties, and they do not evidence a refinance. The *Restatement* reflects a
3 reasonable view that a Court should look at the mechanics of a transaction and the
4 intentions of the parties, and not elevate form over substance. But to reach the
5 analogy Stewart makes between Kim and these facts would require a disregard of the
6 corporate form. DAD did not gift or quitclaim its interest in Cook's Addition to JA. JA
7 has independent legal status. When DAD paid off the IFA and Brown liens, it was not
8 a refinance by JA.
9

10
11 As a separate basis, equitable subrogation could not be an affirmative
12 defense for Sterling because the actions of Stewart (Kitsap) also prohibit the
13 application of the defense under Washington law. The issue is not solely whether
14 Sterling could assert the defense of equitable subrogation, but also whether Stewart's
15 own actions at the time must be taken into account. The Court acknowledges that
16 different jurisdictions reach different results on this issue, but Washington law holds
17 that role of the title insurance should be considered, depending on the facts. Coy v.
18 Raabe, 69 Wn.2d 346 (1966), Kim, supra; Norcom Builders v. GMP Homes, 2011 WL
19 1795265 (2011). The facts of these cases do differ, but the principle is the same.
20

21 Kim:

22
23
24 _____
25 entity, but then clarified in testimony that JA was a single purpose entity and took over no assets or
projects from DAD (except for the purchase of Cook's Addition).

Hon. Jim Rogers
King County Superior Court
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Seattle, Washington 98104

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1 "As in Coy, this case was precipitated by the title company's negligence and
2 failure to acknowledge the lien. Yakima Title not only failed to discover Kim's
3 judgment lien when it conducted its title search for the Lee's loan from
4 Pioneers, as in the Coy case, but also failed to acknowledge the lien when it
5 had actual knowledge of it from Kim's counsel. With the information at hand,
6 Yakima Title still issued the title policy insuring PHH's first lien position.
7 Applying equitable subrogation to extend on favor of Yakima Title would result
8 in alleviating Yakima Title of its own negligence and complete disregard of the
9 actual notice at the expense of an innocent judgment creditor."

10 145 Wn.2d at 92.⁴

11 As noted by counsel for Stewart, Justice Sanders dissent in Kim supported
12 Stewart's position, however, J. Sanders was in the dissent, and his later decision in
13 Prestance did not address a failure by a title insurance company. There are policy
14 reasons for the holding as to why title company actions matter. Title insurance and
15 auto insurance are different (see contra, J. Sanders' dissent at Kim, 145 Wn.2d at 94).
16 Auto insurance does not provide you with information about your new car and then
17 provide you with a warranty at purchase. In a loan transaction, the title company sells
18 and warrants information to be accurate, the parties act upon the information, and
19 then the insurance company insures the parties upon the information it provided. In
20 this limited but important way, the title insurance company becomes a party to the
21 transaction. As noted above, the parties to the transaction may choose to bargain
22 with other lienholders who may have greater priority, if such exist.

23
24
25 ⁴ Overruled by Prestance in part.

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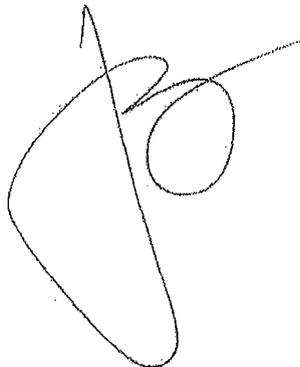
Page 8/9

1 It is undisputed that Sterling wanted to have its Cook's Addition lien in first
2 priority. It required seller DAD to pay off the outstanding liens. Sterling ordered a title
3 report. It bargained for an endorsement for mechanic's lien title coverage, which was
4 not in Stewart's initial proposed policy. Sterling paid for this endorsement. Stewart
5 simply failed to conduct an inspection of the property as required, and has no
6 explanation why. If Stewart had performed the inspection, discovered the Mountain
7 West work, and informed Sterling, the Bank had specific bank policies that had to be
8 followed and presumably would have been followed to ensure that its lien was in first
9 position. For example, one of Sterling's policies was a requirement for obtaining
10 subrogation agreements from contractors. What, if anything, Mountain West might
11 have requested or bargained for is unknown, because the parties never got to that
12 point.
13

14
15 On these facts, where Sterling relied upon the Stewart (Kitsap) title report in
16 structuring the loan between JA and DAD, and Stewart Title's failure led to this result,
17 equitable subrogation is not available as a defense.
18

19 This Court does not reach the separate issue of whether equitable subrogation
20 may be a defense where a mechanic's lien is at issue.
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Hon. Jim Rogers
King County Superior Court
Dept. 45
516 3rd Avenue
KCC-SC-0203
Seattle, Washington 98104

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Hon. James Rogers
Hearing Date: January 11, 2012
Without Oral Argument

IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
IN AND FOR THE COUNTY OF KING

STEWART TITLE GUARANTY
COMPANY, A Texas Corporation,

Plaintiff,

vs.

STERLING SAVINGS BANK, a Washington
corporation; STERLING FINANCIAL
CORPORATION, a Washington corporation;
WITHERSPOON, KELLY, DAVENPORT &
TOOLE, PS, a Washington corporation;
DUANE M. SWINTON and JANE DOE
SWINTON, and the marital community
composed thereof,

Defendants.

No. 10-2-23403-9 SEA

~~PROPOSED~~ ORDER ^{DENYING} ~~GRANTING~~
PLAINTIFF'S MOTION
FOR RECONSIDERATION OF
ORDER DENYING STEWART'S
MOTION FOR SUMMARY
JUDGMENT RE: EQUITABLE
SUBROGATION AND GRANTING
WITHERSPOON'S MOTION

This motion came on for hearing before the below-signed judge of the above-
entitled court pursuant to Plaintiff Stewart Title Guaranty Company's ("Stewart")
Motion for Reconsideration of Order Denying Stewart's Motion for Summary Judgment
re: Equitable Subrogation and Granting Witherspoon's Motion. The Court having

~~PROPOSED~~ ORDER ^{DENYING} ~~GRANTING~~
STEWART'S MOTION FOR
RECONSIDERATION

HIRSCHI STEELE & BAER, PLLC
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COPY



9 of 10 DOCUMENTS

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Case Citations

Chapter 7 - Priorities

Restat 3d of Property: Mortgages, § 7.6

§ 7.6 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.

(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.

COMMENTS & ILLUSTRATIONS:

a. Introductory note. Subrogation is an equitable remedy designed to avoid a person's receiving an unearned windfall at the expense of another. It may arise when one pays or performs in full an obligation owed by another and secured by a mortgage. The effect of subrogation is to assign the mortgage and the obligation to the person performing (termed the "payor" in this Comment) by operation of law, rather than discharging them. The payor thus becomes the subrogee. After performing the obligation, the subrogee is entitled to receive upon request a formal written assignment of these rights. Such an assignment may be placed in the public records and may be helpful in ensuring that others recognize the subrogee's rights. See § 6.4(f).

Subrogation may also occur by voluntary assignment or agreement between the mortgagee and the payor. This is commonly termed "conventional subrogation." However, subrogation imposed as an equitable remedy, often but perhaps inaptly called "legal subrogation," is the subject matter of this section.

Restatement of the Law, Third, Property (Mortgages), § 7.6

The principle of subrogation is applicable to both secured and unsecured obligations. Subrogation to an unsecured obligation may be appropriate where the subrogee has discharged that obligation under circumstances in which it would be unjust to deny the subrogee the right to recover on the obligation against the debtor or obligor. However, the concern of this section is with obligations secured by mortgages. Ordinarily one who is entitled to subrogation is permitted to enforce both the mortgage and the secured obligation. Of course, subrogation does not make anyone liable on the obligation who was not liable before; thus the subrogee may be able to enforce the mortgage against numerous persons, such as holders of junior liens, who have no liability on the obligation.

Subrogation to a mortgage is usually of importance only when a subordinate lien or other junior interest exists on the real estate. If no such interest existed, the subrogee could simply sue on the obligation, obtain a judgment lien against the real estate, and execute on it. However, if an interest exists that is subordinate to the mortgage in favor of some other person, such a judgment lien would be inferior to it in priority and might have little or no value. In this setting the subrogee wants more than a lien; he or she wants a lien with the priority of the original mortgage, and this is precisely what subrogation gives. The holders of intervening interests can hardly complain about this result, for they are no worse off than before the senior obligation was discharged. If there were no subrogation, such junior interests would be promoted in priority, giving them an unwarranted and unjust windfall.

Where subrogation to a mortgage is sought, the entire obligation secured by the mortgage must be discharged. Partial subrogation to a mortgage is not permitted. The reason is that partial subrogation would have the effect of dividing the security between the original obligee and the subrogee, imposing unexpected burdens and potential complexities of division of the security and marshaling upon the original mortgagee. However, if the payor can negotiate a full settlement of the obligation for less than its face value, subrogation will be recognized.

While a subordinate mortgagee who makes partial payments on a prior mortgage (for example, to cure a default in payment of an installment by the mortgagor) may not have subrogation, such a mortgagee may add the payment to the balance owing on the subordinate mortgage, and may recover it in foreclosure or in an action on the debt or for reimbursement of the payment, as appropriate. See § 2.2. The payor may also have an independent claim for restitution to prevent unjust enrichment.

Subrogation is a broad concept, and the situations described in Subsection (b) of this section do not necessarily exhaust it. They should be regarded as illustrative, as should the following comments. Additional situations may arise, beyond those discussed here, in which one who performs a mortgage is entitled to subrogation in order to avoid unjust enrichment.

b. Performance to protect an interest. A person's interest in real estate may be jeopardized by the threat of foreclosure of a prior mortgage. Performing that mortgage obligation may be the only or most feasible means of protecting the interest. Hence one who engages in such performance is subrogated to the mortgage and to the debt discharged. See Illustrations 1 and 2.

c. Performance made under legal duty. In many situations a mortgage obligation is discharged by one having a legal duty to do so. Common examples include insurers, sureties, and guarantors. Such persons are ordinarily given a right of subrogation. See Illustrations 12-15. This is consistent with the treatment of sureties and guarantors under *Restatement Third, Suretyship and Guaranty* § 28.

d. Performance induced by fraud or the like. In some cases one may be induced to perform and discharge a mortgage obligation by misrepresentation, mistake, duress, undue influence, deceit, or other similar imposition. The deception may be practiced on the payor by the mortgagor or by some other person. If the circumstances are such that subrogation to a prior mortgage will relieve the payor, and if no prejudice to any innocent person will result, the payor may have subrogation.

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e. Performance at the request of the debtor. A mortgage debtor may ask another person to discharge the debt. In some circumstances, the payor who does so is warranted in receiving, by subrogation, the benefit and priority of the mortgage paid. The most common context for this sort of subrogation is the "refinancing" of a mortgage loan; that is, the payment of a loan with the proceeds of another loan.

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.

When a mortgage loan is paid by one who makes a new loan for that purpose, the payor will have the benefit of subrogation to the mortgage that was discharged only if the payor was promised repayment of the funds advanced and reasonably expected to receive a mortgage, with the priority of the discharged mortgage, on the real estate to secure that repayment. See Illustrations 23 and 24. Thus, a payor who makes a mere gift, or who makes a loan that is, by its terms, unsecured or secured with a lien of inferior priority, cannot claim subrogation, since that would provide the payor with an unwarranted windfall. See Illustration 25. On the other hand, if the debtor promises to provide security in the real estate to the payor, but fails to do so, the payor is entitled to subrogation.

Perhaps the case occurring most frequently is that in which the payor is actually given a mortgage on the real estate, but in the absence of subrogation it would be subordinate to some intervening interest, such as a junior lien. Here subrogation is entirely appropriate, and by virtue of it the payor has the priority of the original mortgage that was discharged. This priority is often of critical importance, since it will place the payor's security in a position superior to intervening liens and other interests in the real estate. The holders of such intervening interests can hardly complain of this result, for it does not harm them; their position is not materially prejudiced, but is simply unchanged.

Many judicial opinions dealing with a mortgagee who pays a preexisting mortgage focus on whether the payor had notice of the intervening interest at the time of the payment. Most of the cases disqualify the payor who has actual knowledge of the intervening interest, although they do not consider constructive notice from the public records to impair the payor's right of subrogation. Under this Restatement, however, subrogation can be granted even if the payor 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. See Illustration 26. 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. See Illustration 27.

Subsection (b) speaks of the subrogee discharging the obligation secured by the mortgage. This should not be taken to require a direct payment from the subrogee to the prior mortgagee. In a refinancing, the new lender may pay the prior lender directly, may pay a title company or other closing agent with instructions to pay the prior lender, or may disburse funds directly to the mortgagor with an understanding or agreement that the mortgagor will pay the prior mortgage. The mechanics of the transaction are not controlling, and subrogation may be appropriate when any of these forms of payment has been employed.

Subrogation will be recognized only if it will not materially prejudice the holders of intervening interests. The most obvious illustration is that of a payor who lends the mortgagor more money than is necessary to discharge the preexisting mortgage. The payor is subrogated only to the extent that the funds disbursed are actually applied toward payment of the prior lien. There is no right of subrogation with respect to any excess funds. See Illustration 28.

Similarly, if the payor demands a higher interest rate than prevailed under the original mortgage loan, the positions of intervening interest holders may be jeopardized, since the increased interest may result in the mortgage's having a

higher balance at the time it is later foreclosed. Subrogation should be granted only to the extent of the debt balance that would have existed if the interest rate had been unchanged. See Illustration 29. This reasoning is inapplicable if the original mortgage provided for variable or adjustable interest, and the interest on the refinancing loan falls within the parameters thus established.

On the other hand, a mere extension of time resulting from refinancing is generally not regarded as seriously prejudicial to holders of intervening interests, and is often advantageous to them. See the discussion in § 7.3, Comments b and c.

f. Subrogation not granted where injustice would result. Since the purpose of subrogation is to prevent unjust enrichment, it will not be granted where it would produce injustice. In virtually all cases in which injustice is found, it flows from a delay by the payor in recording his or her new mortgage, in demanding and recording a written assignment, or in otherwise publicly asserting subrogation to the mortgage paid. The delay may lead the holder of an intervening interest to take detrimental action in the belief that that interest now has priority.

For example, if the payor who discharges a prior mortgage does not immediately record his or her own mortgage, the public records may for some period of time appear to indicate that the real estate is unencumbered. One who in good faith acquires an interest in the real estate during this period will be severely prejudiced if the payor is permitted to gain priority over that interest by subrogation. In such cases subrogation is denied. See Illustration 30.

Even if the payor's mortgage is recorded immediately, prejudice to the holder of a junior interest can arise if the payor delays in making a demand for subrogation to that holder or seeking subrogation in the courts. For example, a junior mortgage or other subordinate interest in the real estate may be sold to a good-faith purchaser after the first mortgage is discharged. The purchaser of the junior mortgage may believe, from the appearance of the public records, that he or she is acquiring a first lien on the property. Even if the payor who discharged the first mortgage immediately recorded his or her own mortgage, it may not be apparent to the purchaser of the intervening interest that the priority of the old first mortgage will be preserved by subrogation. Such purchasers should be protected against subrogation unless they had actual knowledge that the payor's advances were used to pay the first mortgage. See Illustration 31. The payor could, of course, forestall this problem by an immediate assertion of subordination and the filing of an appropriate action to establish priority. The filing of such an action (and in some jurisdictions, the recordation of an appropriate notice of *lis pendens*) would give constructive notice of the subrogation claim to anyone contemplating a purchase of the junior interest.

1. Blackacre is owned by Mortgagor, subject to two mortgages held respectively by Mortgagee-1 and Mortgagee-2. Mortgagor defaults on the obligation secured by the first mortgage and Mortgagee-1 threatens foreclosure. Mortgagee-2, learning of these facts, pays Mortgagee-1's debt in full. Mortgagee-2 is subrogated to the mortgage and to the debt it secures, and may enforce them against Mortgagor and Blackacre.

2. Blackacre is owned by Mortgagor, subject to a mortgage held by Mortgagee and to a subordinate lease held by Lessee. Mortgagor defaults in payment on the obligation secured by the mortgage, and Mortgagee threatens foreclosure. Lessee, learning of these facts, pays Mortgagee's debt in full. Lessee is subrogated to the mortgage and to the debt it secures, and may enforce them against Mortgagor and Blackacre.

Subrogation is unavailable to a person performing the mortgage obligation to the extent that he or she was primarily responsible for it. The point of subrogation is to prevent unjust enrichment of others, not to compensate one who has paid a debt that in fairness he or she should have paid. Thus, although the subrogee must discharge the entire obligation in order to have the right of subrogation, subrogation will be granted for only the part of the obligation for which the subrogee was not primarily responsible. See Illustrations 3 through 5. As Illustration 3 suggests, one may be primarily responsible for the obligation without necessarily having personal liability on it.

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3. Blackacre is owned by A and B, subject to a mortgage held by Mortgagee, but neither A nor B is personally liable on the mortgage debt. A and B are equal tenants in common, and under applicable law are equally responsible with respect to one another to pay the debt, so that either who pays is entitled to contribution from the other for one-half of the payment. Hence each is primarily responsible for one-half of the mortgage debt. A refuses to pay any part of the debt, and Mortgagee threatens foreclosure. B, learning of these facts, pays Mortgagee's debt in full. B is subrogated to the mortgage to the extent one-half of the debt it secures, and may enforce the mortgage against A's interest in Blackacre in order to recover that amount.

4. The facts are the same as in Illustration 3, except that A and B were formerly married, and the court decree dissolving the marriage ordered B to pay the entire debt secured by the mortgage. Since on these facts B was primarily responsible for payment of the entire debt and A for none of it, B may not have subrogation.

5. Blackacre and Whiteacre are owned by Mortgagor, subject to a blanket mortgage on both parcels held by Mortgagee. Mortgagor sells Blackacre to Grantee, who takes subject to the blanket mortgage but assumes only one-half of the debt; it is the parties' understanding that Mortgagor will pay the other half of the debt in due course. However, Mortgagor fails to do so. Mortgagee threatens foreclosure, and Grantee pays the entire debt in order to protect Blackacre from foreclosure. Grantee is subrogated to the mortgage and to the portion of the debt for which Mortgagor was responsible, and may enforce them against Mortgagor and Whiteacre.

In each of the foregoing Illustrations, the person seeking subrogation held an interest in the mortgaged real estate that was subordinate to the mortgage. In such cases, the performance of the obligation is properly referred to as a redemption from the mortgage; see § 6.4, Comment g. However, subrogation is not limited to cases of redemption; under this section, the subrogee must have performed in order to protect an "interest," but that interest need not be a legally recognized interest in real property. It may be, for example, a business or financial interest that would be impaired by foreclosure of the mortgage, an interest in reputation, or a moral obligation. See Illustrations 6 through 9.

Prior case law has often indicated that one who pays as a "volunteer" is not entitled to subrogation. However, the meaning of the term "volunteer" is highly variable and uncertain, and has engendered considerable confusion. This Restatement does not adopt the "volunteer" rule, but instead requires simply that the subrogee pay to protect some interest.

6. Mortgagor owns Blackacre and obtains a construction loan mortgage from Mortgagee to build an office building. Mortgagor purchases a payment bond from B, a bonding company, under which B becomes liable for payment for any labor or materials supplied to the project for which Mortgagor fails to pay. Mortgagor defaults in payment on the construction loan and Mortgagee threatens foreclosure. B reasonably fears that in the event of foreclosure of the mortgage, B will be subject to numerous claims on the bond by contractors and materials suppliers. To avoid this result, B discharges the mortgage. B is subrogated to the mortgage and the debt it secures, and may enforce them against Mortgagor and Blackacre.

7. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee-1. Mortgagor desires to refinance by obtaining a new first mortgage loan from Mortgagee-2, and Mortgagee-2 requests a title insurance binder from TI, a title insurance company. TI issues a binder showing the existence of the first mortgage held by Mortgagee-1, and indicates that it will not issue a title policy showing a first lien in Mortgagee-2 unless the prior mortgage is discharged. The settlement of the refinancing transaction is conducted by A, who is an "approved" attorney of TI, although not acting as TI's agent in conducting the settlement. A records the new mortgage in favor of Mortgagee-2, but fraudulently absconds with the funds which A should have paid to discharge Mortgagee-1. Assume that under applicable law, as between Mortgagor and Mortgagee-2 this loss would fall on Mortgagor. TI, in order to protect its business reputation in the mortgage lending community, discharges Mortgagee-1's mortgage, although TI has no legal duty to do so. TI is subrogated to the first mortgage and the debt it secures, and may enforce them against Mortgagor and Blackacre.

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8. Mortgagor obtains a loan from Mortgagee, and secures repayment of the loan with a mortgage on Blackacre. Mortgagor is assisted in obtaining the loan by the assurances of F, Mortgagor's father, who advises Mortgagee that his son is a good risk and will repay the loan. J sues Mortgagor and obtains a judgment lien on Blackacre that is subordinate to the mortgage. Subsequently Mortgagor defaults in payment of the mortgage loan, and F, acting under a sense of moral obligation, pays the loan in full. F is entitled to subrogation to the rights of Mortgagee as against Mortgagor and J.

9. Mortgagor resides on Blackacre but has no funds. Blackacre is subject to a mortgage in favor of Mortgagee, payments on which are in default. Mortgagor's children, A and B, acting out of affection for their mother, pay the mortgage debt in full to protect Mortgagor's residence from foreclosure. Upon Mortgagor's death her title to Blackacre passes by intestate succession to her husband H, who made no contribution to the payment of the mortgage debt. A and B are subrogated to the rights of Mortgagee, and can enforce the mortgage against H.

While the concept of "interest" is broadly defined, it does not cover every conceivable payor. A true "intermeddler" who has no legitimate need or reason to pay the mortgage debt is not entitled to subrogation.

In some cases the subrogee discharges a debt secured by a mortgage, but wishes to have subrogation only to the debt and not the mortgage. The subrogee is privileged to disregard the real estate security and seek subrogation only to the debt. Here, as above, the "interest" the subrogee pays to protect may be a legally recognized interest in the real estate, or may be some other benefit. See Illustrations 10 and 11.

10. Mortgagor obtains a loan from Mortgagee and secures repayment of the loan with a mortgage on Blackacre. Later Mortgagor agrees to sell Blackacre to Grantee, with Grantee's purchase to be financed by a new purchase money mortgage loan having first priority. Attorney A is employed by Grantee to conduct the settlement. A records a release of the mortgage from Mortgagee and records the deed to Grantee. However, instead of transmitting to Mortgagee the funds required to discharge the old mortgage, A gives the entire proceeds of the sale to Mortgagor, who promises to discharge Mortgagee. Mortgagor fails to do so. A pays Mortgagee with A's own funds in order to protect A's reputation and to forestall an action for malpractice by Grantee. A is subrogated to Mortgagee's claim against Mortgagor on the debt, even though A does not wish to, and probably could not, assert subrogation to the mortgage.

11. Mortgagor owns Blackacre subject to a recorded mortgage held by Mortgagee-1. Mortgagor borrows money from Mortgagee-2 and gives Mortgagee-2 a mortgage on Blackacre, which Mortgagor falsely represents as having first priority. Mortgagee-2 makes no title examination. Subsequently Mortgagee-2 wishes to assign the second mortgage to another investor, and in preparing to do so discovers the existence of the first mortgage. Mortgagee-2 pays Mortgagee-1's debt in full in order to give the second mortgage first priority, thereby making it more readily marketable in the secondary mortgage market. Mortgagee-2 is subrogated to the debt that was discharged, and can assert it against Mortgagor, even though Mortgagee-2 does not wish to assert subrogation to the mortgage.

12. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee. Pursuant to the terms of the mortgage, Mortgagor purchases fire insurance from Insurer; the policy names both Mortgagor and Mortgagee as loss payees. Mortgagor, by means of arson, causes a fire that destroys the improvements on Blackacre. Under the terms of the insurance policy, Insurer is bound to indemnify Mortgagee for the loss notwithstanding that it resulted from Mortgagor's arson. However, the policy withdraws Mortgagor's insurance coverage as a consequence of the arson. To satisfy its duty under the policy, Insurer pays Mortgagee the entire balance owing on the mortgage debt. Insurer is subrogated to the mortgage and to the debt it secures, and may enforce them against Mortgagor.

13. Mortgagor, owner of Blackacre, borrows money from Mortgagee and gives Mortgagee a promissory note secured by a mortgage on Blackacre. At Mortgagee's insistence, Mortgagor convinces a friend, Guarantor, to give Mortgagee a written guaranty of Mortgagor's note. Subsequently Mortgagor defaults in payment of the note, and Guarantor pays it in full. Guarantor is subrogated to the note and mortgage, and may enforce them against Mortgagor.

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14. The facts are the same as in Illustration 13, except that Guarantor also pledges a municipal bond owned by Guarantor to Mortgagee as security for the guaranty. Upon Mortgagor's default, Mortgagee sells the bond to pay Mortgagor's debt. Guarantor is subrogated to the note and mortgage, and may enforce them against Mortgagor.

15. Mortgagor, owner of Blackacre, borrows money from Mortgagee and gives Mortgagee a promissory note secured by a mortgage on Blackacre. At Mortgagee's insistence, Mortgagor procures a "standby" letter of credit from Bank in favor of Mortgagee to enhance Mortgagor's credit. The letter of credit obligates Bank to pay on the condition that Mortgagor defaults in payment of the note, and obligates Mortgagor to reimburse Bank if it is required to pay. Subsequently Mortgagor defaults and Bank, acting under the letter of credit, pays the secured note in full. Bank is subrogated to the note and mortgage, and may enforce them against Mortgagor, notwithstanding that the letter of credit may be technically regarded as a primary obligation of Bank.

As noted above, one cannot claim subrogation upon payment of an obligation to the extent that he or she is primarily responsible for it. There is no unjust enrichment in paying one's own debts. For example, a grantee of land who assumes a mortgage on it, and subsequently pays the mortgage, is not entitled to subrogation. See § 8.5, Comment c, and § 8.5, Illustration 19. However, in many situations subrogation is appropriate even though the subrogee is personally liable on the obligation being paid, if that liability is partial or secondary. One example is the "accommodation party," who executes an instrument for the purpose of becoming liable on it without any corresponding direct benefit; see Uniform Commercial Code § 3-419 (1995). See Illustration 16. Another is the mortgagor who sells the real estate subject to, or with an assumption of, the mortgage debt, with the purchaser paying cash equal to the difference between the agreed purchase price and the balance owing on the mortgage debt. Such a mortgagor, while still personally liable to the mortgagee by virtue of having executed the original note or other evidence of debt, becomes, as between the mortgagor and the grantee, secondarily liable as a surety when the transfer occurs; see § 5.1, Comment i; § 5.2, Comment c. The mortgagor may pay the debt and be subrogated to the mortgage (whether the transfer was with an assumption or was merely "subject to" the mortgage) as well as the debt (if the transferee assumed the debt). See § 5.1(d); § 5.2(e); Illustrations 17-18.

On the other hand, in the relatively rare case in which the purchaser of land pays the full price in cash but takes subject to a preexisting mortgage with the understanding (or express promise) that the grantor will pay the mortgage debt, the roles of the grantor and grantee are reversed. Here the grantor is primarily liable for payment, and the grantee is, to the extent of the value of the land, a surety. If the grantor fails to pay the mortgage debt when due, the grantee may pay it and be subrogated to the debt and mortgage as against any junior interests. See § 5.2(c); Illustration 19.

16. To raise capital to start a business, Mortgagor wishes to borrow money from Mortgagee on the security of Blackacre, which Mortgagor owns. To induce Mortgagee to make the loan, Mortgagor persuades his sister, S, to execute the promissory note together with Mortgagor, although S is not involved in Mortgagor's business and derives no benefit from the loan. Subsequently Mortgagor defaults on the note and, at Mortgagee's demand, S pays it in full. S is subrogated to the note and mortgage, and may enforce them against Mortgagor.

17. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee, securing Mortgagor's promissory note. Mortgagor sells Blackacre to Grantee, who promises to assume the mortgage debt and pays Mortgagor cash equal to the difference between the mortgage debt and the agreed purchase price of Blackacre. Subsequently Grantee defaults on the note and, at Mortgagee's demand, Mortgagor pays it in full. Mortgagor is subrogated to the note and mortgage, and may enforce them against Grantee.

18. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee. Mortgagor sells Blackacre to Grantee, who takes subject to the mortgage, but does not assume the mortgage debt. Grantee pays Mortgagor cash equal to the difference between the mortgage debt and the agreed purchase price of Blackacre, and expects to make the remainder of the payments on the mortgage debt as they fall due. Subsequently Grantee defaults on the note and, at Mortgagee's demand, Mortgagor pays it in full. Mortgagor is subrogated to the mortgage, and may enforce it against Grantee.

19. Mortgagor owns Blackacre subject to two mortgages, held respectively by Mortgagee-1 and Mortgagee-2. Mortgagor is personally liable on the debts secured by the two mortgages. Mortgagor sells Blackacre to Grantee, who takes subject to the mortgages, but pays the full purchase price in cash with the understanding that Mortgagor will pay the mortgage debts. Mortgagor defaults in payment to Mortgagee-1, and Grantee pays that mortgage debt in full. Grantee is subrogated to the first mortgage, and may enforce it against Mortgagee-2. Grantee is also subrogated to the debt secured by the first mortgage as against Mortgagor.

In Illustration 17 the mortgagor is subrogated to both the note and mortgage as against the grantee, while in Illustration 18 the mortgagor is subrogated only to the mortgage. The difference in result follows from the fact that the grantee did not assume the promissory note in Illustration 18, and hence is not personally liable on it.

20. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee. F, who has no interest in Blackacre, purports to sell it to Grantee subject to the mortgage, and gives Grantee a forged deed. Grantee, believing that she has title to Blackacre, pays the mortgage debt in full. Grantee is subrogated to Mortgagee's rights and may enforce the mortgage and the debt against Mortgagor.

21. Mortgagor holds Blackacre subject to two mortgages, held respectively by Mortgagee-1 and Mortgagee-2. Mortgagor sells Blackacre to Grantee, falsely stating to Grantee that Blackacre is subject only to the first mortgage and promising that Mortgagor will pay and satisfy that mortgage obligation with the proceeds of the sale. Grantee, believing this statement, makes no title examination and is unaware of the existence of the second mortgage. Grantee completes the purchase. Mortgagor uses the proceeds of the sale to satisfy the first mortgage but does not satisfy the second. Grantee is entitled to be subrogated to the rights of Mortgagee-1 as against Mortgagee-2 and may enforce the first mortgage against Mortgagee-2.

22. Mortgagor holds Blackacre subject to a mortgage in favor of Mortgagee, securing Mortgagor's promissory note to Mortgagee. Mortgagee borrows funds from Bank, and as collateral for repayment assigns the note and mortgage to Bank. Subsequently, when Mortgagee repays the borrowed funds, Bank erroneously and negligently releases the mortgage instead of reassigning it to Mortgagee. Mortgagee, upon discovering that Bank has released the mortgage, demands that Bank compensate Mortgagee for the loss of its security. Bank responds by paying Mortgagee the balance owed on the mortgage note. Bank is subrogated to Mortgagee's rights under the note and mortgage, and may enforce them against Mortgagor and Blackacre.

Illustration 21 states that the grantee lacks knowledge of the intervening lien. However, knowledge is not necessarily fatal to the grantee's claim of subrogation, if equity would nonetheless dictate the recognition of subrogation. See the discussion in Comment e, *infra*. Moreover, the grantee's right to subrogation is not lost even if the second mortgage was recorded and the grantee might be held to have had constructive notice of it under the applicable recording act. Although the grantee may have examined the title carelessly or may have made no title examination at all, if the cash price paid by the grantee included the second mortgage balance, subrogation to, rather than extinction of, the first mortgage will result in order to prevent unjust enrichment of the second mortgagee.

23. Mortgagor owns Blackacre subject to two mortgages held by Mortgagee-1 and Mortgagee-2 in order of priority. Both mortgages are recorded. Mortgagor approaches Mortgagee-3, a bank engaged in mortgage lending, and obtains a loan for the purpose of discharging Mortgagee-1's mortgage. Mortgagee-3 is not aware of the existence of Mortgagee-2's interest, does not perform a title examination, and expects that its mortgage will have first priority. Mortgagee-3 makes the loan and disburses the proceeds to pay and discharge in full Mortgagee-1's mortgage. Mortgagee-3 is entitled to be subrogated to Mortgagee-1's mortgage.

24. Blackacre is owned by A and B, subject to a mortgage held by Mortgagee-1. A and B are tenants in common, and under applicable law are equally responsible with respect to one another to pay the debt secured by the mortgage, so that either who pays is entitled to contribution from the other for one-half of the payment. A refuses to pay any part of

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the debt, and Mortgagee-1 institutes foreclosure proceedings. B, learning of these facts, approaches Mortgagee-2 and obtains a loan the proceeds of which are used to fully discharge Mortgagee-1's mortgage. B gives Mortgagee-2 a mortgage on B's interest in Blackacre, but A refuses to execute a mortgage on A's interest. Mortgagee-2 is subrogated to Mortgagee-1's rights, and may enforce the first mortgage against A's interest in Blackacre.

25. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee. Mortgagor asks his mother, M, to pay off the mortgage debt, and orally promises her that he will reimburse her for the outlay. However, Mortgagor does not represent that M will receive any security for this promise. M discharges the mortgage, but Mortgagor does not reimburse M. M is not entitled to subrogation to the debt and mortgage, as she had no reasonable expectation of security with a priority equal to that of the mortgage she discharged.

26. The facts are the same as Illustration 23, except that Mortgagee-3 has actual knowledge of the intervening mortgage held by Mortgagee-2. Notwithstanding this knowledge, Mortgagee-3 is entitled to be subrogated to Mortgagee-1's mortgage.

27. The facts are the same as Illustration 26, except that the mortgage taken by Mortgagee-3 states that it is a "second mortgage." These words establish that Mortgagee-3 did not expect to acquire the priority of the mortgage that was discharged, and Mortgagee-3 is not entitled to be subrogated to Mortgagee-1's mortgage.

28. Blackacre is owned by A and B, subject to a mortgage held by Mortgagee-1 securing a debt of \$ 100,000. A and B are tenants in common. A approaches Mortgagee-2 and induces it to make a loan of \$ 150,000, of which \$ 100,000 is used to pay off the first mortgage in full. The remaining \$ 50,000 is used by A for other purposes. B is not a party to this transaction, but A forges B's name on the note and mortgage to Mortgagee-2. Mortgagee-2 is subrogated to the first mortgage to the extent of \$ 100,000, and can enforce it against B's interest in Blackacre. Mortgagee-2 is not entitled to subrogation with respect to the remaining \$ 50,000.

29. The facts are the same as Illustration 23, except that the interest rate under Mortgagee-1's mortgage was 8 percent, and Mortgagor and Mortgagee-3 agree to an interest rate of 12 percent. Mortgagee-2's mortgage is senior to Mortgagee-3's mortgage to the extent that the increase in the interest rate enlarges the balance owing on the obligation secured by Mortgagee-3's mortgage.

Cases commonly arise in which subrogation is proper under more than one subsection of this section. For example, a lender may be induced by fraud or forgery (Subsection (b)(3)) to make a loan to pay off a prior mortgage (Subsection (b)(4)). See Illustration 28, *supra*. No particular difficulty should arise in granting subrogation in such cases.

30. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee-1. Mortgagor obtains a loan from Mortgagee-2 for the purpose of discharging Mortgagee-1's mortgage. Mortgagee-2 makes the loan and disburses the proceeds to pay and discharge Mortgagee-1's mortgage. A satisfaction of Mortgagee-1's mortgage is recorded in the public records. However, Mortgagee-2's mortgage is not recorded until several days later. During the period between recordation of the satisfaction and the new mortgage, Mechanic, a contractor hired by Mortgagor, commences work under a contract to build a house on Blackacre. Mortgagor fails to pay Mechanic, who records a notice of mechanics lien on Blackacre. Under applicable law, such liens take their priority from the date work on the contract commenced. A court is warranted in finding that a grant of subrogation to Mortgagee-2 would be unjust to Mechanic, and upon such a finding may deny Mortgagee-2's subrogation claim.

31. Mortgagor owns Blackacre subject to two mortgages held respectively by Mortgagee-1 and Mortgagee-2. Mortgagor obtains a loan from Mortgagee-3 for the purpose of discharging Mortgagee-1's mortgage. Mortgagee-3 makes the loan and disburses the proceeds to pay and discharge Mortgagee-1's mortgage. A satisfaction of Mortgagee-1's mortgage is recorded in the public records, and Mortgagee-3's mortgage is recorded immediately. Thereafter, Mortgagee-2 offers to sell the second mortgage to Investor, and represents it as being a first lien on the real estate. Investor examines the public records, confirms that the mortgage previously held by Mortgagee-1 has been

discharged, and purchases the second mortgage from Mortgagee-2. At the time of this purchase Mortgagee-3 has made no claim of subrogation, and Investor is unaware that the funds advanced by Mortgagee-3 were used to pay Mortgagee-1. A court is warranted in finding that, since Mortgagee-2's mortgage appeared to have first priority of record on the date Investor purchased the second mortgage, injustice would result if Mortgagee-3 were subrogated to Mortgagee-1's mortgage as against Investor. Upon such a finding, the court may deny Mortgagee-2's subrogation claim.

REPORTERS NOTES: For general treatments of subrogation, see G. Nelson & D. Whitman, *Real Estate Finance Law*, Practitioner Series, §§ 10.1-10.8 (3d ed. 1994); Marasinghe, *An Historical Introduction to the Doctrine of Subrogation: The Early History of the Doctrine*, 10 Val. U. L. Rev. part 1 at 45, part 2 at 275 (1975-76); Comment, 31 *Mich. L. Rev.* 826 (1932).

Introductory note, Comment a. Cases holding that a partial payment will not entitle the payor to subrogation include *Mutual Life Ins. Co. of N.Y. v. Grissett*, 500 F.Supp. 159 (M.D.Ala.1980) (Alabama law); *In re Cavalier Homes*, 102 B.R. 878 (Bankr.M.D.Ga.1989); *Western Coach Corp. v. Rexrode*, 130 Ariz. 93, 634 P.2d 20 (Ariz.Ct.App.1981); *Capitol Nat'l Bank v. Holmes*, 95 P. 314 (Colo.1908); *Consolidated Naval Stores Co. v. Wilson*, 90 So. 461 (Fla. 1921); *Jessee v. First Nat'l Bank*, 267 S.E.2d 803 (Ga.Ct.App.1980); *United States Fidelity & Guar. Co. v. Maryland Casualty Co.*, 352 P.2d 70 (Kan. 1960). On the other hand, if the payee accepts partial payment as a complete discharge of the mortgage, subrogation will ensue; see *Dietrich Industries, Inc. v. United States*, 988 F.2d 568 (5th Cir.1993). Likewise, a partial or pro tanto subrogation is possible if the entire debt is paid, partly by the subrogee and partly from other sources; see *Ray v. Donohew*, 352 S.E.2d 729 (W.Va.1986).

Cases finding a duty on the part of the mortgagee to give a written assignment to the subrogee include *Motes v. Roberson*, 32 So. 225 (Ala. 1902); *Global Realty Corp. v. Charles Kannel Corp.*, 170 N.Y.S.2d 16 (N.Y.Sup.Ct.1958) (payment by junior tenant); *Payne v. Foster*, 135 N.Y.S.2d 819 (N.Y.App.Div.1954) (payment by holder of remainder); *Simonson v. Lauck*, 93 N.Y.S. 965 (N.Y.App.Div.1905) (payment by a third party at the request of a tenant in common of the real estate); *Averill v. Taylor*, 8 N.Y. 44 (1853).

Performance to protect an interest, Comment b. Illustration 1 is based on *Matter of Forester*, 529 F.2d 310 (9th Cir.1976). To the same effect, but with the subrogee paying a prior property tax lien, is *Smart v. Tower Land & Inv. Co.*, 597 S.W.2d 333 (Tex.1980). See also *C.T.W. Co. v. Rivergrove Apartments, Inc.*, 582 So.2d 18 (Fla.Dist.Ct.App.1991) (payment made by corporation formed by junior mortgagees); *Rock River Lumber v. Universal Mortgage Corp. of Wis.*, 262 N.W.2d 114 (Wis. 1978); *Gaub v. Simpson*, 866 P.2d 765 (Wyo. 1993) (payment of prior federal tax lien). Contra, see *Frago v. Sage*, 737 S.W.2d 482 (Mo.Ct.App.1987), in which the court declined to grant subrogation on the seemingly incorrect reasoning that the junior mortgagee, who foreclosed his own mortgage, took title, and then paid off the senior mortgage, was a mere "volunteer."

Illustration 2 is based on *Brown v. Bellamy*, 566 N.Y.S.2d 703 (N.Y.App. Div.1991); *G.B. Seely's Son, Inc. v. Fulton-Edison, Inc.*, 382 N.Y.S.2d 516 (N.Y.App.Div.1976); and *Dominion Fin. Corp. v. 275 Washington St. Corp.*, 316 N.Y.S.2d 803 (N.Y.Sup.Ct. 1970). See Annot., *Lessee's Right of Subrogation in Respect of Lien Superior to His Lease*, 1 A.L.R.2d 286.

Illustrations 3 and 4 are based on *Snider v. Basinger*, 132 Cal.Rptr. 637 (Cal.Ct.App.1976); *Meckler v. Weiss*, 80 So.2d 608 (Fla.1955); *Evans' Adm'r v. Evans*, 199 S.W.2d 734 (Ky.1947); *Richards v. Suckle*, 871 S.W.2d 239 (Tex. Ct. App. 1994); and *Eloff v. Riesch*, 111 N.W.2d 578 (Wis.1961). Illustration 4 is further supported by *Walters v. Walters*, 466 P.2d 174 (Wash.Ct.App.1970). See Annot., *Contribution, Subrogation, and Similar Rights, As Between Cotenants, Where One Pays the Other's Share of Sum Owing on Mortgage or Other Lien*, 48 A.L.R.2d 1305. See also *In re Stendaro*, 991 F.2d 1089 (3d Cir. 1993) (mortgagee who foreclosed and subsequently paid delinquent property taxes was not entitled to subrogation to property tax lien, since after foreclosure payment of those taxes was mortgagee's responsibility).

Illustration 5 is based on *Cox v. Wooten*, 610 S.W.2d 278 (Ark.App. 1981). A similar result was reached in the

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opposite situation, in which the purchaser agreed to pay a portion of the debt but failed to do so, and it was paid by the vendor, in *Cozzetto v. Wisman*, 819 P.2d 575 (Idaho Ct.App. 1991).

A somewhat unusual illustration of a payment made to protect an interest is found in *State ex rel. Moulton v. Holland*, 367 S.W.2d 791 (Tenn.Ct. App.1962). A city government condemned land on which the owner had placed a mortgage. However, the city's title examination was defective, so it was unaware of the mortgage and failed to name the mortgagee as a party to the eminent domain action. At the conclusion of the action the entire condemnation award was paid to the mortgagors. The city subsequently discovered the mortgage and paid the mortgagee the balance owing on the mortgage debt. It then brought an action to recover that sum from the mortgagors. The court held that the mortgagee could have established a constructive trust or equitable lien on the proceeds of the condemnation, and hence that the city, having paid the mortgagee, was subrogated to those rights as against the mortgagors.

The volunteer rule is discussed and disparaged in G. Nelson & D. Whitman, Real Estate Finance Law § 10.4 (3d ed. 1993); Note, Subrogation and the Volunteer Rule, 24 Va. L. Rev. 771 (1938); Note, 48 Yale L.J. 683 (1939).

Illustration 6 is based on the facts of *Heller Fin. v. Insurance Co. of N. America.*, 573 N.E.2d 8 (Mass.1991), but in that case the bonding company took an express assignment of the mortgage and hence had no need to rely on the doctrine of subrogation. See also *Cagle, Inc. v. Sammons*, 254 N.W.2d 398 (Neb.1977), where the party seeking subrogation was a general contractor which sought subrogation against a bonding company that had written a payment bond in favor of a subcontractor's suppliers. The general contractor paid the suppliers upon the subcontractor's default, and was held subrogated to the suppliers' claims on the bond.

Illustration 7 is based on the facts of *Lawyers Title Insurance Corp. v. Edmar Constr. Co.*, 294 A.2d 865 (D.C.1972). However, that case rejected the title company's subrogation argument, concluding that it was a volunteer.

Illustration 9 is based on *Springham v. Kordek*, 462 A.2d 567 (Md.Ct. App.1983). See also *In re Mach*, 25 N.W.2d 881 (S.D.1947), noted in 32 Mich. L. Rev. 183 (1948) (son who provided support to invalid father was entitled to an equitable lien on father's land and subrogation to father's rights as against noncontributing brother).

See also *Hoppe v. Phoenix Homes, Inc.*, 318 N.W.2d 878 (Neb.1982), in which Phoenix owed money to Hoppe on an unsecured loan. Phoenix owned real estate encumbered by a mortgage, and proposed to convey it to Hoppe in satisfaction of the debt owed to Hoppe, free of encumbrances, if Hoppe would first pay the mortgage debt. Hoppe did so, and Phoenix then deeded the land to Hoppe, but it was subject to two judgment liens, subordinate to the mortgage, of which Hoppe had been unaware. The court held that Hoppe was subrogated to the first mortgage he had paid, and could foreclose it against the judgment liens. Hoppe's position was justified on the basis that he paid the mortgage debt in order to protect his interest in the payment of the debt owed to him by Phoenix.

For a case of "intermeddling," see *Norton v. Haggett*, 85 A.2d 571 (Vt. 1952), in which the plaintiff paid the defendant's mortgage debt in the apparent belief that by subrogation he would become the owner of it. The two parties had recently had several arguments, the plaintiff apparently intended to harm the defendant, and seems to have wished to become the holder of the defendant's mortgage and note in order to harass the defendant. The mortgagee's president testified that he assumed the payment was a gift and that he would not have voluntarily assigned the note and mortgage to the plaintiff. The court found that the plaintiff had no interest to protect in making the payment and denied subrogation. The result is consistent with this Restatement.

Illustration 10 is based on *Cureton v. Frierson*, 850 S.W.2d 38 (Ark.Ct. App.1993).

Illustration 11 is based on *Dolan v. Borregard*, 466 So.2d 11 (Fla.Dist.Ct. App.1985).

Performance made under legal duty, Comment c. Illustration 12 is based on the facts of *McPheeters v. Community Fed. Sav. & Loan Ass'n*, 736 S.W.2d 62 (Mo. Ct. App. 1987). However, in that case as in most similar cases the fire insurer took a written assignment, and no subrogation argument was necessary. See also *Credit Bureau Corp. v.*

Beckstead, 385 P.2d 864 (Wash.1963), in which a title insurance company issued a title policy incident to a sale of real estate which was encumbered by a judgment and a mortgage junior to the judgment. The title company missed the judgment in its title search, and, upon discovering the error, it paid the judgment in full. The holder of the junior mortgage then claimed to hold a first lien on the property. The court held that the title company was subrogated to the judgment it had paid, and could therefore foreclose it against the junior mortgage.

Illustration 13 is based on *Aultman v. United Bank*, 378 S.E.2d 302 (Ga. 1989). See also *Golden Eagle Ins. Co. v. First Nationwide Fin. Corp.*, 31 Cal.Rptr.2d 815 (Cal.Ct.App.1994) (surety on payment bond entitled to subrogation to mechanics' liens which it discharged); *Security Nat'l Trust v. Moore*, 639 So.2d 373 (La.Ct.App. 1994) (accommodation endorser entitled to subrogation upon payment of mortgage debt); *Atlas Fin. Corp. v. Trocchi*, 19 N.E.2d 722 (Mass.1939).

Illustration 14 is based on *Ray v. Donohew*, 352 S.E.2d 729 (W.Va. 1986), except that in that case the mortgagee foreclosed the mortgage and then took the bond for the deficiency; hence there was no mortgage to which the guarantor could be subrogated. She was held subrogated to the note.

The "standby letter of credit" issue in Illustration 15 has been controversial in the courts. Cases allowing subrogation include *In re Valley Vue Joint Venture*, 123 B.R. 199 (Bankr. E.D.Va.1991); *In re Air One, Inc.*, 80 B.R. 145 (Bankr.E.D.Mo.1987); *In re National Service Lines, Inc.*, 80 B.R. 144 (Bankr.E.D.Mo.1987); *In re Sensor Systems, Inc.*, 79 B.R. 623 (Bankr.E.D.Pa.1987); *In re Minnesota Kicks, Inc.*, 48 B.R. 93 (Bankr. D.Minn.1985); *In re Glade Springs, Inc.*, 47 B.R. 780 (Bankr.E.D.Tenn. 1985). This position is endorsed by U.C.C. § 5-117 (1995), which treats the issuer as secondarily liable for purposes of the subrogation doctrine.

Cases denying subrogation, usually on the ground that the issuer of a letter of credit is primarily liable for payment, include *Tudor Development Group, Inc. v. United States Fidelity and Guaranty*, 968 F.2d 357 (3d Cir. 1992); *In re Carley Capital Group*, 119 B.R. 646 (W.D.Wis.1990); *In re Agrownautics, Inc.*, 125 B.R. 350 (Bankr.D.Conn.1991); *Berliner Handels-Und Frankfurter Bank v. East Texas Steel Facilities, Inc.*, 117 B.R. 235 (Bankr.N.D.Tex.1990); *In re St. Clair Supply Co., Inc.*, 100 B.R. 263 (Bankr.W.D.Pa.1989); *Bank of America v. Kaiser Steel Corp.*, 89 B.R. 150 (Bankr.D.Colo.1988); *In re Munzenrieder Corp.*, 58 B.R. 228 (Bankr.M.D.Fla.1986); *Merchants Bank v. Economic Enterprises, Inc.*, 44 B.R. 230 (Bankr.D.Conn.1984). See pre-1995 U.C.C. § 5-103, Official Comment 3 ("The issuer is not a guarantor of the performance of these underlying transactions"); Avidon, *Subrogation in the Letter of Credit Context*, 56 *Brook. L. Rev.* 129, 136 (1990). Even under this view, the bank may have subrogation if the parties have agreed in advance to that effect. See *Wichita Eagle and Beacon Publ. Co. v. Pacific Nat'l Bank*, 493 F.2d 1285 (9th Cir.1974).

For the proposition that an assuming grantee who pays the mortgage is primarily liable to do so, and hence may not have subrogation, see *Pee Dee State Bank v. Prosser*, 367 S.E.2d 708 (S.C.App.1988). The South Carolina Supreme Court subsequently refused to apply this rationale to a case in which the grantee took only a tenancy in common interest in the property, with the understanding that the grantor would pay a pro rata share of the mortgage corresponding to the ownership interest the grantor retained. The grantor was held to have an equitable primary obligation with respect to that portion of the debt, and the grantee who paid the entire debt was given subrogation in that amount. See *United Carolina Bank v. Caroprop Ltd.*, 446 S.E.2d 415 (S.C.1994). No subrogation should be awarded to a grantee who merely takes subject to the mortgage, if the parties' understanding is that the grantee will in fact make the payments on the mortgage debt as they fall due. Such a grantee is regarded as primarily liable to the extent of the value of the land. See § 5.2, Comment c. Cf. *Capabianco v. Bork*, 256 A.2d 76 (N.J. Super. Ct. 1969), which recognizes (incorrectly, under the view of this Restatement) subrogation in favor of a nonassuming grantee.

Illustration 16 is based on *Evans' Adm'r v. Evans*, 199 S.W.2d 734 (Ky. 1947) (wife executed note as surety or accommodation party for husband). See also *Reimann v. Hybertsen*, 550 P.2d 436, modified, 553 P.2d 1064 (Or.1976); *Hoopes v. Hoopes*, 861 P.2d 88 (Idaho Ct.App.1993) (accommodation party who pays note has right of subrogation against personal property security given by principal obligor). If the mortgage secures an instrument governed by

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Article 3 of the Uniform Commercial Code, U.C.C. § 3-419(e) (1995) gives the accommodation party a right of reimbursement against the accommodated party and a right to enforce the instrument itself, but that section does not specifically provide for subrogation to the mortgage security.

Illustration 17 is based on *Malone v. United States*, 326 F.Supp. 106 (N.D.Miss.1971), affirmed, 455 F.2d 502 (5th Cir.1972); *Toler v. Baldwin County Sav. & Loan Ass'n*, 239 So.2d 751 (Ala.1970); *Finance Co. of Am. v. Heller*, 234 A.2d 611 (Md.1967); *Konoff v. Lantini*, 306 A.2d 176 (R.I. 1973); *Sanders v. Lackey*, 439 S.W.2d 610 (Tenn.Ct.App.1968); *French v. May*, 484 S.W.2d 420 (Tex. Ct. Civ. App. 1972); *First Vt. Bank v. Kalomiris*, 418 A.2d 43 (Vt. 1980). See also *Cozzetto v. Wisman*, 819 P.2d 575 (Idaho Ct.App.1991).

Illustration 18 is based on *Johnson v. Zink*, 51 N.Y. 333, 336-37 (1873). See *Wright v. Estate of Valley*, 827 P.2d 579 (Colo.Ct.App.1992); *Howard v. Burns*, 116 N.E. 703 (Ill.1917); *Woodbury v. Swan*, 58 N.H. 380 (1878); *University State Bank v. Steeves*, 147 P. 645 (Wash.1915), noted 2 A.L.R. 237. In *United Carolina Bank v. Caroprop Ltd.*, 446 S.E.2d 415 (S.C.1994), the grantee took only a partial interest in the mortgaged real estate as a tenant in common. The grantee failed to make any mortgage payments despite the parties' understanding that it would do so. The grantor, who was the original mortgagor, then discharged the mortgage and claimed subrogation to the extent of the portion of the debt that the grantee should have paid. The court held that the grantor was only secondarily liable as to that portion of the debt, and gave the grantor subrogation against the grantee.

Illustration 19 is based on *Joyce v. Dauntz*, 45 N.E. 900 (Ohio 1896). See also *Hooper v. Henry*, 17 N.W. 476 (Minn.1883). Modern transactions of this sort are not common; the grantee ordinarily expects to pay the mortgage and pays a cash price reduced by the mortgage balance to reflect that expectation.

Performance induced by fraud or the like, Comment d. See generally *Restatement of Restitution* § 171. Illustration 20 is similar to *Brookfield v. Rock Island Improvement Co.*, 169 S.W.2d 662 (Ark.1943), except that case involved the payment of a property tax lien rather than a prior mortgage. See also *Kuske v. Staley*, 28 P.2d 728 (Kan.1934), in which a mortgagee whose mortgage was forged but who had paid off a prior mortgage was given the benefit of subrogation to that mortgage.

Illustration 21 is based on *Dixon v. Morgan*, 285 S.W. 558 (Tenn. 1926). See also *In re Hubbard*, 89 B.R. 920 (Bankr.N.D.Ala.1988), involving similar facts except that the grantee sent a check to the grantor for the amount necessary to discharge the first mortgage; *Union Trust Co. v. Lessovitz*, 199 N.E. 614 (Ohio.Ct.App.1931), in which a mortgagee was fraudulently induced to pay off a prior mortgage on the assurance that it would then have a first mortgage. See *Farm Credit Bank of Texas v. Ogden*, 886 S.W.2d 305 (Tex. Ct. App. 1994), in which a new lender was granted subrogation to an old mortgage which it discharged; the title company had been instructed to obtain a subordination from the holder of an intervening lien, but due to a mistake it failed to do so. See also *U.S. v. Avila*, 88 F.3d 229 (3d Cir.1996), holding that a purchaser of land who paid off a senior mortgage under the mistaken belief that a junior federal tax lien on the land was no longer enforceable would be subrogated to the senior mortgagee's rights.

Illustration 22 is based on *First Nat'l Bank v. Huff*, 441 So.2d 1317 (Miss.1983). In that case, however, the land had been sold to a bona fide purchaser after the mortgage was released; hence the court held that it would be unjust to give the bank a lien on the land.

Performance at the request of the debtor, Comment e. An occasional case recognizes subrogation of a mortgagee to its own prior lien. See, e.g., *Davis v. Johnson*, 246 S.E.2d 297 (Ga.1978). However, the better view, followed by this Restatement, is that such cases should be handled as replacement mortgages rather than under the principle of subrogation. See § 7.3.

The following cases support the position of this Restatement that subrogation is available to the payor despite actual knowledge of the intervening interest: *Wilkins v. Gibson*, 38 S.E. 374 (Ga.1901); *Klotz v. Klotz*, 440 N.W.2d 406 (Iowa.Ct.App.1989); *Farm Credit Bank v. Ogden*, 886 S.W.2d 305 (Tex. Ct. App. 1994) (subrogation granted where

payor had actual knowledge of intervening lien, and instructed title company to obtain a subordination from its holder, but title company failed to do so); *Med Center Bank v. Fleetwood*, 854 S.W.2d 278 (Tex. Ct. App. 1993) (subrogation granted even though payor was fully aware of intervening lien and trial court found that payor had no expectation of getting security in the tract in question); *Chicago Title Ins. Co. v. Lawrence Inv., Inc.*, 782 S.W.2d 332 (Tex. Ct. App. 1989) (payor apparently had actual knowledge); *Providence Inst. for Savings v. Sims*, 441 S.W.2d 516, 520 (Tex. 1969). See also *Trus Joist Corp. v. National Union Fire Ins. Co.*, 462 A.2d 603 (N.J. Super. App. Div. 1983), in which the payor was fully apprised of the intervening judgment lien by the title insurer, and caused \$ 18,000 of its loan to be placed in escrow to cover the lien. The court set aside the payor's mortgage on the ground that it was a result of a fraudulent conveyance (a risk of which the payor was fully aware when it made the loan), but nonetheless granted the payor subrogation to the extent that its loan had been used to discharge mortgages having priority over the judgment lien.

The Georgia cases subsequent to *Wilkins v. Gibson*, supra, are inconsistent, and it is difficult to determine whether *Wilkins v. Gibson* is still Georgia law. See *Benenson v. Evans*, 134 S.E. 441 (Ga. 1926) (rejecting subrogation where the payor had actual notice); *McCullum v. Lark*, 200 S.E. 276 (Ga. 1938) (leaving unclear whether actual notice would defeat subrogation); *Bank of Canton v. Nelson*, 160 S.E. 232 (Ga. 1931) (holding that constructive notice from recordation would defeat subrogation, but with Hines, J., dissenting); *Davis v. Johnson*, 246 S.E.2d 297 (Ga. 1978) (suggesting that actual knowledge tends to indicate an intent by the payor not to have the priority of the lien being paid).

The majority of cases refuse subrogation if the payor had actual knowledge of the intervening interest, but allow subrogation if the payor's only notice was constructive from the recordation of the intervening interest. See *United States v. Baran*, 996 F.2d 25 (2d Cir. 1993) (N.Y. law); *Han v. United States*, 944 F.2d 526 (9th Cir. 1991) (California law); *United States v. Hughes*, 499 F.2d 322 (8th Cir. 1974) (Arkansas law; unclear whether court would have disallowed subrogation based on constructive notice alone); *Mutual Life Ins. Co. of N.Y. v. Grissett*, 500 F.Supp. 159 (M.D.Ala. 1980); *Burgoon v. Lavezzo*, 92 F.2d 726, 730 (D.C. Ct. App. 1937), noted in 113 A.L.R. 944; *In re Hubbard*, 89 B.R. 920 (Bankr.N.D.Ala.1988); *Herberman v. Bergstrom*, 816 P.2d 244 (Ariz.Ct.App.1991) (priority over intervening homestead declaration denied, where paying lender had actual knowledge of homestead claim); *Commonwealth Bldg. & Loan Ass'n v. Martin*, 49 S.W.2d 1046 (Ark.1932); *Smith v. State Sav. & Loan Ass'n*, 223 Cal.Rptr. 298 (Cal.Ct.App.1985); *Metropolitan Life Ins. Co. v. First Security Bank*, 491 P.2d 1261 (Idaho 1971) (subrogation denied, where payor had actual knowledge of intervening mechanics' liens but believed the lienors had agreed to hold the payor's title insurer harmless against the liens; the agreement, however, had been obtained by the mortgagor by fraud and was unenforceable against the lienors); *Smith v. Dinsmore*, 4 N.E. 648 (Ill. 1887); *Goodyear v. Goodyear*, 33 N.W. 142 (Iowa 1887); *Louisiana Nat'l Bank v. Beello*, 577 So.2d 1099 (La.App.1991); *United Carolina Bank v. Beesley*, 663 A.2d 574 (Me.1995); *Kitchell v. Mudgett*, 37 Mich. 81 (1877); *Prestridge v. Lazar*, 95 So. 837, 838 (Miss. 1923); *Anison v. Rice*, 282 S.W.2d 497 (Mo.1955); *Metrobank for Sav. v. National Community Bank*, 620 A.2d 433 (N.J. Super. App. Div. 1993); *Capabianco v. Bork*, 256 A.2d 76 (N.J. Super. Ct. 1969) (subrogation granted despite payor's actual knowledge of intervening judgment lien, where former owner had submitted a false affidavit averring that the lien was not against him); *King v. Pelkofski*, 229 N.E.2d 435 (N.Y. 1967) (intervening interest was not a second mortgage, but a recorded trust agreement encumbering the real estate); *Home Title Guaranty Co. v. Carey*, 144 N.Y.S.2d 116 (N.Y.Sup.Ct. 1955); *Rusher v. Bunker*, 782 P.2d 170 (Or.App.1989); *Pee Dee State Bank v. Prosser*, 367 S.E.2d 708 (S.C.App.1988); *Lamoille County Sav. Bank v. Belden*, 98 A. 1002 (Vt.1916); Restatement, Second, Restitution § 31, Comment f and Illustration 10 (Tentative Draft No. 2, 1984); Annot., 70 A.L.R. 1396, 1414 (1931).

A minority view denies subrogation even if the payor's only knowledge of the intervening interest was constructive notice from the recordation of that interest. See *In re Gordon*, 164 B.R. 706 (Bankr.S.D.Fla.1994) (Florida law); *Independence One Mortg. Corp. v. Katsaros*, 681 A.2d 1005 (Conn. Ct. App. 1996); *Hieber v. Florida Nat'l Bank*, 522 So.2d 878 (Fla. Dist.Ct.App.1988); *Bank of Canton v. Nelson*, 160 S.E. 232 (Ga.1931); *Belcher v. Belcher*, 87 P.2d 762 (Or. 1939), noted 24 Minn. L. Rev. 121 (1939). The continuing vitality of *Belcher v. Belcher* is called into question by *Rusher v. Bunker*, 782 P.2d 170 (Or.Ct.App.1989), refusing to bar subrogation where the payor had only constructive notice of the intervening lien.

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Several cases deny subrogation because the payor had constructive notice of an intervening mechanic's lien from the knowledge that construction of improvements had recently been completed. See *Collateral Inv. Co. v. Pilgrim*, 421 So.2d 1274 (Ala. Ct. Civ. App. 1982); *Carl H. Peterson Co. v. Zero Estates*, 261 N.W.2d 346 (Minn. 1977); *Cheswick v. Weaver*, 280 S.W.2d 942 (Tex. Ct. Civ. App. 1955); *Richards v. Security Pacific Nat'l Bank*, 849 P.2d 606 (Utah Ct. App. 1993).

The payor is entitled to subrogation only if he or she expected to receive security in the entire real estate encumbered by the mortgage being paid. In *Jefferson Standard Life Ins. Co. v. Brunson*, 145 So. 156 (Ala. 1932), the first mortgage encumbered the entire tract, and the second mortgage only a portion of it. The payor discharged the first mortgage, but took a mortgage on only the portion of the tract which the second mortgage covered. The court refused to grant the payor subrogation to the first mortgage, pointing out that the limited coverage of the mortgage the payor received negated any intent that it should be treated as the equitable assignee of the first mortgage. Similar facts arose in *Farm Credit Bank v. Ogden*, 886 S.W.2d 305 (Tex. Ct. App. 1994). The payor retired a mortgage on a large tract of land, but took a new mortgage that excluded 191 acres of that land. The court held that the payor obviously had no expectation of security as to the 191 acres, and refused to grant subrogation with respect to it.

There is limited authority for subrogation even if the payor was not promised and did not expect to receive any security in the real estate. See *Turney v. Roberts*, 501 S.W.2d 601 (Ark. 1973). That view is not followed in this Restatement.

The fact that the payor did not pay the prior mortgagee directly, but rather disbursed funds to the mortgagor with the understanding that the mortgagor would use them to pay the prior mortgage, will not preclude subrogation; see *Dodge City of Spartanburg, Inc. v. Jones*, 454 S.E.2d 918 (S.C. Ct.App. 1995) (Howard, J., concurring).

Illustration 23 is based on *Davis v. Johnson*, 246 S.E.2d 297, 300 (Ga. 1978). See also *Camden County Welfare Board v. FDIC*, 62 A.2d 416 (N.J. Super. Ch. 1948); *Equity Sav. & Loan Ass'n v. Chicago Title Ins. Co.*, 463 A.2d 398 (N.J. Super. 1983), in which the mortgagor actively concealed the existence of the second mortgage from the third mortgagee. Under this Restatement, no such concealment is essential to the payor's right of subrogation. See also *King v. Pelkofski*, 229 N.E.2d 435 (N.Y. 1967), in which the intervening interest was not a second mortgage, but was a recorded trust agreement encumbering the real estate.

Illustration 24 is based on *Anison v. Rice*, 282 S.W.2d 497 (Mo. 1955).

Illustration 25 is based on the facts of *Talley v. Blackmon*, 609 S.W.2d 113 (Ark. App. 1980). However, that case was not argued on the basis of subrogation but as an equitable mortgage case. The court denied the equitable mortgage on the ground that the mother was not promised any security.

Illustration 26 is based on *Klotz v. Klotz*, 440 N.W.2d 406 (Iowa Ct. App. 1989).

Illustration 28 is based on *New York Fed. Sav. & Loan Ass'n v. Griggs*, 204 N.Y.S.2d 647 (N.Y. Sup. Ct. 1960). In that case the court held that the second mortgage was also enforceable against A's interest in the real estate to the extent of the full amount disbursed. See also *Levenson v. G.E. Capital Mortgage Services, Inc.*, 643 A.2d 505 (Md. Ct. App. 1994); *Federal Land Bank v. Henderson, Black & Merrill Co.*, 42 So.2d 829 (Ala. 1949).

Cases implicating more than one subsection of this section are common. See, e.g., *Equity Sav. & Loan Ass'n v. Chicago Title Ins. Co.*, 463 A.2d 398 (N.J. Super. 1983) (second mortgage obtained by fraud, with its proceeds used to pay off prior mortgage).

Subrogation not granted where injustice would result, Comment f. Illustration 30 is based on *Rock River Lumber Corp. v. Universal Mortgage Corp.*, 262 N.W.2d 114 (Wis. 1978) and *Peterman-Donnelly Eng'rs & Contractors Corp. v. First Nat. Bank of Ariz.*, 408 P.2d 841 (Ariz. Ct. App. 1965). See also *Richards v. Griffith*, 28 P. 484 (Cal. 1891) (intervening judgment lien foreclosed after prior mortgage had been satisfied and payor's mortgage had not yet been

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recorded). See Annot., 70 A.L.R. at 1413.

Illustration 31 is based on *Richards v. Suckle*, 871 S.W.2d 239 (Tex. Ct. App. 1994). In that case the court found that assignee of the second mortgage was aware of the subrogation claim, was not a bona fide purchaser, and hence had no defense to subrogation. The result of Illustration 31 is easier to reach if the assignment of the second mortgage occurs before the third mortgage is recorded; see *Coonrod v. Kelly*, 119 F. 841 (3d Cir. 1902).

The payor's delay in asserting a right of subrogation may prejudice the owners of intervening interests, and may cause a court to reject the claim of subrogation. In *Heegaard v. Kopka*, 212 N.W. 440 (N.D. 1927), the intervening interest was a second mortgage. The payor took a third mortgage, the proceeds of which were used to discharge the first mortgage debt. The holder of the intervening second mortgage then proceeded to foreclose it and bid in the full amount of the debt, in the belief that he now had a first mortgage. If subrogation were granted to the payor, the value of the real estate after deducting the amount of the original first mortgage would apparently have been less than the second mortgage debt. The court refused to grant subrogation to the payor, holding that his delay in seeking subrogation had prejudiced the holder of the second mortgage. See *Railroadmen's Bldg. & Sav. Ass'n v. Rifner*, 163 N.E. 236 (Ind.Ct.App. 1928) (payor delayed nearly four years in asserting subrogation, while intervening contract purchaser continued to make payments on contract; court held purchaser was prejudiced by the delay and denied subrogation). See also *Neff v. Elder*, 105 S.W. 260 (Ark. 1907); *Provident Cooperative Bank v. James Talcott, Inc.*, 260 N.E.2d 903 (Mass. 1970); *Landis v. State*, 66 P.2d 519 (Okla. 1937).

However, a delay in assertion of the right of subrogation does not necessarily prejudice anyone. In *Levenson v. G.E. Capital Mortgage Services, Inc.*, 643 A.2d 505 (Md. Ct. App. 1994), the holder of a deed of trust lent funds to the borrower, a portion of which were used to pay off a prior mortgage loan. The holder subsequently foreclosed its deed of trust, and was informed a few days prior to the foreclosure sale of the existence of certain intervening judgment liens. The court held that it had no right of subrogation against those liens because it had not asserted that right in any judicial proceeding prior to foreclosing. However, it is unclear why this action should have been necessary, since granting subrogation would not have prejudiced the judgment lienholders and no rights of third party purchasers were involved. If the absence of a clear claim of subrogation were thought to have tainted the foreclosure sale, the court could have ordered a reforeclosure.

CROSS REFERENCES: Section 2.2, Expenditures for Protection of the Security; § 5.1, Transfers with Assumption of Liability; § 5.2, Transfers Without Assumption of Liability; § 5.3, Discharge of Transferor from Personal Liability; § 7.3, Replacement and Modification of Senior Mortgages: Effect on Intervening Interests; § 8.6, Marshaling: Order of Foreclosure on Multiple Parcels; *Restatement Third, Suretyship and Guaranty* § 28.

Legal Topics:

For related research and practice materials, see the following legal topics:

Real Property Law Financing Mortgages & Other Security Instruments Satisfaction & Termination General Overview

[*Subrogation of lender who takes new security.*—It is frequently held, there being no intervening equities, that one who advances money to discharge a prior lien on real or personal property, and who takes a new mortgage as security, is entitled to subrogation to the prior lien as against the holder of an intervening lien of which the lender was ignorant.⁹ However, on various grounds such as negligence in examining the records, the voluntary nature of the loan, and the like, subrogation has been denied in some cases and in some jurisdictions.¹⁰

[*Purchaser discharging superior lien as part of purchase price.*—In many jurisdictions it is held that a purchaser

Conventional subrogation can only result from an express agreement either with the debtor or the creditor.”

9. *Ala.*—Shields v. Pepper, 218 Ala. 379, 118 So. 549.

Ark.—Southern Cotton Oil Co. v. Napoleon Hill Cotton Co. 108 Ark. 555, 158 S. W. 1082, 46 L. R. A. (N. S.) 1049.

Cal.—Newman Co. v. Fink, 206 Cal. 143, 273 P. 565.

Fla.—Forman v. First Nat. Bank, 76 Fla. 48, 79 So. 742.

Kan.—Kent v. Bailey, 181 Iowa, 489, 164 N. W. 852; Federal Land Bank v. Hanks, 123 Kan. 329, 254 P. 1040.

Ky.—Federal Land Bank v. Marvin, 228 Ky. 242, 14 S. W. (2d) 762, 70 A. L. R. 1392; Kentucky Lumber & Mill Work Co. v. Kentucky Title Sav. Bank & T. Co. 184 Ky. 244, 211 S. W. 765, 5 A. L. R. 391.

Me.—Federal Land Bank v. Smith, 129 Me. 233, 151 A. 420.

Miss.—Spence v. Clarke, 152 Miss. 542, 120 So. 195.

Neb.—George A. Hoagland & Co.

v. Decker, 118 Neb. 194, 224 N. W. 14.

N. J.—Jackson Trust Co. v. Gilkinson, 105 N. J. Eq. 116, 147 A. 113.

Ohio.—Miller v. Scott, 23 Ohio App. 50, 154 N. E. 358.

S. C.—James v. Martin, 150 S. C. 75, 147 S. E. 752.

Tex.—Kone v. Harper (Civ. App.) 297 S. W. 294, affirmed in (Tex. Com. App.) 1 S. W. (2d) 857.

Vt.—Hill v. Ritchie, 90 Vt. 318, 98 A. 497, L. R. A. 1917A, 731.

W. Va.—Huggins v. Fitzpatrick, 102 W. Va. 224, 135 S. E. 19.

Annotation: 70 A. L. R. 1398.

10. Troyer v. Bank of De Queen, 170 Ark. 703, 281 S. W. 14; Boley v. Daniel, 72 Fla. 121, 72 So. 644, L. R. A. 1917A, 734; Mortgage Guarantee Co. v. Atlanta Commercial Bank, 166 Ga. 412, 143 S. E. 562; Webber v. Frye, 199 Iowa, 448, 202 N. W. 1; Bunn v. Lindsay, 95 Mo. 250, 7 S. W. 473, 6 Am. St. Rep. 48; Heegaard v. Kopka, 55 N. D. 77, 212 N. W. 440 (delay of lender and injury to intervening lienor held to preclude subrogation).

Annotation: 70 A. L. R. 1402.

who discharges, pursuant to his agreement to do so, a specific superior lien on the land as part or full payment of the purchase price, without actual notice of a recorded junior lien, is entitled to subrogation, in the absence of intervening equities, to the rights of the holder of the lien so discharged, as against the junior lien.¹¹ However, in some jurisdictions it is held that the purchaser, in such circumstances, is not entitled to subrogation.¹²]

11. *Barnes v. Cady* (C. C. A. 6th) 232 F. 318, 146 C. C. A. 366; *Shields v. Hightower*, 214 Ala. 608, 108 So. 525, 47 A. L. R. 506, later appeals on other points in 216 Ala. 224, 112 So. 834, and 218 Ala. 379, 118 So. 549; *Commonwealth Bldg. & L. Ass'n v. Martin*, 185 Ark. 858, 49 S. W. (2d) 1046; *Capitol Nat. Bank v. Holmes*, 43 Colo. 154, 95 P. 314, 16 L. R. A. (N. S.) 470, 127 Am. St. Rep. 108; *Burgoon v. Lavezzo*, 92 F. (2d) 726, 68 App. D. C. 20, 113 A. L. R. 944; *W. K. Henderson Iron Works & Supply Co. v. Jeffries*, 159 La. 620, 105 So. 792 (this decision was based, however, upon a statutory provision that subrogation takes place of right for the benefit of the purchaser of any immovable property who employs the price of his purchase in paying the creditors to whom the property was mortgaged); *Williams v. Libby*, 118 Me. 80, 105 A. 855; *Prestridge v. Lazar*, 132 Miss. 168, 95 So. 837; *Dixon v. Morgan*, 154 Tenn. 389, 285 S. W. 558.

Annotation: 37 A. L. R. 386, s. 113 A. L. R. 958.

In *Williams v. Libby*, 118 Me. 80, 105 A. 855, where prior to plaintiff's assumption of and agreement to pay off a mortgage on the property, believed by both the vendor and purchaser to be the only encum-

brance, an attachment had been levied on the property and properly recorded, but no notice had been served on the vendor, and it appeared that plaintiff at the time of the transaction, was much affected, both physically and mentally, it was held that the satisfaction and cancellation of such mortgage would be vacated so as to permit the plaintiff to be subrogated to the lien of the mortgage as against the claim of the attaching creditor on any interest in the property other than the equity of redemption outstanding at the time of the levy, the value of such equity being determined as of the day of the attachment sale, which took place subsequent to the cancellation of the mortgage.

12. *Bank of Canton v. Nelson*, 173 Ga. 185, 160 S. E. 232; *Citizens Mercantile Co. v. Easom*, 158 Ga. 604, 123 S. E. 883, 37 A. L. R. 378; *Storer v. Warren*, 99 Ind. App. 616, 192 N. E. 325; *Smith v. Feltner*, 259 Ky. 833, 83 S. W. (2d) 506; *Fidelity & D. Co. v. Vance*, 135 Okla. 24, 245 P. 578; *Tynes v. Smith*, 105 Okla. 100, 234 P. 637; *Kahn v. McConnell*, 37 Okla. 219, 131 P. 682, 47 L. R. A. (N. S.) 1189.

Annotation: 37 A. L. R. 391, s. 113 A. L. R. 960.



In the Matter of: MARK CHAPMAN TIFFANY; MELODYE GAYLE TIFFANY,
aka Melodye Gayle Romo, Debtors, FIRST FEDERAL BANK OF CALIFORNIA,
Appellant, v. CHEVY CHASE BANK, F.S.B., Appellee.

No. 07-17290

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

342 Fed. Appx. 303; 2009 U.S. App. LEXIS 17694

March 12, 2009, Argued and Submitted, San Francisco, California
August 7, 2009, Filed

NOTICE: PLEASE REFER TO FEDERAL RULES OF APPELLATE PROCEDURE RULE 32.1 GOVERNING THE CITATION TO UNPUBLISHED OPINIONS.

PRIOR HISTORY: [**1]

Appeal from the Ninth Circuit Bankruptcy Appellate Panel. BAP No. NC-06-01256-SKuB. Brandt, Kurtz, and Smith, Bankruptcy Judges, Presiding.

First Fed. Bank of Cal. v. Chevy Chase Bank, F.S.B. (In re Tiffany), 2007 Bankr. LEXIS 4937 (B.A.P. 9th Cir., Aug. 24, 2007)

DISPOSITION: AFFIRMED IN PART, REVERSED IN PART, AND REMANDED.

CASE SUMMARY:

PROCEDURAL POSTURE: Appellant bank challenged a decision of the United States Bankruptcy Appellate Panel of the Ninth Circuit (BAP), which affirmed in part and reversed in part a judgment of the bankruptcy court. The bankruptcy court and the BAP established the priority of competing interests in proceeds from the sale of certain real property.

OVERVIEW: The appellate court concluded that the bankruptcy court correctly disposed of the case. The appellate court agreed with the bankruptcy court that the

attempted transmutation of the property was a fraudulent transfer and that one of the debtors received a community property interest on March 15, 2001. Accordingly, appellant bank's judgment lien attached to the property on March 15 and had priority over another creditor's deed of trust. The appellate court rejected appellee bank's argument that it was a bona fide purchaser of the property and should therefore obtain priority over appellant bank's judgment lien. Per *Cal. Civ. Code § 1213*, every conveyance or real property from the time it was filed with the recorder was constructive notice of the contents thereof to subsequent purchases and mortgages. Appellant bank's judgment lien was duly recorded, and the debtor's grant deed, conveying his interest in the property to the other debtor, was contained in the "grantor" and "grantee" index. This was sufficient to provide constructive notice of the existence of appellant bank's judgment lien and that it would attach to the debtor's interest in the property.

OUTCOME: The appellate court affirmed in part, reversed in part, and remanded to the bankruptcy court with instructions to reinstate its original judgment.

LexisNexis(R) Headnotes

Bankruptcy Law > Practice & Proceedings > Appeals >

Standards of Review > General Overview

[HN1] The appellate court conducts an independent review of the decision of the Bankruptcy Appellate Panel; the appellate court reviews the bankruptcy court's findings of fact for clear error and its legal conclusions de novo.

Real Property Law > Priorities & Recording > Recording Acts

[HN2] Every conveyance of real property from the time it is filed with the recorder is constructive notice of the contents thereof to subsequent purchasers and mortgagees. *Cal. Civ. Code* § 1213.

Real Property Law > Financing > Mortgages & Other Security Instruments > Mortgagee's Interests**Real Property Law > Priorities & Recording > General Overview**

[HN3] Although equitable subrogation will be denied to a new lender who has actual knowledge of the junior encumbrance, it has long been the rule in California that the fact the junior encumbrance was recorded will not by itself bar equitable subrogation.

COUNSEL: For FIRST FEDERAL BANK OF CALIFORNIA, Appellant: Lawrence Allen Abelson, Esquire, Attorney, Epport, Richman & Robbins, LLP, Los Angeles, CA; Steven N. Richman, Esquire, Attorney, EPPORT & RICHMAN, LLP, Los Angeles, CA.

For CHEVY CHASE BANK, F.S.B., Appellee: James L. Stoelker, Esquire, Attorney, MOUNT & STOELKER, San Jose, CA.

JUDGES: Before: WALLACE, THOMAS and BYBEE, Circuit Judges. WALLACE, Senior Circuit Judge, concurring.

OPINION

[*304] MEMORANDUM *

* This disposition is not appropriate for publication and is not precedent except as provided by *Ninth Circuit Rule 36-3*.

First Federal Bank of California ("First Federal") appeals from a decision of the United States Bankruptcy Appellate Panel of the Ninth Circuit ("BAP"), which affirmed in part and reversed in part a judgment of the

bankruptcy court. The bankruptcy court and the BAP established the priority of competing interests in proceeds from the sale of the property at 6372 Gondola Way in San Jose, California ("the property"). First Federal argues that the BAP erred [**2] by (1) finding that Sentinel Trust's deed of trust had priority over First Federal's judgment lien and (2) concluding that Chevy Chase Bank, F.S.B. ("Chevy Chase") is entitled to equitable subrogation. With regard to equitable subrogation, First Federal specifically argues that the BAP should have concluded (a) that First American Title Insurance Company ("First American") (Chevy Chase's title insurance company) is the real party in interest in this action, (b) that Chevy Chase (through the real party in interest, First American) engaged in inexcusable and culpable neglect, and (c) that injustice would occur by applying equitable subrogation.

The parties are familiar with the facts of this case, and we do not repeat them here. As discussed below, we affirm in part, reverse in part, and remand to the bankruptcy court with instructions to reinstate its original judgment.¹

1 [HN1] We conduct an independent review of the BAP's decision; we review the bankruptcy court's findings of fact for clear error and its legal conclusions de novo. *In re Palau Corp.*, 18 F.3d 746, 749 (9th Cir. 1994).

1. Priority of Sentinel Trust's Interest²

2 At oral argument, both parties conceded that they did not object [**3] to the procedures used by the bankruptcy court and that they were not prejudiced by the lack of formal adversary proceedings. *See In re Copper King Inn, Inc.*, 918 F.2d 1404, 1406-07 (9th Cir. 1990). Accordingly, we will analyze the priority of liens without considering any procedural error.

We agree with the bankruptcy court that the attempted transmutation of the property was a fraudulent transfer and that Mark Tiffany received a community property interest on March 15, 2001. Accordingly, First Federal's judgment lien attached to the property on March 15 and has priority over the Sentinel Trust deed of trust.

We reject Chevy Chase's argument that it was a bona fide purchaser of the property and should therefore obtain priority over First Federal's judgment lien. [HN2] "Every

conveyance of real property . . . from the time it is filed with the recorder is constructive notice of the contents thereof to subsequent purchasers and mortgagees . . ." CAL. CIV. CODE § 1213. First Federal's judgment lien was duly recorded, and Mark's grant deed, conveying his interest in the property to Melodye, was contained in the "grantor" and "grantee" index. This was sufficient to provide constructive notice [**4] of the existence of First Federal's lien and that it would attach to Mark's interest in the property.

2. Equitable Subrogation ³

3 Because First Federal's judgment lien has priority over Sentinel Trust's deed of trust, we need not decide if Chevy Chase is also equitably subrogated to Sentinel Trust's deed of trust. This determination would have no effect on the priority of interests between the parties before the court.

The bankruptcy court and the BAP correctly concluded that Chevy Chase was [*305] entitled to equitable subrogation to the interest of World Savings Bank, F.S.B ("World Savings").

a. Real Party in Interest

As we previously held in *Mort*, we will only consider the title insurance company's involvement for purposes of equitable subrogation when "the title insurance company itself [is] seeking equitable subrogation." *Mort v. United States*, 86 F.3d 890, 895 (9th Cir. 1996). Here, Chevy Chase is the named party seeking equitable subrogation, and our analysis does not change merely because First American is fulfilling its contractual obligation to pay for the defense of its insured.

b. Inexcusable and Culpable Neglect

Chevy Chase did not engage in inexcusable and culpable neglect by failing [**5] to uncover the existence of First Federal's judgment lien. As the California courts have noted, [HN3] "[a]lthough equitable subrogation will be denied to a new lender who has actual knowledge of the junior encumbrance, it has long been the rule in California that the fact the junior encumbrance was recorded will not by itself bar equitable subrogation." *Smith v. State Sav. & Loan Ass'n*, 175 Cal. App. 3d 1092, 223 Cal. Rptr. 298, 301 (Cal. Ct. App. 1985).

c. Injustice

Applying equitable subrogation will not result in injustice because all of the lienholders, including First Federal, will remain in the same position that they held prior to the refinancing. Moreover, if the court does not apply equitable subrogation, First Federal will receive a windfall by moving into a better position with respect to the property than it originally had when its judgment lien attached. Essentially, Chevy Chase would be paying more than \$ 500,000 to First Federal to satisfy Mark's debt, even though Chevy Chase paid off a deed of trust that had priority over First Federal's judgment lien, Chevy Chase did not have actual knowledge of First Federal's judgment lien, and Chevy Chase had a legitimate expectation that it would have first [**6] priority. "One cannot fail to see this case as an attempt by [First Federal] to require [Chevy Chase] to pay a portion of [Mark's debt]. [First Federal's] claim that equitable subrogation would make it the victim of 'injustice' is thoroughly unconvincing." *Han v. United States*, 944 F.2d 526, 530 n.3 (9th Cir. 1991).

Accordingly, we conclude that the bankruptcy court correctly disposed of this case. We remand to the bankruptcy court with instructions to reinstate its original judgment. The parties shall bear their own costs on appeal.

**AFFIRMED IN PART, REVERSED IN PART,
AND REMANDED.**

CONCUR BY: WALLACE

CONCUR

WALLACE, Senior Circuit Judge, concurring:

I agree that the bankruptcy court's original judgment should be reinstated. However, I write separately because I believe we can affirm the bankruptcy court's priority determination without addressing whether Mark Tiffany's conveyance of his interest in the property to his wife, Melodye, was a fraudulent transfer.

Under California law, until a judgment lien is satisfied or extinguished, it remains enforceable against the judgment debtor's real property interests regardless of whether the property is transferred to a third party. *Dieden v. Schmidt*, 104 Cal. App. 4th 645, 128 Cal. Rptr. 2d 365, 369 (Cal. Ct. App. 2002); [**7] see also Cal. Code of Civ. P. § 697.390(a) ("[A] subsequent conveyance of an interest in real property subject to a

judgment lien does not affect the lien"). Thus, where a judgment debtor transfers his real property interest, and that interest [*306] is subject to an unsatisfied judgment lien, the lien may be enforced against the transferred property in the same manner and to the same extent as if there has been no transfer. *Weeks v. Pederson (In re Pederson)*, 230 B.R. 158, 163 (9th Cir. BAP 1999); *Cal. Code of Civ. P. § 695.070*.

In this case, the bankruptcy court found that Mark acquired an interest in the property as of March 15, 2001, when his community assets were used to purchase the property. This factual finding is not clearly erroneous. *In re Marriage of Rives*, 130 Cal. App. 3d 138, 181 Cal. Rptr. 572, 586 (Cal. App. 1982) (upholding trial court's finding that a residence purchased with community funds

was a community asset despite the grant deed to the purchaser's wife as separate property). Therefore, it does not matter whether or not Mark's grant deed to Melodye constituted a fraudulent conveyance. First Federal's judgment lien attached to the property by virtue of Mark's community interest in the property [**8] as of March 15, 2001. When Mark subsequently transferred the property to Melodye, First Federal's judgment lien remained enforceable against the property, and retained its priority relative to the subsequently recorded lien of Sentinel.

I would therefore affirm the bankruptcy court's priority determination without reaching the fraudulent transfer issue. In all other respects, I concur in the memorandum disposition.



COUNTRYWIDE HOME LOANS, INC., Plaintiff-Appellee, - vs - ROBIN F. KORB, et al., Defendants, RBS CITIZENS, N.A., SUCCESSOR BY MERGER TO CHARTER ONE BANK, N.A., Defendant-Appellant.

CASE NO. 2010-G-2969

COURT OF APPEALS OF OHIO, ELEVENTH APPELLATE DISTRICT, GEAUGA COUNTY

2011 Ohio 2094; 2011 Ohio App. LEXIS 1799

April 29, 2011, Decided

PRIOR HISTORY: [**1]

Civil Appeal from the Geauga County Court of Common Pleas, Case No. 08 M 000315.

DISPOSITION: Affirmed.

CASE SUMMARY:

PROCEDURAL POSTURE: Appellant, the successor to the holder of an open-end mortgage, challenged a summary judgment entered by the Geauga County Court of Common Pleas, Ohio, in favor of appellee, the assignee of a subsequent mortgage lienholder, on appellee's claim that its mortgage lien had priority over appellant's mortgage lien.

OVERVIEW: Upon the borrowers' refinancing of the property with appellee's assignor, funds had been disbursed to satisfy the borrowers' original mortgage and to satisfy their mortgage with appellant's predecessor. The court found that appellee had set forth a case for equitable subrogation. The facts indicated that appellee satisfied appellant's prior mortgage. Additionally, the documents related to that satisfaction indicated that appellee intended to have the first position lien. Even assuming that appellee's failure to obtain a release rose to the level of negligence, the doctrine of equitable subrogation still applied under the facts of the case.

Appellant was not in a worse position than it was prior to appellee's satisfaction of the original mortgage. There was no evidence that appellant suffered any damage at all due to appellee's failure to obtain a release. Appellant never bargained for or expected to be in the first loan position. Moreover, denying appellee the application of the doctrine of equitable subrogation would result in an unearned windfall for appellant, by placing it in a better position than appellee.

OUTCOME: The court affirmed the judgment.

COUNSEL: Michael J. Sikora, III, and Lee R. Schroeder, Sikora Law, L.L.C., Mentor, OH (For Plaintiff-Appellee).

Pamela s. Petas, Franco M. Barile, and Scott E. Collister, Gerner & Kearns Co., L.P.A., Cincinnati, OH (For Defendant-Appellant).

JUDGES: DIANE V. GRENDALL, J. MARY JANE TRAPP, J., THOMAS R. WRIGHT, J., concur.

OPINION BY: DIANE V. GRENDALL

OPINION

DIANE V. GRENDALL, J.

[*P1] Defendant-appellant, RBS Citizens, N.A., successor by merger to Charter One Bank, N.A. (RBS), appeals the Judgment Entry of the Geauga County Court of Common Pleas, in which the trial court granted plaintiff-appellee, Countrywide Home Loans, Inc.'s (Countrywide) Motion for Summary Judgment. For the following reasons, we affirm the decision of the trial court.

[*P2] On April 16, 2003, Robin and David Korb executed a promissory note in the amount of \$156,800, secured by a mortgage on the Korbs' real property, located at 13331 Caves Road, in Chesterland, Ohio. This mortgage was executed in favor of Mortgage Electronic Registration Systems, Inc. (MERS), and was recorded on April 16, 2003.

[*P3] On May 8, 2004, the Korbs executed an Open-End Mortgage on the same property, in [**2] favor of Charter One Bank, for \$39,900. This mortgage was recorded on May 27, 2004. Subsequently, Charter One was acquired by RBS in a merger, making RBS successor to the mortgage.

[*P4] On October 31, 2005, the Korbs refinanced the property through a mortgage and note to Guaranteed Rate, Inc., in the amount of \$196,000. This mortgage was subsequently assigned to Countrywide. Lakeside Title and Escrow Agency, Inc. (Lakeside) provided closing and escrow services in connection with this refinancing transaction. Upon closing, Lakeside disbursed funds in the amount of \$152,657.74 to satisfy the Korbs' April 16, 2003 MERS mortgage and \$39,486.97 to satisfy the Korbs' May 8, 2004 RBS mortgage.

[*P5] On March 19, 2008, Countrywide filed a Complaint against the Korbs and Charter One Bank, the owner of the RBS mortgage prior to its merger with RBS, seeking to foreclose on the October 31, 2005 Countrywide mortgage on the Korbs' property. Countrywide asserted that the Korbs owed \$191,498 on the October 31, 2005 promissory note. Countrywide also asserted that it should be found that Countrywide, not RBS, has the first and best lien on the Korbs' property.

[*P6] On April 3, 2008, RBS filed a Complaint against the [**3] Korbs and also requested foreclosure on the Korbs' property. The RBS and Countrywide cases were consolidated by the trial court on May 6, 2008.

[*P7] On April 25, 2008, RBS filed an Answer to

Countrywide's Complaint, asserting that RBS has "the first and best lien" on the Korbs' property, based on the May 8, 2004 RBS mortgage being recorded prior to the Countrywide mortgage.

[*P8] On October 6, 2008, Countrywide filed an Amended Complaint and added Lakeside as a third party defendant. Countrywide asserted that Lakeside acted negligently in failing to handle the transaction of satisfying the RBS mortgage and failed to obtain a release of the mortgage from RBS. Countrywide argued that this negligence caused harm, including "the potential loss of [Countrywide's] priority position."

[*P9] On July 21, 2009, Countrywide filed a Supplemental Motion for Summary Judgment, asserting that, as a matter of law, the Countrywide mortgage had priority over the RBS mortgage, because of the doctrine of equitable subrogation. Countrywide argued that it should have the first lien position, but only in the amount of \$152,657.74, which was the amount owed by the Korbs on the MERS mortgage. Regarding the difference between [**4] the amount of the MERS mortgage, \$152,657.74, and the total owed by the Korbs' on the Countrywide mortgage, \$191,498, Countrywide conceded that this amount was not first in time and that Countrywide was not seeking a ruling of priority as to this amount.

[*P10] Countrywide asserted, through pleadings, that upon paying off the Korbs' RBS mortgage, RBS was to sign a release that the RBS mortgage was satisfied by the Countrywide mortgage proceeds. This would allow Countrywide to have the first and best lien on the Korbs' property. However, although RBS received payment from Lakeside, on behalf of Countrywide, to satisfy the RBS mortgage, RBS did not sign such a release. RBS asserts that it was not requested to do so by Lakeside. Additionally, RBS stated that Robin Korb instructed RBS to keep her account open. Although the original May 8, 2004 RBS mortgage was paid with proceeds from the Countrywide mortgage, RBS continued to advance the Korbs money from their RBS account.

[*P11] On April 15, 2010, the trial court granted summary judgment as to Countrywide's claim that its mortgage lien had priority over RBS' mortgage lien. The court found that "the mortgage currently held by Countrywide was intended [**5] to and did take the place of the 2003 mortgage originally held by [MERS]," and that the RBS mortgage was subordinate to the MERS

mortgage and should therefore remain subordinate to Countrywide's mortgage.

[*P12] RBS timely appeals and asserts the following assignment of error:

[*P13] "The trial court erred in granting plaintiff-appellee's motion for summary judgment against defendant-appellant, RBS Citizens N.A., successor by merger to Charter One Bank N.A."

[*P14] Pursuant to *Civil Rule 56(C)*, summary judgment is proper when (1) the evidence shows "that there is no genuine issue as to any material fact" to be litigated, (2) "the moving party is entitled to judgment as a matter of law," and (3) "it appears from the evidence *** that reasonable minds can come to but one conclusion and that conclusion is adverse to the party against whom the motion for summary judgment is made, that party being entitled to have the evidence *** construed most strongly in the party's favor." A trial court's decision to grant summary judgment is reviewed by an appellate court under a de novo standard of review. *Grafton v. Ohio Edison Co.*, 77 Ohio St.3d 102, 105, 1996 Ohio 336, 671 N.E.2d 241. An appellate court must independently review the [**6] record to determine if summary judgment was appropriate. Therefore, an appellate court affords no deference to the trial court's decision while making its own judgment. *Schwartz v. Bank One, Portsmouth, N.A. (1992)*, 84 Ohio App.3d 806, 809, 619 N.E.2d 10; *Morehead v. Conley (1991)*, 75 Ohio App.3d 409, 411-412, 599 N.E.2d 786.

[*P15] RBS asserts that the trial court erred in applying the doctrine of equitable subrogation in favor of Countrywide because equitable subrogation is inapplicable to the facts of this case.

[*P16] Mortgages "take effect in the order of their presentation." *R.C. 5301.23(A)*. Between the RBS mortgage and the Countrywide mortgage, RBS was the first mortgage to be recorded and is first in time. However, Countrywide asserts that the doctrine of equitable subrogation gives its mortgage priority.

[*P17] "Unlike conventional subrogation, which is premised on the contractual obligations of the parties, equitable subrogation ""*** arises by operation of law when one having a liability or right or a fiduciary relation in the premises pays a debt due by another under such circumstances that he is in equity entitled to the security

or obligation held by the creditor whom he has paid." *Assoc. Financial Servs. Corp. v. Miller*, [**7] 11th Dist. No. 2001-P-0046, 2002 Ohio 1610, 2002 Ohio App. LEXIS 1565, at *8, citing *State v. Jones (1980)*, 61 Ohio St.2d 99, 102, 399 N.E.2d 1215 (citations omitted).

[*P18] "[E]quity in the granting of relief by subrogation is largely concerned with and rests its interference, when called upon, on the prevention of frauds and relief against mistakes, and it is correctly stated that the right to it depends upon the facts and circumstances of each particular case." *Jones*, 61 Ohio St.2d at 102 (citation omitted). "Because equitable subrogation is an equitable doctrine, the equity of the party asserting it 'must be strong and his case clear.'" *ABN AMRO Mortg. Group, Inc. v. Kangah*, 126 Ohio St.3d 425, 2010 Ohio 3779, at ¶11, 934 N.E.2d 924, citing *Jones*, 61 Ohio St.2d at 102 (citation omitted).

[*P19] In order for equitable subrogation to apply, a lender should have satisfied a prior mortgage or debt, had the intent to hold the first position lien, and the mortgage sought to be subrogated must have failed to end up in the first lien position through mistake. See *Kangah*, 126 Ohio St. 3d 425, 2010 Ohio 3779, at ¶13, 934 N.E.2d 924.

[*P20] Here, the facts indicate that Countrywide satisfied the prior RBS mortgage. Additionally, the documents related to this satisfaction indicate [**8] that Countrywide intended to have the first position lien. Countrywide did not achieve the first position because RBS did not sign a release and also did not close the Korbs' account. The Korbs continued to use this account and amass further debts to RBS after RBS received the payment from Lakeside.

[*P21] RBS argues that although the elements discussed above were met, equitable subrogation is inapplicable because RBS would be subject to a greater burden than it previously had been subject to if the Countrywide mortgage is granted priority. RBS cites *Kangah*, in which the Ohio Supreme Court found that the party in the second position was in a "worse position that it would have otherwise been," due to the refinancing and because, through equitable subrogation, the party advancing funds was allowed to have its mortgage placed in first position. *Kangah*, 126 Ohio St. 3d 425, 2010 Ohio 3779, at ¶12, 934 N.E.2d 924. The court found that the new mortgage was a larger mortgage than the original mortgage in the first position. Therefore, the party in the second position would be in a worse position than it was

in under the previous mortgage. The *Kangah* court concluded that because the holder of the second mortgage was in a worse position [**9] than it would have been had the mortgage not been extinguished, the doctrine of equitable subrogation was inapplicable. *Id.* at ¶15. RBS asserts that the similar facts exist in the present case and the Supreme Court's holding in *Kangah* should apply.

[*P22] Countrywide asserts that it requested and sought priority only as to \$152,657.74, which is the amount Countrywide paid to satisfy the original MERS mortgage. Countrywide argues because of this, the RBS mortgage would be subordinate to exactly the same amount it had previously been subordinate to prior to Countrywide satisfying the MERS mortgage. Countrywide alleges that it is not seeking priority as to the remaining balance of the Countrywide mortgage. Therefore, RBS would not be in a worse position if the Countrywide mortgage was granted priority under the doctrine of equitable subrogation because it would still be subordinate to a mortgage in the amount of \$152,657.74.

[*P23] Equitable subrogation has been allowed when "[n]o greater burden was placed on the [holder of the secondary mortgage] than she would have borne if the old mortgage *** had not been released." *Fed. Union Life Ins. Co. v. Deitsch* (1934), 127 Ohio St. 505, 512, 189 N.E. 440, 39 Ohio L. Rep. 653. Equitable subrogation [**10] should not place a burden on the opposing creditor and the creditor should not be placed in a worse position due to a court allowing equitable subrogation. See *Kangah*, 126 Ohio St. 3d 425, 2010 Ohio 3779, at ¶16, 934 N.E.2d 924, *Straman v. Rehtine* (1898), 58 Ohio St. 443, 51 N.E. 44, at paragraph one of the syllabus ("the mortgagee has a right to be subrogated to the lien which was paid by the money so by him loaned, when it can be done without placing greater burdens upon the intervening lienholders than they would have borne if the old mortgage had not been released").

[*P24] While the court in *Kangah* does find that the holder of the mortgage in the second position should not be placed in a worse situation by equitable subrogation, the facts from the present case are distinguishable from those in *Kangah*. The record, including Countrywide's Supplemental Motion for Summary Judgment, shows that Countrywide is seeking priority only for the amount of the MERS mortgage. Since Countrywide is seeking priority only as to the amount of the MERS mortgage and not for the entire amount of the new Countrywide

mortgage, RBS will be in exactly the same position as it would have otherwise been. Therefore, we cannot find that equitable subrogation is [**11] improper in this matter based on RBS being placed in a worse position by allowing equitable subrogation.

[*P25] RBS also argues that the doctrine of equitable subrogation is inapplicable to this case because Countrywide was negligent as a matter of law.

[*P26] Countrywide asserts that it was not negligent and that negligence is not dispositive of whether the doctrine of equitable subrogation applies.

[*P27] While it was, at the least, a mistake to fail to obtain a signed release from RBS, we agree with Countrywide that this is not dispositive of whether equitable subrogation applies. Even assuming that the failure to obtain a release rises to the level of negligence, the doctrine of equitable subrogation still applies under the facts of this case.

[*P28] Where a party did not expect to be in the first loan position but becomes first based on mistake or negligence on behalf of the party seeking application of the doctrine of equitable subrogation, such negligence is "immaterial" and the doctrine of equitable subrogation applies. *Bank One v. Jude*, 10th Dist. Nos. 02AP-1266 and 02AP-1268, 2003 Ohio 3343, at ¶25; *Metro. Bank & Trust Co. v. Roth*, 9th Dist. No. 20322, 2001 Ohio App. LEXIS 1850, at *6-7 (where the lender [**12] paid off the first mortgage with the understanding that it would step into the shoes of the holder of the first mortgage, it would be inequitable to allow the lender in the second position to move into the first position).

[*P29] In addition, in cases where the party seeking equitable subrogation is requesting subrogation only in the amount paid to satisfy the mortgage in the first position, courts have held that the doctrine applies as to the amount of the first mortgage. See *Washington Mut. Bank, FA v. Aultman*, 172 Ohio App.3d 584, 2007 Ohio 3706, at ¶42, 876 N.E.2d 617 (where the lender opposing application of equitable subrogation was originally in the second lien position and the other lender sought subrogation only to the extent that it paid off the first mortgage, the equity was strong and the doctrine of equitable subrogation applied); *TCIF REO GCM, LLC v. Natl. City Bank*, 8th Dist. No. 92447, 2009 Ohio 4040, at ¶¶20-21 (court applied equitable subrogation to grant priority to the lender to the extent that it satisfied the first

mortgage). "[T]he negligence of the party seeking subrogation does not defeat him so long as the burden of the lienholder resisting the substitution is not increased." *Union Trust Co. v. Lessovitz (1931)*, 51 Ohio App. 69, 73-74, 10 Ohio Law Abs. 171, 199 N.E. 614.

[*P30] [**13] In this case, RBS is not in a worse position than it was prior to Countrywide's satisfaction of the MERS mortgage. There is no evidence that RBS suffered any damage at all due to Countrywide's failure to obtain a release. RBS never bargained for or expected to be in the first loan position. Therefore, even if this court found that Countrywide's actions in failing to obtain a release were negligent, the application of equitable subrogation would still be proper. As noted previously, Countrywide is only seeking priority as to \$152,657.74, which is the same amount RBS was previously subordinate to under the MERS mortgage. Therefore, the application of the doctrine of equitable subrogation would not place RBS in a worse position than the one it previously occupied.

[*P31] Moreover, denying Countrywide the application of the doctrine of equitable subrogation would result in an unearned windfall for RBS, by placing it in a better position than Countrywide. See *Fed. Home Loan Mtge. Corp. v. Moore*, 10th Dist. No. 90AP-546, 1990 Ohio App. LEXIS 4263, at *7-*8 (a lender who was not "misled or injured" by the negligence of the other party should not advance to the first priority position when such an [**14] advance would result in an "unearned windfall"); *Bank One*, 2003 Ohio 3343, at ¶25 (where party did not "bargain for or even expect a first lien position," to grant that party the first lien position "would create an unearned financial windfall"); *Fed.*

Natl. Mtge. Assoc. v. Webb, 5th Dist. No. 2005CA0013, 2006 Ohio 3574, at ¶¶41-43 (court applied the doctrine of equitable subrogation to prevent unjust enrichment). Applying the doctrine of equitable subrogation in this case prevents RBS from receiving such a windfall.

[*P32] RBS finally argues that if Countrywide's negligence has not been established as a matter of law, this matter should be remanded to the trial court for a determination of negligence.

[*P33] Since we have found that the doctrine of equitable subrogation is applicable regardless of whether Countrywide was negligent, this argument is moot. The trial court need not make such a determination of negligence.

[*P34] We find Countrywide set forth a case for equitable subrogation, and upon these facts, the trial court did not err in granting Countrywide's Motion for Summary Judgment.

[*P35] The sole assignment of error is without merit.

[*P36] For the foregoing reasons, the Judgment Entry of the Geauga County [**15] Court of Common Pleas, granting Countrywide's Motion for Summary Judgment, is affirmed. Costs to be taxed against appellant.

MARY JANE TRAPP, J.,

THOMAS R. WRIGHT, J., concur.

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Damages

Laura Dietz, J.D., Edward K. Esping, J.D., Alan Jacobs, J.D., Theresa Leming, J.D., Lucas Martin, J.D., Jaqualin Friend Peterson, of the staff of the National Legal Research Group, Inc., J.D., Jeffrey Shampo, J.D., Susan L. Thomas, J.D., Lisa A. Zakolski, J.D.

III. Compensatory Damages
E. Limitations on Recovery
4. Compensation Already Received
c. Collateral Sources
(1) Overview of the Collateral-Source Rule

Topic Summary Correlation Table References

§ 392. Generally

West's Key Number Digest

West's Key Number Digest, Damages ¶59, 60

A.L.R. Library

Collateral source rule:admissibility of evidence of availability to plaintiff of free public special education on issue of amount of damages recoverable from defendant, 41 A.L.R. 5th 771

Award of Liquidated Damages Under § 7 of Age Discrimination in Employment Act (29 U.S.C.A. § 626(b)) for "Willful" Violations of Act, 5 A.L.R. Fed. 2d 243

Application of collateral-source rule in actions under Federal Tort Claims Act (28 U.S.C.A. § 2674), 104 A.L.R. Fed. 492

Model Codes and Restatements

Restatement Second, Torts § 920A

The "collateral-source rule" provides that if an injured party received some compensation for injuries from a source wholly independent of the tortfeasor, such payment should not be deducted from the damages which the plaintiff would otherwise collect from the tortfeasor.[1] "Collateral" has the meaning "not lineal, but upon a parallel or diverging line." [2]

Receipt of funds from a collateral source lessens the financial losses that a plaintiff would otherwise suffer. Thus, if the only goal of tort law were to compensate the plaintiff for losses, evidence of these benefits would be

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admitted to reduce the total damages assessed against the defendant.[3] However, reducing recovery by the amount of the benefits received by the plaintiff would grant a windfall to the defendant by allowing a credit for the reasonable value of those benefits. Such credit would result in the benefits being effectively directed to the tortfeasor and from the intended party—the injured plaintiff.[4] If there is a windfall, it is considered more just that the injured person profit rather than grant the wrongdoer relief from full responsibility for the wrongdoing.[5] Thus, courts, under the collateral-source rule, generally hold that benefits received by the plaintiff from a source wholly independent of and collateral to the wrongdoer do not diminish the damages otherwise recoverable from the wrongdoer.[6]

Practice Guide:

The collateral-source rule applies to money paid the plaintiff by his or her own insurer, Social Security benefits, public and private pension payments, unemployment and workers' compensation benefits, vacation and sick leave allowances, and other payments made by employers to injured employees, both contractual and gratuitous.[7]

The authorities, however, are not uniform. In some jurisdictions, distinctions are drawn as to the type of benefits received, and in limited instances these benefits may be shown to decrease the damages recoverable.[8]

Observation:

The collateral-source rule is a judicial expression of public policy[9] but has been subject to criticism.[10]

CUMULATIVE SUPPLEMENT

Cases:

If the tortfeasor provides a benefit to the plaintiff specifically to compensate him for his injury, the benefit does not constitute a collateral source; such payments may, therefore, be taken into account in fixing tort damages, as the tortfeasor need not pay twice for the same damage. *Sloas v. CSX Transp. Inc.*, 616 F.3d 380 (4th Cir. 2010).

Under Virginia law, the mere fact that compensation comes from a tortfeasor does not preclude the possibility that it is from a collateral source; this is ultimately determined by examining the nature of the compensation. *In Matter of Complaint of Vulcan Materials Co.*, 674 F. Supp. 2d 756 (E.D. Va. 2009).

The collateral source rule functions both as a substantive rule of damages, and as a rule of evidence. *In re McQueen*, 193 Cal. App. 4th 495, 2011 WL 856605 (1st Dist. 2011).

Under the common law "collateral source rule," any third-party benefits or gifts obtained by the injured plaintiff accrue solely to the plaintiff's benefit and are not deducted from the amount of the tortfeasor's liability; these third-party sources are collateral and are irrelevant in fixing the amount of the tortfeasor's liability, and, thus, the rule allows double recovery by a successful plaintiff. *Volunteers of America Colorado Branch v. Gardenswartz*, 242 P.3d 1080 (Colo. 2010).

Tortfeasor cannot diminish his liability based on payments made by a non-tortfeasor. *Broda v. Dziwura*, 286 Ga. 507, 689 S.E.2d 319 (2010).

As a substantive rule of damages, the collateral source rule bars a defendant from reducing the plaintiff's compensatory award by the amount the plaintiff received from the collateral source. *Wills v. Foster*, 229 Ill. 2d 393, 323 Ill. Dec. 26, 892 N.E.2d 1018 (2008).

Under the "collateral source rule," benefits received by the injured party from a source wholly independent

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of, and collateral to, the tortfeasor will not diminish damages otherwise recoverable from the tortfeasor. *Wills v. Foster*, 229 Ill. 2d 393, 323 Ill. Dec. 26, 892 N.E.2d 1018 (2008).

Under the "collateral source rule," payments received from an independent source are not deducted from the award the aggrieved party would otherwise receive from the wrongdoer; as a result, the tortfeasor is not allowed to benefit from the victim's foresight in purchasing insurance and other benefits. (Per Justice Weimer with the Chief Justice and three justices concurring in part). *Bellard v. American Cent. Ins. Co.*, 980 So. 2d 654 (La. 2008).

The "collateral source rule" provides that where an injured party received some compensation for his injuries from a source wholly independent of the tortfeasor, such payment should not be deducted from the damages which the plaintiff would otherwise collect from the tortfeasor. *Winchell v. Schiff*, 193 P.3d 946 (Nev. 2008).

The "collateral source rule" is a judicial refusal to credit to the benefit of the wrongdoer money or services received in reparation of the injury caused which emanates from sources other than the wrongdoer. *Arbino v. Johnson & Johnson*, 116 Ohio St. 3d 468, 2007-Ohio-6948, 880 N.E.2d 420 (2007).

[END OF SUPPLEMENT]

[FN1] *Miller v. Ellis*, 103 Cal. App. 4th 373, 126 Cal. Rptr. 2d 667 (1st Dist. 2002); *Dean v. American Family Mut. Ins. Co.*, 535 N.W.2d 342 (Minn. 1995); *Acuar v. Letourneau*, 260 Va. 180, 531 S.E.2d 316 (2000).

[FN2] *North Royalton v. Baker*, 65 Ohio App. 3d 644, 584 N.E.2d 1308 (8th Dist. Cuyahoga County 1989).

[FN3] *Whiddon v. Malone*, 220 Ala. 220, 124 So. 516 (1929); *Montgomery & E. Ry. Co. v. Mallette*, 92 Ala. 209, 9 So. 363 (1891); *Minster v. Citizens' Ry. Co.*, 53 Mo. App. 276, 1893 WL 1732 (1893).

[FN4] *Gypsum Carrier, Inc. v. Handelsman*, 307 F.2d 525, 4 A.L.R.3d 517 (9th Cir. 1962); *Hudson v. Lazarus*, 217 F.2d 344 (D.C. Cir. 1954); *Philip Chang & Sons Associates v. La Casa Novato*, 177 Cal. App. 3d 159, 222 Cal. Rptr. 800 (5th Dist. 1986); *Yarrington v. Thornburg*, 58 Del. 152, 205 A.2d 1, 11 A.L.R.3d 1110 (1964); *Hueper v. Goodrich*, 314 N.W.2d 828 (Minn. 1982).

Restatement Second, Torts § 920A, Comment b.

[FN5] *Overton v. U.S.*, 619 F.2d 1299 (8th Cir. 1980); *Grayson v. Williams*, 256 F.2d 61 (10th Cir. 1958); *District of Columbia v. Jackson*, 451 A.2d 867 (D.C. 1982); *Jones v. Town of Wayland*, 380 Mass. 110, 402 N.E.2d 63 (1980).

[FN6] *Sanjuan v. IBP, Inc.*, 160 F.3d 1291, 50 Fed. R. Evid. Serv. 1199 (10th Cir. 1998) (Kansas law); *Tatum v. Van Liner Ins. Co. of Fenton, Mo.*, 104 F.3d 223 (8th Cir. 1997) (Missouri law); *Rotolo Chevrolet v. Superior Court*, 105 Cal. App. 4th 242, 129 Cal. Rptr. 2d 283 (4th Dist. 2003), Summarized in, 5 WCAB Rptr. 10,31, 2003 WL 262379 (Cal. App. 4th Dist. 2003) and review denied, (Apr. 9, 2003); *St. Francis De Sales Federal Credit Union v. Sun Ins. Co. of New York*, 2002 ME 127, 818 A.2d 995 (Me. 2002); *Brandon HMA, Inc. v. Bradshaw*, 809 So. 2d 611 (Miss. 2001); *Douglas v. Adams Trucking Co., Inc.*, 345 Ark. 203, 46 S.W.3d 512 (2001); *Ratlief v. Yokum*, 167 W. Va. 779, 280 S.E.2d 584 (1981).

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Restatement Second, Torts § 920A(2).

[FN7] *Acordia of Virginia Ins. Agency, Inc. v. Genito Glenn, L.P.*, 263 Va. 377, 560 S.E.2d 246 (2002)

[FN8] As to jurisdictions requiring actual payment of medical or hospital expenses, see § 397.

[FN9] *Philip Chang & Sons Associates v. La Casa Novato*, 177 Cal. App. 3d 159, 222 Cal. Rptr. 800 (5th Dist. 1986).

[FN10] See, e.g., *Hueper v. Goodrich*, 314 N.W.2d 828 (Minn. 1982), which declined to abandon the collateral-source rule, even though the facts of the case (the injured minor plaintiff was treated at a charitable hospital that would not charge patients or accept the proceeds of insurance policies) presented a good case for doing so.

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AMJUR DAMAGES § 392

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APPENDIX G