DIRT Periodic Development for Friday, June 28, 2013
Columbia Community Bank v. Newman Park, LLC

Guest Editor: R. Wilson Freyermuth
John D. Lawson Professor, Curators' Teaching Professor
University of Missouri School of Law

Columbia Community Bank v. Newman Park, LLC, Supreme Court of Washington, 2013 WL 3089572 (June 20, 2013)

SYNOPSIS: The Washington Supreme Court adopts, in full, the provisions of Section 7.6 of the Restatement (Third) of Property — Mortgages regarding equitable subrogation, rejecting the use of the "volunteer rule" as a means to deny subrogation to a refinancing lender.

FACTS: In 2004, Newman Park, LLC (Newman Park) purchased land in Thurston County, Washington for development purposes, obtaining a $400,000 deed of trust loan from Hometown National Bank (HNB). Sturtevant, one of the principals of Newman Park, negotiated the loan terms. Four years later, in 2008, Sturtevant (without the knowledge of the other members of Newman Park) went to Columbia Community Bank (CCB) and requested and obtained a loan for his 95 percent-owned company, Trinity. CCB loaned Sturtevant $1.5 million, to be secured by a deed of trust on the Newman Park property. Sturtevant signed as owner of Landmark, which had a 39 percent interest in Newman Park. However, unbeknownst to CCB, Newman Park's operating agreement required a membership interest of 80 percent or more to approve such a transaction, so Sturtevant lacked the authority to grant CCB a valid lien on the property. [Sturtevant had fraudulently shown CCB an altered version of the Newman Park operating agreement that identified Landmark as the holder of a 100% stake in Newman Park.]

Because CCB was aware that HNB had a prior lien on the Newman Park property, CCB required Sturtevant to use $400,000 of the loan to pay off HNB as a condition of the CCB loan, and Sturtevant did so. In this manner, CCB expected to acquire the first lien position on the land, as HNB was the only prior mortgagee and its interest otherwise would have been extinguished when its $400,000 loan was paid off.

In 2009, Trinity defaulted to CCB, which tried to foreclose on the property. Newman Park objected that CCB never acquired a valid lien on the property, and sued to enjoin CCB's foreclosure. After discovering Sturtevant's fraud, CCB then sought a declaration that its deed of trust was valid under various agency theories or, if not, that it had acquired a lien on the property by virtue of equitable subrogation. On motions for summary judgment, the trial court held that CCB's deed of trust was unauthorized and invalid; however, it also held that because CCB had paid off the $400,000 loan from

HNB, CCB was equitably subrogated to HNB's position and acquired an equitable lien on the property in that amount. The Court of Appeals affirmed, rejecting Newman Park's argument that CCB was a mere volunteer and hence could not benefit from equitable subrogation. The Washington Supreme Court granted review to determine whether the volunteer rule remained Washington law so as to bar equitable subrogation in the refinancing context.

ANALYSIS: The Supreme Court affirmed, rejecting the volunteer rule and holding that CCB was entitled to be equitably subrogated to HNB's position. The court noted that equitable subrogation "allows one party to step into the shoes of a second party who is owed a debt or obligation and to receive the benefit of that debt or obligation, in the absence of any contractual agreement or assignment of rights between those two parties or the debtor," and that subrogation "is permitted without assignment in order to prevent unjust enrichment."

The court noted that Washington courts had traditionally restricted the application of unjust enrichment and equitable subrogation to a party not acting as a "volunteer." Newman Park argued that CCB was a volunteer in that it did not make the payment to HNB to "satisfy an existing legal obligation or protect an existing interest that was under threat." As recently as 2002, in *BNC Mortgage, Inc. v. Tax Pros, Inc.*, 111 Wash.App. 238, 254, 46 P.3d 812 (2002), the Washington courts had ruled that equitable subrogation was unavailable to a refinancing lender because the lender "did not act under any ... duty or compulsion, but instead chose freely and voluntarily to avail itself of a business opportunity."

The court noted, however, that Section 7.6 of the Restatement of Mortgages rejects the application of the volunteer rule. Section 7.6 provides as follows:

(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 … 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.

The comments to Section 7.6 reject the "volunteer rule," instead requiring only "that the subrogee pay to protect some interest," Restatement § 7.6, comment b. The comments also make clear that equitable subrogation ought to protect a refinancing lender "if the debtor promises to provide security in the real estate to the [refinancing lender], but fails to do so" — the precise situation presented in Newman Park.

The court noted that it had previously adopted Restatement § 7.6 in *Bank of America v. Prestance Corp.*, 160 Wash.2d 560, 160 P.3d 17 (2007), but only for the purpose of concluding that a refinancing lender's actual or constructive knowledge of an intervening lien would not defeat the refinancing lender's equitable subrogation claim. The Prestance case had not addressed the volunteer rule as applied to a case such as Newman Park, however, where no intervening lienor was involved. Nevertheless, the court in Newman Park adopted Restatement § 7.6 "in full," noting that (as it had acknowledged in Prestance), "[the] trend is clearly toward the more liberal approach, and we would be wise to follow it," and noting that a more liberal approach to equitable subrogation would "stem the threat of foreclosure" by facilitating more refinancing. The court also noted that a more liberal approach to equitable subrogation might save homeowners by reducing title insurance premiums (an argument advanced by Professors Nelson and Whitman, co-Reporters for the Restatement). The court concluded that the Restatement approach is "the more simple and clear approach" and that the BNC Mortgage decision was overruled to the extent it suggested that the volunteer rule generally bars equitable subrogation in the refinance context.

Applying § 7.6 to the facts, the court acknowledged that CCB "arguably failed to exercise due diligence when it loaned Sturtevant $1.5 million without an in-depth investigation into his claimed assets." Nevertheless, the court noted that Sturtevant had altered the Newman Park operating documents for the purpose of inducing CCB to make the loan on the appearance that Sturtevant was the sole owner of Newman Park. Because Restatement § 7.6(b) lists "misrepresentation, mistake, duress, undue influence, deceit, or other similar imposition" as situations in which equitable subrogation is warranted, § 7.6(b)(3), the court held that Sturtevant's deceit made equitable subrogation especially appropriate here:

CCB may have been less than diligent when it gave Sturtevant a loan with apparently minimal investigation. But granting equitable subrogation here would not result in any prejudice to Newman Park because it retains exactly the same position it would have had if CCB had never paid its loan — it owes a debt of approximately $400,000. The only change is the identity of the party owed.

REPORTER'S COMMENT: Chalk one up for sanity! It makes no sense for courts to continue to apply the volunteer rule to defeat the subrogation claim of a refinancing lender, and it is gratifying to see the Washington court get the issue right. Hopefully, the court's reasoning may help blunt the impact of some of the more abysmal recent

decisions (several of them in the bankruptcy context) denying equitable subrogation to refinancing lenders upon the authority of the volunteer rule. See, e.g., *In re Trask*, 462 B.R. 268 (Bankr. 1st Cir. 2011); *In re Bosley*, 2011 WL 671983 (Bankr. D. Vt. 2011).