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**EQUITABLE SUBROGATION: A SENSIBLE REMEDY, BUT DON'T COUNT ON IT**

*JP Morgan Chase Bank, N.A. v Banc of America Practice Solutions, Inc.*

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*JP Morgan Chase Bank, N.A. v Banc of Am. Practice Solutions, Inc.* (2012) 209 CA4th 855, 147 CR3d 287.

This column was written for the CEB's Real Property Law Reporter on a recent California equitable subrogation decision.

I found nothing surprising or upsetting in *JP Morgan Chase Bank, N.A. v Banc of Am. Practice Solutions, Inc.* (2012) 209 CA4th 855, 147 CR3d 287. It was a more or less run-of-the-mill decision, holding that a new lender (Chase), who was refinancing out two existing lenders (Chevy Chase Bank and Bay Area Financial Corp.) but who had overlooked a recorded intervening lender (Banc) in between it and them, could - by virtue of the doctrine of equitable subrogation - leapfrog over Banc in priority into the positions of those former seniors because their old loans had been paid off with funds that came from Chase. That outcome avoided the windfall (to Banc) and corresponding forfeiture (to Chase) that would have been generated if Banc had been given recording priority over Chase.

Although eminently sensible, the result might have been different elsewhere. About half of the states would instead strictly apply their recording acts to the situation and hold that, because Banc had recorded before Chase had, Banc was entitled to a legal priority that matched its temporal priority-outraged at the notion that a party who had carelessly overlooked an existing interest of record should then be able to claim priority over it. (In 2006, I counted six jurisdictions preferring such a strict recording-order rule as against seven endorsing equitable subrogation principles the other way. See "Statutory Equitable Subrogation" in the American College of Mortgage Attorneys Abstract, found at <http://www.rogerbernhardt.com/index.php/ceb-columns/126-statutory-equitable-subrogation>. Later decisions seem to continue that even split.) This is a touchy issue for courts.

### **Recording Act Logic**

Under recording act logic-whether notice, race, or race-notice-priority should go to the intervening lender (Banc), because its lien was put on the records before the refinancer's (Chase's) was. To get around that result, the court's opinion says our priorities statute is subject to the qualification of "other things being equal," i.e., the equities being in

balance, but that is a red herring. That phrase is a carveout to CC §2897, which provides for common law first in time of *creation* priority, and the “other things” to which it refers is the reversal that a recording act imposes over common law priority when the second interest was recorded first. (In other words, if A takes a mortgage first but does not record it, and B takes a mortgage later in time but records it first, then B’s mortgage has priority over A’s even though A’s was created first.)

Technically, the proper statute to cite was CC §1214 (also CC §1107), which provides that a mortgage is void against a subsequent party “whose conveyance [mortgage] is first duly recorded.” There are requirements of good faith and valuable consideration in §1214 (making it a race-notice act rather than just a race act), but there is no “other things being equal” qualification like there is in CC §2897. Under pure recording law, the fact that a refinancer recorded *after* the intervening creditor did ends the argument, and factors such as whether the intervening lienor was a judgment creditor or consensual lienor or whether the refinancer knew or did not know of it do not matter. Equitable considerations come into the picture only when a first party failed to record and the question is whether the second party had knowledge or notice of that fact, not when the first party had-as here-already recorded. B can beat A when A failed to record and B then recorded first, but it is much harder for B to beat A when A is the one who recorded first.

### **Subrogation**

What a court must say to put the refinancer first is that it is entitled to stand in the shoes of the former lender who was refinanced out of the picture. In this case, the original lenders (Chevy Chase and Bay Area) had recording act priority over Banc (because they had loaned and recorded before Banc). If they had simply assigned their deeds of trust to Chase, Chase would have been automatically prior to Banc. If there was no formal legal assignment, but that was what Chevy Chase/Bay Area and Chase both wanted, then equity can get the same result through its comparable doctrine of subrogation. So the Restatement (Third) of Property: Mortgages §7.6 argues:

(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.

### **The Role of Fairness**

Whether a party takes by subrogation rather than by assignment may look like a minor and innocuous technical consideration, because the effect of both procedures is to merely change the name of the senior party from that of the original lender to that of the refinancing lender. But from a substantive point of view, subrogation avoids a

significant windfall accruing to one party (Banc) and a significant forfeiture occurring to the other (Chase). If equitable subrogation were not applied in this case, Chase would have moved down in priority from its intended senior position into a position below Banc's \$2.1 million lien, and Banc would have moved up in priority from its original junior position (below \$3 million worth of liens) into a senior position. The Restatement says "(b) ... subrogation is appropriate to prevent unjust enrichment ... and if subrogation will not materially prejudice the holders of intervening interests in the real estate" - which was exactly what the court thought in this case was occurring as far as Banc was concerned:

Banc characterizes the use of equitable subrogation in this matter as punishment imposed on it, or an action taken to its prejudice. But that is not an accurate assessment. Equitable subrogation provides Banc just what it bargained for and received from the Siemeses: a deed of trust third in priority. Banc is in the same position it would have been in had the Siemeses not paid off their preexisting first and second deeds of trust by refinancing with Chase. Getting exactly what one bargained for is neither punishment nor prejudicial.

For an equitable subrogation supporter, that may be all that needs to be shown: that the result will avoid a harm to one party and will not hurt the other party. One party is better off and no party is worse off.

But that argument is rejected by many courts on the ground that it lets a party too easily escape the consequences of its own fault in the transaction-a sort of moral rejection of the financial policy behind equitable subrogation. Why should a clearly dictated statutory outcome be avoided by a party who failed to make a proper search of the records as the system expects it to do? Negligent parties should not beat innocent parties.

### **The Role of Fault**

Fault certainly plays some role in the California jurisprudence of equitable subrogation. But how much? Because equitable subrogation is necessary only when recording act priority is unavailable, the refinancer seeking to rely on it has obviously been guilty of some neglect-typically, failing to find or understand some other recorded lien. Equitable subrogation would never be necessary if every party truly and timely searched the records first and then properly recorded its instrument. Certainly, someone at Chase (or its title searcher) should have known better than to rely on a title report that was 70 days out-of-date when the loan was funded. If fault always defeated the doctrine, equitable subrogation would be entirely dead.

In *Simon Newman Co. v Fink* (1928) 206 C 143, 273 P 565, our supreme court said that the refinancer had to be "not chargeable with culpable and inexcusable neglect." I am pleased to see from this decision that failing to make a timely record search can be

excusable (though not always-see *Lawyer's Title Ins. Corp. v Feldsher* (1996) 42 CA4th 41, 49 CR2d 542, covered in my column "Paying the Wrong Debt," available at <http://www.rogerbernhardt.com/index.php/ceb-columns/177-wrong>). But I would not recommend counseling a prospective lender to not bother searching the records (or to ignore the results that a search disclosed) because the line between culpable and excusable neglect is hard to predict in advance. The refinancer who actually knows of the intervening lien has a much shakier case, even when it can show that the funds it advanced were used entirely to retire an existing prior lien, because that wins only the financial half of the battle, not the more unpredictable moral half.

Lenders should be grateful that the doctrine of equitable subrogation exists because it may permit them to avoid incurring catastrophic losses for the clumsy blunders of their employees. But lenders should still hope that they will never have to argue for it, and will instead stick to sensible record-searching and the legal priority that follows from doing it right.