

# **Equitable Subrogation: Washington Supreme Court Adopts**

## ***Restatement Approach***

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### **Introduction**

In a recent case from the State of Washington, *Bank of America v. Prestance Corp.*, 2007 W.L. 1631420 (Wn. Sup. Ct., June 7, 2007), the question before the Washington Supreme Court was whether a refinancing mortgagor must be precluded from equitable subrogation to a first-priority lien if it has actual or constructive notice of a junior lienholder. The court held that that answer was “no.” The court noted that this particular issue was one of first impression for the Washington Supreme Court. The court cited and distinguished its prior ruling in *Kim v. Lee*, 145 Wn.2d 79 (2001), where the refinancing mortgagee’s title insurer (as opposed to a refinancing mortgagor) had constructive and actual knowledge of an intervening judgment lien and the court ruled that the title insurer could not avoid liability through equitable subrogation because it had actual knowledge of the lien and refused to disclose it to the insured prior to issuing the title policy.

### **Facts of the Case**

The facts in this case are somewhat complicated. In 1994, Sakae and Yuko Sugihara (“Borrowers”) received a 30-year home loan of \$543,000 from Washington

Mutual, which loan was secured by a deed of trust on their home. In 1999, Bank of America (“B of A”) made a loan of \$400,000 to Prestance Corporation (“Prestance”), a corporation owned by the borrowers, secured in part by a loan on the borrowers’ home. B of A later furnished Prestance an additional line of credit for \$1 million, secured by Mr. Sugihara’s personal guarantee and an amendment to the existing B of A deed of trust.

In 2001, the Borrowers approached Wells Fargo Bank West (“WFB West”) for a loan in the amount of \$1 million, which was to be secured by a deed of trust on the Borrowers’ property. The court stated, at \*1, par. 4, that:

One purpose of the loan was to pay off the first-position Washington Mutual [home] loan [in the amount of approximately \$500,000]. WFB West expected it would then have priority over the other loans for the amount used to pay Washington Mutual. A preliminary title commitment showed the Bank of America loans, secured by the Bank of America deed of trust and its amendment . . . [I]t was WFB West’s understanding [when its loan closed] that Bank of America’s deed of trust had been (or was being) reconveyed to Wells Fargo Bank (“WFB”) and that WFB (a bank related to WFB West) would subordinate its \$500,000 loan, putting the WFB West deed of trust in first position.

(In November 2001, Mr. Sugihara received a \$500,000 home equity loan from WFB. Part of that loan was used to pay B of A for its original \$400,000 loan to Prestance. B of A cashed the check but never reconveyed the deed of trust to WFB.)

B of A sued the Borrowers, Prestance, WFB and WFB West, seeking a money judgment and foreclosure of the defaulted B of A loan. The trial court, relying on the *Restatement (Third) of Property: Mortgages* sec. 7.6 *Subrogation* (1997) (“Restatement”), ruled that WB West should be equitably subrogated to the first-priority position of Washington Mutual in the payoff amount of \$499,477, which would leave B of A (according to the trial court judge) “in no worse position than it would have been [in] had had [WFB West] never made its . . . loan.” *Id.* at \*1, par. 5. The appellate court reversed, holding that under the *Kim v. Lee* decision, *supra*, “WFB West’s actual knowledge of Bank of America’s lien barred the application of equitable subrogation.” *Id.* at par 5.

### **The Washington Supreme Court’s Decision**

The court noted that the only issue before it was a legal one: whether it should adopt the Restatement position “to hold a refinancing mortgagee’s actual or constructive knowledge of intervening liens does not automatically preclude a court from applying equitable subrogation.” *Id.* at \*2, par. 7.

Describing the origins and purpose of the doctrine of equitable subrogation, the Washington Supreme Court stated that, “Borrowed from English courts of equity, equitable subrogation simply seeks to maintain the status quo . . . . Equitable subrogation preserves the proper priorities by keeping the first mortgage first and the second mortgage second. *Id.* at \*2, par. 9. The court also stated that “Despite an initial resistance to equitable subrogation, many courts now apply it liberally” (citations omitted)). *Id.* at \*2-3, par. 9-10. The court adopted the Restatement position, i.e., that subrogation would occur even if the refinancing lender had actual or constructive notice of the intervening lien.

The court then discussed the three different jurisdictional approaches to equitable subrogation; 1) the Restatement approach (i.e., that actual or constructive knowledge of the intervening lien is irrelevant); 2) the “minority” approach (i.e., that a plaintiff with either actual or constructive knowledge of the intervening lien cannot seek equitable subrogation; and 3) the “majority” approach (i.e., that a plaintiff with actual knowledge of the intervening lien cannot seek equitable subrogation, while one with constructive notice can).

In its discussion of the majority rule, the court dismissed the argument that applying the Restatement approach would “obstruct the predictability and stability of recording act and the rule “first in time, first in right”; the court stated that “while the recording act provides stability and notice to lenders (both vital elements to any successful real estate lending scheme), we cannot rigidly adhere to its strictures where it

works an injustice.” *Id.* at \*5, par. 18. The court also dismissed the minority rule, stating that while the rationale for that rule is that a party should not profit from its own negligence by failing to check the public records, “[f]or practical purposes, this rule swallows the doctrine and is widely criticized.” *Id.* at \*\*4, par. 14-15. The court reasoned that if all such persons who confer a benefit on others due to their negligence would be disqualified from equitable relief even where no other party is harmed, “then the law of restitution, which was conceived in order to prevent unjust enrichment, would be of little or no value” (citations omitted).” *Id.* at \*4, par. 15. The court cited with approval a recent law review article by Grant S. Nelson and Dale A. Whitman, *Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners*, 2006 B.Y.U. L. REV. 305, 315-16, in particular the following:

We have vigorously criticized this approach [the minority rule] and find it impossible to understand in light of the fact that subrogation in this situation harms no one, leaving the intervening lien exactly where it started. In contrast, refusal to grant subrogation gives the intervening lienor an unexpected, unearned, and unwarranted promotion in priority (footnote omitted).

The court also justified its decision (allowing WFB West’s refinancing mortgage to be equitably subrogated to the first-position Washington Mutual loan even though WFB West knew of the existence of the intervening B of A loan) based on economic

considerations, including alleged savings on title insurance premiums and costs. The court stated that “a liberal equitable subrogation doctrine can save billions of dollars by reducing title insurance premiums. Title insurance primarily insures there are no intervening liens, and when a jurisdiction adopts the liberal view of equitable subrogation, the insurance premium is greatly reduced. . . We have demonstrated that title insurance costs in residential mortgage refinancings represent billions of dollars annually – costs that are now borne overwhelmingly by homeowners.” *Id.* at \*11, par. 33. The court further stated that “A liberal approach is in line with the [equitable subrogation] doctrine’s equitable rationale and is becoming the more acceptable rule, in no small part because of the immense benefits it holds for homeowners.” *Id.* at \* 11, par. 34. The court concluded, after examining the existing case law, that “[t]his trend is clearly toward the more liberal [Restatement] approach, and we would be wise to follow it.” *Id.* at \*8, par. 27. Also, in discussing the “history of equitable subrogation,” the court stated, at \*6, par. 24:

The rule requiring a subrogee have no knowledge of intervening interests is left over from an early mistrust of equitable subrogation and was borrowed from courts applying subrogation as a restitution remedy. We abandon this rule since this early mistrust has abated, and we are concerned with refinancing mortgages, not restitution.

In footnote 19 at the end of its opinion, the court stated further that: “Lest anyone fear for the future of the title insurance industry, Professors Nelson and Whitman assure us “the title insurance industry can endure a significant reduction in refinance premiums (citation omitted). Additionally, Nelson and Whitman spoke with a variety of executives representing major title insurance companies and mortgage lenders from all geographic areas of the country . . . Their comments were unanimous in one important respect – they supported either judicial or legislative adoption of the Restatement subrogation rule (citation omitted).”

Finally, the court listed two “policy considerations” that it alleged supported its position that the Restatement approach should prevail: “First, by facilitating more refinancing, equitable subrogation helps stem the threat of foreclosure . . . Second the Restatement approach affords enormous financial benefits for many homeowners [allegedly by significantly reducing title insurance premiums and costs].” *Id.* at \*10-11, par. 32-33.

The dissent in this case argued that the refinancing mortgagee should be protected only if it has *actual* knowledge of the intervening lien. The dissent reasons that “in my view a commercial lender who undertakes no title search will be unable to demonstrate, as the Restatement (Third) requires, that it ‘*reasonably expected*’ to receive a security interest in the real estate with the priority of the mortgage being discharged” (citation omitted) (emphasis in text). *Id.* at \*13, par. 41. (See also footnotes 9-11, which contain a good summary of the case law on equitable subrogation in various other jurisdictions.)

## Discussion

1. The court's opinion in the *Prestance* case is certainly thorough and well researched and reasoned; but the Restatement approach is still (as the court notes) not the "majority" ruling in these types of cases (although the court, after examining the case law on this topic, stated that the trend in recent cases is toward the Restatement approach and is approaching the majority rule). See *Countrywide Home Loans, Inc., v. First Nat'l Bank of Steamboat Springs, N.A.*, 144 P.3d 1224, 1230 (2006) ("We have not . . . applied the doctrine of equitable subrogation as set forth in the Restatement to allow a refinancing mortgagee to step into the shoes of a prior mortgagee for purposes of obtaining lien priority"). Cf. *Golden Delta Ent's v. U.S. Bank*, 213 S.W. 3d 171, 176 (Mo. App. 2007) (adopting Restatement approach [with respect to refinancing creditor] and stating that "The Restatement of Property [Section 7.3] concisely states the rule of law applied in Missouri case law").

2. The *Prestance* decision has almost no discussion regarding the distinction that other cases make between "conventional" and "equitable" (or "legal") subrogation. In this regard, the court itself may be confused by the distinction and states only that "We agree with the Restatement at least in the context of a conventional refinancing. A lender providing funds to pay off an existing mortgage expects to receive the same security as the loan being paid off." *Id.* at \*8, par 27.

With respect to mortgage loans, the doctrine of equitable subrogation generally provides that when loan proceeds from a new loan are used to satisfy a prior lien, the new lender stands in the shoes of the prior lienholder, if there is no prejudice to other lienholders. It rests on the equitable maxim that no one shall be enriched by another's loss, and may be invoked when justice demands its application. The doctrine is designed to prevent an unjust forfeiture, on the one hand, and a windfall amounting to unjust enrichment, on the other. But many courts apply the doctrine of "conventional subrogation," a fraternal -- but not identical -- twin of equitable subrogation, and allow claimants to bypass equitable defenses that have operated to defeat subrogation claims in the past. *See, e.g., Ames Capital Corporation v. Interstate Bank of Oak Forest*, 315 Ill.App.3d 700, 706 (Ill. App. 2nd Dist. 2000):

There are two broad categories of subrogation rights: contractual or conventional rights, and common-law or equitable rights. *Schultz v. Gotlund*, 138 Ill.2d 171, 173 (1990). Equitable subrogation is a creature of chancery (a court of equity) that is utilized to prevent unjust enrichment. There is no general rule that can be laid down to determine whether a right of equitable subrogation exists, since the right depends upon the equities of each particular case. (Citing *Dix Mutual Insurance Co. v. Framboise*, 149 Ill.2d 314, at 319 [1992].) Conventional subrogation, on the other hand, arises from an agreement

between the parties that the subrogee pay a debt on behalf of a third party and, in return, be able to assert the rights of the original creditor. See *Home Savings Bank v. Bierstadt*, 168 Ill. 618, 624 (1897).

Noting that "[t]here are no Illinois cases of recent vintage that explain when subrogation will apply to a mortgage refinancing," the appellate court nonetheless observed that "[t]here are numerous policy reasons to apply the doctrine of conventional subrogation to a case involving a refinancing mortgage." *Id.*, 315 Ill. App. 3d at 709.

But the doctrine of equitable subrogation also has ancient origins and the law is well developed in this area (if not to a great extent in Illinois). Both the "conventional subrogation" and "equitable subrogation" doctrines are creatures of equity, and the court may be creating a distinction without a meaningful difference. (In addition to Illinois, the court in *Aames* lists other state (and federal) jurisdictions that recognize the "conventional subrogation" doctrine.)

*See also* the following cases for a discussion of the difference between "conventional" and "equitable" or "legal" subrogation:

A. *LaSalle Bank, N.I. v. First American Bank*, 316 Ill.App.3d 515 (Ill. App. 1st Dist. 2000), where the court also expressly affirmed the doctrine of conventional subrogation. According to the court:

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

*Id.* at 521.

B. *Welch Foods, Inc. v. Chicago Title Insurance Co.*, 341 Ark. 515 (Ark. Sup. Ct. 2000), where the court stated that:

Conventional subrogation, as the term implies, is founded on some understanding or agreement, express or implied, and without which there is no "convention." *Courtney v. Birdsong*, 246 Ark. 162, 437 S.W.2d 238 (1969). Legal or equitable subrogation, on the other hand, is a creature of equity, and not dependent upon contract, but rather dependent upon the equities of the parties. It arises by operation of law.

*Id.* at 519 (quoting *Courtney v. Birdsong*, 246 Ark. 162, 166, 437 S.W.2d 238 (1969)).

B. *Wyoming Bldg. & Loan Ass'n v. Mills Const. Co.*, 38 Wyo. 515, 269 P. 45, 48-49 (1928):

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

superior lien in order to protect his own lien, to be subrogated to the rights of the superior lienholder (citations omitted).

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

This was clearly demonstrated in another case from the State of Washington Supreme Court, *Kim v. Lee*, 145 Wn.2d 79 (2001), discussed (and distinguished) by the Washington Supreme Court in the *Prestance* case, *supra*. In the *Kim v. Lee* case, the judgment lien holder filed to execute on his judgment lien and the title insurer intervened to protect its insured lender. The title company had failed to discover the judgment lien when it searched title, and even though Kim made the company aware of it prior to closing, the title company closed without paying off Kim's judgment lien. The majority opinion stated: "Under the Restatement [of Property 3d: Mortgages], a modification of a

mortgage will ordinarily cause it to lose priority to junior interests to the extent that the modification is materially prejudicial to those interests. Absent an increase in the principal amount or the interest rate of the mortgage, such modifications normally do not jeopardize the mortgagee's priority as against intervening interests." *Id.* at 89-90. The court also found that the modification of the loan repayment term from 6 years to 30 years and the fact that this was a new mortgage were materially prejudicial to Kim, the junior lien holder. The court refused to allow equitable subrogation where, as in this case, the party seeking subrogation had actual knowledge of the intervening interest. The court then described the role of the title insurer, saying: "Generally, the role of the title insurer is relied upon by the lender, judgment creditor, and other lienors. Just as a lender relies on the title insurer to commit that title is vested in its borrower, subject only to known exclusions, judgment creditors and other lienors rely on title insurers to prevent a debtor from conveying real property without first satisfying a perfected lien. In the instant case, legal remedies and equity suggest that the loss should fall on the title company rather than the innocent judgment creditor." *Id.* at 91. The court summarized its discussion of the equitable subrogation doctrine by saying: "Although the doctrine of equitable subrogation may be applied, this case is controlled by *Coy v. Raabe*, 69 Wn.2d 346, 418 P.2d 728 (1966), which allows equitable subrogation to a bona fide purchaser (or refinance lender) to the extent they were entitled to rely on others to guarantee title. However, equitable subrogation should not apply in favor of a title company, which guaranteed title while on constructive or actual notice of a prior judgment." *Id.* at 92.

This is simply incorrect! A title insurer does *not* "guarantee" title; it insures the title to the property subject to the terms, conditions, exceptions and exclusions contained in the policy. Furthermore, the title insurer itself did not have a lien on the property, its insured lender did, and the lender and not the title insurer would be the direct beneficiary of any right to equitable subrogation! Also, it is a stretch to say that title insurers owe duties to third parties with whom they are not in privity or bound by any contractual relationships. Finally, the court's assertion that permitting equitable subrogation when the title insurer has actual or constructive notice effectively prevents any lien holder (or judgment lien creditor or any other party with an interest in property) from being entitled to the benefits of equitable subrogation whenever that party has title insurance, while those that do not have title insurance will be allowed such benefits. The court in *Houston v. Bank of America*, 119 Nev. 485, 489 (Nev. Sup. Ct. 2003), specifically rejected this approach, noting that, "precluding equitable subrogation when a mortgagee discovered or could have discovered a junior lien runs contrary to the purposes underlying the [equitable subrogation] doctrine."

4. The (slender) majority view of equitable subrogation in the United States is still that the doctrine is only available if the party paying the prior lien has no actual knowledge of the intervening lien. The Restatement seeks to expand the right of equitable subrogation, and provides that a refinancing lender is equitably subordinated to the priority of the first mortgage even where it has actual knowledge of the intervening lien:

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

RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES: MORTGAGES § 7.6 cmt.e  
(1996)

The more liberal Restatement position is, as noted earlier, not yet the majority view. In any event, there are prudent steps that a real estate practitioner who represents mortgage lenders can take to avoid the loss of priority of a new mortgage, where some or all of the proceeds from the mortgage are intended to be disbursed to pay off a prior recorded mortgage. Obviously, the mortgage loan documents should -- and almost always do -- clearly state the intention of both the mortgagor and the mortgagee that the mortgagee is to receive a properly perfected first mortgage lien against the property. It also would be beneficial for the parties refinancing an existing first mortgage lien to state in the loan documents that it is their express intention that the new mortgagee is to

receive the priority of that existing first mortgage (if it is not to be released). The new mortgagee's attorney should obtain a title commitment to ascertain the status of title and to determine if there are any presently existing mortgage liens or other encumbrances against the property, and to obtain a title policy insuring the new mortgagee's security interest as a prior, valid and enforceable first mortgage lien on the property. (The availability, extent and scope of such coverage will depend on the facts and circumstances of each transaction, as well as underwriting considerations based on applicable case law and title insurance regulations; title insurers have recently issued new title products that greatly decrease the cost of title insurance in connection with mortgage refinancings). The refinancing mortgagee's attorney may also find it beneficial to have the existing first-mortgage lienholder, whose loan is to be paid off from the proceeds of the new loan, assign the existing mortgage to the new mortgagee (in those situations where there are intervening lienholders or encumbrancers) instead of releasing the mortgage from record (or at least leave the existing mortgage of record until the new mortgagee's loan is paid in full). Another prudent action would be to require, as a condition to the new mortgage loan, that any known or identified intervening lienholder execute (and agree to have recorded) an intercreditor or subordination agreement, whereby the intervening lienholder would consent to the new mortgage lien and confirm that its lien would be subordinate to the new mortgage (at least to the extent of the outstanding amount of the prior lien being paid from the proceeds of the new loan).

As to the key issue of the scope of equitable subrogation (and its offspring, "conventional subrogation"), litigation is often necessary to determine whether a

mortgage lender who has paid off a prior lien is entitled to the priority of the earlier recorded lien. The goal of the actions mentioned above is to avoid, at all costs, a court challenge to the priority of the new refinancing mortgage. Decisions in this area of the law generally are highly fact-specific and uncertain, and mortgage priority disputes can be time-consuming and expensive for mortgage lenders to resolve. The resolution of such litigation often depends on off-record facts that are difficult to determine and prove -- and meanwhile, title to the property remains undetermined and “in limbo” until the litigation is concluded. *See generally*, David H. Cox and Vernon W. Johnson III, *State Equity Doctrine Helps Title Insurers*, THE NATIONAL LAW JOURNAL, p. B17, Feb. 7, 2000.

It appears that the court in many of the cases discussed in this article is trying to avoid any fact-intensive weighing of the equities, by setting up conventional subrogation as a “rule” to be followed. However, many state courts rely on equitable arguments to justify the rule. Although the cases discussed above involve different fact situations, it seems reasonable that a court should be able to find a "convention," sufficient to invoke conventional subrogation whenever a refinancing lender can show that it intended to pay off the senior debt (whether or not it had actual or constructive knowledge of the intervening lien) and that the intervening lienholder would suffer no harm, and that in exchange it intended to obtain a first mortgage.

Otherwise, the doctrine of equitable subrogation, as interpreted differently by different courts, fosters uncertainty and unpredictability with respect to mortgage priority issues, and “clouds” real property records (and creates headaches for title insurers). Most

real estate practitioners (and title insurers) would prefer real-property priority and recording rules that are clear and consistent. The only certainty at present may be that there is still some uncertainty as to how state courts (and bankruptcy courts construing applicable state law) will rule on this issue. As Professors Nelson and Whitman point out (in the *Prestance* case, supra), without a clear and universal rule to follow, such as the Restatement approach, equitable subrogation is, quintessentially, a factual inquiry and its application is dependent on the facts and circumstances of each case and the jurisdiction where the case is decided.