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Summary of Houston v. Bank of America Federal Savings Bank

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Houston v. Bank of America Federal Savings Bank, 78 P.3d 71
(Nev. 2003).¹

PROPERTY – EQUITABLE SUBROGATION

Summary

Appellants Edward R. Houston and Regina Houston paid David Boone \$740,000 for investment services, which Boone converted to his own use. In May 1998, Boone and his wife Donna divorced and Boone quitclaimed real property to Donna. Norwest Mortgage, Respondent Bank of America's predecessor, held a deed of trust on the real property for \$342,000. That same month, the Houstons filed a complaint against Boone to recover their \$740,000. The Houstons filed a notice of lis pendens in the Clark County Recorder's Office on June 1, 1998 and filed an ex parte motion with the district court directing the issuance of a prejudgment writ of attachment. The court granted the motion and a writ of attachment was filed in the Clark County Recorder's Office in June 1998. The Houstons obtained a judgment against Boone, who had filed for bankruptcy. Boone stipulated that the debt he owed to the Houstons was nondischargeable. The district court granted a writ of execution on the real property and scheduled a sale of the real property. Respondent Bank of America intervened and the sale was enjoined.

Bank of America had refinanced the real property in June 1998, after the Houstons' writ of attachment had been recorded. In May 1998, pursuant to Bank of America's direction, Nevada Title Company had conducted a title search of the property.

Both Bank of America and the Houstons filed motions for summary judgment after the district court enjoined the sale. Bank of America argued that it was the priority lien holder on the real property because it was equitably subrogated to the rights of Norwest Mortgage when it refinanced the property. The Houstons argued that Bank of America was negligent in failing to discover their interest in the real property and that they would be injured if the district court allowed Bank of America to hold the priority lien position. The district court granted summary judgment in favor of Bank of America and denied the Houston's motion for summary judgment. The Houstons appealed.

The Nevada Supreme Court adopted the approach of the Restatement (Third) of Property for equitable subrogation and found that because the Houstons failed to produce any evidence that equitable subrogation of Bank of America to Norwest's priority lien position would materially prejudice them, Bank of America was entitled to equitable subrogation as to the full amount of the Norwest Mortgage deed of trust.

Issue and Disposition

Issue

Is a lender who pays off a prior note equitably subrogated to the former lender's priority position?

¹ By Amy A. Johnson

Does it matter if there is an intervening lien holder?

Disposition

Yes. A subsequent lender who pays off a prior note is equitably subrogated to the prior lender's priority lien position.

No. The subsequent lender will still be equitably subrogated to the full amount of the prior note even if there is an intervening lien holder, so long as the intervening lien holder is not materially prejudiced.

Commentary

State of the Law Before *Houston*

The issue presented in *Houston* is one of first impression. Prior to *Houston*, the Nevada Supreme Court addressed equitable subrogation in *Laffranchini v. Clark*. However, in *Laffranchini*, the issue was equitable subrogation of a holder of an invalid mortgage when the holder was an involuntary creditor.² In *Laffranchini*, the court held that the holder of the invalid mortgage was entitled to be equitably subrogated to the priority position of the lender whose note it had paid off because the holder was not a volunteer.³ Other jurisdictions have adopted three different approaches to determine when a second lender will be equitably subrogated to the priority of the first lender when a third party holds a lien on the property at the time the second lender paid off the first lender's encumbrance.⁴

Other Jurisdictions – The Majority Approach

The majority approach is that actual knowledge of an existing lien prevents the second holder from being equitably subrogated to the priority of the first lender, but constructive knowledge does not.⁵ The majority approach reasons that if a mortgagee does not have actual knowledge of a junior lien holder, the mortgagee expected to assume the position of the creditor whose lien it is paying off.⁶ However, the majority rule encourages prospective lenders to avoid conducting title searches because the lender who fails to conduct a title search will be equitably subrogated to the priority position by virtue of its lack of actual knowledge. On the other hand, the lender who dutifully conducts a title search and discovers a junior lien holder will not be equitably subrogated to the priority position.

² *Laffranchini v. Clark*, 39 Nev. 48, 55-56, 153 P. 250, 251-52 (1915).

³ *Id.*

⁴ *East Boston Savings Bank v. Ogan*, 701 N.E.2d 331, 335 (Mass. 1998).

⁵ *See, e.g. Osterman v. Babar*, 714 N.E.2d 735, 739 (Ind. Ct. App. 1999); *Rusher v. Bunker*, 782 P.2d 170, 172 (Or. Ct. App. 1989).

⁶ George E. Osborne, *Mortgages* § 282, at 573 (2d ed. 1970).

Other Jurisdictions – The Actual or Constructive Knowledge Approach

The second approach prevents the second lien holder from being equitably subrogated when that holder has either actual or constructive knowledge of an existing junior lien.⁷ Additionally, some courts will hold a sophisticated lender to a higher standard or will consider the lender's negligence in determining whether to apply equitable subrogation.⁸ This approach, however, fails to account for the very purpose of equitable subrogation. Equitable subrogation is designed to prevent a junior lienor from being advanced to the priority lien position over a secondary holder who has paid off the first lien on the real property.⁹ In that instance, allowing a junior lienor to be elevated to the priority position would afford the junior lienor an undeserved windfall.¹⁰ Negligence and constructive knowledge should not be factored into whether a lender will be equitably subrogated. Equitable subrogation is aimed at protecting the lender's justified expectation¹¹ in receiving a security interest in the property and at preventing the unjust enrichment of the junior lienor.¹²

Other Jurisdictions – The Restatement (Third) of Property Approach

The Restatement (Third) of Property: Mortgages, section 7.6 does not consider whether a lender has actual or constructive notice of a junior lien, but only whether a junior lien holder will be prejudiced if the second lender is equitably subrogated to the priority position.¹³ Notice of an intervening lien will not prevent a party from being equitably subrogated.¹⁴ The issue is whether the secondary lienor expected to be subrogated to the priority lien position upon payment of the priority lien.¹⁵ Equitable subrogation of a refinancing mortgagee will not occur only if there is affirmative proof that the refinancing mortgagee intended to subrogate its interest to the intervening junior lienor.¹⁶ The intervening junior lien suffers no material prejudice by applying the doctrine of equitable subrogation because the junior lienor remains in the same position it

⁷ See *Harms v. Burt*, 40 P.3d 329, 332 (Kan. Ct. App. 2002); 681 A.2d 1005, 1007-08 (Conn. App. Ct. 1996).

⁸ See, e.g. *Universal Title Ins. Co. v. United States*, 942 F.2d 1311, 1317 (8th Cir. 1991) (stating that professionals will be held to a higher standard than lay persons when determining equitable subrogation); *Bankers Trust Co. v. United States*, 25 P.3d 877, 882 (Kan. Ct. App. 2001).

⁹ Restatement (Third) of Property: Mortgages § 7.6 cmt. a.

¹⁰ *Id.*

¹¹ Even where a lender has actual knowledge of an existing lien on real property, that lender assumes it will be equitably subrogated to the priority lien position. Restatement (Third) of Property: Mortgages § 7.6 cmt. e.

¹² Grant S. Nelson & Dale A. Whitman, *Real Estate Finance Law* § 10.6, at 15-16 (4th ed. 2002).

¹³ See, e.g. *Suntrust Bank v. Riverside Nat. Bank*, 792 So. 2d 1222, 1227 n.3 (Fla. Dist. Ct. App. 2001); *Trus Joist Corp. v. Nat'l Union Fire Ins. Co.*, 462 A.2d 603, 609 (N.J. Super. Ct. App. Div. 1983); *Klotz v. Klotz*, 440 N.W.2d 406, 407-10 (Iowa Ct. App. 1989). *Trus Joist Corp.* and *Klotz* do not adopt the Restatement, but the holdings are similar to the Restatement view.

¹⁴ Restatement (Third) of Property: Mortgages § 7.6(a)(4).

¹⁵ *Id.*

¹⁶ *Id.*

held prior to refinancing^{17, 18} The intervening lienor is “no worse off than before the senior obligation was discharged.”¹⁹

Effect of *Houston* on current law

In *Houston*, the court reasoned through the above approaches for equitable subrogation and adopted the Restatement (Third) of Property approach. Bank of America paid in full the deed of trust held by Norwest Mortgage. The district court found that Bank of America paid the deed of trust “with the intention and belief that it would acquire Norwest Mortgage’s first-position deed of trust lien on the Property.” There was no evidence that Bank of America intended to subordinate its lien priority to the Houstons.²⁰ The Houstons argued that issues of fact existed as to whether they would be materially prejudiced by equitably subrogating Bank of America to the priority position. However, the Houstons did not produce any evidence of prejudice nor did they request additional time to produce such evidence. The Houstons did not show that a change in the mortgagor from Boone and Donna to just Donna materially prejudiced them.²¹ The Houstons did not provide evidence that the new loan’s terms modified the previous loan’s terms in such a manner as to materially prejudice them. Therefore, Bank of America was entitled to be equitably subrogated to the full amount of Norwest Mortgage’s priority lien position.

Unanswered Questions

Central to the Restatement (Third) of Property approach to equitable subrogation is the issue of material prejudice to the intervening lender. However, the court failed to clarify what exactly constitutes material prejudice. The court stated that had there been a showing that the transfer of mortgagor resulted in a mortgagor with a bad credit rating, so little money, or so few assets that the bank would likely have to foreclose on the property resulting in a loss of the intervening lienor’s interest in the property, such might serve as material prejudice. However, the court did not affirmatively state that these factors are the guidelines for determining material prejudice.

¹⁷ However, should subrogation result in material prejudice to the junior lienor, equitable subrogation will not be applied. Nelson & Whitman, *supra* note 10, § 10.6, at 19.

¹⁸ *Id.*

¹⁹ *Id.* at § 7.6 cmt. a.

²⁰ The Houstons argued that Bank of America was negligent in failing to discover the lis pendens and the writ of attachment and that factual issues existed as to whether Bank of America was justified in relying on a title report run one month prior to the closing of the loan. The Nevada Supreme Court found that because it was adopting the Restatement position, Bank of America’s negligence in failing to discover the lis pendens and writ of attachment was irrelevant. The court did not address the Houston’s contention that factual issues existed as to whether Bank of America was reasonable in relying on the month-old title report. It is most likely that the court did not address this because under the Restatement view, actual and constructive knowledge do not matter. Even if Bank of America had actual knowledge of the Houston’s intervening lien, absent a finding of material prejudice, Bank of America would nonetheless be subrogated to the priority position.

²¹ The Houstons made no showing that Donna has poor credit, makes so little money, or has such limited assets that Bank of America would likely have to foreclose on the property, causing the Houstons to lose their interest in the property.

The court also stated there was no evidence of the previous loan's terms to compare with the new loan's terms that would allow a determination of whether modifications existed that would materially prejudice the intervening lienor. While the court seemed to indicate that certain modifications in the terms of a new loan would materially prejudice an intervening lienor, it failed to clarify exactly which terms those might be. The issue of material prejudice has been left open, resulting almost certainly in future litigation. The court will then be forced to clearly spell out the factors that constitute material prejudice in equitable subrogation.

Conclusion

Refinancing lenders are more easily assured of their position following refinancing of a priority loan. Refinancing lenders almost need not worry about intervening liens, so long as the refinance does not "materially prejudice" an intervening lienor. The decision reduces title searches to a mere formality, and seems to place wide discretion in the hands of lenders in considering what is material prejudice. Intervening lienors have very little assurance that the recordation of their junior lien will offer any protection.

Appropriately, the Restatement approach furthers the policy that it is burdensome for lenders to be expected to conduct a title search multiple times during the course of a transaction in order to determine whether an intervening lien has attached. Had the court adopted an actual or constructive notice approach for equitable subrogation, a refinancing lender would be expected to conduct a title search a minimum of two times (once in the beginning of the transaction and once prior to closing). Serious problems would arise when the lender found a clean title at the beginning of the refinancing process yet suddenly was presented with an intervening lien on the closing date. A lender would be forced to conduct a title search almost every day in order to make sure that the lender would not lose its priority position through the refinance. Requiring this of lenders would seriously clog the refinancing process and make it an unavailable process for most homeowners. Compared to the approaches adopted by other jurisdictions, the Restatement approach seems to be the most consistent with the purpose of equitable subrogation.