

SUBROGATION OF THE POSITION OF ONE DEED OF TRUST TO ANOTHER

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Summary

Subrogation of the most recent deed of trust to an earlier deed of trust which was paid off by the proceeds of the most recent deed of trust is possible as noted below. This is particularly helpful when there is an intervening lien between the two deeds of trust. The law is a bit confusing and could be clarified by a statute similar to the one set forth below.

However, it seems fair to conclude that the leading North Carolina case, *Wallace v. Benner*, discussed below, allows "conventional subrogation" where the subrogating lender and borrower agree that the subrogating lender will fund a loan to pay off the earlier indebtedness secured by a prior deed of trust in exchange for the subrogating lender receiving a lien of the priority status of the prior discharged deed of trust. The case does not require the prior deed of trust to be uncanceled of record, although in *Wallace v. Benner* it was uncanceled. Clearly, the case does not require that the subrogating lender be "excusably ignorant" of any lien intervening between the recordation of the prior deed of trust and the recordation of the subrogating lender's deed of trust.

However, it is noted that the *First Union* case discussed below imposed an "excusably ignorant" of intervening liens requirement and found that First Union was not excusably ignorant. However, the *First Union* case cited the *Peek* case, discussed below, in which the "excusably ignorant" requirement was *dicta*. The *First Union* case did not cite *Wallace v. Benner* which contained no such requirement. Therefore, it appears that *Wallace v. Benner* is the best authority available. However, the very recent case of *American General* discussed below has further muddied the waters. *Wallace v. Benner* is still the "guiding light" – such as it is.

While *Wallace v. Benner* does not require it, it is always best if the subrogating lender's deed of trust contains a subrogation clause specifying that the subrogating lender is subrogated to the priority position of any deed of trust the secured indebtedness of which is paid by the subrogating lender's loan proceeds.

In using subrogation as a defense, it is advised that the attorney plead both conventional subrogation and equitable subrogation as an affirmative defense.

Legal discussion

The subrogation of one deed of trust to the priority position of an earlier deed of trust is a helpful defense strategy, particularly in the context of when the intervening lien (that is, the lien that has an effective date of priority between the times of recording of the two deeds of trust) is a "mechanics' lien." However, the intervening lien can just as easily be a judgment lien, federal tax lien or other recorded lien.

EXAMPLE: The following events occur in the following order with respect to *O's* (the owner's) land: *M-1's* \$30,000 construction loan deed of trust is recorded and disbursed; *C-1* first furnishes materials to the site encumbered by *M-1's* deed of trust; *C-2* first furnishes materials to the site; *C-1* files a claim of lien; the federal government files a federal tax lien against *O*; *M-2* records and funds his permanent deed of trust securing a \$40,000 loan and disburses \$30,000 to *M-1* to obtain a satisfaction of *M-1's* trust; and *C-2* files a claim of lien.

The authorities discuss "conventional subrogation" and "equitable subrogation" (or, as the latter is sometimes called, "legal subrogation"). See R. Kratovil and R. Werner, *Modern Mortgage Law and Practice* (2d Ed., 1981), § 31.01; E. Urban and J. Miles, *Mechanics' Liens for the Improvement of Real Property: Recent Developments in Perfection, Enforcement and Priority*, 12 Wake Forest L. Rev. 283,347-349 (1976). For a recent annotation pertaining to the impact on intervening liens, see *Annot.*, 43 A. L. R. 5th 519(1996). The case of *Dedes v. Strickland*, 414 S.E. 2d 134(S.C. 1992), is discussed (intervening lienor won). Mechanics' liens are discussed at 43 A. L. R. 5th 519, at §§ 6 and 12. For a discussion of wrap-around mortgages, see *Annot.*, 36 A. L. R. 4th 144. See E. Urban, *North Carolina Real Property Mechanics' Liens, Future Advances, And Equity Lines - Including Title Insurance* § 8-8 (Thomson * West 1998, Supp. 2004), citing *Wallace v. Benner*, 200 N.C. 124, 156 S.E. 795 (1931).

"Conventional subrogation" exists when *M-2's* security instrument expressly provides that *M-2* is to be subrogated to the lien of any security instrument or other lien discharged. R. Kratovil and R. Werner, *supra*. The agreement need not be set forth in the security instrument, apparently. "Equitable subrogation" or "legal subrogation" exists in absence of such an express agreement under certain circumstances. When "conventional subrogation" exists in the above example, *M-2* will have priority over the intervening lien to the extent of \$30,000. When "conventional subrogation" is applicable, it has been held that neither actual nor constructive notice nor knowledge of an intervening claim of lien will defeat the right to subrogation. *Providence Institution for Sav. v. Sims*, 441 S. W. 2d 516, 520 (Tex. 1969). Also, see R. Kratovil and R. Werner, *supra*, § 31.01; G. Nelson and D. Whitman, *Real Estate Finance Law*, § 10.6 (3rd Ed. 1994). When discussing "equitable subrogation," certain courts have held that the doctrine will not apply against an intervening lien if at the time of the making of the permanent loan, *M-2* had knowledge of an intervening lien. G. Osborne, *Mortgages* (2d Ed. 1970) §151.

The distinction between conventional subrogation and equitable subrogation that some courts seem to make by holding that *M-2's* actual knowledge of intervening liens precludes equitable subrogation but not conventional subrogation is not logical. As to either theory of subrogation, as to a prior lien for \$30,000, the intervening lienors are in no worse a priority position after subrogation than before. They have either relied upon the record in ascertaining what their lien positions will be or have been charged with constructive notice of record of their positions as against the subsequently discharged deed of trust of *M-1*. *M-2* could have taken an assignment of the original note and deed of trust and prevailed over the intervening lienors. Since the amount of *M-2's* loan to the mortgager might have exceeded the amount of *M-1's* loan, therefore requiring the execution and recordation of a new deed of trust instead of taking an assignment of *M-1's* note and deed of trust, *M-2's* priority position to the extent of the amount of *M-1's* position should not be different whether "equitable" or "conventional" subrogation is involved. E. Urban, *supra*, §8-8.

In *Wallace v. Benner*, 200 N.C. 124, 156 S.E. 795 (1931), the owner encumbered the real property with a first and second deed of trust and a third mortgage recorded in that order. The owner applied to the Land Bank for a new first lien deed of trust loan to pay off all prior encumbrances, the first priority deed of trust obligation being in default. All prior existing liens were apparently disclosed in the loan application. The Land Bank's \$12,500 new deed of trust was recorded on April 26, 1923. Two days earlier, the Land Bank drew a loan proceeds check to the owner and the closing law firm and sent the check to the firm with instructions that prior encumbrances be removed before delivery of the check or the money was to be refunded. Unknown to the Land Bank, the attorney disregarded these instructions, obtained the owner's endorsement of the check, paid the taxes that were due and the attorney's fee and paid \$11,800.85 to Page Trust Company, the original holder of the first and second liens, but apparently did not cancel any of the existing encumbrances on the property. Page Trust Company was aware of the owner's instructions and what the Land Bank wanted. The North Carolina Supreme Court affirmed the lower court's ruling and granted the Land Bank subrogation to the priority position of the first and second priority deeds of trust as against Wallace's third mortgage. The court stated that while the principles of equitable subrogation do not apply to a "mere volunteer," in defining "mere volunteer," the court cited a text on mortgages which stated that equitable subrogation does *not* apply to "a case of ordinary borrowing," where there is a fraud or misrepresentation, and the borrower creates in favor of the new lender a new and valid security, although the funds are used to discharge prior encumbrances. In such a case, the lender is the "mere volunteer." The cited authority went on to state that, where money is expressly advanced by the new lender in order to extinguish a prior encumbrance and the money is used for that purpose with the new lender's expectation of obtaining "a valid security," the lender may be subrogated to the rights of the prior encumbrances since the doctrine of equitable subrogation does not allow the encumbrance to become satisfied as to the lender advancing the money but keeps it alive as if assigned to the lender for security. Where money is advanced to the owner-debtor pursuant to an express agreement that is to be used to retire the existing liens and that the lender loaning the money is to have a first lien upon the property for the advance, the cited authority states that the lender may be surrogated to the lienor whose debt has been paid as against an intervening lienor acquiring a lien with knowledge of the circumstances under which the surrogating lender advanced money. This is to prevent the intervening lienor from being accidentally raised to a first lien position. The court found that the subrogating lender was not a volunteer and was not guilty of culpable negligence and that Wallace, the intervening lienor, was not prejudiced. The lengthy opinion in *Wallace v. Benner* makes it somewhat confusing regarding whether equitable or conventional subrogation was applied. Clearly, the court found in the Land Bank's agreement an intention to have a first lien. It may be that a version of equitable subrogation was applied since there was no discussion in the opinion of the subrogating lender's deed of trust or other agreement specifying that the lender would be subrogated. Or, it could be argued that the court found either an express or implied agreement between the owner and the Land Bank that the Land Bank would have a first lien – thus substantiating a case of conventional subrogation. Finally, the opinion's full application is rendered somewhat uncertain by the fact that, as mentioned above, the intervening lender knew of the subrogating lender's requirements. In the opinion of the author, this should not be a significant factor, however.

In *Peek v. Wachovia Bank*, 242 N.C. 1, 86 S.E. 2d 745 (1955), the North Carolina Supreme Court, without citing *Wallace v. Benner*, seems to have made the requirement that the lender seeking the benefit of subrogation must be excusably ignorant of the intervening lien. However, in the paragraph where that appears to be the case, the *Peek* court is merely quoting a subrogation rule. In fact, the court's statement is *dicta*. Subrogation was not applied because Wachovia Bank failed to show that its loan proceeds were advanced with the intent and for the purpose of extinguishing the prior encumbrance. Thus, the court never got to the "excusably ignorant" issue.

In *Plymouth Fertilizer Co. v. Pitt-Greene Production Credit Association*, 58 N.C. App. 207, 292 S.E. 2d 732 (1982), *O* granted *M-1* a deed of trust which was recorded, *J* obtained and docketed a judgment lien against *O*, *O* borrowed money from *M-2*, and *M-2* paid off *M-1* and obtained an assignment of *M-1*'s note and deed of trust. The court held: "Where.....[*O*] is personally liable to [*M-1*] and borrows funds from [*M-2*] to pay off [*M-1*], [*O*] cannot defeat the priority of [*J*], who is senior to [*M-2*], by substituting [*M-2*] for [*M-1*]..... [*M-1*'s] debt is discharged and [*M-1*'s] lien is extinguished." The case would appear to be flatly incorrect or at least illogical for modern times. The case cited neither *Wallace v. Benner* nor the *Peek* case.

For a recent subrogation case, see *First Union National Bank of North Carolina v. Lindley Laboratories*, 132 N.C. App. 129, 510 S.E. 2d 187 (1999), where subrogation was denied because the subrogating lender was not excusably ignorant of the intervening lien (deed of trust) of record. The facts of the case were rather routine: on 11-9-94, the Cobbs gave a deed of trust to First Union on Lot 8 which was recorded; on 5-12-95, the Cobbs and Lindley Laboratories, Inc. (the defendant) executed a loan modification agreement which was recorded and which substituted Lot 8 for the property originally encumbered by the previously existing Lindley deed of trust; on 12-8-95, the Cobbs conveyed Lot 8 to the purchasers, the Tissots, and the deed was recorded; on 12-8-95 the Tissots gave a deed of trust to First Union encumbering Lot 8 and the deed of trust was recorded; the 11-9-94 deed of trust was marked satisfied as of 12-12-95 and was cancelled of record. The Cobbs defaulted on the 5-12-95 deed of trust and, after Lindley commenced foreclosure, First Union filed a declaratory judgment action requesting equitable subrogation of its deed of trust from the Tissots to the lien of the Cobbs' 11-9-94 deed of trust to First Union. In finding that First Union was not "excusably ignorant" of the intervening lien, citing *Peek v. Trust Co.*, 242 N.C. 1, 86 S.E. 2d 745 (1955), but not citing *Wallace v. Benner*, supra, the court did not explain its holding at all. As noted above, however, the *Peek* court's reference to "excusably ignorant" is clearly *dicta*. Further, the term "excusably ignorant" does not appear in *Wallace v. Benner*.

The case of *In re Kline*, 242 B.R. 306 (W.D. N.C. 1999), should be noted. A deed of trust has priority as of its registration or recording in the county where the real property is located, as provided in G.S. 47-20 and G.S. 47-20.1. A deed or trust must be properly indexed in order to be considered properly and validly recorded. It is critical that this occur in view of 11 U.S.C. §544, a statute permitting the trustee to avoid transfers based on priority statutes. In the case, a first deed of trust was properly recorded and a second deed of trust was properly recorded; the defendant's subsequent deed of trust was recorded in the wrong county; the proceeds of the loan secured by the defendant's deed of trust paid off the indebtedness secured by the original first deed of trust, which first deed of trust was cancelled; and the owner - borrower filed bankruptcy. The court held that the trustee could avoid the defendant's deed of trust under 11 U.S.C. §544(a) (11U.S.C. §544(a)(3) in particular) because on the date of the filing of the debtor's bankruptcy, the trustee had the status of a bona fide purchaser for value. Also, the court held that, pursuant to 11 U.S.C. §551, the trustee, through principles of equitable subrogation to the first deed of trust, was entitled to preserve the avoided deed of trust of the defendant for priority purposes over the validly recorded original second deed of trust. The trustee was entitled to subrogate to the priority position of the first deed of trust. Also, see *In re Price*, 97 B.R. 264 (E.D. N.C. 1999).

Further justification that we need a statute similar to the one proposed below is the hot off the press case of *American General Financial Services, Inc. and R. Forquer, Substitute Trustee v. Barnes and Pennsylvania National Mutual Casualty Insurance Company*. (No. COA05-478 Ct. of App. filed 1-03-06). Mr. and Mrs. Barnes ("Barnes") encumbered their land with two deeds of trust to BB&T and American General. Those were recorded. Subsequently, there was docketed a \$430,230 confession of judgment by Barnes in favor of Pennsylvania National. Subsequently, Barnes gave a deed of trust to American General for \$116,819 which was recorded. Prior to that recording, American General had a title update performed. The judgment was not found. After the update and recording, American General paid the two prior outstanding deeds of trust indebtednesses in full and the deeds of trust were cancelled. An additional \$1573 was disbursed to Barnes. The plaintiffs commenced an action to quiet title and to obtain first lien priority. The lower court ruled against the plaintiffs. On appeal, the plaintiffs argued that equitable subrogation should apply. The court of appeals held that the doctrine of equitable subrogation did not apply in this case because Penn National had no liability for the plaintiff's inferior lien position. When Penn National docketed its judgment on January 17, 2002, its lien was subordinate to two prior deeds

of trust. The plaintiffs failed to properly search the public records and caused Penn National's \$430,230.00 judgment to move from third priority to first priority by canceling the two prior deeds of trust, and Penn National did not compel them to refinance. Accordingly, Penn National was an innocent third party, and even assuming, *arguendo*, that American General was "excusably ignorant," the equities do not favor subordinating Penn National's judgment to American General's lien, said the court. The court said that to subrogate Penn National's judgment to American General's second deed of trust would place Penn National in a worse position because it would be subordinate to the additional sum of \$1,573.00 that American General provided to the Barnes family. It would be inequitable to place an innocent third party in an inferior position.

The *American General* court misses the point. Certainly, conventional subrogation under the rule of *Wallace v. Benner* could have been found to have existed in this rather routine set of facts. And the fact that Barnes got \$1573 could have been handled by giving American General a third lien for that amount, in accord with treatises cited above.

Proposed statutes

North Carolina could benefit from the enactment of a subrogation statute. See E. Urban and J. Miles, *Mechanics' Liens for the Improvement of Real Property: Recent Developments in Perfection, Enforcement and Priority*, 12 Wake Forest L. Rev. 283, 347-349 (1976), where the contents of a statute were suggested. In 2002, the author, then serving as NCLTA General Counsel, suggested the following:

G.S. 47-20.9. Subrogation

(a) Definition – as used in this section, "mortgage" means any mortgage or deed of trust.

(b) Subrogation – A subsequent recorded mortgage has the same priority as a prior recorded mortgage as against a lien or encumbrance intervening between the recording of the subsequent recorded mortgage and the prior recorded mortgage, to the extent that the proceeds of the indebtedness secured by the subsequent recorded mortgage are used to pay the indebtedness secured by the prior recorded mortgage. Actual knowledge or constructive notice of record of the intervening lien or encumbrance shall not preclude the application of this section. Cancellation of record of the prior recorded mortgage after the recording of the subsequent mortgage shall not preclude the application of this section.

(c) Conflict with Article 9 of Chapter 25. This section is subject to G.S. 25-9-334.

There is some precedent for such a statute. G.S. 25-9-334(h), pertaining to the priority of security interests in fixtures against other encumbrances, provides in part that:

A mortgage has this priority to the same extent as a construction mortgage to the extent that it is given to refinance a construction mortgage.

The Federal Tax Lien Act, 26 U.S.C. §6323 (j) (2), recognizes subrogation to the extent local real property law does:

Subrogation – Where, under local law, one person is subrogated to the rights of another with respect to a lien or interest, such person shall be subrogated to such rights for purposes of any lien imposed by section 6321 or 6324.

The only problem is, local law could be clearer – and, in modern times, should be statutory. The North Carolina Land Title Association and the Real Property Law Section should add this subject to their legislature agendas.