Consumer Financial Services LAW REPORT

Focusing on Significant Caselaw and Emerging Trends

Route to:

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Debt Collection

Debtor's claims timely removed under CAFA and preempted by FCRA

The 9th U.S. Circuit Court of Appeals recently held that a debtor's state-law claims against an information furnisher and credit reporting agencies were either waived, preempted under the Fair Credit Reporting Act, or properly dismissed. On its way to affirming the District Court's decision in the defendants' favor, the 9th Circuit also agreed that removal of the case to federal court was timely under the Class Action Fairness Act. (*Carvalho v. Equifax Info. Servs., LLC*, No. 09-15030 (9th Cir. 08/18/10).)

Noemia Carvalho's hospital bill went unpaid by her or her insuror. The debt was assigned for collection to Credit Consulting Services, which sent Carvalho a series of dunning letters. Getting no answer, CCS reported Carvalho's debt to Equifax, Experian and TransUnion. Carvalho's attorney explained her situation to CCS in a letter seeking debt verification and an investigation. CCS investigated, replying that it had properly reported the debt and that Carvalho should contact her insuror.

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Fair Credit

FCRA applies to credit reports containing terror 'alerts'

3d Circuit affirms $100,000 punitive damage award

The Fair Credit Reporting Act applies to credit reports containing U.S. government-generated "alerts" regarding individuals with potential terrorist or criminal connections that a credit reporting agency collected and sold to an auto dealership making credit decisions in a consumer credit transaction. The 3d U.S. Circuit Court of Appeals, in ruling on that issue of first impression, affirmed the District Court's damages awards to a car buyer, as well as the denial of the CRA's motion for judgment as a matter of law on the consumer's claims that the CRA negligently and willfully violated the FCRA. (*Cortez v. Trans Union, LLC*, Nos. 08-2465 (3d Cir. 08/13/10).)

Judgment went against the CRA because it failed to properly respond to the consumer's dispute that she was not the person mentioned in the alerts and failed to correct its mistake, explained Chief Judge Theodore A. McKee, presenting the 3d Circuit panel's holdings. But there was more. The CRA also violated the FCRA by failing to provide the consumer with a credit report that included the same information in the credit report it supplied to the auto dealer, the Appeals Court held.

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SPECIAL SUPPLEMENT

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Conventional and equitable subrogation: exceptions to 'first in time, first in right'

By William J. McKenna, Jr., and Thomas C. Hardy*

The default assumption in disputes over title priority is that "first in time equals first in right." This axiom, however, is subject to exceptions that, in certain circumstances, allow a lender to take a first lien on the property despite the existence of prior, recorded liens. These exceptions are the doctrines of conventional and equitable subrogation. Each is a variation on the same concept — a lender that pays off a first mortgage or other lien on property can assume that lien's priority position, even though the new mortgage is recorded after other, intervening liens on the property.

These doctrines may seem academic at first glance, but a lender foreclosing on residential property will find out how real they are when an intervening lien holder suddenly appears and blocks a foreclosure. Consider this case: a lender refinances a home mortgage and duly records its new mortgage. When the lender subsequently forecloses, it finds that a mechanics' lien holder claims a first lien. Its mechanics' lien was recorded after the lender's mortgage, but relates back to a contract dated prior to the recording of the mortgage. The lender asserts it is subrogated to the first lien of the mortgage it paid off, but litigation over priority prevents the lender from foreclosing for two years.

Lenders can take steps to increase their chances of successfully asserting subrogation or avoiding having to rely on it at all, but to do so they need to understand how different jurisdictions apply these doctrines.

Conventional subrogation

Conventional subrogation is the more settled of the two doctrines. In general, conventional subrogation requires an "express" agreement between a lender and the borrower that the lender will pay off a prior lien on property in exchange for receiving that lien's priority position.

Typically, a refinancing lender will state in the loan documents that it expects to receive a first lien on the collateral, and in many jurisdictions such form language suffices to create an express agreement. Though many jurisdictions are willing to look to surrounding circumstances to find an express agreement, courts will not find such an agreement without some evidence. Most courts also determine whether prejudice results to an intervening lien holder, but generally no prejudice results if it is found to have a subordinate lien, because its priority position does not change as a result.

An advantage of conventional subrogation over equitable subrogation is that the refinancing lender's knowledge of the intervening lien is generally unimportant to whether conventional subrogation applies. This is not necessarily the case with equitable subrogation, however.

Equitable subrogation

Equitable subrogation is an equitable doctrine rooted in unjust enrichment. In essence, it prevents an intervening lien holder from receiving a better lien position than it bargained for at the expense of a refinancing lender.

As in the case described above, a refinancing lender's title insurer typically fails to detect an intervening lien on the property, but the loan documents do not contain an express agreement, such that conventional subrogation applies. Then, when the lender files a foreclosure action, the intervening lien holder asserts that it holds a prior lien. Courts tend to focus on the facts and circumstances particular to each case, and cases with very similar facts can have very different outcomes, even within the same jurisdiction.

Three approaches to lender's knowledge

Adding to the uncertainty surrounding equitable subrogation is the three-way split among jurisdictions as to the impact of whether the refinancing lender was aware of the intervening lien or not. The three approaches are:

The majority view: In such jurisdictions, the courts will not allow equitable subrogation where a party had actual knowledge of an intervening lien and failed to protect its interests.

The minority view: In these states, the courts bar parties from claiming equitable subrogation if they had even constructive knowledge of an intervening lien.

The restatement view: These jurisdictions follow the Restatement (Third) of Property (Mortgages), which provides that the knowledge of a party is irrelevant to whether equitable subrogation should apply.

The emerging restatement approach

The Restatement essentially eliminated any inquiry into the refinancing lender's knowledge, whether actual or constructive:

Under this Restatement … subrogation can be granted even if the payor 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

(See **EXCEPTIONS** on page 4)

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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 § 7.6 cmt. e (1996).)

The Restatement has gained considerable support over the last several years as more states have expressly adopted it, including Texas, Nevada and Florida. (*See Sheppard v. Interbay Funding, LLC*, 305 S.W. 3d 102 (Tex. Ct. App. 2009); *Houston v. Bank of Am., FSB*, 78 P.3d 71 (Nev. 2003); *Suntrust Bank v. Riverside Nat 'l Bank of Fla.*, 792 So. 2d 1222 (Fla. Ct. App. 2001).) Typically, courts adopting the Restatement have noted that requiring that a refinancing lender have no knowledge of intervening liens does not serve any practical purpose, since intervening lien holders will still receive the same lien priority for which they bargained and cannot be prejudiced by the subrogation. An emerging consensus, therefore, regards knowledge of the refinancing lender as irrelevant.

Though this consensus is growing, lenders should be aware that the Restatement is still a minority approach. In the majority of jurisdictions that adhere to the other two approaches, a lender's subrogation claim may be barred if it (or even its title insurer) had some type of knowledge of an intervening lien. As a result, a lender asserting or defending a claim of equitable subrogation should take care to determine which approach applies to the claim.

Even in states that have adopted the Restatement, there is no guarantee that a particular court will not take the knowledge of the refinancing lender into account, particularly where a refinancing lender is found to have been negligent. In Florida, for instance, the courts adopted the Restatement in 2001, but in 2003 a federal district court nevertheless barred a refinancing bank that had constructive notice of an intervening lien from taking advantage of equitable subrogation. (*Picker Fin. Grp., LLC v. Horizon Bank*, 293 B.R. 253 (M.D. Fla. 2003).) The court reasoned that the lender was negligent in not reviewing a lien search that revealed the intervening lien and was therefore not entitled to take advantage of subrogation, even though no prejudice would result to intervening lien holders.

Next battleground: sales transactions and non-identical mortgagors

A lender often pays off a prior mortgage on a property as part of a sale of that property to a new owner, who then becomes the mortgagor under the refinanced mortgage. In such a situation, the mortgagor under the prior mortgage and the mortgagor under the new mortgage are different. Whether a lender can rely on equitable subrogation in such a situation is an issue that has recently begun to appear in the case law, with varying outcomes.

Some jurisdictions expressly allow equitable subrogation in such circumstances. For example, the Massachusetts Supreme Court allowed equitable subrogation where the buyer's lender paid off one of the seller's mortgages, but failed to pay off an intervening mortgage. (*East Boston Sav. Bank v. Ogan*, 701 N.E. 2d 331 (Mass. 1998).) The Court noted that "the equities are substantially similar in refinancing and sales transactions." Other states ' courts have reached the same conclusion.

Other courts have refused to allow equitable subrogation on similar facts, however. An Illinois bankruptcy court, for instance, held that equitable subrogation does not allow a lender to succeed to a prior lender's priority position when the borrowers are non-identical. (*In re Pearce*, 236 B.R. 261, 266-67 (Bankr. S.D. Ill. 1999).) The court noted that "[a] subrogee has no greater rights than the subrogor and can enforce only the rights of the subrogor." The mortgagor under the prior mortgage that was paid off was not the same as that under the new mortgage. Because the prior mortgage was not enforceable against the new mortgagor, the new lender could not step into the prior lender's shoes and enforce its lien rights against a stranger to the prior mortgage. At least one other court has followed this rationale in denying equitable subrogation to a lender in the bankruptcy context. (*In re Bill Heard Enter. Inc.*, 420 B.R. 553, 566 (Bankr. N.D. Ala. 2009).)

Though this issue has received less attention than the issue of whether knowledge bars a subrogation claim, the number of recent cases dealing with it suggests it is an emerging issue that lenders should understand.

Best practices

Because of the uncertainty associated with many aspects of subrogation, a lender's best defense is to avoid having to rely on it. In the best-case scenario, a lender should take an assignment of all prior mortgages of which it is aware. If the lender takes an assignment of prior liens, there is no question that it stands in the assigning lien holder's shoes. Of course, this is not always possible or practicable.

If a lender has notice prior to refinancing of intervening liens that, for whatever reason, will not be paid off, it should request that the intervening lien holder execute an intercreditor and subordination agreement making clear that the new lender's lien is superior. Such an agreement will prevent the lender from later having to rely on subrogation to establish its lien priority.

If prior lien holders are unwilling to give assignments or enter subordination agreements, the lender can take steps to ensure that it has the best case possible for conventional subrogation, the less controversial and more defined of the two subrogation doctrines. A lender should include an express agreement in its loan documents that it is to receive the priority of all mortgages it refinances. Though many courts will find an express agreement based on the totality of the circumstances, careful drafting of the loan documents eliminates uncertainty.

Finally, it is always advisable to obtain a title commitment and policy. A lender will generally not be held responsible for its title insurer's negligence (though the insurer may be, if it intervenes on behalf of the lender), but could potentially be held liable in some jurisdictions for failing to review title. As a result, a lender has nothing to lose and much to gain from obtaining a title policy. ❑

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