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Paying the Wrong Debt

Roger Bernhardt²³

If your client is putting new money into a venture to pay off an old lien, he or she probably expects to take over the same position occupied by the old lien. There are a number of ways to do that.

The safest way is to buy the old paper, *i.e.*, take an assignment of the mortgage and thereby acquire all of the rights and priorities of the former lender. See *Strike v Trans-West Discount Corp.* (1979) 92 CA3d 735, 155 CR 132. This may be impractical, however, if the old lender is unwilling to sell, or if the terms of the old loan don't fit the new deal and other parties won't go along with the changes your client and the debtor have worked out. See *Flack v Boland* (1938) 11 C2d 103, 77 P2d 1090. If the existing lienors are accommodating, another alternative is to have them execute subordination agreements putting your client in the proper position. Finally, if your client has done all this without you and didn't get the proper consents, you can hope that equitable subrogation may come to the rescue.

Equitable subrogation is a doctrine that, in certain circumstances, permits a creditor to pay off a debt that someone else owes and then step into the shoes of the original creditor and assert that creditor's rights against the debtor and that creditor's priority as against other creditors. Under *Lawyers Title Ins. Corp. v Feldsher* (1996) 42 CA4th 41, 49 CR2d 542, however, those circumstances have to be very right for the doctrine to apply. One little glitch and your client may instead end up having bestowed a "gift" on the debtor or junior lienholders.

Feldsher sold a business to Razzano and took as payment a \$750,000 note secured by a fourth deed of trust on Razzano's property, behind liens of \$265,000, \$210,000, and \$50,000 (in that order). Feldsher agreed that he would subordinate his deed of trust to a new first, not to exceed \$250,000. Several months later, Greenberg, an experienced, hard-money lender, lent Razzano \$300,000, intending that \$210,000 of it would pay off the old second and put him in that position, on the belief that Feldsher was subordinating his deed of trust to Greenberg's new loan. The title company issued a policy to Greenberg insuring his \$210,000 deed of trust in second position, senior to Feldsher, and his \$90,000 deed of trust in fifth position, junior to Feldsher. Feldsher, however, had agreed to subordinate only to a new *first*, not to a second, so Greenberg's entire \$300,000 was fifth. When Razzano defaulted on his note to Feldsher, Feldsher foreclosed, wiping out Greenberg's entire \$300,000. As a result, Lawyer's Title paid Greenberg for his interest in the purported second and then sued to establish an equitable lien on the property (now held by Feldsher) as Greenberg's assignee.

Because his money had paid off a lien prior to Feldsher's, Greenberg seemed to have a pretty good claim to equitable subrogation: Feldsher had \$210,000 more equity than he would have had without Greenberg's money. But the court of appeal rejected the claim for technical and equitable reasons, both of which are rather counter-intuitive and should cause attorneys to be cautious.

The technical reason Greenberg lost was that he had actual knowledge of Feldsher's lien when he made his loan. According to the court, this knowledge, coupled with his experience as a lender, made him guilty of "culpable and inexcusable neglect" for not assuring himself that Feldsher had signed a subordination agreement. It is true that some cases had stated that a new

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lender's actual knowledge of an existing lien could impair equitable subordination rights, but this statement was always made in the context of holding that mere *constructive* notice (*i.e.*, the fact that the existing lien was recorded) was not enough to preclude equitable subrogation. See, e.g., *Darrough v Herbert Kraft Co. Bank* (1899) 125 C 272, 57 P 983; *Smith v State Sav. & Loan Ass'n* (1985) 175 CA3d 1092, 223 CR 298 (relied on by the trial court). Lack of actual knowledge always seemed to be used merely as an extra reason for reaching that result. After all, the junior lienholder profits just as much from having the senior debt paid off by a payor with constructive knowledge as it does when the payor has actual knowledge.

I had thought that the "actual knowledge" exception was intended to exclude cases in which the new lender was deliberately trying to keep the existing junior down or manipulate the value of the property—*i.e.*, as a sort of antimeddling, antifraud requirement (see, e.g., *Stein v Simpson* (1951) 37 C2d 79, 230 P2d 816)—and that a new lender who mistakenly believes that a prior lien was validly subordinated to the new lien is more like the lender who mistakenly believes that there is no other interest already of record (*i.e.*, who has only constructive notice of it). The court, however, went the other way. It held that Greenberg's failure to get a proper subordination "demonstrates negligence far more culpable than the mere failure to search the records for an intervening lien." 42 CA4th at 52.

I have trouble with that distinction (and with even characterizing as culpable negligence the failure to take steps necessary to protect only yourself), so from now on I will admonish a lender never to assume that it can safely pay off an existing loan and put its new loan in the same position if it has *any* knowledge of a junior interest, even if the funds are used entirely to cancel the old debt and the transaction seems to make the old junior better off.

I say this because the court, while recognizing that its result seemed to create a windfall for Feldsher, justified the result by claiming that it was necessary to avoid prejudice to Feldsher. It is very odd prejudice, however. The old \$210,000 second and the \$50,000 third were due soon after the sale from Feldsher to Razzano. "To revive the \$210,000 second trust deed which was paid off with funds provided by the Greenberg loan would be contrary to the Feldshers' agreement for the sale of their company and deprive the Feldshers of the benefit of their bargain." 42 CA4th at 53. If refinancing a maturing loan is prejudicial to a junior lender, it seems to me that anything can be called prejudicial. The juniors I know generally dread rather than welcome the maturing of a senior loan. And how likely is it that the existing second and third loans would have been "retired as scheduled" in light of the fact that Razzano found it necessary to borrow money to refinance them, and immediately thereafter (so I calculate, because Feldsher's trustee sale was held four months later) defaulted on the fourth (the Feldsher loan)?

Equitable subrogation is applied rarely enough as it is. (Last year I tried, unsuccessfully, to persuade the American Law Institute to have its new Restatement of Mortgages drop the requirement that a junior must pay off a senior loan in full to claim such rights, so that juniors who are forced to make installment payments to reinstate defaulted seniors might get some of the priority of the senior.) No investor should ever consciously count on protection from the doctrine. Equitable subrogation means discretionary subrogation, which too often can mean whimsical nonsubrogation. Getting the paperwork right is the only safe course.