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Sorting Out Lien Priority

By Mark S. Blackman

In the last decade, while interest rates continued to drop to record lows, borrowers repeatedly refinanced their home loans to take advantage of the lower rates. Often, liens in senior position were replaced with new loans without paying off other existing junior liens. As a condition to such refinancing, lenders required the borrower's junior lien holders to subordinate their existing loans to the new loan. For many reasons, including the sheer volume of such loans, when the borrower had multiple outstanding loans, the new lender sometimes failed to obtain subordination agreements from all junior lien holders creating an incomplete subordination by existing lenders. An incomplete subordination or as some courts have described it, a "circuitry of liens" is illustrated by the following:

Borrower has obtained three loans, A, B and C, secured by deeds of trust, recorded in chronological order. As a condition to C making its loan, Lender C requires Lenders A and B to subordinate their deeds of trusts to Lender C's deeds of trust. As a result of some error, Lender C secured Lender A's agreement to subordinate its deeds of trust, but failed to obtain a subordination agreement from Lender B. As a result, C becomes senior to A, but not to B and A becomes junior to C, but B remains senior to C. If this sounds confusing, it is and has troubled lenders for years.

A California legal text, Ogden's *Revised*

California Real Estate Property, described the situation: "A first-rate legal puzzle arises when by agreement or otherwise, a superior mortgage is subordinated to another mortgage that is subject to intervening liens to which the subordinated superior lien is otherwise paramount. Circuitry of liens results because the prior mortgage is displaced by the subordinating lien while retaining its priority over the intervening liens."

A circuitous lien or incomplete subordination presents problems for all players in the foreclosure process: non-foreclosing creditors unsure of their lien priority or their right to surplus funds; title companies and foreclosure trustees who may have difficulty identifying junior lien holders for foreclosure purposes and surplus funds distributions under California Civil Code Section 2924k; potential third party bidders unsure of what is being sold at the foreclosure sale (i.e. what liens will survive the foreclosure sale); and borrowers unsure what liens will be extinguished potentially exposing them to breach of contract claims

On Oct. 22, 2009, in a unanimous decision, the 1st District Court of Appeal, in a case of first impression, set forth a specific methodology to determine lien priority for real estate foreclosure sales and surplus fund distributions disputes.

In *Wells Fargo Bank v. Neilsen* (2009) 178 Cal. App. 4th 602, 100 Cal. Rptr. 3d 547, Neilsen was the owner of a single-family

residence in San Mateo, California. In 2003, he refinanced his home, obtaining a loan for \$322,700 from PHH Mortgage Corp. After the PHH loan was completed, the property was encumbered (in order of recording dates) by the following deeds of trust: American Express Centurion Bank, loan balance at foreclosure, \$28,726; Wells Fargo Bank, N.A., loan balance at foreclosure, \$78,433; and PHH, loan balance at foreclosure, \$322,000.

At the time PHH made its loan to Neilsen, PHH obtained a subordination agreement from first trust deed holder, American Express, but did not obtain a subordination agreement from Wells Fargo, second trust deed holder. As a result, PHH's deed of trust was senior to American Express' deed of trust but Wells Fargo's deed of trust remained senior to PHH's deed of trust.

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In March 2007, American Express foreclosed on its deed of trust. Wells Fargo acquired title to the property at the foreclosure sale for \$400,000, which it bid to protect its lien and because of uncertainty over its lien priority between itself and PHH. After deducting trustee's fees and expenses, surplus funds were approximately \$368,000.

After several months of being unable to determine lien priorities so to distribute the surplus funds under Section 2924k, the Trustee filed an interpleader action.

In March 2008, the interpleader action was assigned to Judge Steven Dylina, who ruled the hearing on the interpleader would be bifurcated so the court could first determine lien priority by applying *Bratcher v. Buckner* (2001) 90 Cal.App. 4th 1177 and then determine whether Neilsen would be entitled to any surplus funds

The *Bratcher* case involved the determination of lien priorities under the Enforcement of Judgments Act wherein *inter alia*, a judgment creditor must obtain a court order to sell a debtor's principal residence to satisfy a debt not related to existing voluntary liens (trust deeds) in order to protect the judgment debtor's right to a homestead.

The *Bratcher* court determined that because of an incomplete subordination, the hypothetical parties described above, A, B and C would be treated as follows: C, by virtue of its subordination agreement was to be paid first, but only to the amount of A's claim, to which B was junior. B received what it expected to receive, the fund less A's prior claim. If A's claim was smaller than C's, C would collect the balance of its claim only after B has been paid in full. A, the subordinator, received nothing until B and C had been paid, except to the extent that its claim, entitled to first priority, exceeded the amount of C's claim, which under its agreement is to be first paid.

Judge Dylina determined that the *Bratcher* court's methodology for determining

relative lien priorities for an Enforcement of Judgments Act case applied equally to a non-judicial foreclosure such as in the *Neilsen* case.

Neilsen argued to the trial court and the Court of Appeal that he was entitled to the surplus funds after payment of Wells Fargo's lien, that Wells Fargo acquired the property at the foreclosure sale subject to PHH's \$322,000 lien, that the priorities to be utilized for surplus funds distribution were adequately dealt with in Section 2924k(a). He also argued that the circuitry of liens analysis in *Bratcher* would have the effect of chilling the bidding process to the disadvantage of borrowers.

The Court of Appeal disagreed, finding that nothing in *Bratcher* limits its reasoning regarding a circuitry of liens problem to involuntary liens such as enforcement of judgment liens; *Bratcher* involved voluntary liens (i.e., deeds of trust); "Neilsen's argument that the Texas Supreme Court case cited in the *Bratcher* decision (*ITT Diversified Credit v. First City Capital Corp.*) involved only personal property was not persuasive because the *Bratcher* court ruled that 'For purposes of application of subordination agreements to lien priority, there is 'no valid basis for [a] distinction...between real property and personalty.'"

Section 2924, which Neilsen argued is applicable and controlling, does not specify how a court with which funds from a foreclosure sale are deposited should resolve the inconsistent priority situation posited in this case.

Rather, the Court of Appeal agreed with Wells Fargo and PHH: "there needs to be a rule for deciding on the priority of real property liens when an inadequate and/or incomplete subordination agreement creates an apparent inconsistency as regards priorities, and that there is no reason why that rule needs to be, or should be, different than when the foreclosure process involves, as it did here, entirely voluntary liens and, thus, the non-judicial foreclosure process dictated by [Section]

2924 *et seq.* versus when it involves the judicial foreclosure process set forth in the [Civil Code]. Indeed, as respondent [Wells Fargo] contends in its brief to us, such a consistency in the prioritization process will clearly help, not hurt (as appellant argues in his brief) the non-judicial foreclosure process."

The court then addressed the argument that Section 2924's so-called comprehensive framework for the regulation of a non-judicial foreclosure sale prevents the use of the *Bratcher* analysis. Citing Sections 2924j and 2924k, the court held that contrary to Neilsen's argument: "There was and is nothing in Sections 2924j and k telling either the trustee or the Superior Court with which the funds were deposited how to determine the 'order of...priority' of real estate liens when some of the parties executed a subordination agreement which resulted in an inconsistency in those priorities.

"There is nothing in those otherwise 'comprehensive' statutes at all instructive as to how the foreclosure trustee or a court should handle a situation where, as here, the last lien claimant in point of time (here, PHH) obtains a subordination agreement from one, but not both, of the previously senior lien holders. Nor apparently is there any judicial interpretation of these provisions which directs a California court how to determine priorities in such a situation."

The Court of Appeal held that the analysis employed in *Bratcher*, *ITT* and the more recent Arizona Supreme Court case, *In re Price Waterhouse, Ltd.* should be employed in non judicial foreclosure cases where partial subordinations have occurred.

As a result, title companies, foreclosure trustees, lenders, borrowers and third party buyers now have a specific methodology for determining lien priority where incomplete or inconsistent liens exist. This provides more certainty for all parties involved in the foreclosure process and should prevent future litigation over circuitry of lien issues.