Washington Law Review

Volume 77 | Number 1

1-1-2002

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THE ERROR OF *KIM V. LEE* AND EQUITABLE SUBROGATION: WHY BIFURCATING LIEN PRIORITIES IS A BETTER REMEDY

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Abstract: Normally, the priority of an interest in real property is determined according to the date when the interest was recorded in the Recorder's Office of the county in which the property is located. The first interest recorded has first priority. When an interest is satisfied, junior interests are elevated to the next priority level. If a landowner is forced to sell the property to satisfy a debt through foreclosure, the priority of interests determines the order for distributing sale proceeds. Equitable subrogation is a remedy whereby a court gives a subsequent interest holder priority over a prior recorded interest because the subsequent interest replaces a senior lien. This leap in priority may effectively deny the intervening lienor the opportunity to foreclose and be paid for the lien. When a court decides whether or not to apply equitable subrogation, it is forced to apply an all-or-nothing remedy when better alternatives exist. In *Kim v. Lee*, the Washington State Supreme Court adopted the Restatement (Third) of Property's rule for applying equitable subrogation but failed to apply the accompanying remedy of bifurcation. This Note argues that the Washington Supreme Court should have bifurcated the lien priorities of the refinance lender and intervening lienor. This Note concludes that bifurcation is a superior remedy because it strikes the appropriate balance between the legal framework that determines lien priority and the need for equitable remedies.

Normally, recording laws establish priority for liens[1] on property based on the date the lien was recorded.[2] In contrast, courts apply equitable subrogation[3] as a remedy to alter the priority of property interests determined by recording laws. Courts justify equitable subrogation in the mortgage context because it protects the refinance lender's justified expectation of a first priority lien.[4]

To illustrate how equitable subrogation works, suppose Eric purchases a house by borrowing money from Bank A.[5] Shortly thereafter, while Eric is out one night, he negligently drives through a cornfield and destroys the crop of a local farmer, Mark. This crop is Mark's only

1. A lien is "[a] legal right or interest that a creditor has in another's property, lasting . . . until a debt or duty that it secures is satisfied." BLACK'S LAW DICTIONARY 933 (7th ed. 1999). A "lienholder," or "lienor," refers to "a person having or owning a lien." *Id.* at 936.

2. For the purposes of this Note, the word "property" refers to real property only.

3. Subrogation is defined as the "substitution of one party for another whose debt the party pays, entitling the paying party to rights, remedies, or securities that would otherwise belong to the debtor." BLACK'S LAW DICTIONARY 1440 (7th ed. 1999).

4. *See infra* Part II.A.

5. Hypothetical created by the author.

source of income. Mark sues Eric and a court determines that Eric owes Mark $50,000 for the damaged crop. Eric has no money or personal property of value to repay Mark for the damage he caused. Mark takes advantage of judgment lien laws and records a lien against Eric's home to ensure that Eric will pay him. Eric subsequently decides to refinance his home, worth $150,000, because interest rates have dropped and he is struggling financially.

As with most lenders, Bank B will not loan money to buy a house unless it can protect its interest against others with interests in the same property. To protect itself, Bank B has a title insurance company search property records to find out if anyone else has an interest in Eric's house. The title company negligently fails to discover Mark's interest. Based on the inaccurate information showing no other interests in Eric's house, Bank B loans Eric $150,000 for a thirty-year term at eight percent interest. Eric uses the money to pay off the loan from Bank A, which had an outstanding balance of $145,000, an interest rate of nine percent, and a fifteen-year term. The additional five thousand dollars of principal on the loan from Bank B represents fees related to refinancing.

The only way for Mark to collect his judgment is to foreclose on Eric's house. However, if a court applies the doctrine of equitable subrogation, Mark may not be able to foreclose because his interest will be subordinated to Bank B's interest.[6] The court may apply equitable subrogation because Bank B has a claim to a first priority lien for $150,000, plus interest. Mark also has a claim to a first priority lien for $50,000, the value of his judgment.[7] Because equitable subrogation puts Mark in a subordinate position and judgment liens are only allowed to exist for a limited time, foreclosure may no longer be an option for Mark.[8] Mark may never be compensated for his damages.

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6. In *Kim v. Lee*, the court said:

> Where a lender has advanced money for the purpose of discharging a prior encumbrance in reliance upon obtaining security equivalent to the discharged lien, and his money is so used, the majority and preferable rule is that if he did so in ignorance of junior liens or other interests he will be subrogated to the prior lien. Although stressed in some cases as an objection to relief, neither negligence nor constructive notice should be material.

Kim v. Lee, 102 Wn. App. 586, 592–93, 9 P.3d 245, 250 (2000) (citing G.E. Capital Mortgage Servs., Inc. v. Levenson, 657 A.2d 1170 (1995)), *rev'd*, 145 Wash. 2d 79, 31 P.3d 665 (2001).

7. Post-judgment interest may also be awarded pursuant to WASH. REV. CODE § 4.56.110 (2000).

8. See *infra* note 73 and accompanying text for an explanation of time limits on judgment liens.

As an alternative to equitable subrogation, courts could bifurcate the priority of the competing interests.[9] Bifurcation creates an outcome that protects the competing interests of both parties by allowing the intervening lienor to have first priority to the extent necessary to put him in the same position he was in before the refinance transaction occurred. Bifurcation would allow Bank B to assume a first priority lien against Eric's house but only to the extent allowed by the original terms of Bank A's mortgage plus new more favorable terms. Mark would have priority to the extent Bank B's new terms prejudiced his judgment lien and any remaining interest of Bank B under the new loan terms would be subordinate to Mark's lien.

Several authorities have recognized the value of bifurcating lien priorities. California bifurcates priorities in some cases and at least one other court has recently applied this approach in the mortgage context.[10] This remedy is also recommended by the Restatement (Third) of Property.[11]

The Washington Supreme Court failed to apply bifurcation when it decided *Kim v. Lee*.[12] The court decided that the remedy of equitable subrogation was not available to protect a title insurer from liability when the title insurer had actual knowledge of an intervening lien before the refinance transaction but failed to disclose that fact.[13] The court went on to adopt the Restatement's view that equitable subrogation is available to the extent that new lien terms do not prejudice junior lienors.[14] Rather than bifurcating priority between the refinance lender

9. While many states have examined the issue of equitable subrogation, courts have taken substantially different approaches. The range of approaches extends from a rather favorable view of equitable subrogation in the mortgage context to an almost complete prohibition on its applicability. *See infra* Part II. Equitable subrogation in the mortgage context was a matter of first impression for the Washington State Supreme Court. Kim v. Lee, 145 Wash. 2d 79, 88, 31 P.3d 665, 669 (2001).

10. *See* Lennar Northeast Partners v. Tahoe Vista Inn & Marina, 57 Cal. Rptr. 2d 435, 442–43 (Cal. Ct. App. 1996) (bifurcating lien priorities when first lienor substantially altered terms of loan); Aames Capital Corp. v. Interstate Bank of Oak Forest, 734 N.E.2d 493, 501 (Ill. Ct. App. 2000) (applying bifurcation to refinance lender and intervening judgment creditor but only when refinance lien was filed before original lien was released).

11. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES, § 7.6 and cmt. e, illus. 28 (1997) (hereinafter Restatement).

12. 145 Wash. 2d 79, 31 P.3d 665 (2001).

13. *Id.* at 82, 31 P.3d at 666–67.

14. *Id.* at 89, 31 P.3d at 670.

and the intervening lienor,[15] the court found some of the refinance terms to be prejudicial and reinstated the trial court's decision allowing the intervening lienor to step into first priority and foreclose.[16] Under the Restatement, bifurcation is recommended when new lien terms prejudice the intervening lienor.[17]

This Note argues that the Washington Supreme Court applied the wrong remedy in *Kim* given the court's adoption of the Restatement's rule for equitable subrogation. Part I discusses property law as it applies to the mortgage context, starting with the creation of a lien and ending with foreclosure and the distribution of proceeds. Part II looks at how courts approach the doctrine of equitable subrogation. Part III analyzes bifurcation as an alternative to equitable subrogation. Part IV discusses *Kim v. Lee* and Washington's approach to equitable subrogation. Finally, Part V argues that Washington should adopt bifurcation and reject equitable subrogation because bifurcation respects the existence of recording laws and best serves the interests of equity.

I. LIENS, MORTGAGES, AND PROPERTY LAW RELATED TO EQUITABLE SUBROGATION AND BIFURCATION

In order to understand equitable subrogation and bifurcated lien priorities, it is first necessary to look at how property secures financial obligations. Once property is owned, it may be burdened by liens that reflect the different interests in that particular piece of property. The mechanics of recording laws play an important part in establishing who has an interest in property and, when multiple parties have interests, how those interests relate to one another. The relationships between multiple interests are important because they create a hierarchy of priority, and this priority affects how courts treat the interests in a foreclosure action. Statutes control the foreclosure process with specific provisions applying

15. For the purposes of consistency, this Note will use the term "refinance lender" to refer to the party requesting first priority through equitable subrogation. The party might not in fact be a bank or commercial lender and cases cited in this Note may use different terminology. Similarly, this Note uses the term "judgment creditor" and "intervening lienor" to refer to the party that has an intervening interest. A judgment creditor is a "person having a legal right to enforce execution of a judgment for a specific sum of money." BLACK'S LAW DICTIONARY 848 (7th ed. 1999). However, the nature of the parties does not affect the appropriateness of bifurcation. Courts can beneficially apply bifurcation instead of equitable subrogation whenever a priority dispute exists between a subsequent party that refinances senior liens and an intervening lienor.

16. *Kim*, 145 Wash. 2d at 93, 31 P.3d at 671–72.

17. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES, § 7.6 cmt. e and illus. 28 (1997).

to judgment creditors who participate in a foreclosure. At the end of this chain of issues, courts may apply equitable subrogation, resulting in a different ordering of lien priorities. Bifurcating lien priorities produces yet another result that differs from equitable subrogation in significant ways.

A. How Liens Affect Property

Property ownership is rarely absolute. For example, the fee simple owner of property has the right to diminish the absolute nature of his ownership by granting liens against the property.[18] Liens represent the right of the lien holder to use the property as security for a debt.[19] Liens may be either consensual or nonconsensual.[20] A mortgage is a type of consensual lien and modern mortgages are frequently insured to protect the lender. A judgment lien is a type of nonconsensual lien and it provides a way for judgment creditors to collect their judgments.

A common type of consensual lien is the home mortgage. A mortgage is considered a consensual lien because the landowner willingly grants the mortgage interest.[21] A mortgage is a transaction in which a lender loans money to someone in exchange for a lien against the property.[22] Such loans are composed of three general elements: (1) the amount of the loan, or "principal," (2) the interest rate, and (3) the length of the repayment period, or "term," of the loan.[23] Loan repayments are structured so that at the end of the term, all of the principal will have been repaid.[24] Each individual payment is used to pay down part of the principal and to pay the interest that has accrued since the last payment.[25] This payment structure is called "amortization" and results in early loan

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18. *See generally* WILLIAM STOEBUCK, REAL ESTATE: PROPERTY LAW, *in* 17 WASHINGTON PRACTICE, § 1.3 (1995).

19. MARJORIE DICK ROMBAUER, CREDITORS' REMEDIES—DEBTORS' RELIEF, *in* 27 WASHINGTON PRACTICE, § 4.1, at 309 (1998).

20. WILLIAM STOEBUCK, REAL ESTATE: TRANSACTIONS, *in* 18 WASHINGTON PRACTICE, § 16.3, at 226–27 (1995).

21. *Id.* § 16.3, at 227.

22. *See* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW, § 1.1, at 1–2 (3d ed. 1994); *see also infra* notes 60–64 and accompanying text (discussing purchase money security interests (PMSI's)).

23. *See* NELSON & WHITMAN, *supra* note 22, § 1.1, at 2–3.

24. *Id.*

25. *Id.* § 1.1, at 2.

payments being primarily used to pay interest.[26] Over time, the amount of each payment used to pay down the principal increases and the amount of interest accruing decreases.[27] At the end of the term of the loan, when all of the principal and interest have been paid, the mortgage is extinguished and the lender's lien against the property is removed.[28]

After a mortgage is created, homeowners frequently purchase mortgage insurance for the benefit of the lender.[29] Mortgage insurance protects lenders from losses resulting from a default by the homeowner.[30] Because many mortgages are later sold on the secondary mortgage market, mortgage insurers and secondary market investors like the Federal National Mortgage Association ("Fannie Mae") have an interest in stability and predictability in the issuance of mortgages and the adjudication of lien disputes.[31]

In contrast, a judgment lien is an example of a nonconsensual lien.[32] A judgment lien is the result of a court entering a judgment in favor of the judgment creditor as part of a legal action. By statute, a judgment creditor may attach a lien in the amount of the judgment to all of the real property owned or thereafter acquired by the landowner.[33] The introductory hypothetical illustrates how a judgment lien may arise. If Mark wins a lawsuit against Eric for the damage to the corn field, a court will enter a judgment in favor of Mark for the value of the damage. Assuming Mark complies with the statutes covering recording of judgment liens,[34] Mark can take a lien against Eric's property for the value of the judgment entered in Mark's favor by the court. The judgment lien can be satisfied if Eric pays Mark or if Mark forecloses and the foreclosure sale proceeds are sufficient to pay off Eric's debt.[35]

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26. *Id.*

27. *Id.*

28. *See* STOEBUCK, *supra* note 20, § 17.26, at 320. Removal of the lender's lien is not automatic. If the lender does not voluntarily remove the lien, the property owner could have it removed by a court. *Id.* § 17.26, at 320–21.

29. NELSON & WHITMAN, *supra* note 22, § 11.2, at 773.

30. *See id.*

31. *See generally id.* at § 11.2.

32. ROMBAUER, *supra* note 19, § 4.1, at 309.

33. WASH. REV. CODE § 4.56.190 (2000).

34. *See infra* Part I.C.

35. If property subject to foreclosure is homestead property, the foreclosure must comply with the requirements of Chapter 6.13 of the Revised Code of Washington. Specifically, homestead property must have net equity before a creditor can foreclose. *See* WASH. REV. CODE § 6.13.090. Practically

B. *Recording Laws and Their Role in Fixing the Rights of Those with an Interest in Property*

Property records are the basis upon which courts determine priority for interests in property. However, recording laws require different procedures for recording different types of liens. Priority is generally determined by the date an interest in property is created[36] and recording that interest creates notice, which is an important concept in property law.[37] Washington modifies this general rule by statute and in some limited cases, recording laws give preference to purchase money mortgages in priority disputes.[38]

Recording laws allow people with interests in land to protect those interests.[39] Interests in property are recorded separately for each county by a county official responsible for keeping the records in an accurate and organized fashion.[40] Recording laws and the resulting property records are used to regulate how multiple interests in the same property relate to one another. Recording an interest in property protects the interest by giving subsequent interest holders notice that another interest exists.

The common law rule regarding interests in property gives the highest priority to the first interest created.[41] This rule is commonly referred to as "first in time, first in right."[42] This rule gives priority to previously recorded liens over subsequently recorded liens, which are referred to as junior liens.[43] Subsequent liens are subordinated in part due to notice.

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speaking, any creditor foreclosing on property, homestead or not, would want there to be sufficient equity to pay off the lien in default or foreclosure may not be worth the time and cost.

36. STOEBUCK, *supra* note 20, § 13.5, at 98.

37. *See, e.g., id.* at 97–100 (discussing, inter alia, the concept of notice).

38. *See infra* notes 60–64 and accompanying text.

39. STOEBUCK, *supra* note 20, § 13.1, at 82–83.

40. WASH. REV. CODE §§ 65.08.070, .160. Title insurance companies use official county records to develop their own databases of property records. STOEBUCK, *supra* note 20, § 13.6, at 140. Generally, potential lienors will hire title insurance companies to determine what interests affect a particular piece of property before any transactions relating to the property are finalized. *See id.* at 141–42. Many lenders may only loan money if they can take a first priority lien, due in part to banking regulations and due in part to the need for adequate security. NELSON & WHITMAN, *supra* note 22, § 8.18, at 683. If properly done, the title insurance company's search will reveal all interests relating to a particular piece of property. *See* STOEBUCK, *supra* note 20, § 13.17, at 145–46. Arguably, if an interest is missed, the title insurance company is negligent. *See infra* Part II.C.

41. STOEBUCK, *supra* note 20, § 13.5, at 98.

42. *Id.*

43. *See, e.g.*, NELSON & WHITMAN, *supra* note 22, § 1.1, at 5.

Washington and many other states alter the common law rule through a recording statute.[44] Washington's recording statute creates a "race-notice" system.[45] The race-notice system allows a person recording an interest to take priority over someone with a senior interest only when four conditions are met.[46] Those four conditions are: (1) the junior interest is created before the senior interest is recorded, (2) the junior party has no notice of the senior party's interest, (3) the junior party gives value for his interest, and (4) the junior interest is recorded before the senior interest is recorded.[47] When a party meets these conditions, the race-notice statute will elevate the priority of a subsequent lien holder over that of a prior lien holder.[48] When a party cannot meet these conditions, the "race" portion of the Washington statute gives priority to the first interest holder to record.[49]

Property records create notice to others that interests already exist in a piece of property. The importance of recording interests in property cannot be overstated because prior recorded interests are said to give notice to subsequent interest holders such that the subsequent interest holder cannot obtain priority over the previously recorded claim.[50] Anyone who obtains an interest in property is charged with having knowledge of prior recorded interests, even if the party does not have actual knowledge of the prior interests.[51] This knowledge is considered constructive notice.[52] A party with constructive notice of prior claims is ineligible to claim bona fide purchaser status and that status is a necessity to claim priority over a prior recorded interest under Washington's race-notice recording laws.[53] Because constructive notice defeats the bona fide purchaser status, a subsequent interest holder cannot gain priority over a

44. STOEBUCK, *supra* note 20, § 13.5, at 99.

45. WASH. REV. CODE § 65.08.070.

46. *Id.*; *see also* STOEBUCK, *supra* note 20, § 13.5, at 100.

47. WASH. REV. CODE § 65.08.070; *see also* STOEBUCK, *supra* note 20, § 13.5, at 100.

48. WASH. REV. CODE § 65.08.070; *see also* STOEBUCK, *supra* note 20, § 13.5, at 100.

49. WASH. REV. CODE § 65.08.070; *see also* STOEBUCK, *supra* note 20, § 13.8, at 112.

50. STOEBUCK, *supra* note 20, § 17.21, at 310.

51. *See id.* § 13.6, at 103.

52. *See id.* § 17.21, at 310.

53. *Id.* § 13.8, at 112. A bona fide purchaser is a good faith purchaser for value who does not have actual or constructive notice of other interests in the thing being sold. *See* Tomlinson v. Clarke, 118 Wash. 2d 498, 500, 825 P.2d 706, 707 (1992); *see also* BLACK'S LAW DICTIONARY 1249 (7th ed. 1999) (defining a bona fide purchaser as one "who buys something for value without notice of another's claim to the item or of any defects in the seller's title").

previously recorded interest.[54] The resulting rule is that the first recorded interest has priority over subsequently recorded interests.[55]

A judgment creditor—a specific type of lienor—can record a judgment lien to preserve a lien's priority. Under Washington statutes, a judgment lien attaches to all of the property a judgment debtor owns or later acquires.[56] In order for a judgment lien to attach to property, the judgment creditor must record the judgment with the county official in the county in which the property is located.[57] For property in the county where the judgment was rendered, judgment liens are given priority based on the date of the judgment.[58] For property outside of that county, the priority is based on the date when the judgment creditor records a certified abstract of the judgment in the county where the property is located.[59] Thus, for property located in the same county as where the judgment was rendered, filing the judgment attaches the lien to the property and establishes priority. For property located elsewhere, filing an abstract establishes the priority date but filing the judgment is still required to attach the judgment to the property.

Beyond recording statutes, courts accord purchase money security interests (PMSI) special status in determining priority.[60] A PMSI is created when a lender loans funds to a buyer so that the buyer can purchase property, the buyer uses the funds for that purpose, and the lender receives a security interest in that property.[61] The resulting mortgage is called a PMSI because the lender's security interest in the property, represented by the mortgage, represents the money used to purchase the property.[62] The fact that a lender gave money for the purpose of buying property is considered to create a special relationship between the lender and the property.[63] This special relationship justifies

54. STOEBUCK, *supra* note 20, § 17.21, at 309–10.

55. *Id.* at 309.

56. WASH. REV. CODE § 4.56.190 (2000).

57. *Id.* § 6.13.090.

58. *Id.* § 4.56.200.

59. *Id.*

60. *See* NELSON & WHITMAN, *supra* note 22, § 9.1, at 695–96.

61. *Id.* § 9.1, at 695.

62. *See id.*

63. *Id.* at 698–700.

giving priority to a PMSI over other claims granted by the purchaser to the extent that loan proceeds are used to purchase the property.[64]

C. *The Foreclosure Process and Judgment Creditors*

After recording statutes and property records establish interests in property, interest holders may foreclose to protect those interests. Washington specifically controls a judgment creditor's foreclosure by statute. The statutory limitations on how long a judgment lien may last are an important consideration for the judgment creditor.

A lienor may initiate the foreclosure process to remedy a default by the landowner.[65] A default occurs when the landowner fails to perform the obligation created by the mortgage or lien.[66] Studies have shown that the likelihood of default is related to the amount of the homeowner's equity.[67] As a homeowner's equity increases, the likelihood of default decreases.[68]

In general terms, foreclosure is a process in which property is sold and the proceeds of the sale are applied to satisfy the liens against the property.[69] When property is subject to multiple liens, foreclosure sale proceeds are used to pay off the liens according to priority.[70] If any funds remain after all liens have been extinguished, the excess proceeds go to the landowner.[71] Normally, the chronological order in which the lien

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64. *Id.* at 696 n.4; *see also* 26 U.S.C. § 163(h)(3) (1994) (allowing for a deduction from gross income for interest relating to acquisition indebtedness of a qualified residence). Acquisition indebtedness is "any indebtedness which is incurred in acquiring . . . any qualified residence" and expressly includes "any indebtedness . . . resulting from the refinancing of indebtedness . . . ." 26 U.S.C. § 163(h)(3)(B)(i). This definition supports the idea that refinanced money retains the quality of a PMSI. *See also* WASH. REV. CODE ANN. §§ 62A.9A.324 (West 2001) (providing priority to a perfected PMSI in personal property when a dispute exists), .334 (giving a PMSI in fixtures priority over a conflicting interest in the related real property).

65. NELSON & WHITMAN, *supra* note 22, § 1.1, at 4. While the lienor may have alternatives to judicial foreclosure, such as non-judicial foreclosure, the applicability of bifurcation to those alternatives is beyond the scope of this Note.

66. *Id.* § 2.1

67. *Id.* § 11.2, at 772–73. Homeowner equity can be expressed as a ratio of loan amount to property value (often referred to as "loan-to-value ratio"). *Id.* at 772.

68. *See id.*

69. *Id.* § 1.1, at 5.

70. *Id.* at 4–5.

71. *Id.* It is also important to note that homestead exemptions are a key component in determining if a foreclosure is permissible and how proceeds will be distributed after foreclosure. *See, e.g.*, WASH. REV. CODE § 6.13.170 (2000). However, a discussion of homestead exemptions is not

holders recorded their interests with the county auditor, subject to additional statutory requirements, determines the priority of liens.[72]

Washington law requires judgment creditors to collect on liens against property within ten years.[73] A judgment creditor can begin the foreclosure process by filing an affidavit stating, inter alia, that the property owner has no personal assets to satisfy the judgment lien.[74] After filing the affidavit, the judgment creditor must get a writ of execution.[75] The writ of execution is an order from the issuing court to the sheriff of the county in which the property is located directing the sheriff to sell the property.[76] After the sheriff conducts the sale, the proceeds from the sale are distributed to the interest holders.[77]

D. The Effects of Equitable Subrogation and Bifurcation on the Distribution of Foreclosure Proceeds

Proceeds from a foreclosure are generally distributed according to lien priority as determined by recording statutes. When courts apply equitable subrogation, they apply a new priority system based on equitable principles. In contrast, bifurcating priorities produces a result different from that of both recording statutes and equitable subrogation. The outcome produced by bifurcation offers some of the protection of recording statutes and also addresses the policies behind equitable subrogation.

Generally, proceeds are distributed according to lien priority.[78] Under the normal lien priority system, a judgment creditor would be first in priority when an original mortgage was refinanced. The release of this first priority mortgage would allow the second priority judgment creditor to assume first priority while the refinance lender would take second

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necessary for the purposes of this Note. Bifurcating lien priorities is completely compatible with homestead exemptions.

72. *See* WASH. REV. CODE § 65.08.070; *see also supra* notes 44–59 and accompanying text.

73. WASH. REV. CODE § 6.17.020. The judgment creditor may extend the period for another ten years by petitioning the court that rendered the judgment within ninety days of the end of the first ten-year period. *Id.*

74. *See id.*

75. MARJORIE DICK ROMBAUER, CREDITORS' REMEDIES—DEBTORS' RELIEF, *in* 28 WASHINGTON PRACTICE, § 7.30, at 111 (1998).

76. *See* WASH. REV. CODE § 6.17.140.

77. ROMBAUER, *supra* note 75, § 7.30, at 112.

78. STOEBUCK, *supra* note 20, § 17.31, at 308.

priority. As a first priority lienor, the judgment creditor would be able to establish the necessary net equity to proceed with foreclosure.

If a court applies equitable subrogation after a judgment creditor initiates foreclosure, it alters lien priorities and the foreclosure sale may be stopped. Applying equitable subrogation puts the judgment creditor back into second priority and allows the refinance lender to take first priority based on the notion that the refinance lender had an expectation of first priority, notwithstanding recording laws to the contrary. This change in priority may leave the judgment creditor without sufficient net equity to move forward with foreclosure.[79] Even more detrimental to the judgment creditor, the new loan may increase the risk of default due to changes in the loan-to-value ratio and increase the time the judgment creditor must wait to foreclose. When courts apply equitable subrogation, lien priority is abandoned as the determinant of how competing interests in property relate to each other.

If a court applies bifurcation, the judgment creditor's foreclosure action may still be stopped, but any new prejudicial loan terms will not compromise the judgment creditor's priority. Bifurcation allows the refinance lender to step into first priority, but only to the extent of the original loan terms plus more favorable terms.[80] If the new terms work any disadvantage to the judgment creditor, the judgment creditor has first priority as to changes in terms that are prejudicial and remains in second priority with respect to the original terms.[81] The refinance lender would have junior priority compared to the judgment creditor with respect to any amounts under the new loan that prejudice the judgment creditor. Thus, under this approach, a judgment creditor's foreclosure may still be postponed, but the judgment lien would only be junior to a loan no more prejudicial than the one in place before the refinance transaction.

79. *See* WASH. REV. CODE § 6.13.010.

80. Bifurcation is consistent with a notion of landlord-tenant law in which a tenant only remains secondarily liable to the landlord for the terms originally negotiated when the tenant assigns a lease to an assignee. STOEBUCK, *supra* note 18, § 6.64, at 399 n.7. If the landlord and assignee negotiate terms more favorable to the tenant, the landlord is considered to have released the tenant to the extent of the more favorable terms. *See id.*

81. The three primary changes to loan terms are an increase in principal, an increase in the interest rate, or an extension of the term. *See* NELSON & WHITMAN, *supra* note 22, § 1.1 at 2–3.

II. MANY COURTS RECOGNIZE EQUITABLE SUBROGATION BUT APPLY IT IN DIFFERENT WAYS

Courts generally recognize equitable subrogation as a potential remedy in the mortgage context.[82] The doctrine is widely understood to amount "to an assignment by operation of law of the original creditor's position to the [refinance lender]."[83] Equitable subrogation is based on a few basic equitable principles, yet courts do not uniformly apply the remedy because of differences in how notice and negligence are treated.

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82. Many courts have dealt with the issue of equitable subrogation in the mortgage context. *See, e.g.*, Ex parte AmSouth Mortgage Co., 679 So. 2d 251, 253 (Ala. 1996); Rush v. Alaska Mortgage Group, 937 P.2d 647, 648 (Alaska 1997); Herberman v. Bergstrom, 816 P.2d 244, 247 (Ariz. 1991); Newberry v. Scruggs, 986 S.W.2d 853, 857 (Ark. 1999); Lennar N.E. Partners v. Tahoe Vista Inn & Marina, 57 Cal. Rptr. 2d 435, 437 (Cal. Ct. App. 1996); Rosenblit v. Williams, 750 A.2d 1131, 1133 (Conn. 2000); Suntrust Bank v. Riverside Nat'l Bank of Fla., 792 So. 2d 1222, 1224 (Fla. Dist. Ct. App. 2001); Bryant v. Cole, 468 S.E.2d 361, 362–63 (Ga. 1996); Hoopes v. Hoopes, 861 P.2d 88, 91 (Idaho 1993); Aames Capital Corp. v. Interstate Bank of Oak Forest, 734 N.E. 2d 493, 497 (Ill. App. Ct. 2000); Wilshire Servicing Corp. v. Timber Ridge P'ship, 743 N.E.2d 1173, 1175 (Ind. Ct. App. 2001); Home Owners' Loan Corp. v. Rupe, 283 N.W. 108, 108–09 (Iowa 1938); Levant State Bank v. Shults, 47 P.2d 80, 81 (Kan. 1935); Ranier v. Mount Sterling Nat'l Bank, 812 S.W.2d 154, 157 (Wintersheimer, J., dissenting) (Ky. 1991); American Bank & Trust Co. v. Trinity Universal Ins. Co., 194 So. 2d 164, 168 (La. Ct. App. 1966); United Carolina Bank v. Beesley, 663 A.2d 574, 576 (Me. 1995); Waicker v. Banegura, 745 A.2d 419, 423 (Md. 2000); E. Boston Savings Bank v. Ogan, 701 N.E.2d 331, 333 (Mass. 1998); Carl H. Peterson Co. v. Zero Estates, 261 N.W.2d 346, 347–48 (Minn. 1978); Equity Servs. Co. v. Hamilton, 257 So. 2d 201, 203 (Miss. 1972); Metmor Fin. Inc. v. Landoll Corp., 976 S.W.2d 454, 456 (Mo. 1998); First Fidelity Bank v. Travelers Mortgage Servs. Inc., 693 A.2d 525, 527 (N.J. Super. Ct. App. Div. 1997); Roth v. Porush, 722 N.Y.S.2d 566, 568 (N.Y. App. Div. 2001); First Union Nat'l Bank of N.C. v. Lindley Labs Inc., 510 S.E.2d 187, 188 (N.C. Ct. App. 1999); Leppo, Inc. v. Kiefer, Nos. 20097, 20105, 2001 WL 81262, at *1 (Ohio Ct. App. Jan. 31, 2001) (unpublished opinion); King v. Towe, 996 P.2d 948, 949 n.1 (Okla. Civ. App. 1999); Dimeo v. Gesik, 993 P.2d 183, 184 (Or. Ct. App. 1999); Langehans v. Smith, No. 3343, 2001 WL 1154161, at *2 (S.C. Ct. App. May 21, 2001) (opinion withdrawn for procedural reasons at 554 S.E.2d 681, 682 (2001)); Almany v. Christie, No. 94C-83, 1997 WL 71801, at *1 (Tenn. Ct. App. Feb. 21, 1997) (unpublished opinion); Baccus v. Westgate Mgmt. Corp., 981 S.W.2d 383, 385 (Tex. Ct. App. 1998); Mead Corp. v. Dixon Paper Co., 907 P.2d 1179, 1181 (Utah Ct. App. 1995); Kim v. Lee, 145 Wash. 2d 79, 31 P.3d 665, 669 (2001); Piemer v. Computer Res. & Tech., Inc., 577 N.W.2d 388 (Wis. Ct. App. 1998) (unpublished opinion); Gaub v. Simpson, 866 P.2d 765, 767 (Wyo. 1993).

83. NELSON & WHITMAN, *supra* note 22, §10.1, at 737–38.

A. *Courts Agree on the Principles Behind Equitable Subrogation, but Vary as to Its General Applicability*

Courts apply equitable subrogation in the mortgage context primarily to solve priority disputes arising from refinance transactions.[84] The doctrine is an equitable remedy and as such, courts apply it according to equitable principles. Because courts have discretion in applying equitable remedies,[85] jurisdictions apply equitable subrogation differently. While some courts apply it sparingly, others apply it more liberally.

The common factual scenario that raises a request for equitable subrogation involves a refinancing transaction.[86] Essentially, a new party pays off a first priority lien and expects to assume the priority of that lien.[87] A priority dispute arises when an intervening lienor, junior to the original lien but senior to the new lender, seeks an elevation in priority due to the extinguishment of the original lien.[88]

Equitable subrogation is designed to prevent unjust enrichment.[89] When a refinance lender's priority is in doubt due to an intervening lien, courts apply the doctrine based on the refinance lender's justified expectation of receiving security.[90] Courts assume this expectation is justified because most lenders will not loan funds secured by a home unless they obtain a lien with enough priority to protect the lender in the event of default.[91] However, because the doctrine is an equitable one, a court will not apply equitable subrogation if it will prejudice a party.[92] Courts only use equitable subrogation when it will produce an equitable outcome that does not result in an injustice to the rights of a party with

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84. Equitable subrogation in the mortgage context is distinguishable from equitable subrogation in the insurance context. In the insurance context, "[s]ubrogation is an equitable doctrine that allows the insurer to recover from the negligent third party the amount that it has paid to its insured." W. Wash. Corp. of Seventh-Day Adventists v. Ferrellgas, Inc., 102 Wn. App. 488, 507, 7 P.3d 861, 871 (2000).

85. *See* ROBERT N. LEAVELL ET AL., EQUITABLE REMEDIES, RESTITUTION AND DAMAGES 11–12 (5th ed. 1994).

86. *See, e.g., Aames Capital Corp.*, 734 N.E.2d at 495.

87. *Id.*

88. *Id.*

89. NELSON & WHITMAN, *supra* note 22, § 10.1, at 737–38.

90. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES, § 7.6 (1997).

91. *See supra* note 40.

92. *See, e.g.*, Langehans v. Smith, No. 3343, 2001 WL 533203, at *2 (S.C. Ct. App. May 21, 2001) (noting that equitable subrogation cannot be applied when it will work an injustice or inequity on another party), *revised at* 554 S.E.2d 681, 682 (S.C. Ct. App. 2001).

equal or superior equities.[93] Courts may determine the equities of each party by analyzing issues such as notice, negligence, or other equitable factors.[94] Occasionally, courts refer to this process as weighing or balancing the equities of each party.[95]

While most states that have addressed equitable subrogation in the mortgage context analyze the same issues, jurisdictions still apply the doctrine with considerable variation.[96] Missouri, for example, only allows equitable subrogation in extreme cases bordering on or reaching fraud.[97] The remedy is reserved to such extreme cases because, according to the Missouri Supreme Court, courts of equity should be loath to interfere with the legal rights of those who are without fault,[98] such as an intervening judgment creditor. Other courts differ over whether it is worse to grant a windfall to refinance lenders by elevating their lien priority despite recording statutes requiring a different outcome, or to grant a windfall to intervening lienors by elevating the priority of intervening liens due to a title search error.[99]

A court that balances the equities of each party is confined to the circumstances of each case.[100] This reliance on circumstances specific to each situation makes it difficult to develop a generally applicable rule for the equities necessary for application of equitable subrogation. This lack of consistency also makes it difficult to predict how a court will resolve a priority dispute of this type under the all-or-nothing nature of equitable subrogation, in which one party takes complete priority over the other party.

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93. Coy v. Raabe, 69 Wash. 2d 346, 350–51, 418 P.2d 728, 731 (1966).

94. *See* Wilshire Servicing Corp. v. Timber Ridge P'ship, 743 N.E.2d 1173, 1178–79 (Ind. Ct. App. 2001) (noting that subrogation depends on the equities and attending facts and discussing negligence and notice).

95. *See, e.g.*, Osterman v. Baber, 714 N.E.2d 735, 739 (Ind. Ct. App. 1999).

96. *See supra* note 82.

97. Metmor Fin., Inc. v. Landoll Corp., 976 S.W.2d 454, 461 (Mo. Ct. App. 1998).

98. *Id.*

99. *Compare* Brooks v. Resolution Trust Corp., 599 So. 2d 1163, 1165–66 (Ala. 1992) (noting that allowing the intervening lienor to gain priority over the refinance lender results in an unjust windfall for the intervening lienor), *with Osterman*, 714 N.W.2d at 739 (noting that allowing intervening lienor to gain priority over refinance lender does not result in an unjust windfall for intervening lienor).

100. Coy v. Raabe, 69 Wash. 2d 346, 350–51, 418 P.2d 728, 731 (1966); *see also* Wilshire Servicing Corp. v. Timber Ridge P'ship, 743 N.E.2d 1173, 1180 (Ind. Ct. App. 2001).

B. *Courts Differ as to the Effects of Actual and Constructive Notice on the Intervening Lien*

When a refinance lender has actual knowledge of the intervening lien, some courts have been reluctant to subrogate the new lender's lien.[101] Actual knowledge results from the lender being informed that another lien exists.[102] The common justification for actual knowledge barring equitable subrogation is that a lender who extends a new loan with actual knowledge of an intervening lien must not have intended to take a senior priority position.[103] Other courts have allowed equitable subrogation even when the refinance lender had actual knowledge,[104] reasoning that the refinance lender should receive first priority absent a showing: (1) that the intervening lienor detrimentally relied on the release of the original lien; (2) that paramount equities exist in favor of the judgment creditor; or (3) that the refinance lender expressed an intent to subordinate.[105]

When a refinance lender has constructive notice, as when the intervening lien has been recorded but a title search misses its existence, courts differ as to whether the notice bars equitable subrogation.[106] Support for constructive notice barring equitable subrogation lies in the idea that the refinance lender can discover a properly recorded intervening lien; therefore, responsibility for the failure to find that lien lies with the refinance lender.[107] When the priority problem has been created by someone other than the intervening lienor, such as a negligent title insurer, some courts view the equities as favoring the loss being borne by someone other than the innocent intervening judgment creditor.[108] Courts that do not hold constructive notice to bar equitable subrogation justify application of the doctrine as preventing a windfall to the intervening judgment creditor, who would be elevated in priority due

101. *See, e.g., Osterman*, 714 N.E.2d at 738–39.

102. *See id.* at 737–38 (explaining how the refinance lender developed actual knowledge).

103. *Id.* at 739.

104. Rush v. Alaska Mortgage Group, 937 P.2d 647, 650 (Alaska 1997).

105. *Id.*

106. *Compare* Dedes v. Strickland, 414 S.E.2d 134, 136–37 (S.C. 1992) (upholding lower court's decision to deny refinance lender's claim for equitable subrogation when lender had constructive notice), *with Rush*, 937 P.2d at 651(excluding any consideration of constructive notice from equitable subrogation analysis).

107. Landmark Bank v. J.V. Ciaravino, 752 S.W.2d 923, 928 (Mo. Ct. App. 1988).

108. Metmor Fin. Inc. v. Landoll Corp., 976 S.W.2d 454, 462 (Mo. 1998).

to parties releasing the senior lien without knowledge of the intervening lien.[109]

C. *Courts Differ as to How Negligence Affects the Application of Equitable Subrogation*

Negligence is an important component of equitable subrogation analysis. The priority dispute between the refinance lender and intervening lienor may arise in part because a title insurance company failed to find the intervening lien during the title search. Missing a recorded lien implies negligence. However, courts differ as to how negligence should affect equitable subrogation. Both the level of negligence and the sophistication of the parties involved may affect the outcome.

The issue of negligence is closely related to, but different from, the issue of constructive notice. In many cases, the reason the refinance lender has constructive notice of the intervening lien rather than actual notice is that the title company or agent of the lender failed to discover the intervening lien while conducting a title search.[110] This failure may constitute negligence. While jurisdictions differ as to the effect of negligence,[111] some courts hold that a negligent title search should not abrogate the rights of a properly recorded intervening lien.[112] Other courts allow equitable subrogation unless the refinance lender is chargeable with culpable negligence.[113] Culpable negligence, in this context, is an act that a reasonable, prudent, and honest person would not do, or the omission of an act that a reasonable, prudent, and honest person would do.[114]

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109. *See* Brooks v. Resolution Trust Corp., 599 So. 2d 1163, 1166 (Ala. 1992).

110. *See, e.g.*, Suntrust Bank v. Riverside Nat'l Bank of Fla., 792 So. 2d 1222, 1223 (Fla. Dist. Ct. App. 2001).

111. *Compare Suntrust Bank*, 792 So. 2d at 1227 n.3 (interpreting law to allow equitable subrogation despite a party's negligence), *with* Wilshire Servicing Corp. v. Timber Ridge P'ship, 743 N.E.2d 1173, 1178–79 (Ind. Ct. App. 2001) (interpreting law to deny refinance lender's claim for equitable subrogation when that party negligently failed to meet reasonable standards in searching for other liens).

112. *See, e.g.*, *Wilshire Servicing Corp.*, 743 N.E.2d at 1178–79.

113. *See, e.g.*, Smith v. State Savings and Loan Ass'n, 223 Cal. Rptr. 298, 299 (Cal. Ct. App. 1986).

114. Newberry v. Scruggs, 986 S.W.2d 853, 858 (Ark. 1999) (noting that title company's failure to find judgment lien upon two searches amounts to culpable neglect); *Wilshire Servicing Corp.*, 743

The sophistication of a party, due to commercial expertise in the property area, may also affect a determination of culpable negligence. The Washington Supreme Court stated that "[i]t would be a gross misapplication of the doctrine of subrogation were we to hold that its cloak settles automatically upon one who has simply made a mistake, when it is a commercial transaction involving a consideration."[115] Expanding on this notion, other courts have refused to allow title companies and banks to be equitably subrogated based on their failure to find an intervening lien because such companies are sophisticated professionals with experience in the area of secured real property transactions.[116] Ultimately, courts disagree as to whether missing a lien is culpable negligence.[117]

III. BIFURCATION ALLOWS COURTS TO LIMIT INEQUITABLE RESULTS WHEN SETTLING LIEN DISPUTES

California courts have found that bifurcating priority between a senior lienor and a junior lienor prevents inequitable results and serves both parties' interests.[118] Bifurcating lien priorities allows two parties to share first priority on a limited basis. This approach is consistent with the principles behind equitable subrogation and recording laws. Further, the Restatement suggests that bifurcation is the appropriate remedy when a refinance loan prejudices an intervening lienor.[119]

In *Lennar Northeast Partners v. Tahoe Vista Inn & Marina*,[120] the California Court of Appeals analyzed a priority dispute in which a first

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N.E.2d at 1178–79 (noting that equitable subrogation will be unavailable where a party is guilty of culpable negligence).

115. Coy v. Raabe, 69 Wash. 2d 346, 351, 418 P.2d 728, 731 (1966) (stating that a bona fide purchaser is eligible and a title insurer is not eligible for equitable subrogation).

116. Osterman v. Baber, 714 N.E.2d 735, 738 n.4 (1999) (citing Universal Title Co. v. United States, 942 F.2d 1311, 1317 (8th Cir. 1991)).

117. *Compare Wilshire Servicing Corp.*, 743 N.E.2d at 1178–79 (finding that a refinance lender's mistake in searching for other liens is sufficiently negligent to deny the refinance lender's request for equitable subrogation), *with Smith*, 223 Cal. Rptr. at 301 (holding that failing to find a recorded lien is not sufficiently negligent to deny the refinance lender's request for equitable subrogation).

118. While California has developed and applied this approach extensively, at least one other state has applied bifurcation on a limited basis. *See* Aames Capital Corp. v. Interstate Bank of Oak Forest, 734 N.E.2d 493, 501 (Ill. Ct. App. 2000) (limiting refinance lender's first priority to value of original lien at time of new lien's perfection).

119. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES, § 7.6 cmt. e and illus. 28 (1997).

120. 57 Cal. Rptr. 2d 435 (Cal. Ct. App. 1996).

priority lienor modified the terms of the related loan.[121] The second priority lienor was held to have first priority by the trial court because the new terms of the first priority loan were prejudicial to the second priority lien.[122] The Court of Appeals reversed the trial court in part, finding that the first priority lienor continued to have first priority but only to the extent of the original loan terms.[123] The second priority lienor had priority over the prejudicial changes made to the first priority loan.[124]

The specific facts of *Lennar* help illustrate how a bifurcating lien allows two parties to share first priority to a limited extent. In *Lennar*, the lender modified the first lien by extending the term, increasing the principal, and increasing the interest rate.[125] In considering the effects of these new terms upon the respective interests of the parties, the court noted that a senior lienor may extend the time of the loan but only if the extension does not impair a junior lienor's rights and security.[126] The court concluded that extending a loan term in order to prevent a default by the property owner did not by itself create enough prejudice to alter lien priorities.[127] However, increases to interest or principal do create significant prejudice to a second priority lienor.[128]

The principles for deciding if a modified lien should take second priority or receive bifurcated priority are similar to those for equitable subrogation.[129] Bifurcated priorities are created when "the senior lien is modified in any material manner which produces an important impact on the value of the junior lien."[130] In *Lennar*, the court noted that because it had ordered the bifurcation of priorities, the question of equitable subrogation need not be addressed.[131] Equitable subrogation, in the court's opinion, required that the junior lienor be "left in exactly the same junior position he had before."[132] Bifurcating priorities

121. *Id.* at 437.
122. *Id.* at 438.
123. *Id.* at 443.
124. *Id.*
125. *Id.* at 439.
126. *Id.*
127. *Id.*
128. *Id.* at 440.
129. *See supra* Part II.A.
130. *Lennar N.E. Partners*, 57 Cal. Rptr. 2d at 441 (internal quotation omitted).
131. *Id.* at 443.
132. *Id.* (internal quotation omitted).

accomplished this goal of leaving parties in the same position.[133] Thus, bifurcating priorities creates an outcome without prejudice to either party, which is exactly the outcome courts intend for equitable subrogation to create.[134]

The Restatement also recommends bifurcation for priority disputes between intervening lienors that are prejudiced by new lien terms and refinance lenders.[135] In highlighting that equitable subrogation is available only when it does not materially prejudice intervening interests, the Restatement limits a refinance lender's priority to the principal and interest rate that controlled the original first priority lien.[136] A change in the term of the loan by itself is prejudicial only if the change can fairly be said to put the junior lienor in a substantially weaker position.[137] Changes that are materially prejudicial limit equitable subrogation by giving the refinance lender priority only to the extent of the terms of the prior first priority lien.[138] The intervening lienor takes priority over the refinance lender with respect to amounts reflected in the prejudicial changes.[139]

IV. IN *KIM V. LEE*, THE WASHINGTON SUPREME COURT ADOPTED THE RESTATEMENT'S RULE FOR EQUITABLE SUBROGATION, BUT THE COURT DID NOT APPLY THE RESTATEMENT'S REMEDY

The Washington Supreme Court considered the doctrine of equitable subrogation in the mortgage context for the first time in *Kim v. Lee*.[140] The court adopted the Restatement rule for applying equitable subrogation.[141] Once having adopted that rule, the court determined that

133. *Id.*

134. *See, e.g.*, Langehans v. Smith, No. 3343, 2001 WL 1154161, at *2 (S.C. Ct. App. May 21, 2001) (noting that equitable subrogation cannot be applied when it will work an injustice or inequity on another party), *revised at* 544 S.E.2d 681 (S.C. Ct. App. 2001)).

135. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES, § 7.6 cmt. e and illus. 28 (1997). Although the remedy is advocated in some instances, the Restatement does not use the term "bifurcation."

136. *Id.* § 7.6 cmt. e.

137. *Id.* § 7.3 cmt. b.

138. *Id.* § 7.6 cmt. e, and illus. 28.

139. *Id.*

140. Kim v. Lee, 145 Wash. 2d 79, 88, 31 P.3d 665, 669 (2001).

141. *Id.* at 89, 31 P.3d at 670.

the refinance lender's new lien terms were prejudicial and held equitable subrogation inapplicable.[142]

A. *The Facts and Procedural History Present Equities in Favor of Both Parties*

Kenneth and Yuk Ok Chang bought a house for their daughter and son-in-law, Sharon and Stanley Lee, in 1995.[143] The Changs paid for the house by obtaining a first mortgage.[144] While the mortgage was in the Changs' name, the Lees made the payments and occupied the home.[145] In May of 1997, Hu Kim received a default judgment against the Lees for $83,565.37 based on the Lees' failure to comply with a court's discovery orders.[146] Six months later, in December of 1997, the Changs quitclaimed a one-half interest in the home to the Lees.[147] The Lees sought to refinance the home in March of 1998 and did so by paying off the Changs' mortgage to Sterling Trust Company and taking a new first mortgage with Pioneer National Bank.[148] This new refinance loan had an interest rate of 6.75 percent per annum and the loan proceeds were used to pay off the existing first mortgage for which the Changs were responsible.[149] The Changs' original first mortgage had an interest rate of 10.5 percent per annum.[150] The significant differences between the two loans were the loan term and the principal. Sterling Trust Company's mortgage had a six-year term and was due in 2001, while the Pioneer Bank mortgage had a 30-year term and was due in 2028.[151] The principal of the loan was increased by approximately $5,557 to cover lender's fees, title insurance, and escrow fees.[152]

As part of the refinance transaction, Yakima Title conducted a title search for Pioneer Bank and issued a preliminary title insurance policy in

142. *Id.* at 90, 93, 31 P.3d at 670, 672.

143. *Id.* at 82, 31 P.3d at 667.

144. *Id.*

145. *Id.*

146. *Id.* at 82-3, 31 P.3d at 667.

147. *Id.* at 83, 31 P.3d at 667.

148. *Id.*

149. *Id.*

150. *Id.*at 82, 31 P.3d at 667.

151. *Id.* at 82-83, 31 P.3d at 667.

152. Supplemental Brief of Petitioner at 3, Kim v. Lee, 145 Wash. 2d 79, 31 P.3d 665 (2001).

March of 1998.[153] The title report and policy failed to list Kim's judgment lien, which had been recorded almost one year earlier.[154] Yakima Title updated the policy in April of 1998 by conducting a second title search.[155] Although both searches failed to reveal the Kim judgment lien,[156] an expert witness testified at trial that an ordinary search disclosed the lien.[157] Because Pioneer National Bank's deed of trust was assigned to PHH Mortgage Services (PHH), the final title insurance policy did not issue until July 17, 1998.[158] However, Kim's counsel informed Yakima Title of Kim's lien prior to the assignment to PHH.[159]

In 1999, Kim's counsel notified PHH and Yakima Title of Kim's intent to foreclose.[160] Kim then went to the King County Superior Court and obtained a writ of execution on the Lees' property.[161] Yakima Title intervened and filed a motion to quash.[162] The court denied the motion and Yakima Title appealed.[163] The primary question presented to the Washington Supreme Court was whether the doctrine of equitable subrogation should be applied to restore the first lien position to PHH, the refinance lender, over that of Kim, the intervening creditor.[164]

B. *The Washington Supreme Court Adopted the Restatement Rule for Applying Equitable Subrogation but Failed To Apply the Restatement Remedy*

In *Kim*, the Washington Supreme Court expressly adopted the Restatement rule for applying equitable subrogation.[165] However, the court did not apply the remedy that is an integral element of the rule.

153. *Kim*, 145 Wash. 2d at 83-84, 31 P.3d at 667-68.

154. *Id.*

155. *Id.*

156. *Id.*

157. Kim v. Lee, 102 Wash. App. 586, 589, 9 P.3d 245, 248 (2000) *rev'd*, 145 Wash. 2d 79, 31 P.3d 665 (2001).

158. *Kim*, 145 Wash. 2d at 84, 31 P.3d at 667-68.

159. *Id.*

160. *Id.* at 84-85, 31 P.3d at 668.

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.* at 85-86, 31 P.3d at 668. PHH is referred to as the refinance lender for simplicity. PHH is actually the assignee of the refinance lender.

165. *Id.* at 89, 31 P.3d at 670.

Without the proper remedy, *Kim* resulted in the intervening lienor being completely protected and the refinance lender being completely unprotected.

The Restatement rule adopted by the court in *Kim* allows equitable subrogation to elevate a refinance lender to first priority but only to the extent the change in terms does not prejudice junior lienors.[166] Additionally, equitable subrogation is only possible under the Restatement when the senior mortgage was recorded prior to the recording of junior interests.[167] In *Kim*, the court noted that under the Restatement rule it adopted, modifications to the senior lien will cause that lien to lose priority with respect to junior liens but only as to materially prejudicial changes.[168] Contrary to the Restatement, the court also held that actual knowledge on the part of the title insurer bars equitable subrogation.[169]

Having identified the applicable rule of law, the court determined that there were changes reflected in the refinance loan and that at least one was prejudicial. With respect to the increase in principal, the court did not find the change to be significant.[170] Similarly, the court did not find the decrease in the interest rate to be prejudicial.[171] However, the change in the term of the loan from six to thirty years was held to materially prejudice Kim.[172]

In addition to finding that Kim was materially prejudiced, the court held that Yakima Title had actual knowledge of Kim's lien.[173] Actual knowledge, in the court's opinion, bars equitable subrogation because any holding otherwise would vitiate the purpose of Washington's recording statute.[174] Additionally, the court determined that equitable principles prohibit parties from shifting liability for their negligent acts to those who are innocent.[175]

166. *Id.*
167. *Id.*
168. *Id.*
169. *Id.* at 90-91, 31 P.3d at 671–72.
170. *Id.* at 87-88, 31 P.3d at 669.
171. *Id.*
172. *Id.*
173. *Id.* at 90, 31 P.3d at 670.
174. *Id.* at 90-91, 31 P.3d at 671.
175. *Id.*

Having found that Yakima Title had actual knowledge of Kim's lien and that Kim was materially prejudiced by changes in loan terms, the court reinstated the trial court's judgment that denied Yakima Title's motion to establish lien priority for PHH over Kim.[176] With the trial court judgment reinstated, Kim took first priority and was free to proceed with the foreclosure and sheriff's sale.[177] PHH's expectation of a first priority lien was neither addressed nor protected.

V. COURTS SHOULD APPLY BIFURCATION BECAUSE IT BETTER SERVES THE INTERESTS OF EQUITY AND RESOLVES THE ISSUES OF NOTICE AND NEGLIGENCE

The Washington Supreme Court engaged in an equitable subrogation analysis in *Kim v. Lee* and produced an inequitable result.[178] Courts should only apply equitable remedies when justice is advanced.[179] Simply put, the cure should not be worse than the disease. Bifurcation is a better remedy because it offers predictability, protects both parties' interests, and is consistent with the principles of equitable subrogation. Bifurcation also minimizes the inconsistency created when courts deal with notice and negligence on a case-by-case basis.

A. Bifurcating Priorities Is Consistent with the Principles Behind Equitable Subrogation and Other Areas of Law, Offers Greater Predictability, and Protects the Interests of Both Parties

Bifurcation represents a superior solution to priority disputes because it better serves the principles that justify equitable subrogation and is consistent with principles reflected in other areas of law. The outcome created by bifurcation also offers predictability in the resolution of lien disputes. Moreover, bifurcation allows both parties limited protection instead of forcing courts to apply the all-or-nothing remedy of equitable subrogation.

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176. *Id.* at 93, 31 P.3d at 672.

177. *See id.* at 84-85, 31 P.3d at 668.

178. *Id.* at 82, 31 P.3d at 666-67. At least part of the inequity created stems from the court adopting the Restatement's rule for equitable subrogation but failing to apply the recommended remedy of bifurcation.

179. *See, e.g.*, United Carolina Bank v. Beesley, 663 A.2d 574, 576 (Me. 1995) (allowing equitable subrogation when doing so did not prejudice any party's interest and the landowner misrepresented the nature of his ownership in order to secure the refinance loan).

1. *Bifurcation Serves Equitable Principles and Is Consistent with Other Legal Principles*

Bifurcation not only serves the principles behind equitable subrogation, it also advances those principles more than equitable subrogation. The principles behind equitable subrogation include protecting the refinance lender's justified expectation of first priority and leaving the intervening lienor in the same position after the remedy is applied as before the refinance transaction took place. Further, courts must respect the interests of those with superior rights and equities.[180] The advantages of bifurcation with respect to these principles can best be understood by looking at an example of its application.

Revisiting the introductory example involving Eric and Mark, bifurcation would protect Bank B's justified expectation of first priority status up to $145,000, for fifteen years, at an interest rate of eight percent. These terms represent those in place at the time the refinance transaction took place, with the exception of the interest rate, which reflects the better rate Eric obtained.[181] Because Bank B will receive limited first priority, its justified expectation of a first priority lien is protected. At the same time, Mark's position is substantially the same after bifurcation is applied as before the refinance transaction took place because the new lien senior to Mark leaves him in approximately the same position except for the more beneficial loan terms. This outcome respects the rights and equities of both parties.

In addition to serving equitable principles, bifurcation is consistent with principles reflected in other areas of the law. For example, courts give priority to a purchase money security interest (PMSI) in certain cases and a refinance transaction can be considered a PMSI because the refinance funds are replacing funds used to purchase the house.[182] Bifurcation reflects this principle by giving the refinance lender first priority. Similarly, bifurcation is also consistent with the legal notion that a tenant should not be bound by subsequent prejudicial terms negotiated

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180. *See supra* Part II.A.

181. Any lengthening of the term of the loan can be seen as prejudicial to the intervening lienor, even if the purported justification is to prevent the owner's default. Extending the loan's term slows the rate at which equity accrues and this could eliminate a judgment lien under the statutory time limit for such liens. *See supra* Part I.A, C. Additionally, higher loan-to-value ratios have a positive correlation with homeowner default and extending the term would slow the rate at which equity accrues. *See supra* note 67 and accompanying text.

182. *See supra* notes 60–64 and accompanying text.

between a landlord and the assignee of the tenant's lease, but is entitled to enjoy the benefit of more favorable terms.[183] Bifurcation reflects this principle by allowing the intervening lienor to take advantage of more favorable terms offered by the refinance lender. Beyond these legal principles, bifurcation also creates predictability for those with interests in mortgages.

2. *Bifurcation Creates Predictability in Lien Disputes*

Bifurcation is preferable to equitable subrogation for many reasons, not the least of which is the increased predictability bifurcation offers. Because equitable subrogation is an equitable remedy, its application will differ according to the facts and circumstances of each case.[184] This makes predicting outcomes particularly difficult. Bifurcation is a superior remedy because all potential lienors could determine the worst case scenario in the event of a priority dispute. Refinance lenders would know that at worst, courts would award them first priority to the extent of the existing loan terms plus any proposed by the refinance lender that would be more favorable to an intervening lienor. The intervening lienor would know the exact terms to which his lien is subordinate by looking at existing lien terms at the time he records. Equitable subrogation does not allow potential lenders to predict this risk because the remedy is applied in widely varying ways and courts' reliance on the circumstances of each case limits predictability.[185]

If courts always applied bifurcation as the remedy for priority disputes such as the one in *Kim*, refinance lenders would know that their potential risk of loss due to an intervening lienor would be limited to the terms of the existing mortgage. These terms are easily obtained by either asking the homeowner or by examining the records at the county recorder's office. This predictability of risk would benefit homeowners as well as mortgage insurers and secondary mortgage market investors by offering a known level of risk. Presumably, as risk is identified and minimized, mortgage insurance premiums will be lowered and additional capital will be drawn to the secondary mortgage market. Additionally, bifurcation protects the intervening lienor by offering the same ability to predict loss from a priority dispute. This predictability may entice lenders to make

183. *See supra* note 80 and accompanying text.

184. *See* LEAVELL ET AL., *supra* note 85, at 11–12.

185. *See supra* notes 82, 100 and accompanying text.

second priority loans, thereby giving homeowners more financial flexibility and liquidity of capital.

3. *Bifurcation Protects Both Parties and Avoids the Harsh All-or-Nothing Outcome of Equitable Subrogation*

Going back again to the introductory example, bifurcation balances the rights and equities of Mark and Eric by giving limited relief to both. Under bifurcation, assuming again that post-judgment interest and homestead exemptions are not part of the equation, Mark will only need to wait six years and one month for $50,000 in equity to accrue.[186] If Mark foreclosed at that point, Bank B would have received approximately $110,000 in principal and interest payments and would have a second priority lien for approximately $94,000 against a house worth $150,000. At the same time, Mark would be able to foreclose a few months sooner than under the original loan. However, if equitable subrogation were applied, Mark would have to wait until Eric built up enough net equity to allow for foreclosure. Under the terms of Eric's new loan, assuming the value of Eric's home remained the same, Mark will have to wait over eighteen years for $50,000 in equity to accrue. If post-judgment interest is factored in, Mark's lien may never be satisfied.[187] Bifurcation, then, respects the rights and equities of both parties by balancing both parties' need for relief and protection.

Therefore, bifurcation is superior to equitable subrogation because bifurcation avoids the all-or-nothing remedy of equitable subrogation by protecting both parties. Under equitable subrogation, either the refinance lender has a justified expectation protected at the expense of the intervening lienor's rights under recording laws or the expectation of a first priority lien by the refinance lender is ignored. Equitable subrogation also fails to account for the difference in loan terms between the original loan and the refinance loan. This difference in loan terms may significantly prejudice the interests of the intervening lienor. Bifurcation, however, protects the refinance lender's justified

186. The calculations in this section are based on standard amortization tables. Under a bifurcation approach, the intervening lienor would remain in second priority until, under the terms of the original lien modified by any more favorable terms, the terms would allow the intervening lienor to step in and foreclose.

187. Appreciation may not keep up with accruing interest. If simple post-judgment interest of 12% accrued on Mark's lien, when Eric paid off the mortgage in 30 years, Mark's lien would be valued at $230,000.

expectation of priority to a limited extent and offers some protection to the intervening lienor under recording laws. The refinance lender receives priority to the extent of the original loan and the intervening lien is accorded some priority based on it having been recorded first. Bifurcation also accounts for the difference in terms between the original and refinance loans, leaving the intervening lienor in at least as good of a position after the remedy as before the refinance transaction.

B. Bifurcating Priorities Allows Parties To Enjoy the Protection of Notice

Bifurcation maintains the protection created by recording laws. Recording laws allow those with recorded interests to know with certainty how their interests relate to other competing interests in the same property.[188] Subsequent interest holders, with actual or constructive notice provided by the recording of prior interests, cannot gain priority over a prior recorded interest. Because equitable subrogation vitiates this protection, it should be rejected in favor of bifurcation.

1. When Actual Notice Exists, Bifurcation Creates an Equitable Outcome by Protecting Both Parties

Bifurcation offers a more equitable solution to priority disputes when the refinance lender has actual notice of an intervening lien. While some courts make actual notice a bar to equitable subrogation and other courts favor an analysis based on the refinance lender's intent, courts are still faced with an all-or-nothing proposition. Bifurcation allows an outcome that protects both parties.

Where actual notice bars equitable subrogation, courts deny refinance lenders the benefit of the equitable notion that a lender with a justified expectation of first priority should receive it.[189] Alternatively, if actual notice does not bar equitable subrogation, courts deny intervening lienors the protection of recording statutes.[190] Bifurcation ameliorates the harshness of these extremes by recognizing a limited remedy for the

188. *See supra* Part I.B.

189. *See* Rush v. Alaska Mortgage Group, 937 P.2d 647, 651 (Alaska 1997) (noting that, regardless of what a lienor actually knows, it is illogical to release a lien if doing so would prejudice lienor's interests).

190. *See supra* Part I.B.

refinance lender and giving the intervening lienor some protection under recording laws.

The outcome created by bifurcation is consistent with the Restatement's view of actual notice. The Restatement suggests that any form of notice should be immaterial unless there is affirmative proof that the refinance lender intended to subordinate its mortgage.[191] Bifurcation supports this view by granting refinance lenders a limited first priority lien while still providing a disincentive for refinance lenders who might purposefully choose to disregard title searches in favor of relying on equitable subrogation.

2. *When Constructive Notice Is at Issue, Bifurcation Creates More Equitable Outcomes Than Equitable Subrogation and Promotes Stability in the Lending Industry*

Bifurcation produces more equitable results when constructive notice is at issue in the same way it produces more equitable results when actual notice is at issue; namely, bifurcation offers both parties some protection. With both parties protected, courts can produce a more fair and moderate outcome. Additionally, bifurcation allows refinance lenders to predict risk in the event of a priority dispute due to an intervening lienor. This ability to predict risk enhances the stability of the mortgage industry and secondary mortgage market.

Bifurcation is a better remedy than equitable subrogation particularly when constructive notice exists. When the refinance lender is unaware that an intervening lien has been recorded, the refinance loan may be made with a justified expectation of first priority. Conversely, an intervening lienor with a properly recorded interest should expect the protection offered by recording laws. The issue of constructive notice forces courts to decide between giving an intervening lienor the protection afforded by recording laws, like Washington's "race-notice" statute, and giving a refinance lender the equitable relief that is available in many states.[192] As with actual notice, an all-or-nothing priority shift causes extreme results regardless of how courts decide. Bifurcation protects both parties by giving the refinance lender a limited first priority lien and by giving the intervening lienor priority over any prejudicial change in terms.

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191. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 7.6 cmt. e (1997).

192. *See supra* Part I.B and note 82.

The facts in *Kim* present a case where bifurcation would result in a more moderate outcome given that, in contrast to the title insurer, the refinance lender had only constructive knowledge of the intervening lien at the time of refinancing.[193] Bifurcating the PHH and Kim liens would have resulted in PHH receiving priority for $130,000 less two years of payments, at an interest rate of 6.75%, until 2001, when a balloon payment became due. Kim would have had first priority over the $5,557 that was added to the principal during the refinance and could have forced a foreclosure sale in 2001 when the original loan became due. Instead, equitable subrogation would force Kim to wait to foreclose until the Lees accrue sufficient net equity.[194] Because of the slow rate at which equity accrues, Kim may have lost the ability to foreclose altogether given the statutory limit on how long liens on property may exist.[195] While post-judgment interest theoretically compensates Kim for the delay in collecting his judgment, denying a judgment creditor timely compensation because of a negligent title search is inequitable and unjust. Bifurcation would prevent this injustice while minimizing any burden on the refinance lender, particularly in light of the refinance lender's ability to predict this risk.

C. *Bifurcation Prevents the Inequality and Instability Caused by the Inconsistent Treatment of Negligence in Applying Equitable Subrogation*

Bifurcation lessens the disparate effects that occur when courts assess the role of negligence in relation to equitable subrogation. The disparate treatment of negligence with respect to priority disputes produces inequality and instability by forcing an all-or-nothing outcome and destroying predictability in the same way that the disparate treatment of notice produces those results. Because of its mitigating effect, courts

193. *See* Kim v. Lee, 145 Wash. 2d 79, 82, 31 P.3d 665, 666–67 (2001). The distinction between the role of the title insurer and the refinance lender is an important one. *See, e.g., id.* at 93-94, 31 P.3d at 672–73 (Sanders, J., dissenting) (articulating the different roles Yakima Title and PHH played in this case). The issue of whether the title insurer's knowledge is attributable to the refinance lender in equitable subrogation cases has been addressed by at least one other court as well. *See* Newberry v. Scruggs, 986 S.W.2d 853, 858 (Ark. 1999) (holding that acts of negligent title insurer are not attributable to refinance lender absent agency relationship).

194. *See supra* note 35.

195. WASH. REV. CODE § 6.17.020 (2000).

should adopt bifurcation to settle priority disputes in the mortgage context.

Courts have treated the issue of negligence inconsistently when applying equitable subrogation. Specifically, courts have disagreed on whether missing a properly recorded intervening lien constitutes an act sufficiently negligent to bar equitable subrogation. Courts commonly hold that "culpable negligence" is a bar to the doctrine and define culpable negligence as behavior that deviates from that of a reasonable person.[196] However, courts disagree as to whether missing a properly recorded lien during a title search constitutes culpable negligence.[197] This split on the issue of negligence forces an unjust result regardless of the decision because the application of equitable subrogation completely shifts priority in favor of one party or the other despite both having legitimate claims for priority. Bifurcation offers a more equitable and predictable solution because courts can grant both parties some relief.

Bifurcation mitigates the inequality caused by courts' treatment of negligence in equitable subrogation analysis. One view of negligence in the mortgage context sees an injustice when courts deny an innocent intervening lienor an elevation in priority as specified under recording laws because of the fault of another.[198] This view suggests that courts should not impose an equitable remedy when the outcome prejudices subsequently intervening rights.[199] Conversely, some courts find that allowing the intervening lienor to step into the first priority position as required by recording statutes because of another party's mistake results in a windfall for the intervening lienor.[200] Bifurcation ameliorates any harm caused by a windfall to the intervening lienor by granting limited priority to the refinance lender. At the same time, courts will not completely reward the negligence of a title insurance company because the refinance lender's priority is limited to the terms of the original loan. The intervening lienor will receive priority over any prejudicial terms and can gain from any beneficial ones.

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196. *See, e.g.*, *Newberry*, 986 S.W.2d at 858; Smith v. State Sav. and Loan Ass'n, 223 Cal. Rptr. 298, 301 (Cal. Ct. App. 1986).

197. *See supra* Part II.C.

198. *See* Wilshire Servicing Corp. v. Timber Ridge P'ship, 743 N.E.2d 1173, 1179–80 (Ind. Ct. App. 2001).

199. *Id.*

200. Brooks v. Resolution Trust Corp., 599 So. 2d 1163, 1166 (Ala. 1992).

Bifurcation results in both more equitable outcomes for the parties and more stability for the mortgage industry. Because bifurcation has a limiting effect on the risk refinance lenders and intervening lienors face due to negligence, more capital may be put into this market. This will benefit homeowners through lenders competing for the opportunity to loan money.

VI. CONCLUSION

Bifurcation is a superior alternative to equitable subrogation for solving lien disputes in the mortgage context. Bifurcation adheres to equitable principles that equitable subrogation does not and bifurcation protects both parties' interests while creating predictability for all concerned parties. With bifurcation, the refinance lender's expectation of first priority is satisfied to the extent of the original loan terms and the intervening lienor remains in at least as good of a position after the remedy is applied as before the refinance transaction occurred. Courts face an all-or-nothing choice when deciding whether to apply equitable subrogation, and that choice will result in either an intervening lienor being denied the protection of recording laws or a refinance lender being denied the benefit of an equitable remedy. In either case, courts trivialize legal and equitable rights when they put unnecessary obstacles in the paths of parties attempting to enforce those rights.[201] The Washington Supreme Court should adopt bifurcation and reject equitable subrogation upon review of the next case in which this issue is presented in order to eliminate obstacles in the paths of those enforcing their rights.

201. *See* Arthur L. Corbin, *Legal Analysis and Terminology*, 29 Yale L. Rev. 163, 167 (1919). Rights must be paired with remedies that courts will enforce. *Id.*