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Does the Doctrine of Equitable Subrogation Include Mortgage Priority as to Ongoing Interest and Costs?

By: Giles L. Krill, Esq., July 1, 2008

INTRODUCTION

In Massachusetts, the doctrine of equitable subrogation allows “the new mortgage given by a mortgagor, who used the proceeds of the new mortgage to extinguish an earlier mortgage, [to] receive the same priority once given to the earlier mortgage.” East Boston Savings Bank v. Ogan, 428 Mass. 327, 330 (1998). Equitable subrogation allows the new mortgagee to step into the shoes of the prior mortgagee or lien holder for purposes of establishing the priority of its new mortgage over an intervening mortgage or lien. As the Supreme Judicial Court stated:

“[o]ne who fully performs an obligation of another, secured by a mortgage, becomes by subrogation the owner of the obligation and the mortgage to the extent necessary to prevent unjust enrichment. Even though the performance would otherwise discharge the obligation and the mortgage, they are preserved and the mortgage retains its priority in the hands of the subrogee.”

Id., quoting Restatement (Third) of Property (Mortgages) § 7.6(a)(1997).

A court must determine the following in order for equitable subrogation to apply: (i) the subrogee made the payment to protect his or her own interest, (ii) the subrogee did not act as a volunteer, (iii) the subrogee was not primarily liable for the debt paid, (iv) the subrogee paid off the

entire encumbrance, and (v) subrogation would not work any injustice of the rights of the junior lien holder. Id. Further, there is no “bright line” rule concerning subrogee knowledge, actual or constructive; indeed, knowledge is not necessarily fatal to a claim of subrogation. Id. at 331. Equitable subrogation is a broad equitable remedy, and depending on the individual case it may apply even where one or more of these factors is absent. Id.

The most common fact pattern in which the doctrine of equitable subrogation is invoked is where a mortgagee pays off one or more mortgages or liens of record, intending to establish a first priority mortgage of record, but mistakenly overlooks a non-priority mortgage or lien that ascends to first priority position following discharge of the senior mortgages or liens.

Illustration:

M-1 has a first priority mortgage of record with an outstanding balance of X dollars. M-2 has a second priority mortgage of record with an outstanding balance of Y dollars. M-3 pays off the M-1 mortgage in the amount of X dollars, fails to discover the existence of M-2, and intends to establish a first mortgage of record in the amount of Z dollars upon the recorded discharge of the M-1 mortgage. M-2 ascends to first priority after the discharge of M-1.

Equitable subrogation allows M-3 to step into the shoes of the M-1 mortgage and be declared prior in time and prior in right to M-2 to the extent of X Dollars.

One question for Massachusetts appellate courts to clarify is whether or not the amount of priority afforded to the equitable subrogee is a fixed amount (i.e., “X Dollars”) or an amount that goes up and down just as it would have in the hands of the original priority lien holder (i.e., “X Dollars, less principal payments, plus interest, together with costs”).

DISCUSSION

The Defendant(s) in an equitable subrogation case will likely take the position that the party claiming equitable subrogation is, in its best case, entitled to no more priority than the exact

amount paid off. Indeed, it is not uncommon to find lower court decisions that treat equitable subrogation like a photograph of a specific amount paid at a specific point in time. However, in the seminal 1970 decision of Provident Co-operative Bank v. Talcott, 358 Mass. 180 (1970), the Supreme Judicial Court specifically stated that the equitable subrogee obtains priority to the extent of “whatever amount would now be payable . . . had that mortgage not been discharged by mistake.” Id. at 189.

In the Provident decision, the Court held that the equitable subrogee obtained priority to the extent of: a) the amount of senior liens it paid off; b) less payments made by the borrower to the subrogee thereafter, each payment to be applied first to interest due then to outstanding principal; c) plus interest accrued on the principal balance, as reduced; and d) plus any real estate taxes paid by the mortgagee. See id. at 190. The approach by the Supreme Judicial Court in Provident expressly contemplated that the amount of the equitable subrogee’s priority may go up or down, depending on the amount of subsequent payments made by the borrowers, reductions in principal, and interest accrued. See id. The Provident decision also recognized that tax payments made by the equitable subrogee may be added to the amount of its priority position. See id.

If tax payments may be added to the equitable subrogee’s position, then it stands to reason that any escrow deficiency for other expenses covered by mortgage covenants, such as property insurance payments, may be added to the equitable subrogee’s priority position. Another unanswered question is whether foreclosure costs may be added to the equitable subrogee’s priority position. The Provident decision suggests that any costs incurred by the equitable subrogee by reason of the mortgagor’s breach of covenants appearing in the discharged mortgage, including costs incurred in exercise of the statutory power of sale, are properly added to the

equitable subrogee's priority position according to the theory that it constitutes "whatever amount would now be payable . . . had that mortgage not been discharged by mistake." Id. at 189. Where the discharged mortgage and the equitable subrogee's new mortgage contain identical mortgage covenants, the argument is strengthened.

SAMPLE LAND COURT DECISIONS

The Massachusetts Land Court is the preferred forum for bringing a claim of equitable subrogation because Land Court judges have experience in the subject matter of equitable remedies affecting right, title or interest to real property. Varying approaches emerge from their decisions.

In a 2003 decision, a Land Court judge ruled on summary judgment that the plaintiff was entitled to equitable subrogation to the priority position of multiple mortgages and judicial liens that it paid off. See Chase Manhattan Mortgage Corp. v. Kissell, Misc. Case No. 258116 (October 8, 2003)(Lombardi, J.). However, the judge also ruled that it would constitute an unjust enrichment if the subrogee's priority position included accrued interest, including interest that would have accrued on the judicial liens at the statutory rate of 12%. See id.

In a 2007 decision, another Land Court judge ruled on summary judgment that while a mortgage was invalid as to a joint tenant whose one-half interest was deeded to the mortgagor by forgery, the mortgagee was nonetheless entitled to equitable subrogation to the position of a valid mortgage it paid off that encumbered both joint tenants' interests. See Norwest Bank Minnesota, N.A., et al. v. McKinnon, et al., Misc. No. 277955 (December 31, 2007)(Piper, J.). The judge also ruled that the equitable subrogee, whose loan was in default, was entitled to charge the joint tenant interest that would have accrued at the rate of the note it paid off, reasoning that it would result in

an unjust enrichment if her title interest was not subject to the equitable subrogee's accrued interest. See id. The judge specifically recognized that the interest rate added to the equitable subrogee's position was lower than the rate of the new mortgage that did not affect the joint tenant's interest. See id. It is unclear whether the judge would have declined to tack on a higher interest rate where the discharged lien so provided.

In another 2007 decision, yet another Land Court judge ruled on summary judgment that a mortgagee, whose mortgage was granted by only one of two joint tenants owning the property, was entitled to equitable subrogation to the position of a mortgage it paid off that affected both joint tenants' interest. See Option One Mortgage Corporation v. Oakhem, Misc. Case No. 316494 (January 11, 2007)(Long, J.). The judge ruled that the equitable subrogee's position included the exact amount of the mortgage it paid off, making no mention of principal payments, interest, or costs. See id. Presumably, the parties did not raise the issue.

CONCLUSION

There is logic for treating an equitable subrogee as the "equitable assignee" of the mortgage it paid off. In theory, the party seeking equitable subrogation could have asked for and obtained an assignment in lieu of a discharge of the senior lien. The remedy of equitable subrogation exists to restore the parties to the positions they would have occupied had the mistake not occurred in the new mortgagee's title search and closing. Therefore, it would seem equitable for a court to order that the discharge is retroactively converted into an assignment for all purposes, included whatever rate of interest the discharged mortgage secured, together with any costs that may be added pursuant to the mortgage covenants contained in the discharged mortgage.

Whether the interest rate secured by the discharged mortgage is higher or lower than the new mortgage should be irrelevant, since the junior lien holder bargained for a position that stood behind amounts due under such interest rate. Indeed, if both loans stay current, the equitable subrogee's first priority lien will only go down over time. Unless the junior lien holder can point to a palpable form of prejudice it will suffer that somehow differs from what it bargained for in taking a non-priority lien, placing the equitable subrogee in the position of holding an equitable assignment that includes accrued interest and costs is consistent with the principle of not allowing the junior lien holder to obtain an unjust enrichment.

Although the formula set forth in the Provident decision supports adding accrued interest and costs, see 358 Mass. at 190, this issue requires further refinement by Massachusetts appellate case law so that lower courts will have more guidance.

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