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TO BE PUBLISHED

Commonwealth of Kentucky
Court of Appeals

NO. 2008-CA-000262-MR

JOSEPH B. ROBERTS

APPELLANT

v. APPEAL FROM HENDERSON CIRCUIT COURT
HONORABLE STEPHEN A. HAYDEN, JUDGE
ACTION NO. 04-CI-00370

MORTGAGE ELECTRONIC
REGISTRATION SYSTEMS, INC.

APPELLEE

OPINION
REVERSING AND REMANDING

** ** * ** * ** *

BEFORE: COMBS, CHIEF JUDGE; THOMPSON, JUDGE; BUCKINGHAM,¹
SENIOR JUDGE.

THOMPSON, JUDGE: Joseph B. Roberts appeals from an order of the Henderson
Circuit Court granting a motion for default and summary judgment made by

¹ Senior Judge David C. Buckingham sitting as a Special Judge by assignment of the Chief Justice pursuant to Section 110(5)(b) of the Kentucky Constitution and Kentucky Revised Statutes (KRS) 21.580.

Mortgage Electronic Registration Systems, Inc. (MERS). Roberts argues that the trial court erred when it applied the doctrine of equitable subrogation and held that MERS's lien had priority over his lien in a foreclosure action. We reverse and remand the case for further proceedings.

On November 5, 1993, Jeffrey A. Michael and Mary J. Michael purchased real property located at 6515 Tandy Lane in Henderson, Kentucky, for \$10,000. On the same date, the Michaels granted a mortgage secured by the Tandy Lane property to Farmers Bank & Trust Co. in the amount of \$9,600.

Subsequently, the Michaels refinanced the property and secured notes in much higher amounts than its original purchase price. On April 5, 1994, the Michaels mortgaged the property to Farmers Bank for \$64,200. On August 24, 1994, they mortgaged the property to Farmers Bank for \$74,800. On December 13, 1996, they mortgaged the property to Kentucky Finance Co. for \$100,760.76. On August 26, 1998, they mortgaged the property to The Money Store Home Equity Corp. for \$108,800.

On June 28, 2000, Roberts recorded a judgment lien of \$25,894.63 against the property.

Three years after Roberts recorded his lien, on September 18, 2003, the property was mortgaged for \$125,800 to New Century Mortgage Corp. According to an affidavit of the assistant vice president of MERS, the proceeds from the New Century loan were used to pay off the 1998 mortgage held by The Money Store, which was then released of record. MERS's complaint alleges that

on September 18, 2003, New Century received a note and mortgage from Jeffrey A. Michael and Mary J. Michael in the amount of \$125,800. They further alleged that just ten days after the execution of the above note and mortgage for consideration of \$89,584.36, MERS received an assignment of the New Century mortgage. New Century then recorded its mortgage of September 18, 2003, on October 7, 2003, in mortgage book 830 at page 664 of the Henderson County Court Clerk's Office. The assignment of the mortgage to MERS which had been executed prior to the recording of the New Century mortgage was not recorded until March 22, 2004. There is no explanation of why New Century Mortgage Corp. would distribute \$125,800 to the borrowers at closing, then just ten days later sell the mortgage and note obligation for \$89,600.

MERS filed a foreclosure action against the Michaels on May 17, 2004. Because of his judgment lien, Roberts was named as a defendant. He filed an answer, counterclaim, and cross-claim, arguing that his judgment lien, recorded on June 28, 2000, had priority over MERS's lien.

The circuit court entered summary judgment in favor of MERS, giving its lien priority over Roberts's through the application of the doctrine of equitable subrogation. It ruled that MERS had, in effect, stepped into the priority position of the 1998 lienholder when it assumed the New Century mortgage. The court concluded that the proceeds from the foreclosure sale of the Michaels' property must be first applied to pay MERS and any proceeds remaining after the disbursement to MERS applied to Roberts's judgment lien.

There is no factual dispute that Roberts's judgment lien was filed prior to the lien sought to be asserted by MERS and that a proper title search would have revealed Roberts's lien. However, MERS relied on a title insurance company that did not issue a title insurance policy nor discover Roberts's lien.

When determining the priority of liens, the statutory law in this Commonwealth is that the race-notice procedure is to be followed. KRS 382.280 provides that: "All bona fide deeds of trust or mortgages shall take effect in the order that they are legally acknowledged or proved and lodged for record." The recording statutes provide an orderly system that gives notice to those who seek to secure a subsequent interest in the property and for a sequential method for the payment of the obligor's debts. Thus, absent an exception to the clear language of the statute, Roberts must prevail.

Before discussing the argument advanced by MERS, we distinguish those cases where a subsequent lienholder was a purchase money lender. In *Kentucky Legal Systems Corp. v. Dunn*, 205 S.W.3d 235 (Ky.App. 2006), the Court held that the purchase money lien was superior to a prior judgment lien regardless of the mortgagees' knowledge of the lien and its failure to search for judgment liens. *Id.* at 237. A subsequent purchase money vendor will prevail over a previously filed judgment lienholder for a fundamentally practical and fair reason: "Without this advance of money, the purchaser-mortgagor would never have received the property and the other claimants would never have had the opportunity to satisfy their claims from such a convenient source." *Id.*, quoting

Restatement (Third) of Property, Mortgages, § 7.2 (1997). However, because MERS did not hold a purchase money mortgage, the reasoning of the Court is not helpful to the resolution of this case.

Faced with its status as an assignee of an existing mortgage, MERS urges that we avoid the recording statutes by invocation of the judicially created doctrine of equitable subrogation and relies on *Louisville Joint Stock Land Bank v. Bank of Pembroke*, 225 Ky. 375, 9 S.W.2d 113 (1928). Because we are requested to circumvent the result unequivocally mandated by our recording statutes and apply a judicially-created doctrine, we examine the doctrine of equitable subrogation with heightened scrutiny and apply it with caution, limiting it to facts that compel the intervention of equity.

Although equitable subrogation was applied in *Louisville Joint Stock Land Bank*, the Court's language reveals that its scope is narrow. It began its analysis with the prefatory observation that "[s]ubrogation is a creature of equity, and rests upon principles of natural justice." *Id.* at 115. To invoke equitable principles, the proponent of equitable subrogation must demonstrate that the facts justify the relief sought. The Court recognized the general rule that if a mortgage has been released or satisfied through accident or mistake, it may be restored in equity and given its original priority as a lien only if an intervening third party will not be prejudiced by the lien's reinstatement. *Id.*

Facts crucial to the Court's decision in *Louisville Joint Stock Land Bank* were that the borrower and the Bank of Pembroke had an agreement that the

Bank would subordinate its mortgage to a new mortgage acquired by Louisville Joint Stock Land Bank. At the time the loan was closed, the borrower supplied an affidavit acknowledged before a Bank of Pembroke employee that there was no lien on the property. The Court stressed that no harm could be caused by the reordering of liens because priority was given to Louisville Joint Stock Land Bank only to the extent that it paid the first mortgage. Under the circumstances, the Bank of Pembroke was precluded from asserting a superior lien. The Court summarized the rule as follows:

[W]hen the holder of a first mortgage takes a new mortgage as a substitute therefor and releases the original mortgage, in ignorance of an intervening lien upon the mortgaged premises, and especially if the release is induced by fraud or misrepresentation on the part of the mortgagor, equity will, in the absence of laches or other disqualifying fact, restore and reinstate the lien of the first mortgage and give it its original priority.

Id. at 116.

The relief afforded a mortgagee depends on the prejudice caused to a prior lienholder. Equity cannot reward those who through lack of diligence lose a legal right to the detriment of another who has taken all precautions to protect the same legal right. Yet, MERS seeks this precise result.

The facts reveal a convoluted lending history by financial institutions regarding a single property with an original mortgage of \$9,600 in 1993, which during the following ten years was encumbered to the extent of \$125,800. The Michaels' property was encumbered by successive mortgages, each securing a

higher debt and, apparently, little deference was given the Michaels' ability to repay the debt and without consideration of the existing liens on the property. Further complicating the scenario was that Roberts's judgment lien was filed before New Century's mortgage; thus, New Century's lien was inferior to Roberts's judgment lien. Absent circuitous reasoning that New Century's lien was superior to Roberts's previously filed lien, MERS was assigned a mortgage subject to Roberts's judgment lien.

MERS argues that its lack of diligence in discovering Roberts's lien should be ignored because no prejudice would be incurred by Roberts if its lien was given priority. MERS points out that it seeks priority only to the extent of \$89,584.36, the amount MERS paid New Century.

MERS's contention is made without consideration of the practical implications of the liens filed after Roberts filed his judgment lien. The New Century loan assigned to MERS was substantially higher than the Money Store lien. Consequently, the Michaels' equity was decreased and impaired their ability to pay, which ultimately lead to foreclosure. If the property is sold for an amount insufficient to repay both MERS and Roberts because of the reordering of lien priorities, Roberts's interest will be entirely or partially defeated. We cannot say with certainty that Roberts will not be prejudiced and, therefore, deny MERS's claim to assert priority.

In hindsight, there is no question that MERS made a bad business deal and may or may not recover the amount paid New Century for the assignment of

the mortgage. However, it is not the role of equity to compensate a party for its lack of sound financial judgment. MERS and New Century are sophisticated financial institutions who must be held to a standard of reasonableness. At the time New Century took its mortgage and MERS was assigned the mortgage, Roberts's lien was properly filed. A simple assignment of the prior Money Store mortgage, or an adequate title search, or a title insurance policy from a legitimate title insurance company would have prevented MERS's potential loss. Under the circumstances, this Court declines to save MERS from its lack of diligence to the detriment of Roberts and in derogation of our recording statutes.

Based on the foregoing reasoning, we hold that the circuit court erred when it reordered lien priorities to Roberts's detriment. Therefore, the circuit court's order is reversed and the case remanded for entry of an order prioritizing the liens in accordance with KRS 382.280.

COMBS, CHIEF JUDGE, CONCURS.

BUCKINGHAM, SENIOR JUDGE, DISSENTS AND FILES
SEPARATE OPINION.

BUCKINGHAM, SENIOR JUDGE, DISSENTING: Because I believe that the doctrine of equitable subrogation as used in the *Louisville Joint Stock Land Bank* case should be applied herein, I respectfully dissent. The majority holds that the circuit court erred to Roberts's detriment when it reordered the priority of liens to give MERS's mortgage priority over Roberts's judgment lien. There appears to be no question that the New Century mortgage was a

refinancing of The Money Store mortgage, which was superior to Roberts's lien. Therefore, I fail to see how Roberts suffered any prejudice when the trial court held that MERS's mortgage, which was an assignment of the New Century mortgage, had the same priority as The Money Store mortgage. As the court in *Louisville Joint Stock Land Bank* held, the equity of the intervening lienholder was not affected. *Id.* at 115.

The majority stresses that an equitable doctrine such as equitable subrogation should not be applied to reward MERS because it lacked diligence. I do not quarrel with the majority's conclusion that MERS lacked diligence when it overlooked Roberts's lien before taking an assignment of the New Century mortgage. Nevertheless, in the absence of prejudice to Roberts, and I conclude there is none, I believe the doctrine of equitable subrogation should be applied. *See Louisville Joint Stock Land Bank* at 116.

Finally, although the point is now moot, I believe MERS's priority over Roberts is only to the extent of the Michaels's debt to The Money Store at the time of the New Century mortgage.

BRIEF AND ORAL ARGUMENT
FOR APPELLANT:

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BRIEF FOR APPELLEE:

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