The Land of Aas, or, Dorothy, We’re Not in Kansas Anymore .......................... 3
By John Paul Hanna and David Van Aria
A review and discussion of the landmark decision, Aas v. Superior Court, in which the California Supreme Court ruled that construction defects in residential housing were actionable only if the defect caused actual personal injury or property damage, the legislative response, and recent court cases.

Mortgage Shotgunning and the Priority of Trust Deeds ................................. 9
By Scott Talkov
This article reviews recent California case law concerning the priority of trust deeds among lenders targeted by the real estate fraud known as mortgage shotgunning. The cases create a district's split among the California Courts of Appeal when evaluating identical facts. In these cases, the county recorder's delay in indexing recorded documents gives rise to a claim from the holder of the second deed recorded interest that it did not receive constructive notice of the first deed recorded interest. The author recommends that the California Supreme Court resolve this circuit split by establishing that the first deed recorded interest by a bona fide purchaser or encumbrant be declared first in priority pursuant to California's statutory notice-recording system.

MCLE Self-Study Article: Real Estate Broker Exculpatory Clauses: Their Use and Misuse ......................................................... 14
By Edward W. Newman
Real estate brokers have an obvious interest in limiting their own professional liability arising out of transactions they handle. This article examines the legal validity and the propriety of provisions included in real estate contracts purporting to restrict the ability of clients or parties to a transaction to seek legal recourse against the real estate broker involved in the transaction.

Loan Modification Law in California .......................................................... 21
By Harold Justman, Scott D. Rogers, and Henry Chuang
This article will provide a brief summary of recent case decisions that have provided judicial precedents forming a foundation for meaningful contract rights entitling California homeowners to permanent modifications of their home loans.

Practice Tip: Using a Prevailing Party’s Pre-Trial Conduct to Reduce Attorneys’ Fees ................................................................. 27
By Jody Burgess
This article examines a litigant's ability to reduce a prevailing party's award of attorneys' fees in a real estate contract dispute by focusing on the prevailing party’s pre-trial conduct and its potential to have unnecessarily increased litigation, thereby warranting an equitable reduction in the fees award otherwise due.
Mortgage Shotgunning and the Priority of Trust Deeds

By Scott Talkov

©2014 All Rights Reserved.

I. MORTGAGE SHOTGUNNING FRAUD

The real estate fraud known as "mortgage shotgunning" or "mortgage slamming" occurs when a homeowner obtains multiple loans secured by the same home in order to receive loan proceeds that, in combination, greatly exceed the value of the real property. The homeowner commits fraud by failing to inform each lender that s/he has obtained multiple loans secured by the same property. The homeowner then absconds with the proceeds of the multiple loans on the same property.

This species of real estate fraud, declared to be an "alarming trend" in 2009, is difficult to detect because of the delay between the trust deed recordation date and the date on which the recorded trust deed is available for discovery by title searchers. Each lender is thereby led to believe that it will have a fully-secured, first-priority trust deed. Indeed, defrauding parties generally use multiple title insurers, notaries, escrow companies, and lenders to reduce the chance of fraud detection before the defrauding party can abscond with the funds.

After falling victim to this fraud, lenders find themselves in a dispute over which lender has a fully-secured, first-priority interest in the subject property. Those without a first-priority lien hold a less-secure, potentially worthless interest in the real property.

The resulting litigation between victimized lenders (often funded by their respective title insurers) has been decided differently in California's Fourth District Court of Appeal (Riverside) and Second District Court of Appeal (Los Angeles). Each district has reached opposite conclusions as to the priority of competing trust deeds recorded by victims of mortgage shotgunning. This district split raises fundamental questions about California's race-notice recording system. In these cases, good faith purchasers (encumbrancers) without notice of an existing trust deed, have recorded their trust deeds shortly after the recordation of an immediately preceding trust deed. Each case also involved a claim that the date on which the county recorder indexes the trust deed changes the priority of those interests from the assumed priority under the race-notice system. However, the two courts reached opposite conclusions, creating a district split that should be reconciled by the California Supreme Court.

II. THE RACE-NOTICE RECORDING SYSTEM

The recording priority of trust deeds in California (and many other states) is governed by the state's race-notice recording statutes, which allow a lender or purchaser to obtain an interest in real property that has priority over another interest in the same real property by:

(a) Acquiring the interest as a bona fide encumbrancer (i.e., lender) or purchaser for valuable consideration, meaning that s/he pays consideration in exchange for an equity or fee interest in certain real property, while possessing neither actual knowledge nor constructive notice of a previously created interest in that property; and

(b) "First duly record[ing]" the interest, meaning that the lender or purchaser records the granting instrument before any competing interest in the property is recorded.

In California, these rules were codified long ago in 1872. Specifically, Civil Code section 1213 states that recorded documents provide constructive notice to third parties, thereby preventing anyone with a subsequently recorded interest from wresting title to the property from the holder of current title without paying value for that interest.

Central to the disputes in mortgage shotgunning litigation, Civil Code section 1107 provides that "[e]very grant of an estate in real property is conclusive against the grantor, also against every one subsequently claiming under him, except a purchaser or encumbrancer who in good faith and for a valuable consideration acquires a title or lien by an instrument that is first duly recorded."

Another pivotal statute in these disputes is Civil Code section 1214. This statute reads in relevant part, "[e]very conveyance of real property . . . is void as against any subsequent purchaser or mortgagee of the same property . . . in good faith and for a valuable consideration, whose conveyance is first duly recorded." The essence of Civil Code section 1214 lies at the heart of mortgage shotgunning litigation. It "renders an unrecorded conveyance void as to subsequent bona fide purchasers who record their title first."

When lenders record their secured interests in real property and fund a loan with hundreds of thousands of dollars (or more) in consideration, only to later find that their interests may be worthless, litigation frequently ensues. In such litigation, lenders with a "duly recorded" deed of trust often assert that a recorded document does not provide notice to third parties until it is indexed by the county recorder, perhaps several days after recordation. This argument tests the very purpose of the race-notice recording system.

III. SIMULTANEOUSLY RECORDED TRUST DEEDS ARE EQUAL IN PRIORITY

The California Court of Appeal has been called upon twice in recent years to determine the priority of simultaneously recorded trust deeds. Although neither case mentions "mortgage shotgunning," the fact that they involve bona fide encumbrancers disputing the priority of their lien rights in the same real property suggests that that this form of mortgage fraud gave rise to the disputes.
In 2011, the California Second District Court of Appeal in Los Angeles issued a published opinion in First Bank v. East West Bank in which lenders with loans secured by the same residential real property dropped off their trust deeds at the Los Angeles County Registrar-Recorder/County Clerk before it opened, causing both trust deeds to be file stamped as if they were recorded at 8:00 A.M. the same morning.\(^{10}\) One lender claimed that its trust deed was first in priority because its deed had been indexed first.\(^{11}\) The court rejected this argument, finding that it "would disrupt the statutory scheme to make priority turn on the random act of indexing," a process that allows the county recorder to find instruments in its computerized database.\(^{12}\) Instead, the court deemed the lenders to hold interests of equal priority in the subject property. This decision drew considerable attention among mortgage attorneys, including Golden Gate University Professor of Law Roger Bernhardt, who wrote an article advising lenders on how to deal with tied priority.\(^{13}\)

In 2012, the California Fourth District Court of Appeal in San Diego authored an unpublished opinion in Baer v. Douglast.\(^{14}\) In Baer, two trust deeds were time and date stamped as though they were recorded at the same moment in time. One lender contended that its lower recording number indicated an earlier priority, and should break the tie. The court rejected this argument, finding that neither the sequence of the recording numbers stamped by the recorder on the parties' simultaneously recorded trust deeds nor the sequence of the page numbers where the trust deeds appear in the official records, determined the relative lien priority of each trust deed. Instead, the court upheld the holding and reasoning in First Bank, that the time of recordation is the only relevant factor in determining priority.\(^{15}\) In other words, indexing plays no role in the court's analysis.

These cases highlight the unwillingness of courts to disrupt the conclusion dictated by the race-notice system, that the first, duly recorded interest maintains priority over others, even when two trust deeds are both recorded "first." While each of these cases involved a determination that each of the defrauded lenders would share in the loss, a more difficult problem arises when courts must decide which defrauded lender will take no loss whatsoever, with all other defrauded lenders bearing the full loss.

IV. DISTRICTS ARE SPLIT AS TO WHICH TRUST DEED HAS RECORDING PRIORITY AMONG TRUST DEEDS RECORDED AT DIFFERENT TIMES BY GOOD FAITH PURCHASERS WITHOUT NOTICE

Although simultaneous recording raises fascinating legal issues, more frequently, multiple interests in the same real property are recorded close in time, but not concurrently, and neither interest holder has actual or constructive notice of the other interest at the time its deed records. Courts addressing this fact pattern in two unpublished cases have reached opposite conclusions as to which trust deed has priority over the other, an issue due for resolution by the California Supreme Court.

A. Simental: The First Duly Recorded Interest Wins

In 2010, the California Fourth District Court of Appeal in Riverside decided the case of Simental v. Inyo-Mono Title Co. Profit-Sharing Plan.\(^{16}\) In Simental, two bona fide encumbrancers paid value for what each thought was the trust deed in first lien position on a parcel of real property. The later-recording party argued that it did not have constructive notice of the first-recorded trust deed because that deed had not been indexed by the county recorder when the later-recording party recorded its interest. The Simental court determined that "the question is not whether [the later-recording party] had constructive notice" of the first-recorded trust deed, but rather, who recorded first.\(^{17}\)

Simental made the rule quite clear, concluding that the first-recorded trust deed "won the race to the recorder's office." Hence, the lender under the first-recorded trust deed held the lien in first priority on the subject property.\(^{18}\)

B. Bank of East Asia: The Second Duly Recorded Interest Wins

In 2013, the California Second District Court of Appeal in Los Angeles came to the opposite conclusion in Bank of East Asia U.S.A. N.A. v. Javaherian.\(^{19}\) The facts of that case were identical to those in Simental:

The [Javaherian] deed of trust was recorded in the recorder's office on March 2, 2005. The Bank's deed of trust was recorded in the recorder's office on March 3, 2005. The [Javaherian] deed of trust was indexed in the recorder's office records on March 5, 2005, and the Bank's deed of trust was indexed on March 7, 2005.\(^{20}\)

Based on these facts, the Bank argued that its deed of trust had priority over the Javaherian deed of trust, because the Bank had no actual or constructive notice of the Javaherian deed of trust.

After quoting First Bank v. East West Bank extensively, the Court of Appeal reasoned that "[a]lthough the [Javaherian] deed was recorded first, it failed to provide subsequent purchasers and encumbrancers with constructive notice until it was indexed. Therefore, when the Bank's deed of trust was duly recorded, the Bank was not charged with constructive notice of the prior deed of trust and the Bank's interest is not subject to the [Javaherian] deed of trust."

The court concluded that the second-recorded trust deed had priority, reasoning that "[b]etween the two innocent parties in this case, Javaherian was in the best position to protect her interest by promptly recording the [Javaherian] deed of trust and verifying that it had been properly indexed."\(^{21}\) Apparently, the court was critical that Javaherian did not record her deed of trust upon execution on February 7, 2005, but recorded her deed of trust nearly a month later, on March 2, 2005. In contrast, the Bank executed its deed of trust on February 28, 2005, and recorded it three days later, on March 3, 2005.

No statute or precedent provides a balancing test in a situation involving two innocent lenders, nor does any test determine which party is in the "best position" to protect its interest by promptly recording and/or verifying the indexing of its trust deed. Either party could have done so here.

Further, even if Javaherian had undertaken such an effort, the situation would not have changed. For example, if Javaherian had verified on March 5 or 6, 2005, that the Recorder's Office had indexed her trust deed, Javaherian would not have had notice of the Bank's trust deed recorded on March 3, 2005. This is because the Recorder's Office did not index the Bank's trust
V. AUTHOR'S RECOMMENDED APPROACH: THE FIRST DUTY RECORDED INTEREST SHOULD PREVAIL

The disparate outcomes of the recent mortgage shotgunning cases raise the issue of whether the first duly recorded interest should prevail. The author argues that it should.

Some courts have decided, and many litigants have argued, that later-recording interests should be first in priority because the first-recorded interest did not provide constructive notice to the later-recording parties. These arguments rely upon "[the purpose of our recording statutes[. which] is to give notice to prospective purchasers or mortgagees of land of all existing and outstanding estates, titles, or interests in it whether valid or invalid, which may affect their rights as bona fide purchasers and so as to protect them before they part with their money]."

However, the recording statutes further encourage such notice by "penaliz[ing] the person who fails to take advantage of recording." Indeed, the severe penalty found in Civil Code section 1214 grants priority to the "first duly recorded" interest without regard to whether third parties have constructive notice of that interest at the moment of recording or at any time thereafter. As such, the statute embodies the "race" of the race-notice recording statutes by encouraging all parties to promptly record their interests. Hence, the statute serves as the tiebreaker in all disputes between interests in real estate because it dictates that the first duly "recorded" interest prevails.

The argument made by later-recording lenders, such as the lender in *Simental*, that lack of constructive notice is sufficient to obtain priority misses the point. Race-notice recording statutes seek to provide constructive notice. They may not do so instantly or perfectly, but the system aims to provide this type of notice nonetheless. However, whether a subsequently recorded lienholder has constructive notice of an earlier lien on the same real property is not determinative of the priority of a duly recorded interest.

In fact, the modern reality of the title insurance industry is that title insurance companies maintain their own title plants to search recorded instruments. As such, the litigation in this area of law seemingly results from private title searches performed earlier than the date on which the funds were issued or from delays in the indexing of instruments by private title-plant owners—not from reliance on the indexing function of the county recorder.

VI. EQUITABLE SUBROGATION AS AN ALTERNATIVE THEORY TO DECIDE PRIORITY

Lenders facing a complete loss of principal on a secured investment have developed creative arguments in their attempt to avoid the harsh consequences of the race-notice rule. One theory that a recording party may rely upon is the doctrine of equitable subrogation.

In 2012, the Fourth District Court of Appeal in Santa Ana applied equitable subrogation to resolve a dispute between lenders regarding the priority of their trust deeds in *J.P. Morgan Chase Bank, N.A. v. Banc of America Practice Solutions, Inc.*

In Chase, the borrower sought to re-finance his house with a senior lien in favor of Chase. Unbeknownst to Chase, the borrower simultaneously obtained a business loan that was to be secured by a junior lien on his house in favor of Banc of America. Contrary to Banc of America's understanding and the borrower's intentions, Banc of America secured its lien first, followed thereafter by Chase paying off the pre-existing deeds of trust and recording what it thought would be a senior deed of trust. California's "first in time, first in right" system of lien priorities dictated that Chase had a junior lien, absent judicial intervention.

Instead, the court found that this rule "is not without exceptions," quoting Civil Code section 2897 to find that "[o]ther things being equal, different liens upon the same property have priority according to the time of their creation." The court found that this exception for equitable subrogation was best stated by the California Supreme Court in 1928:

One who advances money to pay off an encumbrance on realty at the instance of either the owner of the property or the holder of the encumbrance, either on the express understanding, or under circumstances from which an understanding will be implied, that the advance made is to be secured by a first lien on the property, is not a mere volunteer; and in the event the new security is for any reason not a first lien on the property, the holder of such security, if not chargeable with culpable and inexcusable neglect, will be subrogated to the rights of the prior encumbrancer under the security held by him, unless the superior or equal equities of others would be prejudiced thereby, and to this end equity will set aside a cancellation of such security, and revive the same for his benefit.

Because Chase paid off the pre-existing liens except that of Banc of America, the only question for the court was whether Banc of America's "equities are equal to or greater than Chase's." Finding that "[e]quitable subrogation looks to the intentions of the parties," the court found that Chase's later-recorded trust deed was senior to Banc of America's earlier-recorded trust deed because that order of priority was "exactly what [the parties] bargained for." Indeed, Chase expected to receive a senior trust deed, and Banc of America expected to receive a junior trust deed.

Although the *Chase* court noted that "constructive notice, as opposed to actual notice, does not forestall application of equitable subrogation," it seems unlikely that the court would have reached the same result if Chase had simply relied upon the borrower's representation that the trust deed would be senior without conducting any title search to find that Banc of America had recorded its trust deed. In this case, the Banc of America trust deed was "intervening" in the sense that it was filed after
Chase began its loan process, though it was recorded over two months before Chase recorded its trust deed.

As explained above, equitable subrogation requires that the party claiming the doctrine is "not chargeable with culpable and inexcusable neglect." If Chase had delayed too long before recording its trust deed, the excusable neglect requirement in equitable subrogation would suggest that the doctrine should not be applied.

Moreover, as between lenders in mortgage shotgunning situations, equitable subrogation cannot be asserted. Specifically, equitable subrogation is available "unless the superior or equal equities of others would be prejudiced thereby." In the context of mortgage shotgunning litigation between lenders, each lender has equal equities as each lender intended to have first priority. Hence, equitable subrogation should not apply, because neither lender intended to hold a junior interest in the property. Granting priority to a later-recording interest would violate the principal that equitable subrogation cannot be applied when it would be to the prejudice of a party with equal equities, namely the earlier-recording lender. This situation is in contrast to the situation in Chase, where the first-recording party expected to hold a junior lien, but unexpectedly held a senior lien.

Thus, in mortgage shotgunning situations where each lender does not have notice of the other's security interest in the subject real property, and is unaware that they may hold a junior interest, the first-recording party has superior equity. This alone should prevent application of equitable subrogation.

VII. PROPOSAL FOR ELECTRONIC RECORDING

Many of the issues complained of in mortgage shotgunning litigation could be resolved by a publicly-accessible electronic recording system.

Such a system would allow a user to log on, choose the relevant assessor's parcel number for the applicable property, and upload the document. In addition, the county recorder could instantly produce a receipt showing all documents recorded prior in time to the user's document, including those that are still pending human review by the county recorder. Under this system, if no such documents exist, a lender could fund loans worry-free, provided that courts uniformly agree that first in time is first in right. If another user submitted a document one second later, that user would see the newly uploaded document preceding his or hers, thereby providing constructive notice to the subsequent lender not to fund the loan.

VIII. FINAL LESSON: RECORD PROMPTLY

Until and unless changes are made, lenders, title companies, and their counsel should learn from the existing case law in this area. The lesson is clear: a lender should promptly record its secured interests in real property to protect its priority. Moreover, lenders and title officers may be wise to conduct another title search several days after recording and before funding the loan (if possible), to determine if any earlier-recorded documents have been indexed. Finally, the decision in Bank of East Asia suggests that yet another title search should be conducted several days after the operative trust deed has been indexed, to determine whether a competing trust deed was later-recorded.

ENDNOTES


2 A homeowner without an existing lien on the property can engage in mortgage shotgunning by simply accepting multiple payments to purchase or refinance their property.

3 Although mortgage shotgunning raises a number of interesting legal issues, this article focuses solely on the litigation between lenders under the race-notice statutory scheme in California.


5 California's anti-deficiency laws would seemingly be unavailable to protect the perpetrator of mortgage shotgunning fraud as "[t]he defense of sections 580b and 580d prescribing deficiency judgments is not available to the trustor as a defense to an action by the beneficiary for fraud." Glendale Fed. Sav. & Loan Ass'n v. Marina View Heights Dev. Co., 66 Cal. App. 3d 101, 139 (1977).


7 Although these two statutes are often cited concurrently, Civil Code section 1107 relates to a "grant of an estate," which would include grant deeds. On the other hand, section 1214 relates to "[e]very conveyance of real property," which includes trust deeds.


10 First Bank, 199 Cal. App. 4th at 1311.

11 Indexing presumably occurs in the order that the interests are numbered, even though such unique identifiers may reflect interests that are deemed recorded at the same moment in time.

12 No argument was made in this case that lenders or title insurers utilize or rely upon the county recorder's indexing system, as opposed to the title plants maintained by title insurers.


15 Id.


17 Id. at 14.

18 Id. at 15.
The absence of notice is a necessary, but not sufficient, requirement for status as a bona fide purchaser or encumbrancer. See First Bank v. E. W. Bank, 199 Cal. App. 4th 1309, 1314 (2011) ("The absence of notice is an essential requirement in order that one may be regarded as a bona fide purchaser.").