

Advanced Issues in Foreclosure



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**A Review of Complicated Priority
Disputes And Lien
Issues Under California Law**

Submitted by Terrance J. Evans

A Review of Complicated Priority Disputes And Lien Issues Under California Law

By Terrance J. Evans, Esq.

For nearly a decade, I have represented numerous banks, private lenders, and financial services companies in a wide range of secured transactions and complex commercial litigation in federal and state courts throughout the United States. During that time, I have become well acquainted with complicated priority disputes and lien issues. This article will provide a brief overview of California law with respect to priority disputes and lien issues involving real property collateral, and will also provide some helpful tips for lenders seeking to minimize their exposure from priority disputes and lien issues on loans that they make in California.

I. A Review of California Priority Rules

Before delving into some of the more complicated aspects of priority disputes and lien issues in California, it is important to have a firm grasp of the applicable rules. In particular, California has a first in time rule and a race notice recordation statute, which together provide the framework for resolving and avoiding priority disputes in California. *See* Cal. Civ. Code §2897, and Cal. Civ. Code § 1214.

A. California's First In Time Rule

California Civil Code §2897 provides as follows:

PRIORITY OF LIENS. Other things being equal, different liens upon the same property have priority according to the time of their creation.

Cal. Civ. Code §2897.

California Civil Code §2897 creates a first in time rule that prioritizes liens based on their time of creation. *See* Roger Bernhardt, *California Mortgages, Deeds of Trust, and Foreclosure Litigation* §9.43 (4th ed. 2011); *see also* *Thaler v Household Fin. Corp.*, (2000) 80 Cal. App. 4th 1093. Pursuant to this standard, a deed of trust executed and delivered on June 1, 2011, will have priority over a deed of trust executed and delivered on July 1, 2011. *See*, Bernhardt, *supra*; *see also* *Boye v Boerner*, (1940) 38 Cal. App. 2d 567; and *20th Century Plumbing Co. v Sfregola*, (1981) 126 Cal. App. 3d 851, 853, (presumption that deed of trust delivered on date of execution). Please note that different events may trigger the creation of involuntary or special liens, such as mechanics' liens or vendor's liens, but Civil Code §2897 relates solely to consensual liens, such as mortgages and deeds of trust. Bernhardt, *supra*.

The first-in-time rule is not perfect, and does not address situations where a subsequent lender may be unaware of an unrecorded prior deed of trust. Consequently, California has enacted a race notice recording statute that rewards lien holders who first record their security interests in real property, and punishes those who fail to do so. *See* Bernhardt, *supra* ; and Cal. Civ. Code § 1214.

B. California Is A Race-Notice Jurisdiction

California Civil Code §1214 provides as follows:

Every conveyance of real property or an estate for years therein, other than a lease for a term not exceeding one year, is void as against any subsequent purchaser or mortgagee of the same property, or any part thereof, in good faith and for a valuable consideration, whose conveyance is first duly recorded, and as

against any judgment affecting the title, unless the conveyance shall have been duly recorded prior to the record of notice of action.

Cal. Civ. Code § 1214.

California Civil Code §1214 establishes a race-notice jurisdiction in California that allows a subsequently created lien to take priority over an earlier created lien provided that all four following circumstances apply:

1. The earlier lien was not recorded;
2. The later lien holder was without notice of the earlier lien;
3. The later lien holder gave value for the lien; and
4. The later lien was recorded first.

See Bernhardt, supra at §9.44 2.

If any of the four above noted circumstances are absent, the earlier lien has priority over the subsequent lien under California law. *See Bernhardt, supra* at §9.44 2; *Citizens for Covenant Compliance v Anderson*, (1995) 12 Cal. 4th 345; *First Fid. Thrift & Loan Ass'n v Alliance Bank*, (1998) 60 Cal App. 4th 1433, 71 CR2d 295; *In re Pavich*, (Bankr ED Cal 1996) 191 BR 838.

As a general rule, under California's race notice recording statute, a bona fide purchaser for value without notice who first records wins a priority dispute. A helpful mnemonic device is a BFP4V wins a priority dispute under California's race notice recording statute.

1. The Security Instrument Must Be Properly Recorded

To qualify as a bona fide purchaser for value who first records within in the meaning of California's race notice recording statute, the subject lien must be properly recorded. *See Bernhardt, supra* at §9.45. A lien may be deemed unrecorded for purposes of California's race notice recording statute even when the creating instrument has been given to the county recorder, copied into the official records, and entered into the appropriate indexes if the lien is (1) outside the chain of title, (2) improperly indexed, or (3) not properly recordable. *See Bernhardt, supra* at §9.45.

It is well established in California that deeds that are indexed incorrectly by the county recorder are deemed unrecorded because they cannot be discovered by a search of the records. *Id.; Hochstein v Romero*, (1990) 219 Cal. App. 3d 447.

Title insurers maintain real property records by parcels and will likely list an instrument affecting title to the real property as an exception to title on the preliminary report regardless of when it was recorded, thus imparting actual notice even if the recorder did not properly index it. However, the principles of constructive notice are premised on the grantor-grantee index maintained by the recorder. *See Bernhardt, supra* at §9.45.

Instruments that are not properly recordable, such as those that lack acknowledgment or statutory authorization for recordation, are nonetheless sometimes recorded. These documents are generally treated as not giving constructive notice, but they may be regarded as creating enough of a cloud on title to give rise to liability for slander of title. *See Bernhardt, supra* at §9.45; *see also e.g., Seeley v Seymour*, (1987) 190 Cal. App. 3d 844.

Helpful Tip Regarding Title Insurance Policies For Lenders: A lender can reduce its exposure with respect to recordation issues by purchasing title insurance for every loan that it makes, and having the title insurer assume responsibility and liability for the recordation of the deed of trust and other loan documents. A lender should also request that the title insurer provide a preliminary title report listing any and all encumbrances on the title to the real property collateral before the loan is made, and also a final title report after the loan is made. This will allow a lender to confirm the priority of its security interest in the real property collateral, and confirm that there have been no intervening security interests recorded against the real property collateral.

Additional Helpful Tip For Lenders: In addition to purchasing a title insurance policy for every loan that a lender makes, a lender should also purchase a loan modification endorsement to its title insurance policy. This endorsement will ensure that the lender's title insurance coverage remains intact in the event that the loan is modified in the future. It is better for a lender to obtain loan modification coverage when the loan is first made because the lender or its servicer may forget to obtain this coverage in the future during the modification of the loan.

2. Actual Knowledge of a Prior Lien Defeats A Priority Claim, Even if the Prior Lien Was Not Recorded

A party with actual knowledge of a prior lien cannot claim priority over it even if it was not recorded. *See* Bernhardt, *supra* at §9.46. California Civil Code §1217 addresses this issue and provides as follows:

An unrecorded instrument is valid as between the parties thereto and those who have notice thereof.

Cal. Civ. Code §1217.

The statutory requirement of good faith requires the absence of actual or constructive notice of the prior interest. *See* Bernhardt, *supra* at §9.46.; *see also* *Gribble v Mauerhan* (1961) 188 Cal. App. 2d 221, 227, (notice precludes good faith). Even where a party is without actual knowledge, suspicious circumstances (e.g., a reference in a recorded instrument to an unrecorded instrument or the presence of persons on the property whose possession is inconsistent with record title) may impose an obligation to make inquiries, which, if undertaken, would lead to knowledge of the prior lien. *See* Bernhardt, *supra* at §9.46; *see also* *Randall v Allen* (1919) 180 Cal. 298, (constructive notice); *Slaker v McCormick-Saeltzer Co.* (1918) 179 Cal. 387, 388, (actual notice); *Gates Rubber Co. v Ulman*, (1989) 214 Cal. App. 3d 356, (constructive notice).

It is important to note that a party without actual or inquiry notice may still lose its status as a bona fide encumbrancer without notice based on the imputation of constructive knowledge of an agent. *See* Bernhardt, *supra* at §9.46; *see also* *Zeller v Klein* (Apr. 16, 2004, A102248; not certified for publication) 2004 Cal App Unpub Lexis 3728, 2004 WL 823489 (knowledge of mortgage broker who was aware of unrecorded reconveyance imputed to client and assignee of note, who was otherwise innocent and without knowledge).

3. A Party Must Give Value To Assert Priority Over a Prior Unrecorded Lien

Under California law, a party who does not give value is not injured by losing priority to a prior unrecorded claim, because there is no substantial reliance to protect. *See* Bernhardt, *supra* at §9.47. However, when a party has given value for the subject property, complying with California's race notice recording statute protects the party's investment. *See* Bernhardt, *supra* at §9.47; *see also* *Oakdale Village Group v Fong*,

(1996) 43 Cal. App. 4th 539. More than nominal value is required, but the amount need not equal the full market value of the property in the case of a sale. *See* Bernhardt, *supra* at §9.47.

When only part of the agreed value has been transferred at the time of discovery of the earlier lien (as with progress payments under a construction loan or on an installment purchase), protection may be given to the payments made before discovery and denied to those made after notice. *See* Bernhardt, *supra* at §9.47; *see also* *Davis v Ward*, (1895) 109 Cal. 186.

The value requirement means that a recorded judgment lien will generally not prevail over a prior unrecorded lien, because the judgment creditor usually paid no value in reliance on the records when obtaining the judgment. *See* Bernhardt, *supra* at §9.47; *see also* *20th Century Plumbing Co. v Sfregola*, (1981) 126 Cal. App. 3d 851, 853; *Hansen v G&G Trucking Co.*, (1965) 236 Cal. App. 2d 481, 486. This is also true for attachment lien holders. *See* Bernhardt, *supra* at §9.47; *see also* *Bumb v Bennett*, (1958) 51 Cal. 2d 294, 302; *Bank of Ukiah v Petaluma Sav. Bank*, (1893) 100 Cal. 590, 591; *Wells Fargo Bank v PAL Investments, Inc.*, (1979) 96 Cal. App. 3d 431, 157 CR 818.

C. Special Priority Rule For Purchase Money Loans

California Civil Code §2898(a) states:

A mortgage or deed of trust given for the price of real property, at the time of its conveyance, has priority over all other liens created against a purchaser, subject to the operation of the recording laws.

Cal. Civ. Code §2898(a).

California Civil Code §2898(a) gives purchase money loans priority over certain other preexisting liens. *See* Bernhardt, *supra* at §9.48; *see also* *Mercantile Collection Bureau v Roach* (1961) 195 Cal. App. 2d 355. A loan is purchase money whether a third party advances funds to permit the borrower to acquire property or a seller extends credit to the purchaser. *See* Bernhardt, *supra* at §9.48; *see also* *Van Loben Sels v Bunnell*, (1898) 120 Cal. 680, 683.

Please note that the definition of "purchase money" for purposes of Cal. Civ. Code §2898 is broader than the meaning of "purchase money" under Cal. Code Civ. Proc. §580b (the purchase money antideficiency statute. *See* Bernhardt, *supra* at §9.48. Under §580b, third party loans, as opposed to seller financing, are considered purchase money only if the third party loan is made to assist in purchasing one-to-four-unit owner-occupied dwellings.) *Id.* The section has limited application, however, because it is subject to the operation of the recordation laws and because it gives priority only over liens against the purchaser. *Id.*

Furthermore, the purchase money priority rule of Cal. Civ. Code §2898 also breaks ties between parties whose interests attach simultaneously at close of escrow or on any similar occasion when multiple interests arise at the same instant, making ordinary rules for establishing priority—especially "first-in-time" and the recordation acts—unavailable. *See* Bernhardt, *supra* at §9.48; *see also*, *DMC, Inc. v Downey Sav. & Loan Ass'n*, (2002) 99 Cal. App. 4th 190 (owner who lost property in trustee sale subsequently obtained new loan to finance repurchase of property; holding that new loan was purchase money loan under Cal. Civ. Code §2898, the court held that new loan has priority over

preexisting lien that might equitably reattach to property at moment of "redemption").
See Bernhardt, *supra* at §9.48.

1. An Unrecorded Purchase Money Lien Is Vulnerable If Not Recorded

An unrecorded purchase money lien fails as against a subsequent lien that was taken without notice, given for value, and first recorded. *See* Bernhardt, *supra* at §9.49. Under such circumstances, the recordation act, Cal. Civ. Code §1214, prevails over any purchase money priority the first lien might otherwise have had under Cal. Civ. Code §2898(a). *See* Bernhardt, *supra* at §9.49.

2. A New Purchase Money Lien Will Have Priority Over Preexisting Liens That Are Not Against The Subject Property Itself

Purchase money liens do not take priority over preexisting liens against the property itself; they take priority only over preexisting liens against the purchaser personally. *See* Bernhardt, *supra* at §9.50. In this sense, Cal. Civ. Code §2898(a) is designed, in effect, to break ties in priority that occur at closure of a transaction when a purchase money interest is created and when preexisting judgment liens attach at the moment title is conveyed. *Id.*

II. A Review of California's Rules Regarding Lien Priorities

We will now review California's rules regarding vendor's liens, mechanic's liens, and tax and assessment liens.

A. Vendors Liens

California law gives a vendor's lien to a seller who is otherwise unsecured with regard to the unpaid balance of the purchase price. *See* Bernhardt, *supra* at §9.53; *see*

also Cal. Civ. Code §3048. This lien is not recorded, because it arises only when no express security instrument is created. *See* Bernhardt, *supra* at §9.53; *see also*, *Machado v Bank of Italy*, (1924) 67 CA 769, 776. Furthermore, attempts to place it in the records are generally unsuccessful. *See* Bernhardt, *supra* at §9.53; *see also*, *Brown v Johnson*, (1979) 98 Cal. App. 3d 844.

Consequently, it is junior to recorded liens that qualify under Cal. Civ. Code §1214. *See* Bernhardt, *supra* at §9.53; *see also*, *Brock v First S. Sav. Ass'n*, (1992) 8 Cal. App. 4th 661 (vendor's lien is inferior even when subsequent beneficiary of deed of trust has actual knowledge, because it is merely equitable interest and gives way before legal interest created by recorded deed of trust). *See* Bernhardt, *supra* at §9.53; *see also*, *DMC, Inc. v Downey Sav. & Loan Ass'n*, (2002) 99 Cal. App. 4th 190.

The court in *DMC* employed essentially the same analysis as in *Brock* to accord priority to a contractual purchase money lien (that essentially replaced the original senior lien) over a preexisting lien that had been wiped out in a nonjudicial foreclosure but that may have equitably reattached to the property on the obligor's subsequent repurchase of the property. *See* Bernhardt, *supra* at §9.53.

B. Mechanic's Liens

California Civil Code §3134 provides that mechanics' liens are:

preferred to any lien, mortgage, deed of trust, or other encumbrance upon the work of improvement and the site, which attaches subsequent to the commencement of the work of improvement, and also to any lien, mortgage, deed of trust, or other encumbrance of which the claimant had no

notice and which was unrecorded at the time of commencement of the work of improvement.

Cal. Civ. Code §3134.

As noted above, mechanics' lien priority depends on the date work begins on a property, not on the date the lien is recorded. *See Bernhardt, supra* at §9.54. Thus, if a contractor begin work at a real property collateral on January 1, 2011, but does not record a mechanic's lien against the real property collateral until June 1, 2011, that mechanic's lien will relate back to the date the work began at the collateral property (on January 1, 2011).

Under this relation-back theory, mechanics' liens may take priority over purchase money liens and vendor's liens created after work commenced even though recorded before recordation of mechanics' liens. *See Bernhardt, supra* at §9.54; *see also Schut v Doyle* (1959) 168 Cal. App. 2d 698. This special priority rule requires a construction lender to inspect the property visually before funding to assure itself that no construction has started, lest any mechanics' liens prevail over the deed of trust despite the order of recordation. Title insurers issue special endorsements to cover this risk. *See Bernhardt, supra* at §9.54.

Helpful Tip For Lenders To Minimize Priority Disputes With Contractors:

A lender providing construction financing for a project can minimize the risk of a future priority dispute with the general contractor and/or one of the subcontractors by requiring the general contractor and all of the subcontractors to execute subordination agreements in favor of the lender before work begins at the project. In the subordination agreement, the general contractor and the subcontractors would agree that any past,

present or future mechanic's lien claims would be subordinated to the lender's security interest in the real property collateral.

Additional Helpful Tip For Lenders To Minimize Priority Disputes With Contractors: In addition to requiring general contractors and subcontractors to execute subordination agreements in favor of the lender, a lender may also consider having a ribbon cutting ceremony before construction begins on a large construction project. This is only practical for large construction projects. Prior to the ribbon cutting ceremony, the lender would record its security interest (deed of trust) against the real property collateral. Thereafter, the lender would conduct a videotaped ribbon cutting ceremony at the real property collateral, and the borrower, general contractor and subcontractors would be present. On the videotape, and in the presence of all of the aforementioned parties, a lender representative would state that construction at the project will begin after the cutting of the ribbon on such and such date. All of the parties would sign a joint stipulation that construction at the project began on or after the date of the ribbon cutting ceremony. The video tape of the ribbon cutting ceremony would be prima facie evidence of the date when construction at the real property collateral began, and could be admitted as evidence in any future mechanic's lien litigation.

C. Tax and Assessment Liens

California Revenue and Taxation Code §2192.1 provides:

Every tax declared in this chapter to be a lien on real property, and every public improvement assessment declared by law to be a lien on real property, have priority over all other liens on the property, regardless of the time of their creation. Any tax or assessment described in the preceding sentence shall be given priority over matters

including, but not limited to, any recognizance, deed, judgment, debt, obligation, or responsibility with respect to which the subject real property may become charged or liable.

Cal. Rev. and Tax Code §2192.1.

Thus, property tax liens have leapfrog priority over all previous liens, even those of record. *See* Bernhardt, *supra* at §9.55. On the scope of §2192.1, *See* Bernhardt, *supra* at §9.55; *see also* *Isaac v City of Los Angeles*, (1998) 66 Cal. App. 4th 586, 600.

The California legislature has police power to give its own liens priority over preexisting private liens. *See* Bernhardt, *supra* at §9.55; *see also* *German Sav. & Loan Soc'y v Ramish*, (1902) 138 Cal. 120. The priority of a tax lien depends entirely on legislative intent, as expressed in the particular statutory provision that creates the lien. For detailed discussion of relative priorities of various tax and assessment liens, *See* Bernhardt, *supra* at §9.55; *see also* Miller & Starr, *California Real Estate* §§11.93-11.175 (3d ed. 2000). Federal, not state, law sets the priority of federal tax liens. *See* Bernhardt, *supra* at §9.55; *see also* *U.S. v R.F. Ball Constr. Co.*, (1958) 355 US 587, 593, 2 L Ed 2d 510, 78 S Ct 442.

III. Conclusion

In conclusion, this article provides a helpful summary of California law regarding priority disputes and lien issues. As explained above, lenders can reduce their exposure from threats to the priority of their security interest in real property collateral in California by purchasing title insurance for every loan that they make in California, and requiring general contractors and subcontractors to execute subordination agreements in

favor of the lender on contraction projects. Anticipating problems before they occur and planning ahead is always the best approach for lenders making loans in California.

ABOUT THE AUTHOR

Terrance J. Evans is a partner in the Trial Practice Group of Duane Morris in San Francisco. He concentrates his practice in representing the financial services industry, which includes international, national and community banks; loan service companies; and insurance companies. During his career, Mr. Evans has both recovered and saved clients of the firm tens of millions of dollars in settlements, judgments and extrajudicial procedures.

Mr. Evans has represented international, national and community banks and loan service companies in complex commercial litigation and various secured transactions, including commercial and residential nonjudicial foreclosures; unified foreclosures; judicial foreclosures; creditor's rights issues, which includes obtaining relief from stay in various bankruptcy courts; mechanics' lien lawsuits; stop notice claims; abatement issues; priority contests; RESPA claims; forbearance agreements; municipality disputes; transfer tax disputes; property tax disputes; short sales; loan purchase and sale agreements; predatory lending claims; discriminatory lending claims; Fair Debt Collection Practices Act claims; and many other issues.

Mr. Evans has been recognized both locally and nationally for his professional accomplishments. In 2010 and 2008, Mr. Evans was honored by the American Business Trial Lawyers of Northern California for his dedication and professionalism. In addition, he was named one of the top 100 minority associates in the United States for 2007 by the Stakeholder Organization. Mr. Evans has also received special honors from the NAACP, the Congressional Black Caucus, the 100 Black Men of Los Angeles, the Young Black Scholars Program, the Black Women Lawyers Association of Los Angeles, the American Legion and many other organizations.

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