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I. INTRODUCTION

In eras of declining interest rates, millions of residential mortgage loans may be refinanced. When this occurs, it is customary for the refinancing lender to require a title examination and a new mortgagee's title insurance policy. This requirement is expensive, usually costing several hundred dollars or more, and the cost is invariably paid by the borrower. This Article proposes that in the vast majority of refinancings this expense can be substantially reduced or even eliminated. This result can be achieved through proper understanding, adoption, and use of the doctrine of equitable mortgage subrogation articulated in the *Restatement (Third) of Property: Mortgages.*[1] The principle of subrogation comes into play when the proceeds of a new mortgage are used to pay off a preexisting mortgage; it allows the holder of a new mortgage to take the priority of the old mortgage.[2] If subrogation is made available liberally, as the Restatement recommends, it can eliminate the risk that intervening liens, arising between the dates of the original and the refinancing mortgages, will take priority over the refinancing

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1. RESTATEMENT (THIRD) OF PROP.: MORTGAGES §§ 7.3, 7.6 (1997).

2. Priority is critical to mortgage lenders because, in the event of foreclosure, liens having higher priority are paid first out of the foreclosure proceeds. Hence, if an intervening lien, such as a judgment, a mechanic's lien, or the like, acquires priority over the refinancing mortgage, the risk is increased that the foreclosure proceeds will be insufficient to pay the mortgage in full. *See* 1 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 1.1 (4th ed. 2001).

mortgage. Hence, the need for new title insurance protection can be largely or entirely avoided.

Part II of this Article[3] describes the most recent wave of refinancings and estimates the costs involved in providing mortgagee's title insurance. Part III[4] focuses on traditional subrogation and related principles as they operate in the mortgage refinancing context and shows how the Restatement approach greatly reduces the risk of loss of mortgage priority for mortgage lenders. Part IV[5] describes and advocates two simple changes to current residential mortgage documents that would greatly enhance their usefulness in the context of subrogation. Part V[6] discusses the value that title insurance adds to a refinancing lender's rights and considers whether, under a modern concept of mortgage subrogation, lenders might elect to forego their current requirement that title insurance be issued. Part VI[7] describes how direct assignment of refinanced mortgages could serve as an alternative to subrogation and evaluates whether such a change in present practice is feasible. Part VII[8] examines conditions in the mortgage and title insurance markets and argues that the pervasive adoption of the subrogation principle should either reduce title insurance premiums substantially in refinancings or, alternatively, cause major mortgage lenders to eliminate the need for title insurance completely. Finally, Part VIII[9] considers whether state judicial adoption of the Restatement's mortgage subrogation principles is the best course of action or whether Congress should enact the Restatement approach by legislation; we advocate the latter. Part IX offers a brief conclusion.

II. THE COSTS OF REFINANCING

Beginning in April 2002, the United States experienced an astonishing decline in residential mortgage interest rates. The thirty-year fixed-rate mortgage, usually considered the standard or bell-

3. *See infra* text accompanying notes 10–29.
4. *See infra* text accompanying notes 30–79.
5. *See infra* text accompanying notes 80–121.
6. *See infra* text accompanying notes 122–148.
7. *See infra* text accompanying notes 149–159.
8. *See infra* text accompanying notes 160–195.
9. *See infra* text accompanying notes 196–201.

weather of the industry, had been near 7%[10] since the beginning of 2001.[11] But in April 2002, it began a remarkable plunge,[12] reaching a low of 5.21% in June 2003. It has remained near or below 6% to the present.[13] Adjustable rate mortgages,[14] which nearly always carry rates lower than fixed-rate loans, experienced a similar decline, falling to 4.5% in mid-2002 and ultimately reaching a low of 3.36% in March 2004; they remain just above 5% at this writing.[15]

Some perspective on the extraordinary nature of these rate reductions is gained by considering the historic data on average new home mortgage yields published in the annual Economic Report of the President. Since the commencement of that data series in 1963, the lowest reported yield prior to 2000 was 5.81% in 1965—more than one-half of a percentage point higher than the June 2003 low.[16]

10. Data are based on the Freddie Mac Primary Mortgage Market Survey (PMMS). *See* http://www.freddiemac.com/dlink/html/PMMS/display/PMMSOutputYr.jsp?year=2006 (last visited Feb. 22, 2006). The data are also available at Mortgage-X.com, National Average Mortgage Rates: Historical Data, http://mortgage-x.com/general/historical_rates.asp (last visited Feb. 22, 2006). Currently, 125 lenders across the nation—thrifts, commercial banks, and mortgage lending companies—are surveyed each week. *Id*. Rates given are for conventional financing on conforming mortgages with loan-to-value (LTV) rates of eighty percent or less. *Id*. The effect of points and fees charged by lenders is not included. The data are available from 1992 onward on a continuously-updated basis. *Id*.

"Conforming" loans are those eligible for purchase by Fannie Mae and Freddie Mac. *Id*. The upper limit of conforming loans is adjusted annually by these two government-sponsored enterprises. For example, in 2000, the limit for single-family homes was $252,700. By 2005, it had been increased to $359,650. *Id*.

11. The 7% level was considered relatively low, but not unusual. Rates had fallen to the 7% range in late 1993, in February 1996, and through the period from the beginning of 1998 through mid-1999. *Id*.

12. The reduction in rates was primarily a product of the actions of the Federal Open Market Committee, an entity of the Board of Governors of the Federal Reserve System, which controls U.S. monetary policy. Rates were reduced to stimulate the economy in the face of a recession that occurred in 2001. *See* James H. Stock & Mark W. Watson, *How Did Leading Indicator Forecasts Perform During the 2001 Recession?*, 89 FED. RES. BANK OF RICHMOND ECON. Q. 71 (2003); Milton Marquis, *Setting the Interest Rate*, FRBSF ECON. LETTER 2002–30, Oct. 11, 2002.

13. As of Feb. 16, 2006, the rate was 6.28%; this was the highest level it had reached since a brief peak of 6.29% in June 2004. *See* http://www.freddiemac.com/pmms/pmms30.htm (last visited Feb. 22, 2006).

14. The data reflect one-year adjustable rate mortgages indexed to constant maturity U.S. Treasury debt with a one-year maturity.

15. As of February 16, 2006, the rate was 5.17%, the highest it had been since January 2002. *See* http://www.freddiemac.com/pmms/pmmsarm.htm (last visited Feb. 22, 2006).

16. 2004 ECON. REP. OF THE PRESIDENT, at tbl.B-73, http://frwebgate2.access.gpo.gov/cgi-bin/waisgate.cgi?WAISdocID=8527428750+3+0+0&WAISaction=retrieve. Because of variations in methods of data collection and computation over time, and because the historical

The inevitable result of these drastically lowered interest rates was a wave of residential mortgage refinancings that far eclipsed in number those of any previous period. Refinancing volume began accelerating in early 2001 and reached a sustained peak during April though June of 2003.[17] Refinancings represented 55% of all one-to-four-family mortgage loans in 2001, 59% in 2002, and 66% in 2003.[18]

The dollar amount of mortgage originations resulting from refinancing was also exceptional. During the three-year period from 2001 through 2004, refinancing loans totaling about $5.4 trillion were originated.[19] Given an average refinanced mortgage amount of $130,000,[20] about 41 million home mortgage refinancings were originated during that period. If no households had refinanced more than once during 2001 through 2003, this figure would represent ninety-two percent of all homeowners with regular or home-equity mortgages.[21] These figures indicate the massive size and volume of the recent refinancing activity.[22]

This Article argues that the doctrine of subrogation, properly understood and applied, has the potential to eliminate or greatly reduce the expense of proof of title to mortgage lenders in refinancing transactions. If title expense had been lower, it is likely

data in the Economic Report of the President are yields (incorporating the effect of points and fees) rather than promissory note rates, the historical data are not strictly comparable with the current Freddie Mac PMMS data.

17. The peak is graphically illustrated in John Robbins, Douglas G. Duncan & Jay Brinkman, Economic/Housing Outlook, Powerpoint Presentation given at 91st Annual MBA Convention, at 18 (Oct. 27, 2004), http://www.mortgagebankers.org/files/Conferences/presentations/91st_annual/ConventionEconForecast10-27-04-Finalized.pdf.

18. *See* Mortgage Bankers Ass'n, *1-to-4-Family Originations*, http://www.mortgagebankers.org/marketdata/data/03/1-4_originations.html (last visited Feb. 22, 2006).

19. *See* U.S. Dept. of Housing and Urban Development, *An Analysis of Mortgage Refinancing 2001–2003*, Nov. 2004, at 2, http://www.huduser.org/Publications/pdf/MortgageRefinance03.pdf.

20. The average amount refinanced during 2001 and early 2002 was $128,800. We have adjusted the figure upward slightly to approximate inflation during 2002–03. *See* Glenn B. Canner et al., *Mortgage Refinancing in 2001 and Early 2002*, FED. RES. BULL., Dec. 2002, at 470 tbl.1, http://www.federalreserve.gov/pubs/bulletin/2002/1202lead.pdf.

21. *See* Insurance Information Institute, Mortgage Finance and Housing, Financial Services Fact Book 2006, http://www.financialservicesfacts.org/financial2/mortgage/mortgages/index.html (last visited Feb. 22, 2006) (indicating that in 2003, there were 45,471,000 households that had regular or home-equity mortgages).

22. Because there were multiple refinancings by some households, these numbers overstate somewhat the number of households that refinanced.

that even more refinancings would have occurred during 2001–2004, and refinancing would have been even more efficient and advantageous to those who did refinance. Hence, the estimation of size of the title expense is extremely useful. Undertaking such an estimation, however, is no easy task. Mortgage lenders almost always require a new title insurance policy, which the borrower pays before the borrower may refinance an existing loan.[23] However, no national uniformity in title insurance methods or rates is currently in place. In many areas of the nation, title insurance is written by agents[24] who also perform the necessary search of the records and charge an all-inclusive rate. In other areas, attorneys or local companies act as title insurance agents and make a separate charge for their services in examining the records. Rates tend to be similar among title companies in a given locality but vary widely throughout the nation. There is no national database of title insurance rates.

The issue is further complicated by many title companies' use of reissue rates. A reissue rate is a discounted rate that is made available if the same title company has previously issued a policy on the same property during a fixed time period, usually five or ten years. The discount may reduce the insurance premium forty to sixty percent of the standard rate.[25] Title underwriters' approaches to the concept of the reissue rate vary widely, and consumers are sometimes unaware that such reissue rates are even available. Therefore, consumers often do not receive the benefit of reissue rates.[26]

Despite these variations, it is possible to make a reasonable estimate of the title insurance cost for a new loan policy issued in connection with a residential mortgage refinancing. Where an all-

23. Charles Kovaleski, *Should You Refinance?*, ALTA, http://www.alta.org/consumer/refinance.cfm (last visited Jan. 28, 2006) ("When you refinance your home, you are in effect taking out a new loan. Your lender is going to require that you purchase lender's title insurance to protect their investment."); *see also* Fannie Mae, *Refinancing: Requirements & Costs*, http://www.fanniemae.com/homebuyers/findamortgage/refinancing/requirements.html (last visited Jan. 28, 2006).

24. The agent represents the underwriter, which is actually the entity that issues the insurance policy.

25. *See* Kenneth R. Harney, *It's Homeowners vs. Title Insurers*, L.A. TIMES, Dec. 2, 2001, *available at* http://www.radianexpress.com/RadianExpress/pdf/radian_lien_la_times.pdf; Kenneth R. Harney, *Refinancing's Magic Words: Reissue Rate*, WASH. POST, June 8, 2002, at H01.

26. *See* Kenneth R. Harney, *Title Insurance "Reissue Rates" Spark Class Action Suits, Controversy*, REALTY TIMES, Feb. 22, 2006, *available at* http://realtytimes.com/rtcpages/20030414_reissuerates.htm.

inclusive rate is available, our estimate of the cost for an average $130,000 refinancing is approximately $400.[27] Given the roughly 41 million residential refinancings during 2001–2003, the amount spent on title services protecting refinancing lenders was approximately an astounding $16 billion. This sum was, from the viewpoint of consumers, a deadweight loss because consumers have no independent need or desire for a new title insurance policy when refinancing. The expenditure is merely a costly condition of obtaining the new loan. Even from the lender's viewpoint, the

27. One national title insurance underwriter, First American Title Ins. Co., provides an Internet calculator that can be used to determine premium rates. *See* Firstam.com, http://titlefees.firstam.com/Titlefees.asp (last visited Jan. 28, 2006). The following rates were calculated from that web site on the basis of a loan of $130,000 refinancing a previous loan made five years earlier, and having a current balance of $130,000 to eliminate taking cash from the refinancing. The calculator examines reissue discounts where available.

All-inclusive rate states (sample):	
Arizona (Maricopa County)	$541
California (Los Angeles County)	$360
Illinois	$330
Michigan (Wayne County)	$337
New York (Westchester County)	$382
Nevada (Clark County)	$279
Oregon	$689
Utah	$471
Washington (King County)	$313
Average of the foregoing	$411
States in which a search fee is separately charged:	
Florida	$362
Massachussetts	$195
Minnesota	$161
Missouri	$166
Ohio	$364
Average of the foregoing	$250

The average rate of the "separate search fee" states has little meaning because there is no basis for determining the additional search fee. However, it seems to be at least $150 on average.

The estimate in the text is borne out by LendingTree.com, an Internet mortgage loan service, whose web site gives an overall national estimate of $450 to $600. See Lending Tree, Costs of Refinancing, http://www.lendingtree.com/stmrc/refiarticle5.asp?bp= (last visited Jan. 28, 2006); Pete Boisseau, Radian Continues To Spread Incorrect Cost-Savings, 81 TITLE NEWS, Sept.–Oct. 2002, at 9 (criticizing the lien-impairment guaranty offered by Radian Group, Inc. as an alternative to title insurance). The author notes that, "[o]n a $100,000 loan, true title insurance would cost less than Radian's $325 flat rate in 36 states. On a $150,000 loan, title insurance would be less expensive in 28 states." *Id.*

expenditure was largely unnecessary and a significant drag on the economic benefit refinancing generated.

This analysis suggests that title assurance costs for refinancing residential mortgages are very significant. Of course, residential mortgages are only part of the story—loans on commercial, industrial, and agricultural property are also refinanced as interest rates fall. While restrictions and fees on prepayment impede refinancing such loans to a much greater extent than with respect to residential loans,[28] nonresidential refinancings are still quite common. These loans are typically much larger than residential loans and are thus tied to correspondingly higher title assurance costs.

Title assurance costs act as an impediment to refinancings. In some cases, they impede enough to cause a mortgagor to forego refinancing altogether in the hope that a further reduction in interest rates will make the transaction more worthwhile in the future. In other cases, the refinancing transaction may still go forward, but the economic benefit to the mortgagor is lessened by the title assurance expense. In general, the cost of title assurance, like all transaction costs, makes the overall transaction less efficient.[29]

The question we address here is simple: is there a feasible way to reduce the cost of title assurance in mortgage refinancings? We believe that the answer is yes, and suggest a simple change in the law—a change that would harm no one and that is already in effect in a few states—that would drastically reduce the cost of assuring refinancing lenders they are receiving mortgages with the priority they expect and desire. This change involves the doctrine of mortgage subrogation and its related principles.

III. APPLYING SUBROGATION PRINCIPLES TO MORTGAGE REFINANCINGS

A mortgagor who seeks to refinance may obtain the new loan either from the same lender that made the existing loan or from a different lender altogether. This choice is important for our purposes

28. *See* Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 UCLA L. REV. 851, 851–52 (1993); Joe Mattey, *Mortgage Interest Rates, Valuation, and Prepayment Risk*, FRBSF ECON. LETTER 98–30, Oct. 9, 1998, *available at* http://www.sf.frb.org/econrsrch/wklyltr/wklyltr98/el98-30.html (noting that the vast majority of residential mortgages are freely prepayable).

29. Ronald H. Coase, *The Nature of the Firm (1937)*, http://people.bu.edu/vaguirre/courses/bu332/nature_firm.pdf (last visited Jan. 28, 2006).

because traditional subrogation doctrine applies when using a different lender. Different principles, albeit "subrogation-like," would govern in the former situation.[30] Because refinancing by a new lender is more frequent[31] and is governed by pure subrogation rules, we focus first on such a transaction.

A. Refinancing by a New Lender

The concept of subrogation in mortgage law is simple: "One 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."[32] Thus, subrogation amounts to an assignment, by operation of law, of the obligation and the mortgage to the subrogee. To see how this concept can be applied to a refinancing, assume a homeowner-mortgagor currently has a fixed rate mortgage loan on her house with a $200,000 balance that is held by a bank. Because market interest rates have declined since the loan was obtained, the owner decides to refinance the balance with a different bank. The typical mechanics of such a transaction include the following: The mortgagor will execute a new promissory note and mortgage in favor of the new bank, and the proceeds of the new loan will be used to pay off the balance at the old bank. The old bank will then cancel the mortgagor's original note and record a discharge of the mortgage. The new bank's mortgage will be recorded concurrently and the new bank will receive a title insurance policy insuring that it has a senior mortgage on the property. The homeowner-mortgagor will pay the title insurance premium.

The title insurer's primary task in this transaction is to insure that no intervening liens or other interests in the property have been created since the original mortgage was recorded because such interests might acquire priority over the new mortgage.[33] The

30. *See* discussion *infra* Part III.C.

31. *See* Michael D. Larson, *Refinancing: New Rate, New Rules*, http://www.bankrate.com/brm/news/loan/20010106a.asp (last visited Jan. 28, 2006).

32. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6(a) (1997).

33. For example, you may have taken out a second mortgage on the home that could threaten the priority of the new lender's mortgage. Or, there could be legal judgments against you or a mechanic's lien against the property by a supplier who was not paid for home improvements. Chi. Title Ins. Co., Why Title Insurance Is Needed when Refinancing a

doctrine of subrogation can be used to reduce or eliminate the title insurance company's risk in this transaction.

For our purposes, the branch of subrogation theory that is of interest involves one who pays off the debt of another because the person making the payment is requested by the debtor to do so.[34] This is precisely what happens in the typical mortgage refinancing—the mortgagor requests the refinancing lender, the second bank—to pay off the prior mortgage loan, which is commonly a first mortgage. In conventional thinking, this discharges the prior mortgage, leaving the refinancing lender's mortgage as the new first mortgage. Of course, this result is assumed to follow only if no intervening liens or other interests in the land exist in priority between the old and new mortgages. If intervening interests do exist, the refinancing lender is concerned that if the prior mortgage is paid, these interests will be promoted in priority and will trump the refinancing mortgage. As a means of self protection, the refinancing lender orders a title examination and a new title insurance policy, at the expense of the borrower, to ensure that no such intervening interests exist. If the old mortgage can be assigned by operation of law to the refinancing lender, intervening liens or other interests become far less threatening for the refinancing lender, if not completely irrelevant.[35] In such a scenario, those liens will remain subordinate to the refinanced mortgage because the refinancing mortgagee will "inherit" the priority of the mortgage being paid off. Hence a refinancing lender who could be assured of the benefits of subrogation would put pressure on title insurance companies to reduce their premium rates or even eliminate the title insurance

Mortgage Loan?, http://www.titleinsuranceny.com/brochure/cons_info_4419.html (last visited Jan. 28, 2006).

34. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6(b)(4) (1997).

35. Junior liens, despite their lack of priority, do present some disadvantages to senior mortgagees. *See* Joshua Stein, *Subordinate Mortgage Financing: The Perils of the Senior Lender*, REAL EST. REV., Fall 1997, http://www.real-estate-law.com/articles/subordinate_mortgage.htm. These disadvantages are relatively minor, particularly in the context of residential financing, and would not likely cause the refinancing lender to refuse to fund the loan. The chief disadvantage is that a junior lien may impose on the borrower an additional monthly cash outflow obligation, straining the borrower's limited resources and increasing the probability of a default. *Id.* However, refinancing lenders can (and generally do) require borrowers to complete loan application forms that identify, or negate the existence of, such junior liens. A sworn affidavit on the point might be required as additional protection for the lender.

requirement, thus allowing the lender to offer refinancing to prospective customers at a lower total cost to them.[36]

Under what conditions is subrogation to the prior mortgage available to a refinancing lender? The answer is controversial and may depend on the nature and extent of the refinancing lender's knowledge or notice of the existence of intervening liens. The *Restatement (Third) of Property: Mortgages* takes a very expansive view of the application of the subrogation principle. The Restatement holds that the refinancing lender should be entitled to subrogation even if it had actual knowledge of a junior lien, if it "reasonably expected to receive a security interest in the real estate with the priority of the mortgage being discharged, and if subrogation will not materially prejudice the holders of intervening interests in the real estate."[37] Moreover, "[a] refinancing mortgagee should be found to lack such an expectation only where there is affirmative proof that the mortgagee intended to subordinate its mortgage to the intervening interest."[38] In recent years, a significant number of courts have adopted the Restatement or followed its logic.[39]

Some courts are more conservative than the Restatement approach in recognizing subrogation. One group, probably the majority of all courts nationally, refuses subrogation if the payor had

36. *See infra* text accompanying notes 160–195.

37. RESTATEMENT (THIRD) OF PROP. : MORTGAGES § 7.6(b)(4)(1997).

38. *Id.* § 7.6 cmt. e; *see also id.* illus. 27.

39. Cases adopting the Restatement approach include Lamb Excavation, Inc. v. Chase Manhattan Mortgage Corp., 95 P.3d 542 (Ariz. Ct. App. 2004); E. Sav. Bank v. Pappas, 829 A.2d 953 (D.C. 2003) (dictum); Wilkins v. Gibson, 38 S.E. 374 (Ga. 1901); Bank of N.Y. v. Nally, 820 N.E.2d 644 (Ind. 2005); Klotz v. Klotz, 440 N.W.2d 406 (Iowa Ct. App. 1989); E. Boston Sav. Bank v. Ogan, 701 N.E.2d 331 (Mass. 1998); Burney v. McLaughlin, 63 S.W.3d 223 (Mo. Ct. App. 2001); Houston v. Bank of Am., 78 P.3d 71 (Nev. 2003); Providence Inst. for Sav. v. Sims, 441 S.W.2d 516 (Tex. 1969); Farm Credit Bank v. Ogden, 886 S.W.2d 305 (Tex. App. 1994); Chi. Title Ins. Co. v. Lawrence Invs., Inc., 782 S.W.2d 332 (Tex. App. 1989); *see also* Trus Joist Corp. v. Nat'l Union Fire Ins. Co., 462 A.2d 603 (N.J. Super. Ct. App. Div. 1983), *rev'd sub nom.*, Trus Joist Corp. v. Treetop Assocs., 477 A.2d 817 (N.J. 1984). Several intermediate appellate courts have expressed approval of the Restatement approach, but have declined to apply it because they considered themselves bound by earlier state supreme court decisions that were less favorable to subrogation. *See* Ripley v. Piehl, 700 N.W.2d 540 (Minn. Ct. App. 2005); First Commonwealth Bank v. Heller, 863 A.2d 1153 (Pa. Super. Ct. 2004); Bank of Am. v. Wells Fargo Bank, 109 P.3d 863 (Wash. Ct. App. 2005). The Colorado Supreme Court came close to adopting the Restatement view in *Hicks v. Londre*, 125 P.3d 452 (Colo. 2005), but indicated that it might deny subrogation if the refinancing lender was a sophisticated commercial lender with actual knowledge of the intervening interest.

actual knowledge of the intervening interest, but allows subrogation if the payor's only notice was constructive from the recordation of the intervening interest.[40] This approach places a premium on ignorance—not such a bad thing in the present context. If the refinancing lender can preserve the right to subrogation by *avoiding knowledge* (e.g., by refraining from obtaining a title examination), then refraining from examining the title is an entirely rational step and has the added advantage of saving money.

In addition to the Restatement approach and the more conservative approach that permits subrogation unless the refinancing lender had actual knowledge of the intervening lien, there is a third approach, which is the most hostile to the refinancing lender. It denies subrogation even if the payor's only knowledge of the intervening interest was constructive notice from the recording of that interest.[41] We have vigorously criticized this approach[42] and

40. *See* Vogel v. Veneman, 276 F.3d 729 (5th Cir. 2002) (applying Texas law); United States v. Baran, 996 F.2d 25 (2d Cir. 1993) (applying New York law); Han v. United States, 944 F.2d 526 (9th Cir. 1991) (applying California law); United States v. Hughes, 499 F.2d 322 (8th Cir. 1974) (applying Arkansas law); Burgoon v. Lavezzo, 92 F.2d 726 (D.C. Cir. 1937); Mut. Life Ins. Co. of N.Y. v. Grissett, 500 F. Supp. 159 (M.D. Ala. 1980); United States v. Fagin, 252 B.R. 118 (Bankr. W.D. Tex. 2000) (applying Texas law); *In re* Hubbard, 89 B.R. 920 (Bankr. N.D. Ala. 1988); Herberman v. Bergstrom, 816 P.2d 244 (Ariz. Ct. App. 1991); Lawyers Title Ins. Corp. v. Feldsher, 49 Cal. Rptr. 2d 542 (Cal. Ct. App. 1996); Smith v. State Sav. & Loan Ass'n, 223 Cal. Rptr. 298 (Cal. Ct. App. 1985); *Pappas*, 829 A.2d 953 (adopting the Restatement in dictum, but actually holding merely that constructive notice to the refinancing lender would not bar its subrogation claim); Metro. Life Ins. Co. v. First Sec. Bank, 491 P.2d 1261 (Idaho 1971); La. Nat'l Bank v. Belello, 577 So. 2d 1099 (La. Ct. App. 1991); United Carolina Bank v. Beesley, 663 A.2d 574 (Me. 1995); Metrobank for Sav. v. Nat'l Cmty. Bank, 620 A.2d 433 (N.J. Super. Ct. App. Div. 1993); Gerenstein v. Williams, 723 N.Y.S.2d 257 (N.Y. App. Div. 2001); Home Title Guar. Co. v. Carey, 144 N.Y.S.2d 116 (N.Y. Sup. Ct. 1955); Rusher v. Bunker, 782 P.2d 170 (Or. 1989); Pee Dee State Bank v. Prosser, 367 S.E.2d 708 (S.C. Ct. App. 1988), *overruled by* United Carolina Bank v. Caroprop, Ltd., 446 S.E.2d 415 (S.C. 1994); Pierner v. Computer Res. & Tech., Inc., 1998 WL 51496 (Wis. Ct. App. 1998) (unpublished opinion).

41. *See In re* Gordon, 164 B.R. 706 (Bankr. S.D. Fla. 1994) (applying Florida law); Indep. One Mortgage Corp. v. Katsaros, 681 A.2d 1005 (Conn. App. Ct. 1996); Hieber v. Fla. Nat'l Bank, 522 So. 2d 878 (Fla. Dist. Ct. App. 1988); Bank of Canton v. Nelson, 160 S.E. 232 (Ga. 1931); Harms v. Burt, 40 P.3d 329 (Kan. Ct. App. 2002); Thompson v. Chase Manhattan Mortgage Corp., 90 S.W.3d 194 (Mo. Ct. App. 2002); Metmor Fin., Inc. v. Landoll Corp., 976 S.W.2d 454 (Mo. Ct. App. 1998); Am. Gen. Fin. Servs., Inc. v. Barnes, 623 S.E.2d 617 (N.C. Ct. App. 2006); First Union Nat'l Bank v. Harmon, 2002 WL 1980705 (Ohio Ct. App. 2002) (unpublished opinion); Centreville Car Care, Inc. v. N. Am. Mortgage Co., 559 S.E.2d 870 (Va. 2002); Kim v. Lee, 31 P.3d 665 (Wash. 2001), *modified*, 43 P.3d 1222 (Wash. 2001); *see also* Belcher v. Belcher, 87 P.2d 762 (Or. 1939). The continuing vitality of *Belcher v. Belcher* is uncertain in light of *Rusher v. Bunker*, 782 P.2d 170 (Or. Ct. App. 1989), which refused to bar subrogation where the payor had only constructive

find it impossible to understand in light of the fact that subrogation in this situation harms no one, leaving the intervening lien exactly where it started. In contrast, refusal to grant subrogation gives the intervening lienor an unexpected, unearned, and unwarranted promotion in priority.[43]

This last approach, in effect, forces the refinancing lender to obtain new title insurance,[44] and it casts the loss on the refinancing lender in the first instance if no title insurance is issued or is issued in

notice of the intervening lien. *See* Dimeo v. Gesik, 993 P.2d 183 (Or. Ct. App. 1998) (declining to resolve the issue on summary judgment). The position of the Kansas courts is also in doubt as a result of the holding in *National City Mortgage Co. v. Ross*, 117 P.3d 880 (Kan. Ct. App. 2005), granting subrogation even though the refinancing lender had constructive notice of the intervening interest (a purchaser's interest in a real estate installment contract) by virtue of the possession of the contract purchasers.

Michigan appears to be alone in denying subrogation on the ground that a refinancing lender is a "mere volunteer," since it has no legal obligation to pay off the prior mortgage. *See* Wash. Mut. Bank v. ShoreBank Corp., 703 N.W.2d 486 (Mich. Ct. App. 2005). This position disregards the widely held understanding that subrogation can be granted to one who pays a debt at the request of the debtor, as a refinancing lender obviously does. *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6(b)(4) (1997).

42. *See* 1 NELSON & WHITMAN, *supra* note 2, § 10.6, at 802.

43. Exceptional situations can arise in which subrogation would be unjust to the intervening lienor, but they arise only when the parties depart from normal procedure. For example, in *Bankers Trust Co. v. Collins*, 124 S.W.3d 576 (Tenn. Ct. App. 2003), a lender made a loan to refinance a prior recorded mortgage, but the refinancing mortgage was not recorded. Subsequently, a different mortgagee made a loan on the property with no notice of the prior unrecorded mortgage. Since the later mortgagee was a bona fide purchaser, it was held to have priority over the unrecorded loan on the basis of the recording act. *Id.* at 578–79. The holder of the unrecorded mortgage attempted to defeat this argument by asserting that it was subrogated to the (recorded) mortgage it had paid off. The court correctly rejected this argument. *Id.* at 579–80. Since the original mortgage that had been refinanced was discharged of record, and the refinancing mortgage was unrecorded, it would have been unjust to grant it priority over the bona fide purchaser. *Id.* at 579. *In re Lewis*, 270 B.R. 215 (Bankr. W.D. Mich. 2001), is similar, except that it involved the strong-arm rights of a trustee in bankruptcy rather than an actual intervening lienor.

The same sort of problem can arise if the original mortgage is discharged of record but a delay occurs in recording the refinancing mortgage. *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6 cmt. f, illus. 30 (1997). However, this is an extremely rare situation. The usual case is just the opposite: the new mortgage is recorded immediately after closing, while the discharge of the old mortgage is not recorded for several weeks or months. *See* UNIFORM RESIDENTIAL MORTGAGE SATISFACTION ACT, Prefatory Note (2004), http://www.law.upenn.edu/bll/ulc/umsa/2004finalact.pdf (holding that a refinancing mortgagee was not entitled to subrogation where it made no title examination before making its loan).

error. Of course, if a new title policy is in fact obtained, as is usually the case, the ultimate loss if the title examination fails to identify an intervening lien falls on the title insurance underwriter. Indeed, a number of the decisions in this category seem to be motivated by nothing less than undisguised hostility to the title insurance industry.[45] They express the view that, if the title insurer makes a search error, it ought to pay for it even when the payment is merely compensation for giving the intervening lienor the unearned promotion in priority mentioned above. This attitude is inexplicable. It makes no more sense to deny subrogation to a title insurer here than it would to deny a fire insurer subrogation against an arsonist or to deny a liability insurer subrogation against a tortfeasor. Insurers, after all, are not simply vast reservoirs of free money. They pay claims out of the premiums paid by their insureds, and if they are forced to pay unnecessary claims, the competitive forces of the insurance market will inevitably drive their premiums upward, making settlement costs higher for all mortgagors. There is simply no reason to impose on consumers the cost of giving windfall promotions of priority to junior lienholders.

45. The following passages indicate this hostility:

> Another factor in our determination, and one which [the refinancing lender] urges us to ignore, is whether a title insurer had an opportunity to review the title and find the recorded judgment lien. That a title insurer was paid to perform precisely the function that would have revealed the [intervening] judgment lien is a factor within the purview of a determination of the equities.

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

> Under a contractual obligation, [the title insurance company] was negligent in giving its expert opinion and insuring title. The doctrine of subrogation does not apply to relieve a title insurance company of its contractual obligation because a title insurance company not only receives consideration for rendering an expert opinion, but also for acting as an insurer of its accuracy. [The company] failed to discover a recorded and perfected judgment lien and upon receiving actual notice, failed to disclose or remedy the situation.

Kim v. Lee, 31 P.3d 665, 672 (Wash. 2001) (citation omitted), *modified*, 43 P.3d 1222 (Wash. 2001).

> [A]ny "windfall" in this case as a result of granting subrogation would inure to the benefit of the negligent title examiner and the party that insured the title for [the refinancing lender and purchasers]. While [they] have recourse against those parties for the loss in this case, [the intervening lienor] has no such recourse.

Centreville Car Care, Inc. v. N. Am. Mortgage Co., 559 S.E.2d 870, 874 (Va. 2002); *see also* Suntrust Bank v. Riverside Nat'l Bank, 792 So. 2d 1222, 1228 (Fla. Dist. Ct. App. 2001) (Stone, J., dissenting).

B. Avoiding Material Prejudice to Intervening Interests

As noted above, all courts deny subrogation to the refinancing lender to the extent that subrogation would result in "material prejudice" to intervening interests.[46] Here we consider how such material prejudice might arise and what its impact might be. When a mortgage is refinanced, the parties often modify some of the loan terms. The most common changes are an increase in the loan's balance (often known as a "cash-out" refinancing) and an increase in the term to maturity. A third type of modification, also fairly frequent, is a change from an adjustable interest rate to a fixed rate. The purpose of this Section is to evaluate whether such modifications represent "material prejudice" and the impact that such changes are likely to have on a mortgage's priority in relation to junior liens.

Cash-out residential refinancings have become increasingly common over the past decade.[47] Federal Reserve Board survey data indicate that in 1994 only about 25% of refinancing homeowners increased their loan balances; in 1998 and 1999 about 35% did so.[48] By 2001–2002 the proportion of cash-out refinancings had risen to 45%.[49] Data for loans refinanced by Freddie Mac[50] indicate a peak in cash-outs during 2000, with some reduction since that time and an overall cash-out rate for the 1999–2004 period of about 56%.[51]

46. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6(b)(4).

47. The risks to borrowers of "cash-out" refinancing are discussed in William R. Emmons, *Consumer-Finance Myths and Other Obstacles to Financial Literacy*, Dec. 8, 2004 (unpublished paper presented at the St. Louis University School of Law), http://law.slu.edu/conf/lending/docs/Emmons_lending_Conference04.pdf.

48. Peter J. Brady et al., *The Effects of Recent Mortgage Refinancing*, FED. RES. BULL., July 2000, at 441, 445.

49. Canner et al., *supra* note 20, at 469, 472.

50. Freddie Mac, one of the two federally chartered secondary mortgage-market purchasers, defines a cash-out refinance as one in which the balance of the loan is increased by more than 5%. This definition recognizes that many homeowners need to borrow enough, over and above their preexisting loan balances, to cover the settlement costs of the refinancing. An increase of 5% in loan balance will typically permit the mortgagor to recover little or no actual cash for other purposes.

51. Averaging the percentage of quarterly cash-out refinancings reported by Freddie Mac from 1999 through 2004 yields the following percentages: 1999: 64%; 2000: 79%; 2001: 55%; 2002: 52%; 2003: 38%; 2004: 50%. *See* News Release, Freddie Mac, *Cash-out Refinance Share Falls Modestly in Fourth Quarter 2004*, Feb. 1, 2005, http://www.freddiemac.com/news/archives/rates/2005/4qupb04.html.

Cash-out refinancings are potentially problematic in terms of the "material prejudice to junior lienors" test mentioned above.[52] If we assume that under the operation of the subrogation doctrine discussed above, the priority of the original mortgage will be available to the refinancing lender, an increase in the balance owing on the loan may be harmful to the interests of the junior lienors. As the Restatement points out:

> Subrogation will be recognized only if it will not materially prejudice the holders of intervening interests. The most obvious illustration is that of a [lender] who lends the mortgagor more money than is necessary to discharge the preexisting mortgage. The [lender] is subrogated only to the extent that the funds disbursed are actually applied toward payment of the prior lien. There is no right of subrogation with respect to any excess funds.[53]

There can be no serious doubt that a higher loan balance, or an increased interest rate that results in a slower reduction in the loan balance (so that at any given future date, the loan will have a higher balance than would have been the case under its original amortization schedule), prejudices the positions of any intervening interest-holders.[54] The increase in balance on the prior mortgage

52. *See supra* text accompanying note 35.

53. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6 cmt. e (1997).

54. *See* Shane v. Winter Hill Fed. Sav. & Loan Ass'n, 492 N.E.2d 92 (Mass. 1986) (finding that an interest rate increase in excess of the 1% "default interest kickup" provided for in the original mortgage documents was prejudicial to junior mortgagee and hence not binding upon it); Burney v. McLaughlin, 63 S.W.3d 223 (Mo. Ct. App. 2001) (holding that extensions of time for payment did not materially prejudice an intervening lienor but that additions of various fees to the mortgage balance and inclusion of cross-default clause did cause prejudice, and should therefore be denied priority *pro tanto* as against the intervening lien); Fleet Bank of N.Y. v. County of Monroe Indus. Dev. Agency, 637 N.Y.S.2d 870 (N.Y. App. Div. 1996) (agreeing with the Restatement test and finding that a material issue of fact existed as to material prejudice); Shultis v. Woodstock Land Dev. Ass'n, 594 N.Y.S.2d 890 (N.Y. App. Div. 1993) (finding that an increase in interest rate materially prejudiced the intervening lienor but that a *pro tanto* loss of priority of the senior mortgage, to the extent that the higher interest resulted in a higher loan balance, was the appropriate remedy); Mergener v. Fuhr, 208 N.W. 267 (Wis. 1926) (holding that an increase in interest rate would result in a *pro tanto* loss of priority of the senior mortgage to an intervening lien).

Courts sometimes suggest that the prejudice may be so substantial as to warrant *complete* rather than a *pro tanto* loss in priority. "This sanction may be called for where the increase in the senior mortgage obligation is so substantial that no equity whatsoever remains to secure junior liens." 1 NELSON & WHITMAN, *supra* note 2, at 802. *But see* E. Sav. Bank v. Pappas, 829 A.2d 953 (D.C. 2003) (concluding that even a substantial interest rate increase did not result in material prejudice to the junior lienors); Dorothy Edwards Realtors, Inc. v. McAdams, 525 N.E.2d 1249 (Ind. Ct. App. 1988) (holding that a mortgage modification deferring some places them farther down the "food chain," and, if foreclosure becomes necessary, their probability of recovering their debts out of the property is reduced. The scenario of the increased rate is not particularly relevant here because mortgagors ordinarily refinance to get lower interest rates, not higher ones,[55] and a lowered rate is obviously advantageous to intervening lienors. But an increased loan balance plainly represents an increased exposure to risk to the intervening lienholders.

We need to consider how much additional money is typically involved. Federal Reserve Board data for residential refinancings in 2001–2002 indicates that, for mortgagors taking cash out by refinancing,[56] the mean loan balance before refinancing was nearly $125,931. The amount of new cash raised by the refinancing[57] had a mean of $26,723 and a median of $18,500.[58] Remarkably, even after the refinancing, the loans in the survey had loan-to-value ratios of only 62.9% (mean) or 65% (median)[59]—levels perceived as having very low default risk by the residential mortgage industry.[60]

payments and increasing the interest rate did not prejudice an intervening lienor). But see *American General Financial Services, Inc. v. Barnes*, 623 S.E.2d 617 (N.C. Ct. App. 2006), in which the court flatly denied subrogation, in part because the borrowers had drawn down an additional $1,573 in addition to paying off about $114,000 on two prior deeds of trust. It seems not to have occurred to the court to grant *pro tanto* subrogation.

55. Averaging the quarterly ratios of old to new interest rates reported by Freddie Mac from 2001 through 2004 yields an overall average ratio of 1.19 to 1. *See* News Release, Freddie Mac, Cash-out Refinance Share Falls Modestly in Fourth Quarter 2004, Feb. 1, 2005, http://www.freddiemac.com/news/archives/rates/2005/4qupb04.html. Stated differently, the average residential mortgagor was able to reduce his or her interest rate by about 16% by refinancing. Federal Reserve Board data for 2001–2002 indicate that 96% of mortgagors who refinanced during this period obtained lower interest rates, with an average reduction of 1.83 percentage points. *See* Canner et al., *supra* note 20, at 471.

56. The Federal Reserve Board data is based on a definition of "cash out" as any new loan having a balance exceeding the amount due on the preexisting loan plus closing costs. *See* Canner et al., *supra* note 20, at 473 tbl.7.

57. Note that this full amount did not necessarily become available to the mortgagors for other expenditures since some portion of it was inevitably eaten up by title insurance, loan fees, appraisal fees, and other expenses of refinancing.

58. *See* Canner et al., *supra* note 20, at 473.

59. *Id.*

60. It has long been recognized that loan-to-value ratio is a very strong—perhaps the best—predictor of the probability of mortgage default. *See, e.g.*, Carl E. Case & Robert J. Shiller, *Mortgage Default Risk and Real Estate Prices: The Use of Index-Based Futures and Options in Real Estate*, 7 J. HOUSING RES. 243, 245 (1996) ("Strong evidence . . . shows that the best single predictor of default is the current ratio of loan to market value for each property."). Lower loan-to-value ratios produce lower default rates because (1) borrowers with larger equities have more to lose when a default occurs, and consequently try harder to avoid

The impact of the additional loan balance is likely to be far less than at first appears. The refinancing mortgagee in the average transaction described above would have a loan balance of $152,654 but mortgage priority and title insurance coverage of only $125,931—a shortfall of about 17.5% of the total loan amount. This may initially seem to be a serious deficiency, but two factors must be remembered. First, the low loan-to-value ratio makes a default in payment by the mortgagor very unlikely. Second, even if the loan-to-value ratio were significantly higher, the fact that the subrogation doctrine confers mortgage priority on 82.5% of the new loan balance might still be a sufficient incentive to a title insurer to cover the entire new loan balance at a significantly reduced rate.

Refinancing loans also commonly provide for longer amortization periods than the loans they replace. However, it is highly unlikely that "stretching out" the term for payment of the loan would be considered "materially prejudicial" to intervening junior interests.[61] Usually "courts assume that extensions of maturity reduce the likelihood of foreclosure of the senior mortgage and hence that they are helpful, rather than prejudicial, to the interests of junior lienors."[62] There is a "strong presumption" against finding prejudice in this context.[63] Except in extreme cases,[64] we agree with this view.

default; and (2) borrowers with larger equities are more likely, when faced with a financial crisis, to be able to sell the property and realize a positive net cash return after paying transaction costs and the mortgage balance.

61. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.3 cmt. c (1997) takes the view in a related context that "[a]bsent an increase in the principal amount or the interest rate of the mortgage, such modifications normally do not jeopardize the mortgagee's priority as against intervening interests. . . . Extensions of maturity generally reduce the likelihood of foreclosure of the senior mortgage and thus are beneficial, rather than prejudicial, to the interests of junior lienors." Cases that agree with this position include *Shultis v. Woodstock Land Development Associates.*, 594 N.Y.S.2d 890, 892 (N.Y. App. Div. 1993), and *Lennar Northeastern Partners v. Buice*, 57 Cal. Rptr. 2d 435, 442–43 (Cal. Ct. App. 1996).

This position is not beyond debate. An increase in maturity may well reduce the monthly cash obligations of the borrower, making default less likely, but it also means that the loan will amortize more slowly, and, hence, will have a higher balance at any given point in time before it is fully paid. The higher balance is obviously detrimental to junior lienors if a foreclosure of the senior mortgage occurs. The courts have usually disregarded this factor, or have assumed that the detriment is outweighed by the benefit of the lower probability of default. *See Shultis*, 594 N.Y.S.2d 890; *Lennar Ne. Partners*, 57 Cal. Rptr. 2d 435. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.3 cmt. c and Reporter's Note (1997).

62. 1 NELSON & WHITMAN, *supra* note 2, at 800.

63. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.3 cmt. b.

Of course, changes in maturity as a result of refinancing can go in either direction. During the past several years a common form of refinancing has involved shortening, rather than lengthening, the maturity of the earlier loan. For example, the refinancing loan may have a fifteen-year amortization, while the loan being paid off was for a thirty-year term. Even though such transactions almost always result in a significantly lower interest rate, the shorter amortization period sometimes means that the monthly payments will actually increase. Of course, the borrower will need to be satisfied with his or her own ability to make the higher payments, and the refinancing lender will ordinarily insist on qualifying the borrower by examining his or her ability to do so.[65]

From the viewpoint of the junior lien-holder, the refinancing of a senior mortgage loan with a shorter term than the original senior mortgage represents both good news and bad news. The good news is that the senior debt will be discharged more rapidly and ultimately be paid in full earlier than if the refinancing had not occurred. The

64. Such an "extreme case" arguably existed in *Kim v. Lee*, 31 P.3d 665 (Wash. 2001), *modified*, 43 P.3d 1222 (Wash. 2001), in which the original mortgage loan had a six-year maturity but was refinanced with a loan having a thirty-year maturity (but a much lower interest rate). The court found that the extension of the loan term prejudiced the junior lienor, who held a judgment lien. *Id.* at 669. The original loan had a fifteen-year amortization schedule with a balloon payment due after six years, while the refinancing loan (made three years and four months later) had a thirty-year amortization schedule and no balloon payment. Hence, the new loan amortized more slowly than the old one; under the original loan terms, the loan would have had a balance of $100,134 at the time of the balloon payoff in January 2002, while the new loan would have had a balance of $115,807 on that date. On the other hand, because of the interest rate reduction (from 10.5% to 6.75%), the borrower's monthly payment was reduced nearly one-half, from $1,437 to $785.

It is not easy to say whether the change in loan terms was prejudicial to the judgment lienholder. If the borrowers defaulted on the new loan during the period prior to the old loan's balloon maturity, and the new loan was foreclosed, the judgment lienholder would have realized less money after the senior mortgage was paid—potentially as much as $15,000 less, depending on the date of foreclosure. However, the probability of a default by the borrowers was surely reduced significantly by the huge reduction in their monthly payment. It is simply unclear to which mortgage, the old or the new one, the judgment lienor would have preferred to be subordinate.

65. A common method of qualification requires proof that the monthly payments will not exceed a given percentage of the borrower's household income. That percentage will usually be in the range of 28% to 33%, depending on the particular lender's policies. An additional "total expense ratio" test, often applied, requires proof that the combination of the borrower's mortgage payment and all other monthly debt payments not exceed a percentage, typically 33% to 41%, of the borrower's household income. *See* Jack M. Guttentag, *Qualifying for a Mortgage*, Dec. 12, 2000, http://www.mtgprofessor.com/A%20-%20Qualifying/qualifying_for_a_mortgage.htm.

bad news is that the borrower may have a larger monthly obligation to meet, thus increasing the borrower's financial stress and potentially leading to a default on either the senior or junior debt. Nonetheless, except in extreme cases[66] this sort of refinancing should not result in a finding of prejudice to junior lienors. While higher monthly payments may impact the mortgagor's cash flow and conceivably make his or her ability to service the junior lien more problematic, the transaction clearly also benefits the junior interest.

For example, assume the borrower's old loan for $100,000 carried a 7.5% interest and an original term of 30 years, with 25 years remaining at the time of refinancing. Monthly payments on such a loan would be $700 per month, and it would have a balance owing of $94,510 when refinanced. Assume that the borrower refinances that balance with a new loan at 6% interest for 15 years. The new monthly payments will be $798, an increase of nearly $100. Despite the increased cash flow, because of the lower interest rate and shorter amortization on the new senior mortgage, the mortgagor's total interest obligation is reduced and the junior's position is thus strengthened.

In sum we believe, and the courts generally agree,[67] that changes in senior loan maturity, at least within a "normal" range of ten to thirty years, should be disregarded in examining prejudice to junior lienors. "Cash-out" refinancings that involve increases of loan balance may be considered prejudicial to juniors, but only if they increase the loan-to-value ratio above the 75% or 80% range since only above that range do residential mortgage loans exhibit a significant risk of default.

66. By "extreme cases," we mean situations in which the borrower's monthly payments increase drastically, the term is reduced drastically, or where the borrower would not have been able to qualify for the refinancing loan under ordinary payment-to-income ratio requirements. *See supra* note 65. An illustration is provided by *Gluskin v. Atlantic Savings & Loan Ass'n*, 108 Cal. Rptr. 318 (Cal. Ct. App. 1973), in which "[t]he principal amount of the loan was reduced [from $2.2 million] to $712,530, the interest rate was raised from 6 1/4% to 10%, the monthly payments reduced to approximately $5,900 and the maturity of the note shortened [from 30 years] to 10 months (with a balloon payment at the end)." *Id.* at 321. The court refused to enforce the change against a subordinating lienholder. *Id.* at 325.

67. As to maturity extensions, see authorities cited *supra* notes 61–62. We have found no case authorities involving a reduction of maturity.

C. Refinancing by the Same Lender

Refinancings by the same lender may use either of two different formats. In the first, which is analogous to a refinancing by a new lender considered above, the lender cancels the original note and releases its mortgage of record. At the same time, the mortgagor executes a new note and mortgage and the lender promptly records the mortgage. A new lender's title insurance policy normally will be issued and the premium will be paid by the mortgagor. This type of refinancing is appropriately termed a "replacement transaction."

In the second type of refinancing transaction by the same lender, the original note and mortgage are simply modified by a written agreement. No new money is advanced by the lender. We describe this as a "modification transaction." The original mortgage is not released of record; rather, the modification agreement is promptly recorded. An actual modification transaction from a few years ago provides an example. The original loan carried a fixed rate for five years at 7%. At the end of the five-year period it would convert to a variable-rate loan. It was refinanced at the then-current balance during its second year at a fixed interest rate of 5.75% for an additional five years at which time it would convert to a variable rate. The mortgagor paid the mortgagee a fixed fee of several hundred dollars and executed a modification agreement which the lender recorded. A new lender's title policy was not required, making it a very efficient transaction.

Our overall concern in same-lender refinancings is the same as in new-lender refinancings discussed above: whether title insurance protection is needed against the risk that an intervening lien will gain priority over the new loan. Let us consider how mortgage law treats intervening junior lienors in each of the foregoing situations. The replacement transaction is usually not governed by subrogation principles.[68] This is because "subrogation cannot be involved unless the second loan is made by a different lender than the holder of the first mortgage; one cannot be subrogated to one's own previous

68. There are a few judicial opinions to the contrary, applying subrogation to benefit lenders that refinanced their own prior mortgages. *See, e.g.*, Rush v. Alaska Mortgage Group, 937 P.2d 647 (Alaska 1997); W. Fed. Sav. & Loan Ass'n of Denver v. Ben Gay, Inc., 436 P.2d 121 (Colo. 1967); Suntrust Bank v. Riverside Nat'l Bank of Fla., 792 So. 2d 1222 (Fla. Dist. Ct. App. 2001). These courts evince confusion as to the proper context for application of subrogation.

mortgage."[69] Rather, a different body of law, employing principles similar to subrogation, is usually applied. Under section 7.3 of the Restatement, when

> a senior mortgage is released of record and, as part of the same transaction, is replaced with a new mortgage, the latter mortgage retains the same priority as its predecessor, except to the extent that any change in the terms of the mortgage or the obligation it secures is materially prejudicial to the holder of a junior interest in the real estate.[70]

The test of material prejudice for replacement purposes is the same as in the subrogation context. An increase in the principal amount is deemed prejudicial, as is an increase in the interest rate if the rate in the original mortgage was fixed.[71]

The same principles also govern modification transactions. According to the Restatement and the substantial case law supporting it, "[i]f a senior mortgage or the obligation it secures is modified by the parties, the mortgage as modified retains priority as against junior interests in the real estate, except to the extent that the

69. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6 cmt. e (1997).

70. *Id.* § 7.3(a). Many of the cases that are the basis for this Section articulate the rule slightly differently—they confer priority on the replacement mortgage as against intervening lienors unless "paramount equities" are present. This phrase, like "material prejudice," is grounded in the notion of detrimental reliance. Both the Restatement formulation and the cases reflect the same normative principle. The Restatement uses the words "material prejudice" simply because they are more descriptive than the "paramount equities" language. *See id.* § 7.3 Reporter's Note to cmt. b; *see also* Farmers & Merch. Bank v. Riede, 565 So. 2d 883 (Fla. Dist. Ct. App. 1990); State Bank of Lake Zurich v. Winnetka Bank, 614 N.E.2d 862 (Ill. App. Ct. 1993); Rebel v. Nat'l City Bank of Evansville, 598 N.E.2d 1108 (Ind. Ct. App. 1992); Jackson & Scherer, Inc. v. Washburn, 496 P.2d 1358 (Kan. 1972); Guleserian v. Fields, 218 N.E.2d 397 (Mass. 1966); Commerce Sav. Lincoln, Inc. v. Robinson, 331 N.W.2d 495 (Neb. 1983); Houston Lumber Co. v. Skaggs, 613 P.2d 416 (N.M. 1980); Resolution Trust Corp. v. Barnhart, 862 P.2d 1243, 1248 (N.M. Ct. App. 1993) ("[W]here a senior mortgagee discharges its mortgage of record and contemporaneously takes a new mortgage, the senior mortgagee's lien is not subordinated to intervening liens in the absence of (1) evidence of an intent to subordinate, or (2) paramount equities in favor of junior lienholders that justify subordinating the senior mortgagee's lien"—the court refers to this as "equitable reinstatement."); Skaneateles Sav. Bank v. Herold, 376 N.Y.S.2d 286 (N.Y. App. Div. 1975); Hummel v. Hummel, 896 P.2d 1203 (Okla. Civ. App. 1995); Kellogg Bros. Lumber v. Mularkey, 252 N.W.2d 596 (Wis. 1934). *Contra* Hilco, Inc. v. Lenentine, 698 A.2d 1254 (N.H. 1997) (refusing to recognize the senior's mortgagee's priority for its replacement mortgage where it had constructive notice of the intervening liens). The *Hilco* case is similar to the rigid view of subrogation reflected in the cases cited *supra* note 41.

71. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.3(a) cmt. b (1997); 1 NELSON & WHITMAN, *supra* note 2, at 799.

modification is materially prejudicial to the holders of such interests."[72] As in the subrogation and replacement mortgage contexts, while a decrease in interest rate[73] or an extension of the maturity of a senior mortgage[74] is not deemed prejudicial, increases in either interest rate or the principal amount of the obligation will result in a *pro tanto* loss of priority.[75]

In one important respect, both replacement and modification lenders receive more favorable treatment than their subrogation counterparts. As we have seen, many states that have not yet adopted the Restatement approach to subrogation demote in priority new refinancing lenders who have actual or constructive knowledge of

72. *Id.* § 7.3(b); *see, e.g.*, Resolution Trust Corp. v. BVS Dev., Inc., 42 F.3d 1206 (9th Cir. 1994); Crutchfield v. Johnson & Latimer, 8 So. 2d 412 (Ala. 1942); Lennar Ne. Partners v. Buice, 57 Cal. Rptr. 2d 435 (Cal. Ct. App. 1996); Eurovest Ltd. v. 13290 Biscayne Island Terrace Corp., 559 So. 2d 1198 (Fla. Dist. Ct. App. 1990); Burney v. McLaughlin, 63 S.W.3d 223 (Mo. Ct. App. 2001); Prudential Ins. Co. of Am. v. Nuernberger, 284 N.W. 266 (Neb. 1939); Shultis v. Woodstock Land Dev. Ass'n., 594 N.Y.S.2d 890 (N.Y. App. Div. 1993); Skaneateles Sav. Bank v. Herold, 376 N.Y.S.2d 286 (N.Y. App. Div. 1975).

73. *See, e.g.*, Big Land Inv. Corp. v. Lomas & Nettleton Fin. Corp., 657 P.2d 837 (Alaska 1983) (decrease in interest rate does not prejudice the interests of junior lienors). *Contra* Citizens & S. Nat'l Bank of S.C. v. Smith, 284 S.E.2d 770 (S.C. 1981).

74. *See In re* Fowler, 83 B.R. 39 (Bankr. D. Mont. 1987) (reamortization of two senior mortgages after an intervening judgment lien did not affect the priority of those mortgages); Guleserian v. Fields, 218 N.E.2d 397 (Mass. 1966) (maturity extension of senior mortgage did not impair its priority); Burney v. McLaughlin, 63 S.W.3d 223 (Mo. Ct. App. 2001); 1 NELSON & WHITMAN, *supra* note 2, at 799–800.

75. *See, e.g.*, Bank of Searcy v. Kroh, 114 S.W.2d 26 (Ark. 1938); *Lennar Ne. Partners*, 57 Cal. Rptr. 2d at 435, 442 ("[W]hen the obligation is increased, by an increase in the principal amount or an increase in the interest rate, the junior lienholder's position is worsened. . . . [T]he impairment to [junior's] security and its rights as a junior lienholder caused by the modification can be fully eliminated by denying priority to the modification."); *Burney*, 63 S.W.3d at 232 ("'[W]here the modification entails an increase in the senior mortgage interest rate or an increase in its principal amount, the junior lienor will gain priority over the earlier mortgage to the extent of the modification'" (quoting 1 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE § 9.4 (3d. ed. 1993))); Fleet Bank v. County of Monroe Indus. Dev. Agency, 637 N.Y.S.2d 870, 871 (N.Y. App. Div. 1996) ("Where, however, the actions of the senior lienor prejudice the junior lienors but do not substantially impair their security interest or destroy their equity, the senior lienor will be required to relinquish to the junior lienors its priority with respect to the modified terms only."). Where the modifications are extreme, the senior mortgage may sometimes completely lose its priority:

> One situation might be where there is a substantial increase in the mortgage interest rate and a long term evenly amortized payment schedule is changed to a one year balloon mortgage. This sanction may also be called for where the increase in the senior mortgage is so substantial that no equity whatsoever remains to secure junior liens.

1 NELSON & WHITMAN, *supra* note 2, at 801–02.

intervening interests.[76] By way of contrast, in the context of replacement mortgages and modification of mortgages, there is no similar penalty on the lender for having actual or constructive knowledge of intervening liens. Indeed, in this context, the lender's knowledge is irrelevant. This is true under both the Restatement and the case law.[77]

In sum, case law currently protects refinancing lenders in both the replacement and modification contexts against intervening junior interests so long as neither the interest rate nor the principal amount of the prior loan is increased. The applicable Restatement sections are consistent with these cases. As we have already seen, refinancing lenders find less protection in subrogation decisions in many jurisdictions because the right to subrogation is conditioned upon the lender's absence of knowledge of intervening interests. Under the Restatement, however, protection is afforded to the new lender irrespective of such knowledge. The Restatement requires only that the new lender *expected* to have the priority of the old mortgage—and that expectation should be presumed, as the Restatement says,[78] in the absence of evidence of a contrary intent on the part of the new lender.

The Restatement rule is the fairest approach because it rejects conferring a windfall on intervenors who, after all, do not acquire their liens and other interests with the expectation of being anything but subordinate to a senior mortgage. Courts that refuse to follow this approach offer no policy reasons for doing so, but only the moralistic argument that the refinancing lender should be ashamed of itself for not being more careful—an attitude that tacitly assumes the refinancing lender must spend (or more realistically, force its borrower to spend) the cost of a new title examination. More generally, the Restatement approach is friendly to first mortgage refinancing, a process that clearly is beneficial to homeowners. Consequently, as a normative matter, we strongly urge the adoption of the Restatement subrogation rule. It has already gained

76. *See supra* notes 40–41 and accompanying text.

77. *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.3 (1997). For the most part, the case law simply ignores the notice issue; *see* cases cited *supra* notes 70, 72. The one exception seems to be *Hilco, Inc. v. Lenentine*, 698 A.2d 1254 (N.H. 1997).

78. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6 cmt. e, illus. 27 (1997).

considerable ground, and we believe and hope it is well on its way to becoming the predominant rule.[79]

IV. HELPING SUBROGATION WORK: TWO SIMPLE MORTGAGE CLAUSES

While the Restatement's approach to subrogation has enjoyed a strong positive judicial reception since its 1997 adoption,[80] there are two simple mortgage clauses that, if widely adopted in mortgage forms, would greatly strengthen subrogation's effectiveness in the context of mortgage refinancings and advance the overall goal of avoiding most or all of the expense of a new title examination. The first, discussed in Section A below, is a clause expressly stating that the mortgagee intends to have the priority of the previous mortgage it is paying off, and the second, discussed in Section B below, is a "future advance" clause.

A. Adopting "Conventional" Subrogation

The first of these clauses stems from the concept of "conventional" subrogation. A word of explanation is in order here. The concept of subrogation referred to thus far in this Article, and in the great majority of judicial decisions, is usually termed "equitable" subrogation, and courts often say they will award it only when

79. One court recently described the traditional notice-based approach to subrogation as being "rapidly eroded" in favor of the Restatement approach. Bank of Am. v. Wells Fargo Bank, 109 P.3d 863, 868 (Wash. Ct. App. 2005). That court quite obviously would have preferred to adopt the Restatement rule, but was constrained from doing so by the stare decisis effect of the Washington Supreme Court's decision in *Kim v. Lee*, 31 P.3d 665, *modified*, 43 P.3d 1222 (Wash. 2001).

80. *See* Lamb Excavation, Inc. v. Chase Manhattan Mortgage Corp., 95 P.3d 542 (Ariz. Ct. App. 2004); E. Sav. Bank v. Pappas, 829 A.2d 953 (D.C. 2003); Wilkins v. Gibson, 38 S.E. 374 (Ga. 1901); Bank of N.Y. v. Nally, 820 N.E.2d 644 (Ind. 2005); Klotz v. Klotz, 440 N.W.2d 406 (Iowa Ct. App. 1989); E. Boston Sav. Bank v. Ogan, 701 N.E.2d 331 (Mass. 1998); Burney v. McLaughlin, 63 S.W.3d 223 (Mo. Ct. App. 2001); Providence Inst. for Sav. v. Sims, 441 S.W.2d 516 (Tex. 1969); Farm Credit Bank v. Ogden, 886 S.W.2d 305 (Tex. App. 1994); Chi. Title Ins. Co. v. Lawrence Invs., Inc., 782 S.W.2d 332 (Tex. App. 1989); *see also* Trus Joist Corp. v. Nat'l Union Fire Ins. Co., 462 A.2d 603 (N.J. Super. Ct. App. Div. 1983), *rev'd sub nom.*, Trus Joist Corp. v. Treetop Assocs., Inc., 477 A.2d 817 (N.J. 1984). Several lower courts have endorsed the Restatement approach, but have refused to apply it because they considered themselves bound by earlier state supreme court decisions that were less favorable to subrogation. *See* First Commonwealth Bank v. Heller, 863 A.2d 1153 (Pa. Super. Ct. 2004); Bank of Am. v. Wells Fargo Bank, 109 P.3d 863 (Wash. Ct. App. 2005).

equitable considerations require it.[81] There is, however, an alternate version of subrogation—conventional subrogation—which is said to rest on the existence of an *agreement* to give the refinancing lender the priority of the mortgage which it pays.

If such an agreement existed between the refinancing lender and the intervening lienor, no one would doubt its effectiveness; in effect, it would constitute a subordination agreement by the intervenor, preventing its lien from being promoted in priority when the original first mortgage was paid. But the remarkable thing about conventional subrogation is that the agreement need not involve the intervening lienor in any way, rather, it can simply be an agreement between the refinancing lender and the borrower. As the Nebraska Court of Appeals recently put it, "[c]onventional subrogation arises where one pays the debt of another under an agreement, existing at the time of the payment, with *either the debtor or the creditor*, that the person paying shall be subrogated to the liens existing as security for the debt."[82] It is extremely doubtful that conventional

81. *See, e.g.*, *Kim*, 31 P.3d at 669 ("Subrogation is fundamentally an equitable concept designed 'to impose ultimate responsibility for a wrong or loss on the party who, in equity and good conscience, ought to bear it.'" (quoting Mahler v. Szucs, 957 P.2d 632, 640 (Wash. 1998))).

82. Am. Nat'l Bank v. Clark, 660 N.W.2d 530, 535 (Neb. Ct. App. 2003) (citing Hoppe v. Phoenix Homes, Inc., 318 N.W.2d 878 (Neb. 1982)) (emphasis added). Cases actually applying conventional mortgage subrogation (rather than merely recognizing the concept) are fairly sparse. *See, e.g.*, Vogel v. Veneman, 276 F.3d 729, 735 (5th Cir. 2002) ("Contractual subrogation arises when 'a person advances money to take up and extend indebtedness secured by a vendor's lien on land under an *agreement* that such person shall stand in the place of the original holder of the indebtedness.' . . . A valid deed of trust executed by both the borrower and lender establishes contractual subrogation." (quoting Glassock v. Travellers Ins. Co., 113 S.W.2d 1005, 1009 (Tex. Civ. App. 1938) (applying Texas law))); Wolf v. Spariosu, 706 So. 2d 881 (Fla. Dist. Ct. App. 1998) (applying conventional subrogation where the refinancing lender had an express agreement with the borrower to take the priority of the mortgages being paid); LaSalle Bank v. First Am. Bank, 736 N.E.2d 619 (Ill. App. Ct. 2000) (applying conventional subrogation primarily on the basis of a provision in a construction loan agreement stating that the borrower was obligated to provide a title insurance policy insuring that the construction mortgage was a first lien); Med Ctr. Bank v. Fleetwood, 854 S.W.2d 278, 283 (Tex. Ct. App. 1993); Rock River Lumber Corp. v. Universal Mortgage Corp. of Wis., 262 N.W.2d 114, 118 (Wis. 1978) (applying conventional subrogation where the refinancing mortgage stated "the mortgagor hereby covenants that the mortgagor is seized of a good title to the real estate in fee simple, free and clear of all encumbrances"). Although numerous Louisiana cases apply conventional subrogation, they are not considered here because of the unique features of Louisiana property law. *See also* Bankers Trust Co. v. United States, 25 P.3d 877, 882 (Kan. Ct. App. 2001) (recognizing but rejecting the application of conventional subrogation and commenting, "[w]e fail to see how the intention of [the refinancing lender] has anything to do with whether its

subrogation is really a matter of enforcing a contract between the refinancing lender and the borrower[83]—indeed, it is hard to see how such a contract could possibly affect the intervening creditor's rights. A much more convincing explanation was provided by the Nebraska Supreme Court in a conventional subrogation case many years ago:

> It is not enough to entitle to subrogation that, with the proceeds of [a new] mortgage, prior mortgages have been discharged. "The real question in all such cases is whether the payment made by a stranger was a loan to the debtor through a mere desire to aid him, or whether it was made with the expectation of being substituted in the place of a creditor. If the former is the case, he is not entitled to subrogation; if the latter, he is."[84]

When conventional subrogation is viewed in this light, it becomes clear that the courts employing conventional subrogation are saying precisely what the Restatement says: that subrogation should be granted, irrespective of the subrogee's knowledge of the intervening lien when the subrogee "reasonably expected to receive a security interest in the real estate with the priority of the mortgage being discharged."[85] The agreement is simply evidence that the subrogee had that expectation.

We need to examine the precise nature of the agreement that is needed to trigger the doctrine of conventional subrogation. A recent Illinois Court of Appeals case, *Aames Capital Corp. v. Interstate*

lien is a priority lien upon the property"); Wash. Mut. Bank v. Shorebank Corp., 703 N.W.2d 486 (Mich. Ct. App. 2005) (recognizing conventional subrogation but refusing to apply in the absence of any evidence of an agreement giving the refinancing lender priority).

83. *See* 1 NELSON & WHITMAN, *supra* note 2, at 829 ("Subrogation in the last case is sometimes called 'conventional' subrogation and is may [sic] be said to arise from contract, an agreement between the subrogee and either the debtor or the creditor, although there is serious doubt that its real basis is contractual. An agreement between the debtor and the person claiming subrogation clearly does not in itself transfer the right of the creditor to such person.").

84. Bohn Sash & Door Co. v. Case, 60 N.W. 576, 581 (Neb. 1894) (quoting Tradesmen's Bldg. & C. Ass'n v. Thompson, 32 N.J. Eq. 133 (N.J. Ch. 1880)). A similar point was made in *Martin v. Hickenlooper*, 59 P.2d 1139, 1152 (Utah 1936): "That equity applies the doctrine of subrogation in [conventional subrogation] cases, not in exacting a performance of the contract, but as a matter of doing justice under the circumstances; the so-called agreement only being of value showing such a situation where the doctrine should be applied in order to do justice and as evidence that the lender was not a volunteer." *See also Rock River Lumber*, 262 N.W.2d at 117 ("Even where a definite agreement for subrogation is shown, therefore, subrogation will be denied where it would lead to an uncontemplated and inequitable result.").

85. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6(b)(4) (1997).

Bank of Oak Forest,[86] is instructive. *Aames* involved a typical refinancing: the new lender, Pacific Thrift & Loan Co., employed the standard Fannie Mae/Freddie Mac uniform residential mortgage form. After the mortgage documents were executed and recorded, Pacific assigned them to Aames. The property was subject to a recorded judgment lien in favor of Interstate Bank, which Pacific apparently failed to discover. The court noted that the case might have been decided on the basis of equitable subrogation, but because Illinois authority on that doctrine was sparse, it preferred to use conventional subrogation instead.

Since conventional subrogation requires an agreement between the borrower and the new lender that the latter will "inherit" the priority of the old mortgage, the court was forced to search the Fannie Mae/Freddie Mac uniform mortgage to find such an agreement. Unfortunately, no such express agreement exists in that standardized document. The court was undaunted. It identified two provisions that it felt suggested an intention for the refinancing mortgagee to keep the priority of the paid-off mortgage. First, the form states that the "[b]orrower shall promptly discharge any lien which has priority over this Security Instrument."[87] Second, if the borrower fails to perform this duty, the form states that the lender can take any reasonable action to protect its rights.[88]

A fair reading of these provisions suggests that they are, at most, a highly ambiguous statement of the refinancing lender's expectation to gain the priority of the mortgage it paid off. The court conceded as much, but nevertheless stated:

> [W]e believe that the above-referenced provisions, when read together, indicate that the agreement of the parties was that the mortgage held by Pacific would be a first priority mortgage, and

86. 734 N.E.2d 493 (Ill. App. Ct. 2000).

87. *Aames*, 734 N.E.2d at 500; Freddie Mac, Fannie Mae/Freddie Mac Uniform Single-Family Instrument, Form 3014 (Illinois), January 2001, ¶ 4, http://www.freddiemac.com/uniform/doc/3014-IllinoisMortgage.doc. Quotations in the text are from the current version of the form, but it evidently does not vary materially from the form reviewed by the court in *Aames*.

88. Freddie Mac, *supra* note 87, ¶ 9 ("Lender's actions can include, but are not limited to: (a) paying any sums secured by a lien which has priority over this Security Instrument . . . . Any amounts disbursed by Lender under this Section 9 shall become additional debt of Borrower secured by this Security Instrument.").

> that any other prior mortgages of record would be paid off by Pacific, with the new mortgage securing that debt.[89]

The holding in *Aames* is obviously a result-oriented stretching of the mortgage's language, but we agree with the result. The court's decision would have been easier had the Fannie Mae/Freddie Mac form—used for a huge majority of U.S. residential mortgages—contained an express provision like the following:

> This Security Instrument is intended to create a first lien on the Property. Borrower and Lender agree that this Security Instrument shall have, and Lender intends and expects to have, the priority of any other security instrument that has been paid or discharged with the proceeds of the Loan secured by this Security Instrument.

Adding this language would make the application of conventional subrogation almost irresistible, while costing nothing.[90] Moreover, in a jurisdiction following the Restatement approach to equitable subrogation it would enormously solidify the conclusion that the mortgagor "reasonably expected to receive a security interest in the real estate with the priority of the mortgage being discharged."[91] While we do not consider such language essential to the application of equitable subrogation, it seems only common sense to include it. Such language provides no absolute guarantee that a court will apply subrogation, but it strongly increases the likelihood.

B. Using the "Open-end" or Future Advances Clause

A second clause is designed to meet the problem of cash-out refinancing, where the balance on the new loan exceeds the amount

89. *Aames*, 734 N.E.2d at 500. The court contrasted the refinancing mortgage before it with the mortgage in *Firstmark Standard Life Insurance Co. v. Superior Bank*, 649 N.E.2d 465 (Ill. App. Ct. 1995). In that case, the refinancing mortgage contained an express statement that it was subject to the prior lien over which the mortgagee now sought priority; the court refused to grant conventional subrogation.

90. We say "almost" because even a definite agreement is no guarantee of subrogation if the result would be inequitable. See, for example, *Rock River Lumber Corp. v. Universal Mortgage Corp. of Wisconsin*, 262 N.W.2d 114 (Wis. 1978), which points out that prejudice to the intervening lienor might exist if a delay occurred between the recording of the satisfaction of the original mortgage and the recording of the refinancing mortgage, and if the intervening lienor extended credit during the period of delay in reliance on the apparently clear title of the property at that time. Such a delay had occurred in *Rock River*, but the court found no reliance on it by the intervening lienor, and granted conventional subrogation.

91. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6(b)(4) (1997).

paid to discharge the old loan.[92] As we have already noted, there can be no serious doubt that the additional sum advanced will prejudice junior lienors, making subrogation against them unjust to that extent.[93] There is, however, a simple way to overcome this objection to full subrogation in a cash-out refinancing: the use of a "future advance" or "open-end mortgage" clause in the original mortgage.

From the 1950s through the 1980s, future advance clauses were routinely used in residential mortgages.[94] Such a clause might read as follows:

> Upon request of Borrower, Lender, at Lender's option prior to release of this Security Instrument, may make future advances to Borrower. Such future advances, with interest thereon, shall be secured by this Security Instrument when evidenced by promissory notes stating that said notes are secured hereby. The maximum principal amount of such future advances shall not exceed one-half of the original amount secured by this Security Instrument.[95]
>
> At no time shall the principal amount of the indebtedness secured by this Instrument, not including sums advanced in accordance herewith to protect the security of this Instrument, exceed the

92. Roughly half of all recent refinancings have involved this situation. *See supra* notes 47–51 and accompanying text.

93. *See supra* text accompanying notes 54–55. It is arguable that small amounts of cash disbursed over and above the balance on the old mortgage should be disregarded and subrogation ordered. The court did so in *Union Planters Bank v. FT Mortgage Cos.*, 794 N.E.2d 360 (Ill. App. Ct. 2003), stating that $4,000 of additional cash did not prevent application of conventional subrogation.

94. Such clauses were included in standard Fannie Mae/Freddie Mac mortgage forms when they were developed in the 1970s. *See, e.g.*, D. BARLOW BURKE, JR., *Nonuniform Covenant 20 of the District of Columbia FNMA/FHLMC Single Family Deed of Trust Form*, LAW OF FED. MORTGAGE DOCUMENTS app. a (1989). Use of future advance clauses was apparently discontinued in those forms in the early 1990s. This was confirmed by a conversation of one of the coauthors with John Mansfield, Vice President and Deputy General Counsel, Federal National Mortgage Association, September 9, 1994.

95. The language is derived from the clause quoted in *In re Hawkins*, 156 B.R. 745 (Bankr. D. Vt. 1993). We have modified it to be consistent with the terminology of the current Fannie Mae/Freddie Mac uniform one-to-four-family mortgage instrument. For similar illustrations, see *Hill v. Delta Loan & Finance Co.*, 277 S.W.2d 63, 64 (Ark. 1955); *Downing v. First National Bank*, 81 So. 2d 486, 488 (Fla. 1955). Note that this clause contemplates that the additional advance will refer specifically to the original mortgage and, therefore, differs from a "dragnet" clause, which typically provides that the mortgage will secure "any other indebtedness that may be owed to lender by borrower." See 1 NELSON & WHITMAN, *supra* note 2, § 12.7, for an extended discussion of dragnet clauses.

original amount of the Note (US$__________) plus the additional sum of US$__________.[96]

The priority of advances under this sort of clause has traditionally depended on whether the advances were optional or obligatory. The traditional rule held that unless the lender had a contractual duty to make the future advance, it would lose priority to any intervening liens that the lender had notice of when the advance was made.[97] This rule would render the future advance clause useless in preserving the priority of the full mortgage balance in a cash-out refinancing, which by its nature involves the making of an optional and discretionary advance.

However, the advent of statutory changes in a large number of jurisdictions and the teaching of the Restatement on this issue have caused a major change in the legal attitude toward the priority of future advances. The Restatement takes the view that all future advances should be granted the priority of the original mortgage but permits the borrower to issue a "cut-off notice" to the lender, terminating the borrower's right to any additional advances.[98] Under the Restatement, so long as the lender has not received a cut-off notice, it can be confident that all of the advances it makes will carry the original mortgage's priority.

Changes in the law along similar lines have become quite pervasive, mainly because of statutory changes during the past twenty-five years. The Restatement contains a statutory table

96. The final sentence appeared in the "nonuniform covenants" of the Fannie Mae/Freddie Mac form in a number of jurisdictions; it was inserted to comply with individual state statutes requiring a statement in the mortgage of the maximum amount of principal to be secured. An illustrative clause appeared as Nonuniform Covenant 33 of the Texas FNMA/FHLMC Multifamily Deed of Trust form, *reprinted in* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 14.16, cl. 33 (3d ed. 1993).

97. *See, e.g.*, Model Home Bldg., Inc. v. Turnquist, 102 N.W.2d 717 (Minn. 1960) (refusing to accord priority to the advances because they were optional, without reference to senior lender's notice of junior liens); S. Trust Mortgage Co. v. K & B Door Co., 763 P.2d 353 (Nev. 1988) (granting obligatory advances priority over intervening mechanic's liens); Colonial Bank v. Marine Bank, 448 N.W.2d 659 (Wis. 1989) (refusing to recognize priority of optional advances made at a time when senior lender had actual knowledge of junior liens). On the complex question of whether, and what sort of, notice of junior liens to the senior lender will cause the senior lender to lose priority, see Grant S. Nelson & Dale A. Whitman, *Rethinking Future Advance Mortgages: A Brief for the Restatement Approach*, 44 DUKE L.J. 657, 680–82 (1995).

98. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 2.3 (1997).

summarizing the priority of future advances in all fifty states.[99] In thirty-five states, even an optional future advance will ordinarily retain priority. In sixteen of these states, the borrower is empowered to send a cut-off notice terminating further advances, and any advances made thereafter will lose priority. In another eleven states, the lender will lose priority for advances made after the lender receives written notice of the presence of any intervening lien.[100] These notice procedures should cause no risk to lenders; in the relatively rare case in which a senior lender receives a cut-off notice or notice of the existence of a junior lien, the senior lender would simply place the notice in the loan file to warn that the senior lender could not safely make any additional advances. Since the original mortgage's priority continues to govern under these statutes, no title examination or new title insurance would be necessary.

Of the thirty-five states listed in the Restatement as protecting the priority of future advances, twenty-eight also require a statement of maximum principal amount, either to ensure the priority of the advance or to establish its validity as a secured claim.[101] For this reason, a provision like the second sentence of the clause in the indented quotation above is essential in those states. Once again, this is not a burdensome requirement. The lender might, for example, set the maximum total amount at roughly fifty percent above the amount of the original loan. This would be more than sufficient for the vast majority of refinancings.[102]

On its face the future advances clause enables the borrower to refinance, without the expense of a title examination and title insurance, with the same lender that made the original mortgage loan. However, for a variety of reasons, the borrower may wish to

99. *Id.* § 2.1 statutory note.

100. *Id.* Some of the statutes listed also require recording of the notice. Those requiring recording also require direct notice to the senior mortgagee, thus eliminating any concern that a title examination by the mortgagee would be necessary prior to the making of the additional advance. *See, e.g.*, CONN. GEN. STAT. § 49-2 (2005); FLA. STAT. § 697.04(1)(b) (2005); ME. REV. STAT. ANN. tit. 9-B, § 436(1)(A), (2) (2005); NEB. REV. STAT. § 76-238.01(1) (2005); N.C. GEN. STAT. § 45-72(a) (2005) (document to be recorded must be requested from mortgagee); OHIO REV. CODE. ANN. § 5301.232(C) (West 2005).

101. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 2.1 statutory note.

102. Based on the data collected by the Federal Reserve Board on cash-out refinancings in 2001–2002, the average additional amount of cash taken was only about twenty-one percent of the current loan balance (and hence, an even smaller percentage of the original loan balance, which would have been paid down somewhat by monthly amortization payments). *See supra* note 50 and accompanying text.

obtain the refinancing from a different lender—one who is offering more attractive loan terms, for example. The subrogation doctrine that we advance allows the refinancing lender to take advantage of a future advance clause in the original mortgage. Subrogation, after all, is nothing more than an assignment of the original mortgage to the refinancing lender by operation of law.[103] Hence, the refinancing lender's rights should not be materially different than if it had acquired the original mortgage by a literal, written assignment.[104] While we have found no case directly raising this issue, courts in other contexts have readily permitted mortgage assignees to benefit from clauses in the original mortgages.[105] Ordinarily, of course, subrogation is applicable only to the extent that the proceeds of the refinance loan are applied to pay the original loan.[106] But if the benefit of the future advance clause is available to the new lender, the limitations of the subrogation theory for cash-out refinancing simply disappear in all cases in which the original mortgage contains an appropriate future advance clause. Any intervening lienors can hardly complain since they knew of the risk of being subjected to a larger prior lien by the recorded future advance clause.[107] That risk is

103. *See* G.E. Capital Mortgage Servs., Inc. v. Levenson, 657 A.2d 1170, 1179 (Md. 1995); RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6 cmt. a.

104. It seems obvious that a mortgage investor taking an assignment of a note and mortgage containing a future advance clause would be permitted to make advances under the clause and have the benefit of the priority that would have been available to the original mortgagee. See *Texas Bank of Beaumont v. Bozorg*, 457 So. 2d 667 (La. 1984), in which a bank taking an assignment of a mortgage and subsequently making additional advances made this argument. The court rejected the argument on the ground that the original loan agreement did not sufficiently reflect an intention that future advances would be covered by the mortgage, but appeared to agree that if the agreement had been sufficient, the advances by the assignee would have been entitled to priority under Louisiana law. *Id*. at 672–73.

105. *See* Ala.-Fla. Co. v. Mays, 149 So. 61, 64 (Fla. 1933) ("The general rule is that the assignee of a mortgage is invested with the powers and interests of the mortgagee as fully as if he had been named such in the mortgage."); Money Store Inv. Corp. v. Summers, 822 N.E.2d 223 (Ind. Ct. App. 2005) (Transfer Granted, Opinion Vacated, IN RAP 58(A)) (permitting assignee of mortgage to exercise rights under mortgage's dragnet clause); *In re* McCurdy's Estate, 154 A. 707 (Pa. 1931) (same).

106. *See, e.g.*, Union Planters Bank v. FT Mortgage Cos., 794 N.E.2d 360, 365 (Ill. App. Ct. 2003) (permitting a subrogated refinancing lender to gain priority despite a small increase in the loan balance).

107. *See* Bank of Barron v. Gieseke, 485 N.W.2d 426, 436 (Wis. Ct. App. 1992) ("[B]ecause the [intervening lienors] were aware of the future advance clause, they had notice that their claims would be subordinate to any liens falling within the purview of the [senior mortgage].").

not materially different if the additional advance is made by a different lender rather than by the original lender.

In sum, the two clauses discussed above have the potential to eliminate virtually all of the problematic aspects of equitable subrogation as applied to mortgage refinancings. The clause expressing the refinancing lender's intent to acquire the priority of the mortgage being paid off will, under the conventional subrogation concept, ensure that the courts are not burdened by debates about the refinancing lender's notice or knowledge of intervening liens. The clause providing for future advances will give the refinancing lender the ability to provide cash out without worry about loss of priority for the additional cash. Both clauses are essentially free; they involve no cost beyond a slight rewording of existing mortgage forms.

C. Expanding Subrogation to New Debtors

Once the notion is accepted, as outlined above, that a mortgage lien may extend through more than one financing of a given debtor's property, the question arises whether it may extend to more than one debtor. Consider a case in which an original mortgage, containing a future advance clause and appropriate "conventional" subrogation language (if necessary to actuate subrogation under applicable state law), is assumed by a new owner of the real estate. It would be highly desirable if the mortgage lien—enlarged as necessary to meet the financial needs of the new owner of the property but only within the limitations imposed by the future advance clause—could continue to secure the new owner's purchase-money debt. However, it is standard doctrine that subrogation is assumed to apply only to debts incurred by the original debtor.

The necessity for such a "warning" may be somewhat overblown in any event. In the analogous situation involving personal property security under article 9 of the Uniform Commercial Code, subordinate lienors lose priority to future advances made under an appropriate clause in the senior security agreement, even though the security agreement itself is not a matter of public record (since only a financing statement, and not the entire security agreement, need be filed). In effect, all subordinate lienors of personal property security must accept the risk that a future advance clause in the senior security agreement will impair their position. *See* U.C.C. § 9-310 (2000) (generally requiring filing for perfection of a security interest); *id.* § 9-323 (generally giving all future advances the priority of the original security agreement); *id.* § 9-323 cmt. 3 (stating that if a financing statement has been filed, "it is abundantly clear that the time when an advance is made plays no role in determining priorities among conflicting security interests").

This assumption is well illustrated by the Alabama Court of Civil Appeals' opinion in *Collateral Investment Co. v. Pilgrim*.[108] A developer, Cameron, built a townhouse project with funds lent by Central Bank on the security of a construction mortgage.[109] Cameron failed to pay Pilgrim, a supplier of electrical equipment, for the project, giving Pilgrim the right to file a materialman's lien.[110] However, before the lien was filed, Cameron sold two of the houses to Burleson and Hatfield, who borrowed mortgage funds from Collateral to finance their purchases.[111] Pilgrim filed its lien after these sales were consummated.[112] Collateral attempted to gain priority over the lien by asserting a right of subrogation to the construction loan, which clearly would have had priority over the lien and which had been paid off pro-rata with the funds lent by Collateral.[113] However, the court rejected Collateral's assertions:[114]

> We cannot find in the present case that the money was advanced at the instance of the debtor to satisfy the prior incumbrance [sic]. The debtor to Central was Cameron. Collateral's debtors were Burleson and Hatfield. Burleson and Hatfield were not debtors of Central. Therefore Burleson and Hatfield had no obligation to Central. Although it is clear that Collateral paid this debt to Central in order to satisfy the encumbrance, this was not done at the instance of Cameron. . . . Collateral argues that it advanced money for the express purpose of satisfying this prior encumbrance. However, we cannot agree. Collateral loaned this money to the individuals based on these individuals' credit. The money was not loaned for the express purpose of satisfying this prior encumbrance.[115]

Clearly, the Alabama court's assumption was that only a request by the original debtor for a payment of the debt will result in subrogation. Yet there seems to be no particular reason to make this assumption, and the statements of the subrogation principle made by

108. 421 So. 2d 1274 (Ala. Civ. App. 1982).
109. *Id.*
110. *Id.*
111. *Id.* at 1274–75.
112. *Id.* at 1275.
113. *Id.* at 1275–76.
114. *Id.* at 1276.
115. *Id.*

most courts do not intrinsically embody it.[116] We must concede that cases in which subrogation has actually been applied after a transfer of the property or a substitution of debtors are rare indeed. We are aware of only one in which the issue was seriously considered: *East Boston Savings Bank v. Ogan*.[117] There, the Massachusetts Supreme Judicial Court adopted the broad, "no-fault" Restatement view of subrogation. The decision clearly reflects the court's understanding that it was doing something a bit unusual[118] in applying subrogation to a case in which the property had been sold at the time of the new financing:

> Because we find that the equities are substantially similar in refinancing and sales transactions, and that application of equitable subrogation to a sale is consistent with our precedent, we hold that equitable subrogation applies in this case.
>
> . . . .
>
> . . . [T]he distinction between a sale and a refinancing exists, but subrogation arising out of either context yields the same result.[119]

The Massachusetts court's understanding is correct. Moreover, if widely applied, and if used with mortgage documents containing appropriate future advance clauses, that understanding would have the potential to eliminate the need for lenders' title insurance coverage in a vast additional class of cases involving new purchase-money financing of real estate sales. At the same time, adoption of the principle would earn the undying enmity of the title insurance industry, depriving it of a major source of its revenue. Of course, the need for title insurance would not be wholly eliminated in sale transactions since the purchaser of the property (who, not being a lender, would be ineligible for subrogation) would still need assurance that she or he is obtaining title of an acceptable quality.

116. Perhaps presciently, RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6(b)(4) (1997) does not make this assumption. It makes subrogation appropriate if the refinancing lender pays the original mortgage debt "upon a request from the obligor *or the obligor's successor* to do so." *Id.* (emphasis added).

117. 701 N.E.2d 331 (Mass. 1998). The court applied subrogation to benefit a lender making a loan to the purchasers of the property in *National City Mortgage Co. v. Ross*, 117 P.3d 880 (Kan. Ct. App. 2005). However, there is no indication in the opinion that the court realized it was doing anything novel.

118. The court cited no authority outside of Massachusetts for its action. *Id.*

119. *Id.* at 334–36.

We do not advocate here the application of subrogation to mortgages on properties that have been sold to new owners. Case authority supporting it is extremely limited, and it lies outside the ordinary scope of the subrogation doctrine. Perhaps the notion is too radical, portending too great a change in established, conventional practices in real estate sales. Or perhaps its time is simply yet to come. We present it merely to illustrate the potential power of the subrogation doctrine, and to suggest that a modest amount of creative thinking about the priority of mortgages might result in the saving of a great deal of money. Even without applying subrogation to properties whose title is being transferred, the two clauses described in this section—the clause expressing the lender's intent to have the prior mortgage's priority[120] and the clause providing for future advances[121]—can enormously solidify the legal foundation for the subrogation concept, and hence can vastly reduce the need for new title protection when refinancings occur.

V. IS THERE A REMAINING ROLE FOR TITLE INSURANCE IN REFINANCING?

It is clear that at present, the primary role of title examination and title insurance in the context of a mortgage refinancing is to ensure that there are no intervening liens or other interests in the property that might gain priority over the new mortgage. As the courts adopt the concept of subrogation we advocate, this function will become unnecessary. Hence, we consider here whether title insurance provides any other "value added" to refinancing lenders sufficient to justify their continued insistence that borrowers purchase it.

A. Protective Functions of Title Insurance

In addition to insuring against intervening liens, title insurance provides certain other protections to a refinancing mortgage lender. One clear advantage of title insurance is that it, in effect, guarantees the authenticity of the borrowers' signatures on the refinancing documents—the promissory note and the mortgage or other security

120. *See supra* notes 81–91 and accompanying text.

121. *See supra* notes 92–107 and accompanying text.

instrument.[122] This is insurance against forgery, and forgery is hardly unknown among mortgage borrowers.[123] Various forms of incapacity of the borrowers—infancy, insanity, duress, and the like—are also insured against.[124] However, if the doctrine of subrogation is otherwise available, it will almost certainly solve these problems as well as the problem of the intervening lien. Subrogation, after all, does not require that the refinancing lender *in fact* have a valid mortgage, but only that the refinancing lender have paid off the old loan with the *expectation* of having a valid (and prior) mortgage. Hence, if the new mortgage is a forgery, is granted without capacity, or its execution is defective in some other way, the refinancing lender is still entitled to the validity (and priority) of the old mortgage.[125] The new lender may still be at risk with respect to any "cash out" unless the old mortgage contains a future advances clause,[126] but its concern about mortgage defects is obviously greatly mitigated by subrogation. Hence, the absence of title insurance would be far less significant than it might first appear.

A similar issue arises if a mortgage is given by a person currently in bankruptcy. Because the bankrupt debtor's estate is entirely under the control of the trustee in bankruptcy or debtor in possession, any transfer is subject to approval by the bankruptcy court, and a mortgage given without court approval is voidable.[127] Once again,

122. *See* American Land Title Ass'n, Questions About Title Insurance, http://www.alta.org/consumer/questions.cfm (last visited Feb. 17, 2006).

123. *See id.*; *see also* Brant v. Hargrove, 632 P.2d 978 (Ariz. Ct. App. 1981) (wife's signature forged on mortgage given by husband); Resolution Trust Corp. v. Hardisty, 646 N.E.2d 628 (Ill. App. Ct. 1995) (husband's signature on mortgage given by wife); Bank One v. Koch, 649 N.W.2d 339 (Wis. Ct. App. 2002) (signature on mortgage of one tenant in common forged by the other tenant in common).

124. *See, e.g.*, Ferrell v. Inter-County Title Guar. & Mortgage Co., 213 So. 2d 518 (Fla. Dist. Ct. App. 1968) (mortgage from corporation improperly executed by officers in their personal capacities); Narbeth Bldg. & Loan Ass'n v. Bryn Mawr Trust Co., 190 A. 149 (Pa. Super. Ct. 1937) (individual spouse alone lacked authority to transfer any interest in property held in tenancy by the entirety).

125. *See* Union-Davenport Trust & Sav. Bank v. Lyons, 212 N.W. 380 (Iowa 1927) (holding that even if mortgage signatures were forged, refinancing lender obtained a valid lien by subrogation); *see also* Kuske v. Staley, 28 P.2d 728 (Kan. 1934); Fed. Nat'l Mortgage Ass'n v. Woodbury, 679 N.Y.S.2d 116 (N.Y. App. Div. 1998); Equitable Life Assur. Soc'y v. McFadden, 72 P.2d 795 (Okla. 1937).

126. *See supra* text accompanying notes 92–107.

127. 11 U.S.C. § 549 (2000). If the bankruptcy petition was filed involuntarily, the transfer is not voidable unless made after an order of relief is entered. *Id.* § 549(b). Interests in property transferred to bona fide purchasers are not voidable. *Id.* § 549(c). However, to

however, subrogation would almost certainly give the refinancing lender great, if not total, protection if the original mortgage had been recorded prior to the filing of the bankruptcy petition.[128]

Even if subrogation did not insulate refinancing lenders against the risks described above, those risks are rarely significant, and lenders might well decide simply to absorb them rather than impose the costs of new title insurance policies on their customers. After all, banks and other institutional lenders accept many other sorts of loan documents from borrowers without any insurance of their validity. Examples include unsecured promissory notes, security agreements based on personal property collateral, and modifications of existing mortgage loan agreements. Lenders typically do nothing to corroborate the authenticity of these documents or the signatures on them beyond asking to see a government-issued photo identification and, perhaps, including a statement in the loan application that the borrower has not filed and will not file bankruptcy. These risks are not covered by title insurance,[129] but they are simply not thought great enough to warrant particular concern.

A second advantage of title insurance is its coverage of what might be called the "delayed recording gap." The issue arises because the old lender in a refinancing transaction is rarely willing to provide a recordable discharge of its mortgage until after (sometimes several weeks or months after) it receives its payoff. During this "gap" period there is, at least conceptually, some risk that the old lender will refuse or fail to provide a discharge, perhaps taking the position that the payoff amount is inadequate (despite the fact that it is invariably based on a written payoff statement supplied by the old lender). A number of statutes, including the newly promulgated Uniform Residential Mortgage Satisfaction Act, attempt to mitigate this risk by use of a variety of measures, including: obligating paid-

qualify as a bona fide purchaser, the refinancing lender would need to perform a title examination, thus defeating the objective we seek here. *See In re* McConville, 110 F.3d 47 (9th Cir. 1997) (The parties stipulated that the lender was a bona fide purchaser, but the court seemed unconvinced; it recognized the lender as having a lien to recover the principal amount of its loan, but no more.).

128. *See In re* Halabi, 184 F.3d 1335 (11th Cir. 1999) (original mortgage was recorded prior to filing of bankruptcy; secondary market investor who took assignment of mortgage after bankruptcy filing was protected by original mortgage priority as against bankruptcy's trustee's "strong-arm" powers).

129. *See, e.g.*, Bank of Miami Beach v. Lawyers Title Guar. Fund, 214 So. 2d 95 (Fla. Dist. Ct. App. 1968) (title insurance does not protect lender from forgery of promissory note).

off lenders to issue discharges;[130] imposing damages liability and penalties on lenders who fail to do so;[131] making payoff statements binding on those who reasonably and detrimentally rely on them;[132] and as a last resort, permitting title insurance companies or other settlement agents to record a discharge if the lender has failed to do so despite ample notice.[133] But these measures are not perfect and disputes still arise between old and new lenders as to whether the payoff amount was proper. Fortunately, the amount disputed is typically small[134] and, in the vast majority of cases, is probably resolved without a claim on the title insurance carrier, much less any litigation. Hence, the absence of the theoretical protection of title insurance is unlikely to be thought significant by refinancing lenders.

A third value of title insurance is the insurance underwriter's obligation to pay the expense of litigation involving the refinancing lender's title to the mortgaged property. This is a widely touted

130. Uniform Residential Mortgage Satisfaction Act § 201 (2004). For a brief description of the state statutes, see 1 NELSON & WHITMAN, *supra* note 2, § 6.6 nn.31–36 and accompanying text. The duty to provide a discharge exists as a matter of common law as well. *See id.* § 6.6 n.28; RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 6.4(b) (1997).

131. Uniform Residential Mortgage Satisfaction Act § 203.

132. *Id.* § 202. Under RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 1.6(c) a lender issuing a payoff statement "may be estopped to deny its accuracy as against one who has reasonably and detrimentally relied on" it. However, lenders often litter their payoff statements with disclaimers (e.g., "this statement is subject to final reconciliation by the issuer"), the effect of which is uncertain. *See* Uniform Residential Mortgage Satisfaction Act § 201 cmt. 7.

133. Uniform Residential Mortgage Satisfaction Act §§ 301–306.

134. Based on discussions held during the drafting of the Uniform Residential Mortgage Satisfaction Act, two types of disputes commonly arise. In one situation, the borrower has paid, and the lender has credited to the borrower's account, a regular monthly payment received by check shortly before the payoff statement is issued. A few days later, the check is dishonored by the drawee bank and the lender adds its amount to the original payoff figure. However, the refinance closing may already have occurred by this time, based on the original figure.

The second situation involves expenditures made by, or on behalf of, the original lender shortly before the issuance of the payoff statement is issued for such items as inspections to the property, payment of expenses to preserve the property, attorneys' fees involved in attempting to collect a delinquency, or the like. If the lender does not receive a bill for such services until after the payoff statement is issued, it will want to add their amounts to the original payoff figure. Again, the refinance closing may already have occurred by this time.

The amounts involved in these disputes are likely to be relatively small: a few hundred, or at most, a few thousand dollars. Moreover, the original lender can ordinarily prove convincingly that the additional money is owed. Interview with Professor R. Wilson Freyermuth, Reporter, Uniform Residential Mortgage Satisfaction Act, in Columbia, Mo. (July 7, 2005). Hence, there is little point in attempting to shift this sort of loss to a title insurer.

benefit of all title insurance,[135] although perhaps it amounts to a bit less than it appears since it is not uncommon for a title insurer to refuse to defend the insured's title, leading to litigation between the insured and the insurer.[136] Nonetheless, the value of the insurer's obligation to defend the title cannot be discounted. At least in jurisdictions in which the reach of the subrogation doctrine is uncertain or is readily contested, there is clear value to lenders in having someone else pay the costs of the contest.

However, if we are correct that a new and broader concept of subrogation is gaining ground, the need for litigation will surely diminish as that process proceeds. Obviously, litigation can arise in any dispute, but lenders do not think it essential to be insured for litigation costs in the general run of consumer or commercial loan transactions in which they engage. Once the lender's risk of loss of lien priority is eliminated by the application of a more modern concept of subrogation, it is unlikely that the remaining risks of litigation will be considered worth insuring against.

Title insurance agents often perform one additional service in mortgage refinancing that is not intrinsically related to the insuring function: they handle the settlement or closing. This involves obtaining a payoff figure from the existing mortgagee, preparing or procuring preparation of the necessary documents, obtaining the parties' signatures, recording the new mortgage and the satisfaction of the old mortgage, and disbursing the funds from the new loan to those entitled to receive them. Whether it makes sense for a lender to "farm out" these functions is highly debatable in cases in which the settlement agent is not also performing a title examination and

135. "The Loan Policy guarantees the lender a valid and enforceable lien, and assures that no claimant other than those noted in the policy has a prior claim against the real estate. The policy assures that the purchaser-borrower has title to the property being pledged as security for the loan. And, the policy obligates the title insurer to pay for defending against any claim filed against the title that might supersede the lender's lien. If unsuccessful, it must also satisfy that claim should it be upheld in court." American Land Title Ass'n, *Title Insurance: A Comprehensive Overview* 6, *available at* http://www.alta.org/press/TitleInsuranceOverview.pdf (last visited Jan. 21, 2006).

136. *See* JOYCE D. PALOMAR, TITLE INSURANCE § 11:3 (Release 3, August 2005). If the insured prevails in such a suit, the insurer will usually be liable for the attorneys' fees and litigation expenses incurred by the insured in defending its own title. *Id.* § 10.4(5) nn.15–21. However, that can be a long road, surely not one likely to be taken unless the amount involved is very substantial.

issuing title insurance.[137] For small, low-volume lenders, the delegation of these duties to a separate settlement agent may well be efficient, avoiding the necessity of training and paying in-house personnel whose time would be divided between these and other functions. For larger lenders, whose volume is sufficient to keep in-house staff busy, it is likely that when title insurance is no longer necessary, the settlement function will be brought back into the lender's organization.[138] Whether to continue to outsource settlement services—to title insurance agents, to independent escrow

137. Outsourcing the settlement function has the advantage of placing it in the hands of personnel who are presumably well trained and skilled in the process, but it has the disadvantage of requiring the movement of large volumes of paper between the lender and the settlement provider, with the attendant risks of miscommunication and lost documents.

138. Both of the present authors well recall their early days of law practice in the 1960s in Minneapolis and Los Angeles, when it was commonplace for lenders to handle their own closings.

In 2002, the Department of Housing and Urban Development issued a proposed regulation that would have amended HUD's interpretation of the Federal Real Estate Settlement Procedures Act, 12 U.S.C. § 2604 (2000). *See* 67 Fed. Reg. 49,134 (July 29, 2002). The proposal (which was never made final) would have introduced the concept of the Guaranteed Mortgage Package Agreement (GMPA), under which mortgage lenders would have been permitted to provide a wide variety of settlement services, include the lender's title insurance costs, into a single fee to be charged to the borrower. Such a fee would have been readily comparable among lenders, unlike the plethora of fees and charges often imposed at present. This would, HUD believed, have led to greater price competition and ultimately to the driving down of settlement costs for consumers. The proposal was greeted warmly by larger lenders, but met with squeals of pain from the title insurance industry and a variety of other providers of settlement services. Consumer groups generally welcomed it, although they complained that it did nothing to resolve the problems of predatory lending. *See* Sheldon E. Hochberg, *HUD's RESPA Regulations: The Proposals, the Comments, the Future*, TITLE NEWS, Jan.–Feb. 2003, *available at* http://www.alta.org/publications/titlenews/03/01_01.cfm. The proposal was similar to one made by one of the present authors eighteen years earlier. *See* Dale A. Whitman, *Home Transfer Costs: An Economic and Legal Analysis*, 62 GEO. L.J. 1311, 1346–60 (1974).

HUD predicted that lenders who offered GMPAs would have an incentive to bargain down their costs of loan origination, either by negotiating more favorable contracts with existing suppliers of settlement services or by bringing the services in-house. *See* HUD, ECONOMIC ANALYSIS AND INITIAL REGULATORY FLEXIBILITY ANALYSIS FOR RESPA PROPOSED RULE TO SIMPLIFY AND IMPROVE THE PROCESS OF OBTAINING MORTGAGES TO REDUCE SETTLEMENT COSTS TO CONSUMERS (July 2002), *available at* http://www.compliancetimes.org/pdfs/ea-chapters.pdf. Since title examination is the element of settlement services requiring the greatest technical expertise, if that function were no longer necessary it is even more likely that larger lenders would internalize the remaining functions.

The HUD GMPA concept is not dead but is certainly severely wounded at this writing, two years after it was proposed. *See* 70 Fed. Reg. 37,646 (June 29, 2005) (HUD announcement of a series of roundtable discussions to consider how its RESPA reform proposals might be recast).

companies, or to other types of entities—is a matter of business judgment that each lender will need to answer.[139] But as the subrogation doctrine evolves and title insurance becomes increasingly unnecessary, it is clear that the net cost of the refinancing transaction will be decreased, regardless of who handles the settlement.

B. Informational Functions of Title Insurance

One function currently served by title insurers in mortgage refinancing will remain essential even if a broad view of subrogation is widely adopted. The refinancing lender or its settlement agent must have some mechanism for determining what lender holds the existing first mortgage simply because it is necessary to (1) obtain a payoff statement from that lender, (2) transmit the payoff funds to it, and (3) obtain from it a recordable discharge of the old mortgage.[140] None of these acts can occur until the holder of the original mortgage is identified. Presently, title insurance companies or agents ordinarily perform this service and provide the information to the lender or its settlement agent in a title insurance binder, preliminary title report, or other similar document.

Fortunately, title insurance is not the only way for refinancing lenders to gain the needed information. One alternative for the refinancing lender is to ask the mortgagor to present the existing title insurance policy that was issued when the property was acquired or previously refinanced. Mortgagors might be asked to provide, along with the title policy, a brief affidavit that states that the policy presented accurately represents the current holder of the first mortgage and perhaps a photocopy of their payment book, billing statement, or other recent correspondence from the current mortgage servicer.[141] The refinancing lender would then verify the information by requesting a payoff statement from the servicer.[142]

139. This discretion is fettered in some jurisdictions by rules governing the unauthorized practices of law. *See, e.g.*, Bishop v. Jefferson Title Co., 28 P.3d 802 (Wash. Ct. App. 2001) (employee of escrow company engaged in unauthorized practice of law).

140. This process is aptly described in Uniform Residential Mortgage Satisfaction Act, Prefatory Note (2004).

141. These items would alert the refinancing lender to any change in servicing that might have occurred after recordation of the existing mortgage. "Servicing" refers to the processes of collecting loan payments, maintaining any escrow accounts for taxes and insurance, paying those items out of the relevant escrow accounts, making collection efforts if a payment default occurs, and, if necessary, foreclosing the mortgage. In modern mortgage practice, servicing is

A second alternative method for the refinancing lender to learn the identity of the existing mortgagee is the use of one of several Internet-based services providing basic title information. Some of these services are operated by title insurers[143] and others by independent businesses.[144] Their cost is extremely modest in comparison with conventional title insurance policies.[145]

Yet a third alternative for the refinancing lender that is rapidly becoming more readily available is to check the public records directly on the Internet.[146] An increasing number of public recorders' offices have made their records directly searchable online, and many more are certain to do so in the near future.[147] The recent adoption of the Uniform Real Property Electronic Recording Act[148] by the

often divorced from the holding of the loan and is carried out by a different entity than the holder. The servicer is an agent of the mortgage holder for purposes of carrying out the functions indicated above. *See generally* Robin Paul Malloy, *The Secondary Mortgage Market—A Catalyst for Change in Real Estate Transactions*, 39 SW. L.J. 991 (1986) (discussing the development of the modern secondary mortgage market).

142. In theory, if a payoff were erroneously made to the original mortgagee after the mortgage had been assigned on the secondary market (with a corresponding change of servicing), the refinancing lender making the payoff could be liable to pay a second time. *See* Dale A. Whitman, *Reforming the Law: The Payment Rule as a Paradigm*, 1998 BYU L. REV. 1169, 1171. This risk is eliminated for non-negotiable promissory notes by RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 5.5 (1997). In all events, it arises mainly with individual lenders, and is a risk of minuscule proportions when institutional first mortgage lenders are involved. Whitman, *supra*, at 1197.

143. *See, e.g.*, RealQuest, operated by First American Real Estate Solutions, http://firstamres.com/products/realquest.jsp?CMP=KNC-GOOG (last visited Jan. 30, 2006); Land Records, operated by Fidelity National Title Ins. Co., https://www.fntic.com/services/l_records.htm (last visited Jan. 30, 2006).

144. *See, e.g.*, HomeInfoMax, http://www.homeinfomax.com/Real_Property_Records.php (last visited Jan. 30, 2006).

145. For example, "Title and Vesting" reports from RealQuest, *supra* note 143, are $20 each with a $300 monthly purchase commitment by the subscriber, or $25 each with no commitment. Detailed reports from HomeInfoMax, *supra* note 144, are about the same price.

146. *See* Dale A. Whitman, *Are We There Yet? The Case for a Uniform Electronic Recording Act*, 24 W. NEW ENG. L. REV. 245 (2002); Dale A. Whitman, *Digital Recording of Real Estate Documents*, 32 J. MARSHALL L. REV. 227 (1999).

147. *See* PROPERTY RECORDS INDUSTRY ASS'N, URPERA ENACTMENT AND ERECORDING STANDARDS IMPLEMENTATION GUIDE (Draft 1.3, 2005) (on file with author) (indicating that forty-eight counties or other local jurisdictions had adopted electronic recording procedures by 2004). Nearly all of these counties' procedures provide for online viewing of recorded documents, as do many other recorders that are not yet accepting electronic recording.

148. The Act was approved by the Conference in August 2004. The NCCUSL website indicates that at the time of this writing it has been introduced in seven jurisdictions and enacted in five: Arizona, Delaware, the District of Columbia, North Carolina, and Texas. *See*

National Conference of Commissioners on Uniform State Laws will facilitate this movement's growth. Determining the identity of the lender holding the existing first mortgage on a residential property is a simple task under most of these online records systems.

In sum, the advantages of title insurance to refinancing lenders—apart from assurance against loss of lien priority—are marginal at best. If the Restatement's approach to mortgage refinancing is widely adopted, title insurance may or may not continue to be used by refinancing lenders. If it continues to play a role, its benefits will be far less significant than in the past, and its cost should be reduced commensurately.

VI. Direct Assignment as an Alternative to Subrogation

Our discussion thus far has focused on the doctrine of subrogation as a means of reducing the reliance of refinancing lenders on title insurance. However, there is an alternative to the subrogation doctrine for passing on the priority of the old mortgage to the refinancing lender: a direct, written assignment of the old mortgage to the new lender. If a widespread practice of giving such assignments were established, it would have the same effect as subrogation, but without the quibbles about notice of, and prejudice to, intervening lienors discussed above.[149] After such an assignment, the refinancing lender could amend the promissory note (and the mortgage if necessary) to reflect the change in the loan's terms—typically a lower interest rate. Since neither the assignment nor the lowering of the interest rate[150] would impair the mortgage's priority, the refinancing lender's retention of the original priority against intervening lienors would be assured.

However, so far as we know, the granting of an assignment by the old lender to the refinancing lender is a common practice only in the state of New York. Oddly, the New York practice of assigning mortgages to be refinanced was not established as a way of ensuring the priority of the new lender's position but as a way of avoiding the state's extremely burdensome mortgage recording tax.[151] No one

http://www.nccusl.org/update/uniformact_factsheets/uniformacts-fs-urpera.asp (last visited Jan. 30, 2006).

149. *See supra* notes 37–43, 46–67 and accompanying text.

150. *See supra* text accompanying note 55.

151. The recording tax is assessed on a complex schedule and depends on the amount of the mortgage, whether the property is a one-to-two-family residence and whether the property

ever seems to have considered assignment as a way to preserve the original mortgage's priority and thereby avoid the necessity of a new title examination or new title insurance.

Refinancings (as well as financings for real estate sales) are often handled in New York by use of a "Consolidation, Extension, and Modification Agreement" ("CEM"), which serves both to assign the mortgage and to restate its terms as necessary.[152] While New York lenders whose loans are being paid off have no legal obligation to facilitate this sort of transaction[153] unless the terms of their mortgages require them to do so, many cooperate voluntarily, but only if they receive a fee—usually in the range of $200 to $1000 with a median of perhaps $600.[154]

is located in New York City, Yonkers, or other parts of the state. In the worst case, for nonresidential properties within New York City, the tax is 2.75% of the mortgage amount. Even for one-to-two-family residential properties with mortgages under $500,000 in New York City, the tax is 2% of the mortgage amount, less $25. *See* N.Y. TAX LAW § 253 (McKinney 2005). The mortgagee pays 0.25% of the tax, and the remainder is paid by the mortgagor. *Id.* at 1-a(a). The schedule is set out graphically in a convenient form at http://www.empireabstract.com/taxinfo.htm (last visited Feb. 18, 2006). The rationale for use of the assignment as a mortgage tax avoidance device is spelled out in Petition No. M991230A, New York Commissioner of Taxation and Finance, Advisory Opinion (Feb. 25, 2000), *available at* http://www.tax.state.ny.us/pdf/advisory_opinions/mortgage/a00_1r.pdf.

152. The rationale for the form is explained at http://www.freddiemac.com/cim/pdf/nycemaqa.pdf (last visited Jan. 30, 2006). The text of the Fannie Mae/Freddie Mac-approved CEM form appears at http://www.efanniemae.com/sf/formsdocs/documents/specialpurpose/pdf/3172.pdf (last visited Jan. 30, 2006). The form provided by the New York Board of Title Underwriters appears at http://www22.inetba.com/newyorktitle/filecabinet/Consolidation_Extension.pdf (last visited Jan. 30, 2006).

153. An earlier New York statute, former N.Y. REAL PROP. LAW § 275, captioned "Assignment of mortgage required in lieu of certificate or discharge," enacted by Chapter 408 of the Laws of 1914, required lenders to execute such assignments. However, it was repealed by Chapter 241, Laws of 1989. *See* Michael J. Berey, *Legislation Addresses Mortgage*, N.Y. L.J., Aug. 24, 1998, at S6.

It is quite arguable that when a mortgage loan is paid in full by someone who is not primarily responsible for payment, the payor is entitled to an assignment as a matter of law. *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6 cmt. a (1997); *see also* Payne v. Foster, 135 N.Y.S.2d 819 (N.Y. App. Div. 1954) (payment by holder of remainder); Simonson v. Lauck, 93 N.Y.S. 965 (N.Y. App. Div. 1905) (payment by a third party at the request of a tenant in common of the real estate); Global Realty Corp. v. Charles Kannel Corp., 170 N.Y.S.2d 16 (N.Y. Sup. Ct. 1958) (payment by junior tenant). However, none of the authorities cited recognize any corresponding right when payment is made by the mortgagor rather than a third party.

154. Cooperation is more likely between institutional lenders since their mortgage forms are likely to be mutually acceptable. With respect to the amount of the fee, see Hillary Potashnick, *Mortgages and Co-op Loans*, RESIDENTIAL REAL ESTATE CONTRACTS & CLOSINGS 2004, 140; PRACTICING LAW INSTITUTE NEW YORK PRACTICE SKILLS COURSE HANDBOOK

On its face, this New York practice should make a new title insurance policy entirely unnecessary when a mortgage loan is refinanced, at least if the loan balance is not increased. It is, after all, the same mortgage with the same priority as when it was originated, and the title insurance protection runs with the mortgage.[155] Nonetheless, refinancing lenders in New York typically insist on a new title insurance policy even when the old mortgage is assigned to them. If the loan balance is not increased, the demand for a new title policy (at the mortgagor's expense, of course) seems entirely unwarranted. The cost to the mortgagor is far from trivial and will usually exceed $1000 for a residential refinancing.[156]

SERIES 321, 330 (2004). Citibank charges $650. *See* https://www.citimortgage.com/ServicingWebStatic/faq/faq_payoff.jsp#Payoff7 (last visited Jan. 30, 2006). The fee is ostensibly to cover the original lender's costs in preparing and delivering the CEM Agreement, but it seems fairly obvious that this explanation is a sham. The lender, after all, has an obligation to discharge the mortgage of record unless a CEM Agreement is requested, and there is no reason to suppose that executing and delivering the CEM costs the lender more than executing and recording the discharge. The fee is charged simply because lenders know the mortgagor's only alternative to obtaining the CEM is to pay the mortgage recording tax on the amount of the new loan. In light of the fact that the tax can cost many thousands of dollars, lenders have more than ample leverage to exact a fee of hundreds of dollars for the CEM Agreement. According to the National Association of Realtors, the median sale price of a residential unit in the New York City/northern New Jersey metropolitan area in 2004 was $385,900. *See* http://www.realtor.org/Research.nsf/files/REL05Q4T.pdf/$FILE/REL05Q4T.pdf (last visited Feb. 24, 2006). If an average mortgage of 80% of value, or about $320,000, is assumed, the mortgage tax (at 2% minus $25) would be $6375. It is easy to see why property owners who refinance would prefer to pay the old lender's fee for the CEM Agreement.

155. For example, the American Land Title Association's 1992 Loan Policy, *available at* http://www.alta.org/forms/loan.doc (last visited Jan. 21, 2006), defines "insured" to include "the owner of the indebtedness secured by the insured mortgage and each successor in ownership of the indebtedness." *Id*. at Conditions and Stipulations 1(a)(i).

> The intent of the first definition of "insured" in the ALTA loan policies is to insure the mortgage lien both while the loan is held by the original lender and when the loan is sold to an assignee in the secondary mortgage market. Such assignee does not have to be named as an insured in the policy's Schedule A or added by a subsequent endorsement.

JOYCE PALOMAR, TITLE INSURANCE LAW § 4.9 (Release 3, 2005) (footnote omitted).

156. For a refinanced mortgage of $320,000, a typical amount as estimated in *supra* note 159. In the Bronx or Queens, the premium rate for a mortgagee's title insurance policy would be $344 for the first $35,000 of coverage plus $3.64 per $1,000 of additional coverage, or a total premium of $1381. These rates are provided by the New York Title Insurance Rate Service and are found at http://www.nytitle.com/contact.ivnu (last visited Dec. 17, 2005).

A discounted "reissue rate" is available in some circumstances. The New York Title Insurance Rate Service website states,

> A Refinance or Subordinate Mortgage Policy issued within ten years of a previously insured Mortgage or fee interest where the premises are identical, there has been no

In an effort to discover why new title insurance is thought necessary when a mortgage is assigned for refinancing in New York, we secured the assistance of a prominent New York City real estate practitioner in raising the question with a group of about 125 other real estate lawyers who belong to an email Listserv.[157] We found the answers to be underwhelming.[158] On the whole, we were left with

> change of ownership, and the amount is less than $250,000 shall be charged 50% of the Mortgage Rate on the liability up to the amount of the existing indebtedness and 100% of the Mortgage Rate on any liability in excess of the existing indebtedness.

Id.; *see also* James M. Orphanides & S.H. Spencer Compton, *New Advances and Tools for Lenders and Counsel in Title Insurance,* PRACTICING LAW INSTITUTE, COMMERCIAL REAL ESTATE FINANCING 2004: WHAT BORROWERS & LENDERS NEED TO KNOW NOW 545, 555 (2004).

It is entirely possible that the mortgagor will not be informed of the reissue rate and will pay the full rate despite the theoretical availability of the discount. *See In re* Coordinated Title Ins. Cases, 2004 WL 690380, at *17 (N.Y. Sup. Ct. Jan. 8, 2004) (certifying a class action against eight New York title insurance companies charging them with fraud and deceptive business conduct for failing to advise mortgagors of the reissue rate); Kenneth R. Harney, *Title Insurance "Reissue Rates" Spark Class Action Suits, Controversy*, REALTY TIMES, Apr. 14, 2003, *available at* http://realtytimes.com/rtcpages/20030414_reissuerates.htm (last visited Feb. 23, 2006).

157. The attorney who assisted us was Joshua Stein of the New York City office of Latham and Watkins. We are grateful for his help.

158. The basic answers were as follows:

1. The new title insurance has the advantage of insuring the validity of the assignment itself—something that the original title insurance obviously cannot do. This is correct, but it is difficult to give it any serious weight. An assignment of a mortgage is, as between the parties, largely an unnecessary document. Anyone who acquires the right to enforce the debt will automatically be regarded as having the right to enforce the mortgage as well. *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 5.4(a) (1997) ("A transfer of an obligation secured by a mortgage also transfers the mortgage unless the parties to the transfer agree otherwise."); *see also* Johnson v. Hart, 3 Johns. Cas. 322 (N.Y. Sup. Ct. 1803). Hence, if the assignee acquires the promissory note, the risk of the mortgage assignment's being held invalid is so remote as to be trivial.

2. If the original mortgagor and mortgagee had modified the mortgage's terms before making the assignment, the assignee might be subject to a risk of partial loss of priority. Once again, the observation is correct, but the problem seems extremely minor and easy to manage. If the lender who takes the assignment is unaware of the modification and merely inspects the original mortgage and note, there is no risk at all, since under applicable law, it is precisely the terms of those documents that will continue to have full priority over any intervening liens. If the lender who accepts the assignment is relying on the modified terms of the mortgage, it can only be because that lender is fully aware of the modification. In that (relatively rare) case, if the modification was not within the scope of any future advance clause, the assignee may well wish to obtain a new title insurance policy—in effect, to ensure that there are no intervening interests to whose holders priority might be lost.

3. Mortgagee title insurance policies routinely exclude coverage for title defects "created, suffered, assumed or agreed to by the insured" and for matters "not known to the

the impression that although the advantages of new title insurance were marginal at best, lenders and their counsel saw little reason to change the present practice because the cost of the new title insurance could so easily be passed on to borrowers.

The industry's attitude is disheartening but perhaps unsurprising. We are dealing with traditional practices that are not readily susceptible to change through "jawboning." The only likely motivator of change will be an altered understanding of the competitive forces of the market on the part of refinancing lenders. We believe that such a change may well occur,[159] but until it does, we do not think it fruitful to recommend or argue for adoption of a widespread national practice of making written mortgage assignments a part of residential refinancings. Doing so would entail major changes in the flow of documents in areas of the nation outside New York, would require retraining of personnel, and would inevitably involve significant startup costs. Moreover, for the change in practice to be effective, it would require adoption by a large number of lenders. There is no existing entity with the overarching authority necessary to require or even encourage such a change. Without question, some lenders would resist change on grounds of a short-term cost increase. Despite its theoretical advantages over subrogation, we have reluctantly discarded assignment. Subrogation,

Company, not recorded in the public records at Date of Policy, but known to the insured claimant and not disclosed in writing to the Company." AMERICAN LAND TITLE ASS'N, 1992 LOAN POLICY, EXCLUSIONS FROM COVERAGE 3, *available at* http://www.alta.org/forms/loan.doc (last visited Jan. 30, 2006). If the original mortgagee knew of, or agreed to, a title defect, would that knowledge or agreement be imputed to an assignee of the mortgage so as to bar it from recovering on the policy for that title defect? Superficially this appears to be a legitimate concern of the refinancing lender, but almost certainly it is not. The reason is that knowledge or act of the original insured cannot properly be imputed to the assignee. See *S. Title Ins. Co. v. Crow*, 278 So. 2d 294 (Fla. Dist. Ct. App. 1973), in which the court immediately saw through this sort of defense by the title insurer. It held:

> [The policy] excludes defects "known to the insured Claimant." Appellant reads this as if it said "named insured," and that is the fallacy in its argument. There is no claim that either of the "insured *claimants*" knew of the defect, and while the defense might be good against the original insured, it is not available against the [assignees], who took without notice of the defective title.

Id. at 295. *But see* Countrywide Homes, Inc. v. Lafonte, No. 14265/01, 2003 WL 1389089 (N.Y. Sup. Ct. Apr. 13, 2003) (An unreported New York case taking the contrary view—imputing the original mortgagee's knowledge of a mortgage defect to the assignee. This holding and result seem plainly wrong.).

159. *See infra* text accompanying notes 186–195 (describing the increasing competitiveness in the residential mortgage market).

by contrast, imposes no added costs on lenders and requires no changes in the flow of paperwork, and the broad Restatement view of subrogation is already well on its way to becoming the predominant view nationally.

VII. THE ECONOMIC IMPACT OF THE RESTATEMENT APPROACH

We have argued above that a liberal view of mortgage subrogation would result in a major reduction in the cost of title proof in refinancing transactions.[160] In this Part, we consider who will benefit from that reduction. There are several possibilities. The title insurance industry might become more profitable as a major cost of doing business is eliminated. On the other hand, the rule might inure to the benefit of homeowners in the form of lower title insurance premiums as title insurers are forced by competitive pressures to pass their savings on in the form of lowered premiums. Alternatively, mortgage lenders might decide to become self-insurers of title in the refinancing context, dropping the requirement for title insurance altogether, with an accompanying cost saving for homeowners.

To gain a better perspective on these important questions, we conducted conversations with a variety of executives representing major title insurance companies and mortgage lenders from all geographic areas of the country.[161] They were extremely helpful and forthcoming with their insights. In part, this was because they were assured that their comments would not be quoted with personal attribution. Their comments were unanimous in one important respect—they supported either judicial or legislative adoption of the Restatement subrogation rule. This is hardly surprising, since the rule dramatically reduces the financial risk to lenders and title insurers posed by intervening lienors in the refinancing context.

However, when the focus turned to whether the uniform adoption of the Restatement approach would yield significant savings to homeowners in the form of lower title insurance premiums, there

160. *See supra* text accompanying notes 123–139.

161. Ten individuals were interviewed during the summer and fall of 2004. They were selected on the basis of the authors' personal acquaintance with them or with others who could provide introductions to them. No claim is made that they represent the mortgage and title industries as a whole, but all were highly knowledgeable and familiar with industry conditions in their areas of the nation. Because they were being asked questions whose answers could potentially be highly useful to their competitors, all were promised anonymity.

was far less unanimity. A large minority of our contacts believed that the national adoption of the Restatement approach would bring substantial and relatively immediate consumer savings. Others, making up a slight majority, were much more guarded in their responses. Some in this latter category foresaw small, incremental savings to consumers while others predicted virtually no short-term change in refinancing title insurance rates and relatively modest long-term reductions.

While we initially found these responses somewhat perplexing, our discussions revealed several important considerations that may account for much of the disparity of views. Several respondents who foresaw little impact on consumer costs emphasized governmental regulation of title insurance premium rates. The degree of state regulation varies widely from state to state. A few states have virtually no rate regulation.[162] Many other states follow a "file and use" approach; in these jurisdictions, title insurers file their rate schedules with the appropriate state agency and they become effective within fifteen to thirty days.[163] Others are categorized as "file and use and justify"; these states impose an additional requirement on insurers to "justify" their rates.[164] While in some of these latter two types of jurisdictions, the insurer's rate decision is virtually incontestable, in others, the state agency may sometimes challenge a proposed rate change. More extensive regulatory restrictions are found in "file for approval" states. In such states, the regulatory agency must review rate filings to determine that they do not violate state substantive restrictions.[165] Finally, a few states are classified as "regulatory rate-

162. Our research reveals that seven states have no rate regulation of title insurance premiums. These states include Arkansas, Georgia, Illinois, Indiana, Massachusetts, Oklahoma, and West Virginia. In addition, Iowa does not permit the writing of title insurance within the state.

163. *See, e.g.*, ALA. CODE § 27-25-6 (2004); ARIZ. REV. STAT. ANN. § 20-376 (2002); COLO. REV. STAT. § 10-11-118 (2005); KY. REV. STAT. ANN. § 304.22-020 (2001); MICH. COMP. LAWS ANN. §§ 500.2406, 500.7312 (West 2002); NEV. REV. STAT. § 692A.120(3) (2003); TENN. CODE ANN. § 56-35-111 (2000); UTAH CODE ANN. § 31A-19A-209 (2005); WASH. REV. CODE ANN. § 48.29.140 (West 1999).

164. *See, e.g.*, ALASKA STAT. §§ 21.66.370, 21.66.380 (2004); CAL. INS. CODE §§ 12401.1, 12401.2 (West 2005); N.J. STAT. ANN. §§ 17:46B-42, 17:46B-43 (West 1994); N.C. GEN. STAT. § 58-40-30 (2003); OHIO REV. CODE ANN. § 3935.04 (West 2002); 40 PA. CONS. STAT. ANN. §§ 910-37, 910-38 (West 1999).

165. *See, e.g.*, CONN. GEN. STAT. ANN. § 38a-419 (West 2000); IDAHO CODE § 41-2706 (2003); MD. CODE ANN., INS. § 22-101 (West 2002); S.C. CODE ANN. § 38-75-980 (2002); WYO. STAT. ANN. § 26-23-326 (2005).

setting"; a state regulatory agency sets title insurance rates in these jurisdictions.[166]

To the extent that states either mandate or heavily regulate title insurance rates, the market is likely to be slower to react to risk-reducing legal changes than in states where title underwriters are relatively free to set rates. Two of our contacts indicated that it would take "years" to see premium reductions in heavily regulated states. On the other hand, where states allow title insurers greater flexibility in rate-setting, competition among title insurers is much more likely to put more immediate downward pressure on rates. Some of the pessimism about the rate-reduction potential of the Restatement rules is attributable to the fact that several of our contacts were from states having heavy regulation.

However, this pessimism may be overstated. If competitive pressures force title insurers to lower refinancing premiums in states with low regulation, it seems unlikely that rates will lag inordinately in heavy regulation jurisdictions. This is because both title insurance underwriters and major mortgage lenders are national in their operations. For example, assume that a major lender like Bank of America obtains a substantial reduction in refinancing title insurance rates in California (where there is great flexibility for the industry to make rate reductions). The bank is unlikely to permit those rates to continue indefinitely higher in Florida, where the regulatory regime normally makes rates much harder to change. We suspect that a title insurer that wants to keep Bank of America's business on a national basis will be under significant pressure to file promptly for a rate reduction in Florida and to pursue the matter vigorously with that state's regulators. Moreover, if the title insurer that applies for the rate reduction can show that its risk has been significantly reduced by modernization of the subrogation doctrine, the regulators should have a significant incentive to endorse the rate reduction.

Another factor that some of our contacts believed would restrict the potential for a significant reduction in title insurance rates was the fact that industry claims losses[167] are a relatively small percentage of total premiums collected. For example, these percentages were

166. FLA. STAT. ANN. § 627.782 (West 2005); N.M. STAT. ANN. § 59A-30-6 (LexisNexis 2004); TEX. REV. CIV. STAT. ANN. art. 9.07 (Vernon 1981).

167. The term "losses" includes loss-adjustment expense, which refers to attorneys fees, court costs, investigation expenses, and other costs associated with payment and settlement of claims.

5.3%, 4.8%, 4.6%, 4.0%, and 4.5% for the years 2000–2004 respectively.[168] The argument is that if overall claims paid are relatively low, a change in mortgage subrogation law to better protect refinancing lenders and their insurers can have, at most, only a modest impact on title insurance rates.

There is a good reason why these percentages are so low as compared, for example, with the property/casualty insurance industry, where the analogous ratio of claims paid to premiums collected averaged 80.4% for most of the same period.[169] The reason is that a great deal of the money charged for title insurance goes into risk *reduction* rather than claims *payment*. As one analyst has noted:

> Title insurers sell protection against losses caused by problems with title . . . arising out of events that occurred before the effective date of the policy. Because most uncertainty about the past can be reduced by careful research, a title insurer can exert a great deal of control over the risks it underwrites.
>
> . . . .
>
> Consequently, title insurers operate by collecting premiums, much of which are used to cover the underwriting costs associated with the issuance of a title insurance policy. Therefore, in contrast to property and casualty insurers, title insurers expend premium dollars before collection and therefore do not retain most of the premium dollar before it is expended in the ordinary course of business.[170]

Stated another way, title insurers have relatively low claims payouts because they expend large amounts on personnel and infrastructure costs before losses occur.

However, significant reductions in premiums should result from our proposed change in the law because its implementation should

168. Gary A. Davis & Richard McCarthy, *Title Industry Running on All Cylinders,* A.M. BEST SPECIAL REPORT, October 4, 2004, at 9 (covering 2000–2003 reporting years), *available at* http://www.alta.org/industry/AMBest04.pdf; *see also* American Land Title Association, Annual Statement for the year 2004 of the American Land Title Association Industry, at 3, *available at* http://www.alta.org/industry/TitleInsurInd04.pdf (covering 2004 reporting year); *see also* Demotech, Inc., *Title Insurance Industry Information & Economic Data 2003 Year in Review: Solving Tomorrow's Insurance Challenges Today*, June 2004, http://www.demotech.com/pdf/PTIC/2003_Year_in_Review.pdf.

169. Davis & McCarthy, *supra* note 168, at 9.

170. *Id.* at 8–9.

permit a substantial reduction in both the title insurance industry's underwriting costs and its loss payouts.[171] Under our proposal, where the refinancing loan does not involve an increased principal amount, or the increased principal is covered by a future advances clause, the risk of losing priority to intervening interests is virtually eliminated. Consequently, if the same title company that wrote the original loan policy writes the refinance insurance, it may no longer be necessary for the title company to conduct any new title search whatever.

Moreover, even where the refinancing involves "cash out" to the borrower, the title company's search may be more cursory and the need for close evaluation of the results less compelling. As we stressed earlier, lenders require title insurance in refinancing transactions largely because of a concern that intervening liens and similar interests will trump their new mortgages.[172] The title industry itself emphasizes this as the most important risk.[173] If the law is changed so that a refinancing lender is subrogated in every instance up to the amount of the mortgage that it replaces, then the most important component of title risk in the typical refinancing transaction will have been obviated.[174] Of course, the Restatement approach will not protect the lender to the extent that the refinanced debt is increased unless that increase is within the scope of a future advances clause.[175] However, as we explained earlier, the typical

171. One can think of underwriting expenses as falling into two major categories: maintenance of a "title plant" (a set of records reflecting all recorded transactions) and the personnel cost involved in searching in the plant. Subrogation will not affect the first of these expenses, but it should result in a major curtailment of the second, as searches for intervening liens become unnecessary in refinancing transactions.

172. *See supra* text accompanying notes 33–36.

173. In response to the question why a homeowner must pay for a refinancing lender's title policy, the American Land Title Association responds:

> Even if you recently purchased or refinanced your home, there are some problems that could arise with the title. For instance, you might have incurred a mechanics lien from a contractor who claims he/she has not been paid. Or you might have a judgment placed on your house due to unpaid taxes, homeowner dues, or child support for instance. The lender needs reassurance that the title to the property they are financing is clear.

American Land Title Association, Questions About Title Insurance, http://www.alta.org/consumer/questions.cfm (last visited Jan. 28, 2006).

174. Title insurance also protects the refinancing lender against other relatively minor risks; for example, that one of the borrower's signatures on the new mortgage was forged. In addition, the cost of the title policy may include loan closing services to the lender. *See supra* text accompanying notes 122–148.

175. *See supra* text accompanying notes 92–107.

"cash out" amount is relatively small compared to the average homeowner's equity and generally results in a very low-risk loan-to-value ratio.[176] Even without a future advances clause, lenders may also consider the risk of loss of priority for the additionally-financed amount without an additional title examination to be insubstantial.

Such a significant legal change would not go unnoticed by the lending industry. Large institutional lenders are sophisticated consumers, and they will realize that one of the title insurer's major risks has been eliminated. Even now, with the protection afforded by the law of subrogation far from uniform, lenders doubtless are aware that title insurance underwriting efforts are less intense in refinances than in the context of a home purchase-money mortgage. The title insurance industry concedes that this is so:

> In underwriting refinance transactions, the title insurer or its agent performs a more limited title search than is necessary for a resale transaction. This less comprehensive title search occurs because only the position of the lender of the refinanced mortgage has to be determined to assure the lender of its priority.[177]

Lenders compete constantly for loan customers, and they are highly sensitive to the costs they impose on those customers. Once the lending industry realizes that the risk to the title insurance industry in insuring refinancings is largely obviated by modernization of the subrogation doctrine, it is likely to put substantial market pressure on title insurers to lower their premiums substantially. This pressure on title insurance companies will come in an economic environment that already is highly competitive. While refinancing premiums have been important to the overall economic health of the title insurance industry,[178] it is now under serious pressure to reduce

176. *See supra* text accompanying notes 56–60.

177. Davis & McCarthy, *supra* note 168, at 11.

178. Refinancing premiums as a percentage of total title insurance premium revenues vary substantially depending on whether mortgage interest rates are falling or rising. In periods of sharply declining rates, refinancings increase substantially and total premiums rise, often dramatically. *See supra* notes 17–22 and accompanying text. Refinanced mortgages averaged 60% of all one-to-four-family mortgage originations for the period 2001–2003. *See* Mortgage Bankers Association, *1-to-4 Family Mortgage Originations 1990–2003*, http://www.mortgagebankers.org/marketdata/data/03/1-4_originations.html (last visited Jan. 28, 2006). The converse is true when interest rates are rising. The refinancing share of premium revenues has generally varied from a low of 20% to a high of 60% over the past several years. As of this writing, our information indicates that 40–50% of premium income is attributable to refinancing. *See* E-mail from Denise Warren, Director of Investor Relations,

those premiums, which are already substantially lower than for new purchase mortgages.[179] Major institutional lenders continue to negotiate significantly lower bulk rate premium packages, and some major title insurers are already planning further major reductions.[180]

In the final analysis, the title insurance industry can endure a significant reduction in refinance premiums. The past several years have been highly profitable for the industry. As one leading analyst of the industry summarized, "[t]he title industry reported record results in 2003 for the second consecutive year, as performance continued to improve and it benefited from favorable economic conditions. The industry's strong revenue generation was due to improved loss experience, enhanced operating efficiencies and the continued booming housing market."[181] As the refinancing boom comes to an end, the industry's revenues will undoubtedly fall, and the increasing availability of subrogation will force them to fall

First American Corporation, to Benjamin Gardner, Research Assistant to Professor Grant Nelson (June 10, 2005) (on file with author) (estimating the current percentage to be 40%); Telephone Interview by Benjamin Gardner with the Head Title Officer of a leading title insurer (June 13, 2005) (notes in possession of author) (estimating the current percentage to be 45–50%). The highest estimated percentage during the past decade was over 80%. *Id.*

179. The primary reason is the operation of so-called "reissue rates," which in effect represent discounts for issuance of a new title policy by a company that wrote a prior policy on the same real estate within some fixed time period. *See, e.g.*, First American Corporation, *2004 Annual report Issue*: *Management's Discussion and Analysis*, BUSINESS NOW: THE MAGAZINE OF CORPORATE SUCCESS, at 17, *available at* http://www.firstam.com/faf/ir/pdf/annual-rpt-04.pdf (last visited Jan. 28, 2006); Stewart Information Services Corporation, *Defining Our Future, Building Our Business: 2004 Annual Report*, Feb. 16, 2005, at 21, *available at* http://www.stewart.com/docs/Stewart_04AR.pdf.

180. One major insurer has lowered those premiums 30% from an already discounted base. *See First American Does One-Rate*, 29 NAT'L MORTGAGE NEWS 8, Apr. 18, 2005, § 30. One of our industry interviewees reported that a major title insurer had agreed to give a large institutional lender a bulk rate of $275 for residential refinance policies that normally would carry a $750 premium.

181. Davis & McCarthy, *supra* note 173, at 1. This analysis further explains:

> Following record earnings generated in the previous year, the title industry reported robust earnings in 2003 for the eighth consecutive year. The industry reported pretax operating gains, including net investment income, of approximately $1.5 billion for 2003, which was a staggering 87% higher than 2002. This record performance was driven by strong underwriting results, growth in operating revenue and an increase in net investment income attributed to a mounting invested asset base. Growth in operating revenue reflected a surge in demand for title products, as lower interest rates fueled refinance activity and strong home sales. While total operating revenue in 2003 exceeded the prior year's record by 31%, the industry was able to absorb this large influx of new business more efficiently, primarily due to technological advancements.

Id.

farther. However, subrogation will also reduce operating costs, cushioning the revenue drop.

A major change is also occurring in the market for home mortgages. For a number of years, lenders have granted home equity loans while imposing only minor settlement costs, or none at all, on consumer borrowers.[182] Lenders simply internalized those costs, reflecting them in the overall interest rate return. Now, for the first time, lenders are seriously examining a similar approach to first mortgage lending. This is a radical departure from past practice, under which lenders making first mortgage loans imposed numerous "junk fees" (in addition to the arguably legitimate cost of title insurance, credit reports, and the few other fees required for actual services from outside providers).[183] The lending industry widely understood that the "junk fee" approach was intended to confuse consumers, make price comparisons among lenders difficult, and frustrate the sort of vigorous shopping that the Real Estate Settlement Procedures Act was designed to encourage.[184]

The new trend, however, seems to signify a recognition by home mortgage lenders that confusing and frustrating their customers may, in the long run, be poor business strategy. Instead, lenders are beginning to roll all fees and charges into a single interest rate and a single loan fee.[185] Without doubt this will facilitate price competition

182. Kenneth R. Harney, *No-Cost Equity-Style Loans Come to Primary Mortgages*, WASH. POST, May 6, 2005, at F01.

183. HUD defined "junk fees" as "any fee charged for a service to a borrower that has little or no value in relation to the charge, and/or may be duplicative, to increase a loan originator's profits." Real Estate Settlement Procedures Act, 67 Fed. Reg. 49,134, 49,136 n.6 (proposed July 29, 2002) (to be codified at 24 C.F.R. pt. 3500).

184. It was precisely for this reason—the ineffectiveness of RESPA in making loan and settlement costs "shoppable"—that HUD issued its Guaranteed Mortgage Package Agreement proposal. *See supra* note 138. As HUD put it, "[A]n exemption should be provided for packaging to facilitate earlier comparison shopping by borrowers, greater competition among mortgage lenders and others, and guaranteed prices to borrowers from the time the borrower applies for a mortgage through settlement." Real Estate Settlement Procedures Act, 67 Fed. Reg. 49,145 n.35. In effect, the proposal signified HUD's admission that RESPA had failed. *See* Kenneth A. Markison, *HUD's Proposal To Overhaul the Mortgage Process To Lower Costs and Increase Homeownership*, 12 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 62, 63 (2002).

185. Beginning in May, 2005,

> Bank of America [began] offering what it calls its 'Mortgage Rewards' plan, which essentially brings its streamlined, zero-cost equity line program to people shopping for primary mortgages to buy homes. Initially it will [sic] available in 20 states, including Maryland and Virginia, and the District of Columbia. Mortgage industry sources say other large, well-known banks are developing their own versions . . . .

Harney, *supra* note 182.

simply because it is far easier for consumers to shop the market for a single fee than for a multiplicity of complex fees.

This new approach to marketing by residential lenders is largely a product of the growth in consumer use of the Internet. Because the Internet makes the gathering of information significantly less costly and more convenient than in the past,[186] providers of a wide variety of goods and services have become more competitive in terms of price.[187] In the primary mortgage market, a consumer who wishes to gather information about the interest rates and loan fees of, say, ten lenders can do so in a few minutes at the computer rather than spending several hours on the telephone.[188] Moreover, it has become practical for consumers to consider lenders across the nation, rather than only those with local offices.[189] In these conditions, lenders who frustrate and confuse their potential customers with lengthy lists of

186. The costs of storing, transmitting, and processing information have been dropping continuously by 25 to 35% per year for the last 30 years, and that trend is expected to continue for at least the next 5 to 10 years. *See* Till M. Guldimann, *How Technology Is Reshaping Finance and Risks*, BUS. ECON., Jan. 2000, at 41, 44. As one analyst noted,

> Consumers view financial products, including mortgages, to be commodities with only the price differentiating product offerings. And many consumers have ready access to price information via the Internet. Market research shows that consumers are becoming impatient with firms that fail to provide convenience and access to innovative products and that lack the ability to execute transactions quickly.

Forrest Pafenberg, *The Single-Family Mortgage Industry in the Internet Era: Technology Developments and Market Structure,* at 28 (2004), http://www.ofheo.gov/media/pdf/technology paper12004.pdf (footnotes omitted).

187. "Today's home mortgage market is highly securitized and competitive, bolstered by government-sponsored enterprises like Fannie Mae and Freddie Mac. Large mortgage lenders have adopted high-volume, low-cost strategies based on highly automated systems, resulting in strong price competition." Jeffery W. Gunther & Robert R. Moore, *Small Banks' Competitors Loom Large*, SOUTHWEST ECON., Jan.–Feb. 2004, *available at* http://www.dallasfed.org/research/swe/2004/swe0401b.html.; *see also* Jane Bryant Quinn, *Cutting the Commissions*, NEWSWEEK, July 18, 2005, at 47 (describing how the Internet has made the market for residential real estate brokerage services more price competitive).

188. *See Online Shopping for Mortgages*, BANKRATE.COM, Mar. 15, 2004, http://www.bankrate.com/brm/news/real-estate/buyerguide2004/online-mortgage.asp; Broderick Perkins, *Online Mortgage Shopping Today*, REALTY TIMES, Jan. 23, 2004, http://realtytimes.com/rtcpages/20040123_webshop.htm. Online mortgage shopping sites that access multiple lenders simultaneously include www.nextag.com, www.theloanpage.com, www.finance.yahoo.com, www.lendingtree.com, and www.eloan.com. Many individual lenders also provide on-line rate quotes and loan applications. *See, e.g.*, http://www.flagstar.com/lending/mortgage/refinance.

189. "The other favorable trend has been a transformation of the mortgage industry. To get a loan twenty years ago, you usually went to a local bank or savings association, which approved the application and provided the money. Now, the mortgage business is mostly national." Robert J. Samuelson, *Is Housing a New Bubble?*, NEWSWEEK, Apr. 19, 2004, at 55.

miscellaneous charges for the loan and ancillary services simply cannot survive in the long run. All-inclusive loan quotes, in which the consumer need only consider a single interest rate and a single loan fee, will almost certainly predominate in the future. Thus far, the new programs adopted by lenders have not included title insurance, primarily because title insurance rates are regulated, and therefore the lending industry cannot bargain them down as quickly and effectively as other costs. But as we have suggested above,[190] this is surely a temporary limitation. If lenders cannot get title insurance expenses down to acceptable levels, they are likely to dispense with title insurance entirely, becoming self-insurers. The Restatement approach to mortgage subrogation will make such decisions possible by greatly reducing—indeed, virtually eliminating—the risks of self-insurance.[191]

The requirements of the two federally sponsored secondary mortgage market purchasers, Fannie Mae and Freddie Mac,[192] comprise a major element in the equation of residential refinancing. These two congressionally chartered corporations purchase huge numbers of residential mortgages from local lenders.[193] They then either hold the mortgages in their portfolios or securitize them.[194] Most lenders want to preserve the option of selling their loans to these two entities and, hence, comply with their guidelines in every residential loan they make. At present, both Fannie Mae and Freddie Mac insist that a new title insurance policy be issued on every new loan.[195] Hence, lenders are quite unlikely to decide to self-insure title

190. *See supra* text accompanying notes 162–166.

191. See *supra* text accompanying notes 122–147 for a discussion of the remaining risks.

192. For a discussion of the vast scope of the influence of these two entities, see Economist.com, *Building the American dream . . . or Nightmare?*, THE ECONOMIST GLOBAL AGENDA, Feb. 18, 2005, http://www.economist.com/agenda/displayStory.cfm?story_id=3686475.

193. Together, Fannie Mae and Freddie Mac purchased 54% of the residential mortgages originated in the United States in 2003 and 51% of those originated in 2002. Office of Federal Housing Enterprise Oversight, *Mortgage Markets and the Enterprises in 2003*, Oct. 2004, at 12, http://www.ofheo.gov/media/pdf/MME2003.pdf.

194. *See* Freddie Mac, Our Business, http://www.freddiemac.com/corporate/about/what_we_do/business.html (last visited Jan. 30, 2006).

195. *See, e.g.*, Fannie Mae Selling Guide, Part V, Ch. 2, Title Insurance, Dec. 4, 1998, http://www.allregs.com/efnma/ ("The lender must assure that title insurance that satisfies our requirements is in place before a mortgage is delivered to us for purchase or securitization. The title insurance policy must ensure full title protection to us."); Fannie Mae, Refinancing Costs Refinancing Requirements: & Costs, http://www.fanniemae.com/homebuyers/findamortgage/refinancing/requirements.jhtml (last visited Jan. 30, 2006); Freddie Mac,

to refinancing mortgages until Fannie Mae and Freddie Mac decide to do so as well. However, a decision along these lines seems quite feasible; indeed, there are a number of states in which the two government-sponsored agencies could eliminate their title insurance requirements for refinance mortgages today. As the Restatement subrogation rule spreads to additional jurisdictions, the two secondary market agencies could (and we believe, should) accordingly make available an exemption from the title insurance requirement.

In sum, we believe that adoption of the Restatement approach to subrogation and related issues will greatly reduce, if not eliminate, the title risk in mortgage refinancings and will create compelling pressures on title insurance companies to respond with substantially lower premiums. This change should enable the industry to achieve major savings in underwriting costs. To be sure, the regulatory regime for title insurance may retard competition in some parts of the country. However, given the market strength of the major institutional lenders and the growing price competition in both the mortgage and the title insurance markets, it seems highly likely that the proposed legal changes will dramatically benefit lenders and their homeowner clientele. Should the title insurance industry resist significant premium reduction, it will face a lending industry whose members will be increasingly willing to self-insure.

VIII. CHANGING SUBROGATION LAW: IS THE SOLUTION STATE OR FEDERAL?

This Article demonstrates that the pervasive adoption of the Restatement approach to subrogation and related priority issues in refinancing transactions is correct as a normative matter and likely to lead to substantial savings for refinancing homeowners. We consider here the optimal way to proceed in order to allow this adoption to become reality. We are, of course, heartened that the recent trend of case law has been favorable to the Restatement approach.[196] The continuation of that trend is desirable if homeowners are to receive substantial savings when they refinance. However, state-by-state judicial adoption of a Restatement rule can be a tedious and uneven

Review Checklist for Final Delivery Electronic Mortgage Documents, May 6, 2005, http://www.freddiemac.com/sell/multifamily/docs/specialproductschecklist.doc.

196. *See supra* note 39.

process, likely to extend over many years. Even more problematic would be an attempt by the National Conference of Commissioners on Uniform State Laws to promulgate the Restatement approach as a uniform act. As we have noted elsewhere, uniform acts dealing with real estate or mortgage law have been only rarely and sporadically adopted by state legislatures.[197]

The future of the Restatement subrogation rule and related doctrines may lie with Congress. It is a well-understood fact that the residential mortgage market in the United States is a national market, and that its efficiency is inevitably impaired to some extent by varying state rules of law.[198] It is for that reason that we recently advocated the adoption by Congress of the Uniform Nonjudicial Foreclosure Act, promulgated in 2002 by the National Conference of Commissioners on Uniform State Laws.[199] We concluded that the national adoption of a uniform nonjudicial foreclosure procedure was justified as a constitutional and policy matter, given "the enormous impact of mortgage financing on the national economy and the dramatic growth of the secondary market for mortgages. . . ."[200]

If anything, the proposal here is more modest. There we advocated the congressional preemption of state foreclosure procedure in those states that already utilize some version of nonjudicial foreclosure, and the imposition of that type of foreclosure remedy on the states—nearly half of the nation—where only judicial foreclosure is currently permitted. This would admittedly be a radical move, displacing a large body of state law in a large number of states.

197. Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399, 1408–09, 1509 (2004); Ronald Benton Brown, *Whatever Happened to the Uniform Land Transactions Act?*, 20 NOVA L. REV. 1017, 1017–18 (1996).

198. *See* Peter M. Carrozzo, *Marketing the American Mortgage: The Emergency Home Finance Act of 1970, Standardization and the Secondary Market Revolution*, 39 REAL PROP. PROB. & TR. J. 765, 787 (2005); Robin Paul Malloy, *The Secondary Mortgage Market—A Catalyst for Change in Real Estate Transactions*, 39 SW. L.J. 991, 996–97 (1986); James E. McNulty, *Secondary Mortgage Markets: Recent Trends and Research Results*, FED. HOME LOAN BANK BOARD J., Apr. 1984, at 10, *available at* http://www.findarticles.com/p/articles/mi_m6201/is_n3_17/ai_3209769. The national focus of the mortgage market is illustrated by the extremely heavy involvement of Fannie Mae and Freddie Mac in acquiring home mortgages. *See supra* note 193.

199. Nelson & Whitman, *supra* note 197, at 1509–13.

200. *Id.* at 1509.

The proposal here is more analogous to congressional enactment of the Garn-St.Germain Depository Institutions Act of 1982 (the "Garn Act"), which made mortgage due-on-sale clauses enforceable as a matter of preemptive federal law.[201] Prior to that enactment, there was great uncertainty under many state statutes and judicial decisions concerning the enforceability of "due-on-sale" provisions in mortgages. Congress was motivated largely by desire to aid a then-struggling savings and loan industry. In a sense, the subrogation proposal presented here, like the Garn Act, deals with a relatively narrow substantive rule rather than a wholesale change in foreclosure practice. Like the Garn Act, this proposal, if enacted, could very well save billions of dollars annually—but for refinancing homeowners, not lenders.

Moreover, congressional enactment is entirely feasible from a political standpoint. While the title insurance industry might oppose the concept on the ground that it would sustain a loss of revenue in refinancing transactions, the mortgage lending industry would have a strong incentive to support it in order to reduce overall costs to refinancing borrowers. It is quite realistic to expect Congress to act.

IX. CONCLUSION

This Article advocates adoption of a package of proposals to reform the law of mortgage refinancing with the Restatement's approach to the doctrine of subrogation as its centerpiece. We have demonstrated that title insurance costs in residential mortgage refinancings represent billions of dollars annually—costs that are now borne overwhelmingly by homeowners. We have illustrated how adoption of the Restatement sections dealing with subrogation and related priority issues would virtually eliminate the risk of loss of mortgage priority for refinancing lenders. We have also described how two simple additions to mortgage documents would serve to enhance this protection by strongly increasing the likelihood that courts would apply the subrogation doctrine and would grant priority to refinancing lenders even when the new mortgage exceeds the amount of its predecessor. These latter steps could largely be

201. This mortgage clause authorizes a lender to accelerate the obligation and foreclose if the real estate is transferred without the lender's written permission. *See* Grant S. Nelson & Dale A. Whitman, *Congressional Preemption of Mortgage Due-on-Sale Law: An Analysis of the Garn-St. Germain Act*, 35 HASTINGS L.J. 241, 251 (1983).

accomplished by Fannie Mae and Freddie Mac incorporating the appropriate language in their standard residential mortgage forms. We also considered the technique of direct assignment to new lenders of mortgages being refinanced as an alternative to subrogation, but concluded that the adoption of such an approach would be impractical at this time.

Ultimately, the Restatement approach should be enacted by Congress. Such federal legislation, buttressed by the two drafting techniques described above, would represent a package of protections for lenders that would largely obviate the major reason for title insurance in refinancing transactions. In such an environment, we believe that title insurers would either substantially reduce premiums in home mortgage refinancings or run the risk that major institutional lenders would eliminate the need for title insurance completely by becoming self-insurers. Either way, American homeowners would be the major beneficiaries.

The potential savings quite literally amount to billions of dollars. Whether the change is accomplished by Congress or by the incremental process of state adoption, it is vital that it occur before the next major decline in mortgage interest rates and the corresponding wave of mortgage financings. Economic efficiency in the marketplace, and the attendant savings for individual households, demands nothing less.