Filed 10/30/12 Integral Design v. Anderson CA2/6

NOT TO BE PUBLISHED IN THE OFFICIAL REPORTS

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION SIX

INTEGRAL DESIGN, INC., Plaintiff, Cross-defendant and Respondent, v. KENNETH J. ANDERSON, as Trustee, etc., Defendant, Cross-complainant and Appellant.	2d Civil No. B233319 (Super. Ct. No. 56-2009-00361868-CU-BC-VTA) (Ventura County)

Indymac Bank, FSB (Indymac) loaned Scott Hoover $3,395,000 to construct a luxury home on his beachfront property. Hoover paid off that loan by borrowing $4,850,000 from appellant Kenneth J. Anderson.[1] Anderson was not aware that respondent Integral Design, Inc. (Integral) had an existing mechanic's lien on the property.

After Hoover defaulted, Anderson foreclosed and purchased the property with a $4,100,000 credit bid. Integral sued to foreclose its mechanic's lien.

[1]Anderson appears in his capacity as trustee of the following trusts: Glen R. Irani Trust of 1997 dated 2-10-97, Mazen Irani Trust dated 6-14-97, Lillian Mueller Trust dated 2-10-97, and Martin R. Irani Trust dated 2-10-97.

Although the mechanic's lien was senior to Anderson's deed of trust, the trial court determined Anderson's deed of trust should be equitably subrogated to the extent of the original Indymac loan. Anderson agrees equitable subrogation was proper, but contends the trial court erred by finding that the mechanic's lien survived the foreclosure sale and that Integral is entitled to $336,736.56 based on that lien.

Anderson is correct that the foreclosure sale extinguished Integral's mechanic's lien. It did not, however, extinguish Integral's right to its share of the "surplus proceeds" from the sale. The trial court correctly determined that Integral, as the second lienholder, is entitled to the difference between the amount of the senior Indymac loan and the $4,100,000 purchase price. We reverse the portion of the judgment enforcing the mechanic's lien against the property and modify the judgment to reflect a money judgment against Anderson in the sum of $336,736.56, plus interest and costs. We affirm the judgment in all other respects.

FACTUAL AND PROCEDURAL HISTORY

In October 2006, Hoover borrowed $1,051,666 from Bruce and Jane Defnet to purchase a beach lot located at 1089 Mandalay Beach Road, Oxnard, California (Property). The trust deed securing the Defnet loan was not recorded until March 2, 2007.

Hoover obtained a $3,395,000 construction loan from Indymac, secured by a deed of trust recorded on December 6, 2006. Hoover hired Integral, a licensed general contractor, to construct a luxury single-family home on the Property. Integral commenced construction in January 2007.

In June 2008, the appraised value of the Property was $7 million. Hoover refinanced the project by borrowing $4,850,000 from Anderson as trustee of several trusts. On August 28, 2008, Anderson recorded a deed of trust against the Property in that amount. The loan proceeds were used to pay the $3,463,437.27 balance on the Indymac construction loan and the $819,631.36 balance on the Defnet loan. Indymac and the Defnets reconveyed their deeds of trust.

In 2008, Hoover acknowledged he owed Integral a final construction payment of $348,657.69. After Hoover paid only a small portion of that amount, Integral recorded a mechanic's lien in the amount of $337,183.82. Anderson was unaware of the mechanic's lien when he recorded his deed of trust.

Hoover defaulted on the Anderson deed of trust. Anderson foreclosed and purchased the Property at the trustee's sale with a $4,100,000 credit bid. At the time of the sale, the total amount due under the Anderson deed of trust was $6,347,492.21. This sum included interest at the contract rate of 12 percent per annum.

Integral sued Hoover and Anderson for the unpaid debt and to foreclose the mechanic's lien. Hoover failed to answer and the court entered his default. Anderson cross-complained for a judicial declaration that he is entitled to equitable subrogation rights in the amount of the payoff on the Indymac and Defnet loans and that, as a result, Integral no longer has an enforceable mechanic's lien against the Property.

The parties stipulated that Integral's mechanic's lien was senior to the Defnet deed of trust and that the Indymac deed of trust had priority over the mechanic's lien. Following a bench trial, the court concluded that Integral has an enforceable mechanic's lien; that Anderson did not have actual knowledge of that lien and thus was entitled to rely upon the doctrine of equitable subrogation to take the position of Indymac; and that Integral was entitled to judgment against Anderson in the amount of $336,736.56, plus interest and costs. The trial court calculated this amount by subtracting $3,763,263.44 -- the amount of the Indymac loan payoff plus the interest that would have accrued on the loan had it remained in effect -- from the $4,100,000 purchase price, leaving a balance of $336,736.56.

On March 16, 2012, the trial court entered judgment against Anderson confirming that Integral has a mechanic's lien upon the Property in the amount of $336,736.56, plus interest and costs, and ordering foreclosure of the lien. The court

also entered judgment against Hoover for $335,545.17.[2] The judgment entitles each debtor to credit for payments made by the other. Anderson appeals.

At our request, the parties submitted supplemental letter briefs addressing whether the court has legal or equitable authority to treat the difference between the $4,100,000 credit bid and the amount of the Indymac construction loan as "surplus proceeds" for purposes of entering a money judgment against Anderson in that amount.

DISCUSSION

We review the trial court's findings of fact under the substantial evidence standard. (*Westfour Corp. v. California First Bank* (1992) 3 Cal.App.4th 1554, 1558.) We review the trial court's conclusions of law de novo. (*Ibid.*)

As a general rule, a foreclosure sale extinguishes or "wipes out" all interests that were junior in priority to the foreclosing party's deed of trust. (5 Miller & Starr, Cal. Real Estate (3d ed. 2009) § 11:100, pp. 11-297 to 11-298.) In certain situations, however, a party who pays off or refinances a senior lien will take priority over existing liens through the doctrine of equitable subrogation. (*Id.* at § 11:115, at pp. 11-354 to 11-359.) "When the payer pays a debt in full that was secured by a senior lien and the lien [is] reconveyed or discharged of record, under the doctrine of equitable subrogation the court will revive the reconveyed lien with the same priority as the former lien to provide the payer with an enforceable lien with the same priority as the former lien." (*Id.* at p. 11-357; see *Caito v. United Cal. Bank* (1978) 20 Cal.3d 694, 704 (*Caito*).) In other words, equitable subrogation sets aside the cancellation of the former encumbrance and revives the priority of that encumbrance for the payer's benefit. (*Simon Newman Co. v. Fink* (1928) 206 Cal. 143, 146-147; *Katsivalis v. Serrano Reconveyance Co.* (1977) 70

[2] Integral's judgment against Hoover is slightly less than the judgment against Anderson. The reason for this discrepancy is not apparent from the record.

Cal.App.3d 200, 210; see *JPMorgan Chase Bank, N.A. v. Banc of America Practice Solutions, Inc.* (2012) __Cal.App.4th ___, [2012 WL 4457776, 3-4] (*JPMorgan*).)

In *Parker v. Tout* (1929) 207 Cal. 590, 591 (*Parker),* the defendant bank held a $25,000 note and trust deed on Tout's property. After a contractor commenced digging a well on the property, Tout borrowed an additional $2,500 from the bank to pay for the well and other expenses. (*Id.* at pp. 591-592.) Unaware of the contractor's mechanic's lien, the bank reconveyed the first deed of trust and recorded a new trust deed in the amount of $27,500. (*Ibid.*) Our Supreme Court held that "[j]ustice and equity and well-established precedents compel a decree that the lien of the bank under its trust deed is superior in right to the mechanic's lien to the extent of the amount of the original note and interest thereon." (*Id.* at p. 594.) As to the amount over the original note, "[t]he mechanic's lien is prior in right to [such] advances . . . ." (*Ibid.*; accord *Lennar Northeast Partners v. Buice* (1996) 49 Cal.App.4th 1576, 1585-1589 [denying priority to loan modification that increased the amount of the senior debt and thus lessened the return available to junior lienholders].)

The facts here are similar to those in *Parker*. Integral's mechanic's lien attached to the Property when construction commenced in 2007. (See Civ. Code, § 8450, subd. (a); *D'Orsay International Partners v. Superior Court* (2004) 123 Cal.App.4th 836, 842.)[3] Unaware of this inchoate mechanic's lien, Anderson paid off the Indymac and Defnet loans in 2008 and recorded a new deed of trust. The parties stipulated the "Indymac Trust Deed had priority over Integral's inchoate mechanic's lien rights."

After Indymac reconveyed its deed of trust, Integral's mechanic's lien assumed the first priority position. At trial, Anderson successfully asserted that his deed of trust should be equitably subrogated to the position of the original Indymac

[3] All statutory references are to the Civil Code.

construction loan.[4] Anderson acknowledges that under the trial court's ruling, his "lien for the amount of the Indymac construction loan, plus interest, was first in priority; [the] mechanic's lien was second; and [Anderson's] lien for sums loaned to Hoover in excess of those owed under the Indymac was third." The dispute centers on the effect of the foreclosure on Integral's mechanic's lien.

Anderson contends that because the trial court equitably subrogated his deed of trust to Indymac's prior position, the foreclosure sale extinguished Integral's junior mechanic's lien. We agree. The equitable subrogation ruling revived the priority of the Indymac construction loan, giving Anderson a first priority equitable lien in the amount of the Indymac loan. (See *Parker*, *supra*, 207 Cal. at p. 594.) Anderson's foreclosure of this equitable lien eliminated all junior interests, including the second priority mechanic's lien and the third priority, nonsubrogated portion of Anderson's deed of trust. (5 Miller & Starr, *supra*, at § 11:100, pp. 11-297 to 11-298; *Hohn v. Riverside County Flood Control & Water Conservation Dist.* (1964) 228 Cal.App.2d 605, 610 [purchaser at trustee's sale obtains title "free of all claims subordinate to the mortgage or trust deed under which the sale was made"].) By enforcing the mechanic's lien against the Property, the judgment effectively returned Integral to its first priority position, negating the impact of the equitable subrogation ruling.

Because the foreclosure sale extinguished the mechanic's lien, the trial court erred as a matter of law by ruling that Integral still has a lien on the Property. (See 5 Miller & Starr, *supra*, at § 11:100, pp. 11-297 to 11-298; *Hohn v. Riverside County Flood Control & Water Conservation Dist.*, *supra*, 228 Cal.App.2d at p. 610.) Integral has provided no authority supporting reinstatement of a junior lien following foreclosure of a senior equitable lien.

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[4] Anderson did not obtain equitable subrogation of the Defnet loan. The parties stipulated that Integral's mechanic's lien always was senior to that encumbrance.

This does not necessarily leave Integral without a remedy. Following the foreclosure sale, "subordinate liens against the foreclosed property attach to the surplus proceeds in order of their priority. [Citation.]" (*Caito, supra,* 20 Cal.3d at pp. 701-702.) Section 2924k requires that the trustee, after paying the sale expenses, satisfy the obligation secured by the foreclosing deed of trust, followed by any "obligations secured by any junior liens or encumbrances in the order of their priority."[5] (*Id.* at subd. (a)(1)-(3).)

Anderson's deed of trust was equitably subrogated only to the extent of the Indymac loan. As of the date of the sale, the full amount of the Indymac loan, including interest, was $3,763,263.44. The trial court correctly determined that if Anderson had purchased the Property with a credit bid in that specific amount, nothing would have been available for distribution to junior lienholders under section 2924k, subdivision (a)(3). (See *Passanisi v. Merit-McBride Realtors, Inc.* (1987) 190 Cal.App.3d 1496, 1503-1504 (*Passanisi*).) Because Anderson's credit bid of $4,100,000 exceeded that amount, the trial court concluded that Integral, as the second lienholder, is entitled to the surplus proceeds, i.e., the difference between the Indymac loan amount and the purchase price.

Anderson contends that no surplus proceeds exist because he purchased the property through a credit bid in which no money exchanged hands.

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[5] Section 2924k provides, in pertinent part: "(a) The trustee, or the clerk of the court upon order to the clerk pursuant to subdivision (d) of Section 2924j, shall distribute the proceeds, or a portion of the proceeds, as the case may be, of the trustee's sale conducted pursuant to Section 2924h in the following order of priority: [¶] (1) To the costs and expenses of exercising the power of sale and of sale, including the payment of the trustee's fees and attorney's fees permitted pursuant to subdivision (b) of Section 2924d and subdivision (b) of this section. [¶] (2) To the payment of the obligations secured by the deed of trust or mortgage which is the subject of the trustee's sale. [¶] (3) To satisfy the outstanding balance of obligations secured by any junior liens or encumbrances in the order of their priority."

We disagree. A nonjudicial foreclosure sale is a creature of statute. (*Kachlon v. Markowitz* (2008) 168 Cal.App.4th 316, 334 ["The Civil Code contains a comprehensive statutory scheme regulating nonjudicial foreclosure"].) Under this statutory framework, "[e]ach and every bid made by a bidder at a trustee's sale . . . shall be deemed to be an irrevocable offer by that bidder to purchase the property . . . for the amount of the bid." (§ 2924h, subd. (a); *Alliance Mortgage v. Rothwell* (1995) 10 Cal.4th 1226, 1237.) The trustee's deed upon sale states "[t]he amount paid by the grantee [Anderson] at the trustee sale was . . . $4,100,000[]." The substantial evidence supports the trial court's finding that this was the purchase amount. Section 2924h draws no distinction between a cash and credit bid in establishing the purchase amount. Indeed, once the foreclosing lender makes a credit bid, no difference exists between it and other purchasers' cash bids. (*Id.* at subd. (b); *Passanisi*, *supra*, 190 Cal.App.3d at p. 1503.)

Unquestionably, if a cash bidder had purchased the Property for $4,100,000, the trustee would have paid Anderson $3,763,263.44 in full satisfaction of the subrogated portion of his deed of trust and then remitted the balance to Integral as the second priority lienholder. (See § 2924k, subd. (a)(1)-(3).) This result should not be any different because Anderson acquired the Property through a credit bid.

Only the foreclosing lienholder (beneficiary) may make a credit bid; other successful bidders must pay cash. (See § 2924h, subd. (b).) Section 2924h permits the beneficiary of the "deed of trust under foreclosure" to submit a credit bid "only to the extent of the total amount due the beneficiary including the trustee's fees and expenses." (*Id.* at subd. (b); see *Michelson v. Camp* (1999) 72 Cal.App.4th 955, 963-964; *Passanisi*, *supra*, 190 Cal.App.3d at p. 1503.) Anderson did not limit his credit bid to the amount of his equitable lien, i.e., the Indymac loan. He made a credit bid of $4,100,000 because "[t]hat was an amount that they thought that the [P]roperty might sell for because of the prior listings that it had." This was

improper because under the equitable subrogation ruling, the "deed of trust under foreclosure" was the Indymac loan. (§ 2924h, subd. (b).) Anderson had statutory authority, therefore, to make a credit bid in the amount of that loan, but not to make a higher credit bid based upon the nonsubrogated portion of his deed of trust which remained junior to the mechanic's lien. (*Ibid.*; see *Kolodge v. Boyd* (2001) 88 Cal.App.4th 349, 356.)

Anderson's credit bid exceeded the Indymac loan by $336,736.56. It is reasonable to treat this excess as "surplus proceeds," which Anderson should have paid to the trustee as part of the purchase price and which the trustee, in turn, should have disbursed to Integral as the second priority lienholder. (§ 2924k, subd. (a)(1)-(3); see *Caito*, *supra*, 20 Cal.3d at pp. 701-702.) This is consistent with the general public policy favoring the claims of contractors who contribute to the value of a project. (*Wm. R. Clarke Corp. v. Safeco Ins. Co*. (1997) 15 Cal.4th 882, 888-889.) It also is consistent with the tenet that equitable subrogation "'. . . must not work any injustice to the rights of others.' [Citations.]" (*Caito* at p. 704; see *JPMorgan*, *supra*, 2012 WL 4457776, at pp. 3-4.) Allowing an equitable lienholder to acquire property with a credit bid that exceeds the amount of the equitable lien prejudices not only junior lienholders, but also any competing bidders who, by statute, must bid only in cash. (§ 2924h, subd. (b).)

The trial court properly upheld Integral's right to the surplus proceeds from the sale. Because the foreclosure extinguished the mechanic's lien, Integral is entitled to a money judgment for $336,736.56, but not to a judgment enforcing the lien against the Property.[6]

[6] In addition to seeking foreclosure of the mechanic's lien, Integral's complaint sought a judgment against Anderson in the sum of $337,183.82, plus interest and costs.

DISPOSITION

The judgment is reversed to the extent it provides, in paragraphs 2 through 6, that Integral has an enforceable mechanic's lien and orders foreclosure of that lien. We modify the judgment to delete those paragraphs and to enter instead a money judgment in favor of Integral and against Anderson in the amount of $336,736.56, plus interest and costs. In all other respects, the judgment is affirmed. The parties shall bear their own costs on appeal.

NOT TO BE PUBLISHED.

PERREN, J.

We concur:

GILBERT, P.J.

YEGAN, J.

Mark S. Borrell, Judge

Superior Court County of Ventura

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