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ARIZONA COURT OF APPEALS

DIVISION ONE

MARKHAM CONTRACTING CO., INC., an Arizona corporation, Plaintiff/Appellant, v. FEDERAL DEPOSIT INSURANCE COMPANY, a receiver for First Arizona Savings and Loan Association, a federal savings bank; PRIMEAZ/LIBRA, LLC, an Arizona limited liability company, Defendants/Appellees.	Court of Appeals Division One No. 1 CA-CV 14-0752 Maricopa County Superior Court No. CV2010-000707

PLAINTIFF/APPELLANT'S REPLY BRIEF

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INTRODUCTION

The fundamental issue in this case is whether Markham's mechanic's lien remains on the Property. If it does, the Lenders will pay Markham for its work—work which enhanced the value of the property the Lenders now hold. If it does not, then the Lenders may sell the Property and keep for themselves all proceeds without paying Markham, even though those proceeds will almost certainly exceed the value of both Markham's and the Lenders' liens. In other words, the Lenders will obtain a windfall at Markham's expense. *Cf. Wahl v. Sw. Sav. & Loan Ass'n*, 106 Ariz. 381, 385 (1970) ("We are, however, convinced that our Legislature intended that laborers and materialmen, who contribute of their labor and means to enhance the value of the property of another, should be jealously protected." (quotation marks and citation omitted)).

As the Opening Brief explained, that latter option cannot, as a matter of law, be the result in this case because the Lenders acquired the Property by exercising rights they had only by virtue of an interest subordinate to Markham's lien—the 2008 Deed of Trust. Decisively, they made a credit bid that was ***necessarily*** made pursuant to that subordinate interest because it exceeded the credit bid that could have been made had the Lenders not refinanced the 2006 Loan. Although the Lenders had every right to acquire the Property with that bid, doing so comes with consequences. Specifically, it means that the statutes governing priority may not now be judicially tinkered with.

Tellingly, although the Lenders say over and over again that the 2008 Deed of Trust automatically became superior to Markham's lien (and therefore foreclosure on that deed automatically extinguished Markham's lien), they never confront the central issue: neither equitable subrogation nor replacement gave the Lenders the superpower to acquire property with a credit bid in excess of any first position interest they may have held (whether by way of replacement or subrogation). Indeed, rather than provide any principled basis that would justify construing the law in the manner they urge, they instead tell the Court to not worry about the consequences implied by their position because nothing bad happened in this case. That, however, is not how the rule of law works, particularly in the area of real property interests where the rules must be clear and known in advance.

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Moreover, the Lenders implicitly recognize that absent replacement or subrogation, Markham held an interest senior to the 2008 Deed of Trust. *See* A.R.S. § 33-992(A) (mechanics' liens are generally "preferred to all liens, mortgages or other encumbrances upon the property attaching subsequent to the time the labor was commenced . . . ."). Yet they cannot benefit from those doctrines due to the prejudice it would cause Markham. For these and other reasons, the Court should hold that Markham's lien remains on the Property.

ARGUMENT

I. Replacement does not apply in this case and it does not help the lenders in any event.

Despite acknowledging (at 15) that "both the parties and the court treated the doctrines of replacement of mortgages and equitable subrogation as being essentially interchangeable," the Lenders now attempt to draw distinctions between the two, and claim that the limitations on equitable subrogation do not apply to replacement. That runs contrary to what they told the superior court, and is legally incorrect.

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A. The Lenders told the superior court there were no substantive differences between replacement and equitable subrogation.

In the superior court, the Lenders first raised replacement in a reply to a cross motion for summary judgment on Count Two.[1] At the hearing on the motion, Markham argued that replacement did not apply because this case involved multiple lenders, and involved a new transaction rather than a replacement loan.[2] The Lenders then clarified that in their view replacement applied to First Arizona, and equitable subrogation applied to PrimeAZ.[3] As they then stated, "[s]o essentially, both doctrines apply in this case. One applies to the PrimeAZ portion and one applies to the First Arizona Savings portion."[4]

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[1] R-68.

[2] 8/1/2011 Tr. at 26:18-27:4 (*Continental* is "very clear that in a situation like this it's [replacement is] ***not going to apply because we have got two completely different lenders***. It's a completely different transaction. And actually, they do say it's a question of fact with regard to the transaction. But in this situation, given the fact that PrimeAZ Libra and First Arizona Savings are two separate parties and the first lender was just First Arizona Savings. It wasn't that it was PrimeAZ, and the same percentages and then just increasing the dollar amount of the loan. ***It might be replacement in that [same lender] situation, but not here***.") (emphasis added).

[3] *Id.* at 28:6-18.

[4] *Id.* at 28:19-21.

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When Markham later sought to preclude the Lenders from invoking replacement because they raised the issue too late (i.e., in a reply), the Lenders took the position that it was "really a semantical issue," and that "if the second lender is the same as the first lender, then you don't call it equitable subrogation. You call it replacement."[5] The Lenders further explained that "it's the same issues. You know, what was paid to satisfy? Is there prejudice?,"[6] and made clear that it was the ***same*** prejudice under both doctrines:

> ***It's the same prejudice, whether it's prejudice under equitable subrogation or prejudice under replacement***. So in my view, ***it's really just semantical*** whether you can call it both lenders get equitable subrogation up to the amount that was satisfied in 2006 or you say Prime AZ is called equitable subrogation, First Arizona is called replacement.[7]

After making that pitch to the superior court, the Lenders again moved for summary judgment on Count Two, but argued only equitable subrogation. In response to ***that*** Motion, Markham stated that "as the original lender, the theory of replacement and not equitable subrogation is

[5] 5/24/12 Tr. at 9:17-10:1.

[6] *Id.* at 11:17-18.

[7] *Id.* at 11:19-25.

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the only equitable remedy available to" FDIC (First Arizona).[8] Markham then argued equitable subrogation did not apply, and noted that "these [same] arguments" apply to replacement.[9] In further briefing and argument, the parties argued in terms of "the doctrine of equitable subrogation/replacement."[10]

In the Opening Brief (at 32 n.*), Markham, in effect, conceded the position urged by the Lenders below, i.e., that "[i]t's the same prejudice, whether it's prejudice under equitable subrogation or prejudice under replacement."[11] Markham further (correctly) noted (at 32 n.*) that "this case involved multiple-lender refinancing, making equitable subrogation the appropriate doctrine." That, of course, is consistent with what

[8] R-180 at 8.

[9] *Id.* at 9 n.1 ("If the FDIC files a new Motion for Summary Judgment based on the doctrine of replacement, these arguments will be applicable to them, as well.").

[10] *See*, *e.g.*, R-291 at 5 (arguing that "Markham has utterly failed to demonstrate that the Lenders obtained some inappropriate advantage as a result of the fact that its bid was in excess of the replacement/subrogation amount.").

[11] *Id.* at 11:19-25.

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Markham said at the outset: that replacement could not apply because this case involved multiple lenders.[12]

B. Replacement applies only to cases involving single-lender refinancing.

Apparently recognizing the weakness of their argument concerning equitable subrogation, the Lenders now rely heavily on replacement. In light of the above, however, the Court may decline to consider the Lenders' replacement arguments because, although they initially drew some distinctions between the doctrines, they abandoned that position below. *See* ARCAP 13(b)(2) ("The appellee's answering brief may include in the statement of issues presented for review and may discuss in the argument any issue that was ***properly presented*** in the superior court without the

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[12] *See* note 2, supra; *see also* R-102 (Markham arguing that "the replacement theory of mortgages is not applicable here, as the 2006 Loan and the 2008 Loan were made by different entities.").

8/1/2011 Tr. at 26:18-27:4 (*Continental* is "very clear that in a situation like this it's [replacement is] ***not going to apply because we have got two completely different lenders***. It's a completely different transaction. And actually, they do say it's a question of fact with regard to the transaction. But in this situation, given the fact that PrimeAZ Libra and First Arizona Savings are two separate parties and the first lender was just First Arizona Savings. It wasn't that it was PrimeAZ, and the same percentages and then just increasing the dollar amount of the loan. ***It might be replacement in that [same lender] situation, but not here***.") (emphasis added).

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need for a cross-appeal . . . .") (emphasis added). In any event, their position lacks merit.

1. The Restatement and Arizona law limit replacement to cases involving a single lender.

The Restatement expressly provides that "[w]here a mortgage loan is refinanced by the ***same lender***, a mortgage securing the new loan may be given the priority of the original mortgage under the principles of replacement and modification of mortgages; *see* § 7.3." Restatement § 7.6 cmt. e. For this reason, this Court has emphasized that replacement is an "analogous legal theory" to equitable subrogation that applies "in a single-***lender refinancing***." *Cont'l Lighting & Contracting, Inc. v. Premier Grading & Utils., LLC*, 227 Ariz. 382, 386 ¶ 12 (App. 2011) (emphasis added).

The Lenders cite no decision that has applied replacement where two different lenders refinanced a loan. Moreover, they cite no case that has permitted a new lender like PrimeAZ to claim replacement in connection with a partial refinancing of another lender's loan. Their contention (at 17) that this difference in lenders should not matter because they ***could have*** structured the loan differently misses the point. The law often draws distinctions based on how parties structure deals, and the fact that they could have—in hindsight—structured the deal differently does not matter. *See, e.g.*, *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202, 1204 (4th Cir. 1979) ("[W]e likewise need not consider whether the parties could have structured their arrangement in some other form. The parties in this case chose to implement their plan for joint ownership by means of a stock transfer rather than a partnership agreement or a sale of assets."); *Occidental Life Ins. Co. of N. C. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255, 1262 (4th Cir. 1974) ("The fact that the transfer could have been accomplished in a different way has no significance.").

If the Lenders wanted to benefit from a doctrine applicable only to single-lender financing, they needed to structure the loan as a single lender refinance. But they did not, and thus cannot now benefit from the replacement doctrine. *See* Restatement § 7.6 cmt. e. ("Where a mortgage loan is refinanced by the ***same lender***, a mortgage securing the new loan may be given the priority of the original mortgage under the principles of replacement and modification of mortgages; see § 7.3."). The Lenders are stuck with the deal they actually did.

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2. The Lenders' complaints about fairness miss the mark.

The Lenders' contention (at 18) that limiting them to equitable subrogation is somehow unfair does not withstand scrutiny. If they wanted to draw a distinction and introduce the "Loan Participation Agreement" (as they now contend at 18), then they could have—and should have—done so before the superior court. Instead, as noted above, they correctly recognized below that there was no substantive difference between the doctrines. Moreover, that alleged agreement cannot change the fact that two lenders in fact refinanced the 2006 Loan (as reflected in the 2008 Deed of Trust).[13]

In addition, to the extent they had other evidence relevant to replacement, they had an obligation to disclose it and introduce it because they were aware of Markham's argument related to replacement as early as August 1, 2011.[14] Tellingly, the Lenders even listed the "Loan Participation Agreement" in a joint pretrial statement filed May 9, 2012—more than nine months after Markham made its position clear.[15] All of this weighs in favor

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[13] APPV1_049.

[14] *See* 8/1/2011 Tr. at 26:18-27:4.

[15] *See* R-121 at 15 (Proposed Exhibit 3).

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of not now considering the replacement arguments the Lenders make on appeal.

C. Contrary to the Lenders' contention, courts may consider all the equities when deciding whether to judicially reorder priorities under either replacement or subrogation.

In addition to ignoring the above limitation on the replacement doctrine, the Lenders contend that replacement gives them more rights than are available under equitable subrogation. They repeatedly say things like "there is no need to engage in the case-by-case analysis that has been applied to determine whether equitable subrogation should be available to a subsequent lender." (Ans. Br. at 20.) But they never actually cite any case for that contention, and instead claim the Restatement dictates that result. The Lenders' position, however, ignores other comments in the Restatement, and otherwise does not withstand scrutiny.

1. The Arizona cases do not support the Lenders' position.

The Arizona Supreme Court has never adopted Restatement § 7.3 nor otherwise endorsed the replacement doctrine in any form. This Court has recognized the doctrine in two cases. *See Cont'l Lighting*, 227 Ariz. at 388 ¶ 22; *Brimet II, LLC v. Destiny Homes Mktg., LLC*, 231 Ariz. 457, 460-61 (App. 2013).

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Continental held that when a single lender (REEL) made a $1,000,000 loan in 2007 and used $803,125.08 of the proceeds to pay off an $825,000 loan made in 2005, "the 2007 deeds of trust assumed the priority of the original deed of trust it replaced to the extent of $803,125.08." *Cont'l Lighting*, 227 Ariz. at 389 ¶ 23. As noted above, *Continental* emphasized the similarity of replacement to equitable subrogation, and that the same "rationale and policy considerations" apply. *Id.* at 388 ¶ 20. Invoking the unjust enrichment principle applicable to equitable subrogation, *Continental* explained that a "windfall" would result if the doctrine did not apply in that case. *Id.* at 389 ¶ 24. *Continental* did not consider any issues relating to a credit bid, nor did the holder of the mechanic's lien in that case argue that delay in asserting replacement resulted in prejudice.

Brimet held that the same lender could ***not*** benefit from replacement because after the refinancing, the borrower made payments in excess of the original loan balance (thereby wiping out whatever first position may have existed). *Brimet*, 231 Ariz. at 461 ¶ 21 ("In sum, the construction loan had priority over the Option under the doctrine of replacement in the amount of $442,296.12. On June 1, 2006, the Borrower paid more than that amount towards the loan balance and the priority ceased to exist.").

Tellingly, *Brimet* involved both the same lender and a new lender (for a different loan) both making priority claims. *Brimet* observed that "[w]hen the lenders are of the same identity, priorities are determined under replacement and not equitable subrogation." *Id.* at 460 ¶ 12. But it further noted the doctrines were "similar" and drew no distinction between them other than that subrogation applies in multi-lender cases. *See id*. at 459-60 ¶¶ 10-12. Like *Continental, Brimet* did not consider the issues raised in this case.

In sum, Arizona courts have largely treated the doctrines interchangeably pursuant to the Restatement's directive that for replacement "the requirements are essentially similar to those for subrogation." Restatement § 7.6 cmt. e.

2. Other courts have expressly limited replacement to single-lender refinancing and subject to a careful examination of the equities.

Focusing on other similar comments in the Restatement, the Michigan Court of Appeals expressly held that § 7.3 applies only in single lender situations, and subject to "a careful examination of the equities":

> We caution, however, that the lending mortgagee seeking subrogation and priority over an intervening interest relative to its newly recorded mortgage ***must be the same lender*** that held

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> the original mortgage before the intervening interest arose; and, furthermore, ***any application of equitable subrogation is subject to a careful examination of the equities of all parties and potential prejudice to the intervening lienholder***.

CitiMortgage, Inc. v. Mortg. Elec. Registration Sys., Inc., 813 N.W.2d 332, 334-35 (Mich. App. 2011) (emphasis added).

That court emphasized the "material prejudice" and "paramount equities" language in comment b—finding it "[o]f particular note"—and observed that so "limited" § 7.3 is "consistent with Michigan precedent." Emphasizing the limitations, the court adopted it with the caution provided above. *Id.* at 334 ("Thus limited, because § 7.3 of the Restatement reflects the present state of the law in Michigan, we hereby adopt it.").

3. Common sense supports considering all equitable considerations under both doctrines.

Common sense also supports giving courts the power to consider all equities before deciding whether to judicially reorder priorities. Importantly, the Lenders do not dispute that absent replacement or subrogation, Markham held an interest senior to the 2008 Deed of Trust. *See* A.R.S. § 33-992(A) (mechanics' liens are generally "preferred to all liens, mortgages or other encumbrances upon the property attaching subsequent to the time the labor was commenced . . . .").

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Although they contend that replacement is more generous to lenders, they offer no principled reason for treating the doctrines differently. In cases involving mechanics' liens, both doctrines involve a judicial re-ordering of the otherwise statutorily dictated priorities. Precluding courts from considering "the equities of all parties and potential prejudice to the intervening lienholder" merely because in one case a new lender refinances the loan, and in the other case the same lender refinances the loan makes no sense. *CitiMortgage*, 813 N.W.2d at 334-35.

Fundamentally, then, the Lenders advance a fundamentally flawed position. At bottom, they claim that a lender may obtain a first-position interest more easily under the replacement doctrine, and that lenders may simply invoke whatever doctrine they like at whatever time they like and in whatever amount they like. Although they understandably wish the law were this way, the law is not that absurd.

II. Due to their conduct and the prejudice Markham suffered, the Lenders may not now claim replacement or equitable subrogation.

As explained in the Opening Brief, the facts and circumstances in this case preclude the Lenders from circumventing the priority dictated by § 33-

992(A) (under either replacement or equitable subrogation). The Lenders' arguments to the contrary do not withstand scrutiny.

A. The prejudice a court may consider when determining whether to judicially reorder priorities is broader than the Lenders acknowledge.

The Opening Brief explained (at 33) that if a lender delays in "publicly asserting subrogation to the mortgage paid," that delay may result in prejudice to others that precludes the lender from later claiming subrogation. The Lenders do not dispute this principle (at least as applied to subrogation), but contend (at 33-34) that Markham (and Judge Haines) misconstrue what "will actually cause prejudice to an intervening lienholder." According to the Lenders, the contractor cannot claim prejudice unless a contractor begins work when there is no prior lien of record because the judicial reordering does not make the contractor any worse off. (*See* Ans. Br. at 34-36.)

The Lenders, however, cite no opinion that has so limited the requisite prejudice. Moreover, Illustration 30 (upon which the Lenders heavily rely) is just that—one ***illustration*** of the type of prejudice that may result, not an exhaustive list of the types of prejudice a court may consider. That is why the Arizona Supreme Court has emphasized that equitable

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subrogation is an "equitable remedy" that has "no general rule" and instead applies depending "upon the particular facts and circumstances of each case as it arises." *Sourcecorp, Inc. v. Norcutt*, 229 Ariz. 270, 272 ¶¶ 5-7 (2012) (citation omitted); *cf.* Restatement § 7.6 cmt. e ("Subrogation will be recognized ***only if*** it will not materially prejudice the holders of intervening interests.") (emphasis added). That is also why courts generally emphasize that "any application of equitable subrogation is subject to a careful examination of the equities of all parties and potential prejudice to the intervening lienholder." *CitiMortgage*, 813 N.W.2d at 334-35. Although the Lenders disagree, they offer no principle to preclude courts from carefully examining the equities in connection with replacement or subrogation. In sum, prejudice is not as narrow as the Lenders claim. For that reason, most of what they say—including their attempt to distinguish *In re Mortgs. Ltd.*, 482 B.R. 298 (Bankr. D. Ariz. 2012)[16]—simply misses the mark.

[16] Among other things, the Lenders argue (at 31) that a district court decision cannot trump a contrary holding from this Court. True enough, but no binding decision compels a contrary result, and this Court may consider well-reasoned decisions of the federal district court as persuasive authority. *Cf. State v. Romero*, 236 Ariz. 451 ¶¶ 13-14 (App. 2014) (looking

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B. Contrary to their contention, the Lenders' conduct before the trustee's sale misled Markham, resulted in prejudice, and precluded the superior court from reordering the priorities.

As emphasized in the Opening Brief, the key prejudice to Markham resulted from the Lenders' conduct before and in connection with the trustee's sale during which the Lenders acted inconsistently with their later claim that they held and exercised a right superior to Markham's lien at that sale. Contrary to the Lenders' suggestion (at 27-28), Markham did not claim that the Lenders had to record a written assignment to qualify for subrogation. Nor did Markham claim that failure to publicly assert subrogation before a trustee's sale ***always*** precludes the application of equitable subrogation. Instead, Markham accurately stated (at 33) that "[a]lthough '[n]otice of subrogation to intervening claimants is not required' under Arizona law, *BAC Home Loans Servicing, LP v. Semper Invs. L.L.C.*, 230 Ariz. 587, 590 ¶ 6 (App. 2012), a lender's failure timely to 'publicly assert[]' subrogation may result in prejudice to intervening lienholders." Whether it does so depends on each case's particular facts and circumstances. (*See* Op. Br. at 30-33.) The particular facts and

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to federal district court interpretations of federal rule when applying similar Arizona rule).

circumstances of this case preclude the application of replacement and/or equitable subrogation.

C. The Lenders' conduct resulted in prejudice to Markham during the trustee's sale process.

The Lenders do not dispute that they knew Markham had started work, and had been told by the title company that such work would preclude them from obtaining first position. (*See* Op. Br. at 11-12.) The Lenders also do not dispute that before the trustee's sale they accordingly asked Markham to subordinate its interest, and Markham refused. (*See* Op. Br. at 12.)

Although the Lenders now put their own spin on the parties' correspondence before the sale (at 38-39), it is undisputed that Markham alerted the Lenders to its senior position in advance of the sale. It is also undisputed that although the Lenders questioned whether Markham had any lien (and asked Markham to provide some proof), they did not dispute Markham's assertion that if it had a lien, then its lien relates "back to at least May of 2008, and therefore has superior priority over Lenders' deed of trust."[17]

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[17] APV2_107-108.

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As explained in the Opening Brief (at 14), before the trustee's sale, the Lenders also assured Markham it would "get paid in full." In their brief, the Lenders claim (at 36) that "[t]his assertion has no support in the record." (The Lenders also mistakenly presuppose (at 36) that unless this evidence relates to the work for which Markham claimed a lien it is not relevant.) The Opening Brief, however, cited extensive evidence showing the Lenders had "been saying all along [to Markham] you guys are going to get paid."[18] The Lenders simply ignore the actual undisputed evidence—evidence that shows either (1) at the time the Lenders had no intention of disputing the priority of Markham's lien, or (2) they were committing fraud. In either case, their conduct bears on whether they could later claim replacement or equitable subrogation.

The Lenders also attempt (at 38-40) to discount the effect their conduct had on Markham. To do so, they claim (at 39-40) that "[a]ccording to the only <u>admissible</u> evidence below (an appraisal performed on September 29, 2009), the Property in its then-unfinished condition was worth, at the most, $2,375,000, which was far less than the priority amount

[18] Op. Br. at 17 n.34; *see also id.* at 14 n.25, 15 n.27, and 20 n.51.

of $2,912,574.44." In making this claim, however, the Lenders erroneously dismiss Mike Markham Sr.'s opinion (which also reflected his own belief). *State v. McDonald*, 88 Ariz. 1, 12 (1960) ("Opinion evidence is also usually admitted from persons who are not strictly experts, but who from residing and doing business in the vicinity have familiarized themselves with land values.").

More fundamentally, the Lenders ignore that (1) they also obtained an appraisal that valued the Property at $3.175 million based on a ***bulk sale*** to a single purchaser after completion,[19] (2) it would have cost the Lenders $258,246.80 to complete the project,[20] (3) the Lenders in fact made a credit bid of $3.175 million (not $2,375,000),[21] and (4) Markham's lien totaled $341,777.25.[22]

Accordingly, if the Lenders had in any way indicated that they planned to exercise any rights under the 2006 Deed of Trust (either via

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[19] APPV2_137 (September 28, 2009 appraisal).

[20] APPV2_060 (July 28, 2009 letter noting "a balance of $258,246.80 to finish the project").

[21] *See* APPV2_110 (Trustee's Deed noting the amount bid, namely $3,175,000.00, which payment was made by credit bid.").

[22] APPV2_129 (Lenders' Response to Statement of Facts) ¶ 5; APPV2_131 (Lenders' Response to Statement of Facts) ¶ 15.

replacement or subrogation), Markham would have been foolish not to bid at the sale. If they had proceeded in that manner, the Lenders would have been limited to a credit bid of $2,912,574.44, and it would cost Markham ***less*** than $258,246.80 to complete the project (because it could do the work itself). Those numbers combined (which total $3,170,821.24) are less than the $3,175,000 bid and appraisal, and even that appraisal had an assumption built in that made it unreasonably low (i.e., "bulk sale"). The Lenders cannot therefore credibly now claim they overpaid for the Property. *Cf. Balcor Real Estate Holdings, Inc. v. Walentas-Phoenix Corp.*, 73 F.3d 150, 153 (7th Cir. 1996) (holding in attorneys' fee context that the amount paid "is not 'evidence' about market value; it *is* market value.").

Because Markham faced losing $341,777.25, Markham reasonably could have (***and would have***) bid significantly more than $2,912,574.44. Consequently, the lynchpin of the Lenders' position—that applying replacement and/or equitable subrogation in this case did not make Markham worse off—rests on a demonstrably false premise. (*See also* Ans. Br. at 53 (claiming that is it "impossible to see how Markham could possibly have been prejudiced as a result of the 'excess' bid amount.").) By acting as if they were only exercising rights under the 2008 Deed of Trust to both Markham and the world—and in fact exercising rights available to them only under that Deed of Trust—applying replacement and/or subrogation after the fact would badly prejudice Markham.

As for the effect the Lenders' conduct had on others at the trustee's sale, the Lenders contend (at 41) that it is "pure speculation" to suppose others were affected because there is no evidence concerning other bidders. But the Lenders do not and cannot dispute that they in effect gave themselves a $341,777.25 bidding advantage at the sale. (*See* Op. Br. at 23-24.) Given the above numbers, the Lenders also cannot dispute that their conduct would have discouraged any ***reasonable*** bidder from participating in the sale. Focusing on the impact on a reasonable bidder makes sense given how difficult it would be to obtain evidence concerning counterfactual actual bidders, particularly because Markham had no reason to do so at the time. To hold otherwise would again create incentives to mislead the public about what is happening at a trustee's sale.

D. The Lenders' other conduct also prejudiced Markham and is relevant to whether the Lenders may benefit from a judicial reordering of the priorities.

In addition to the above facts pertinent to the trustee's sale, the Opening Brief also noted (at 15) that after Pinnacle stopped paying the 2008

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Loan, the Lenders convinced Markham to keep helping them with the project and promised Markham it "would get paid in full for what it was owed for the work already done on the project." (Op. Br. at 15.) Markham further noted (at 17-18) that Lenders took both the Property and money set aside to pay Markham, including retention that had become due. The Lenders are wrong that the Court should disregard these facts when deciding whether to judicially reorder the parties' priorities.

With respect to the Lenders' efforts to convince Markham to continue working on the project and its related promise to pay, the Lenders do not dispute these events occurred. Nor do they dispute that they failed to tell Markham that the Office of Thrift and Supervision had shut down the project. (*See* Op. Br. at 15.) Instead, they note that Markham did not assert a lien claim for this additional work. This response misses the point: Markham helped the Lenders because they told Markham it would get paid for the work on which it had asserted a lien, and the Lenders ***also*** did not pay Markham for this additional work.

Nor do the Lenders dispute that they took both the retention due to Markham as well as the Property. They instead first claim (at 24) that Markham did not make this argument below. But Markham argued below

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that the Lenders "received the property that's been improved" without paying Markham, and that "[t]here was $342,000 left in that account that could have gone to pay Markham."[23] That is the same "double dip" argument, and Markham made it more than once below.[24]

The Lenders later claim (at 37-38) that "[t]he money in question was not 'Markham's money.'" But the Lenders simply ignore First Arizona's admission below that the retention was "money that we would all agree was earned" by Markham.[25] Although they suggest the money was not due, that is also incorrect.[26] Consequently, the Lenders were only able to take Markham's money because it had been wrongly withheld, and they

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[23] 5/6/2013 Tr. at 11:10-20.

[24] *See also id*. at 12:16-13:2 (arguing that there was retention in an account to pay Markham); *id*. at 17:10-17 ("We have our 2006 loan, Markham begins work. We have our 2008 loan. We have a promise that we will keep funding this loan. And in this June, July time period they have a written agreement and then by the time of the trustee sale they still have all that money in the account that they never give to Markham, but yet they want to move in front of Markham.").

[25] APPV2_118 (Moorhead Depo. at 106:18-21); *see also* APPV2_121 (*id.* at 109:11-18) (explaining that it was our intention to complete the project, and that "upon completion of the project, we would release the retention."); APPV2_077 (Markham, Sr. Depo. at 19:22-23) (Markham, Sr. testifying that Moorhead told him "I've been saying all along you guys are going to get paid.").

[26] *See* Op. Br. at 16 n.33.

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had previously promised Markham it would be paid. The Court may also consider this.

E. The cases the Lenders rely upon do not help their position.

The Lenders' contention that the cases they cite support their position in this case is wrong. As noted above, the contractor in *Continental Lighting* did not allege it suffered any prejudice. There is also nothing in that case that suggests the lender misled the contractor about the effect of the trustee's sale.

The Lenders' reliance on *BAC Home Loans Servicing, LP v. Semper Invs. L.L.C.* 230 Ariz. 587 is misplaced for several reasons. First, the argument the Lenders attribute to Markham (which they claim (at 29-31) *BAC* "emphatically rejected") misconstrues Markham's argument. More fundamentally, this Court decided *BAC* before *Sourcecorp* clarified that equitable subrogation always "depends on the facts of the particular case." *Sourcecorp*, 274 P.3d at 1210 ¶ 29. To the extent *BAC* disregarded that principle, it is no longer good law.

The Lenders also rely (at 41-43) on *G.E. Capital Mortg. Servs., Inc. v. Levenson*, 657 A.2d 1170 (Md. 1995). As a threshold matter, equitable subrogation would not have been available to the Lenders under that case because it held that "[o]ne of the elements that permits a court to apply equitable subrogation is the absence of actual knowledge on the part of the subrogation claimant concerning the intervening lien." *G.E. Capital*, 657 A.2d at 1178. Moreover, that case emphasized that the intervening lienholder (i.e., the lienholder in Markham's position) could have determined what was going on. The refinancing deed of trust stated that it refinanced the first-position deed of trust, contained an endorsement acknowledging payment, and that acknowledgment was recorded before the trustee sale. *See id.* at 1173 (entries for April 6, 1990 to Jan. 2, 1991). Thus, the opinion emphasized that the intervening lienholder "had ***actual knowledge*** that G.E. Capital claimed a first priority position for the part of the debt owed to it, and . . . [the intervening lienholder] had that knowledge ***in time to challenge*** the claimed first priority, and did so." *Id.* at 1177-78 (emphases added).

Second, the court articulated a timeline for when a claim of equitable subrogation must be made, which confirms Markham's position: "The latest time by which a claimant may assert priority over the intervening lienor based upon equitable subrogation ordinarily would be on exceptions

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to an auditor's report that did not apply the doctrine.[27] Absent unusual circumstances, those exceptions may be filed up to the time when the court ratifies the audit." *Id.* at 1178.

In other words, a party claiming equitable subrogation must assert priority ***in time for the intervening lienholder to do something about it***, and in *G.E. Capital* the intervening lienholder did in fact have knowledge of the claim in time. *Id.* at 1177-78. Here, by contrast, the Lenders did not assert equitable subrogation (or replacement) until well into this litigation, long after Markham could have done anything to protect its interests.

Moreover, *G.E. Capital* does not purport to interpret Arizona law and is not binding on this Court. To the extent it could be extended to permit the Lenders to wipe out Markham's lien, then it should not be followed in Arizona for the other reasons explained here.

The Lenders' reliance on *Pappas v. E. Sav. Bank, FSB*, 911 A.2d 1230 (D.C. 2006) is misplaced, as well. There, the court held that the lender

[27] After a foreclosure sale in Maryland, a mandatory audit is conducted to determine distribution of surplus proceeds. *See* Md. R. 14-215(a); Md. R. 14-216. Those "claiming an interest in the property" must make a claim "before final ratification of the auditor's account." Md. R. 14-216(a).

claiming subrogation did not act inconsistently at the trustee's sale, in sharp contrast to the Lenders' actions in this case. *See id.* at 1235 ("We discern nothing in the foregoing information from the foreclosure sale notice that is inconsistent with ESB having foreclosed on its priority lien. ").

Similarly, their reliance on *Chicago Title Ins. Co. v. Lawrence Invs., Inc.*, 782 S.W.2d 332 (Tex. App. 1989), also misses the mark. The Lenders cite it for the proposition that a lender "may bring a declaratory action after a trustee's sale," but that point does not appear to have been litigated. The court mentioned in a single sentence, "We believe that bringing action for declaratory judgment is a sufficient assertion at a judicial proceeding to establish the subrogation." *Id.* at 335. The parties in that case held simultaneous and competing trustees' sales, *id.* at 333, and the opinion provides few details about what was claimed at the time of those sales. Thus, the case does not stand for the broad proposition the Lenders claim.

III. The Trustee's sale could not have extinguished Markham's lien.

More fundamentally—and regardless of the application of replacement or equitable subrogation—the foreclosure sale that occurred in this case could not have extinguished Markham's lien. As the Opening Brief demonstrated, if the law actually permitted a lender to refinance (or

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replace) a senior loan, and then wipe out intervening interests pursuant to a credit bid necessarily made pursuant to the lender's subordinate interest, it would wreak havoc with property rights in Arizona. It would mean that any lender who held a first position lien worth less than the property's value (***as in this case***) could simply refinance that loan, acquire the property with a credit bid in excess of the first position lien, and wipe out the intervening lien holders (as the Lenders claim occurred in this case).

Although they attempt to do so, at bottom the Lenders cannot defend this absurd position. They first claim (at 45) that Markham "misunderstand[s] . . . the doctrines of replacement and subrogation" because under replacement "the latter mortgage retains the same priority as its predecessor" and under subrogation the lender "succeeds to the rights of the creditor in relation to the debt." (emphasis added by Lenders) (citations omitted). But these observations are irrelevant to what happens when a lender exercises rights unavailable under the predecessor mortgage, and instead exercises rights available only under the latter subordinate mortgage. *Cf. Sourcecorp*, 229 Ariz. at 273 ¶ 5 (lender seeking subrogation is subject to the "limitations of the person paid"); A.R.S. § 33-

801(5) (credit bid limited to the "amount of the contract or contracts secured by the trust deed . . . .").

Indeed, built into the Lenders' argument is the premise (at 46) that "the foreclosure of the Replacement Deed of Trust alone was sufficient to" extinguish Markham's lien because it "automatically had priority over Markham's lien by operation of law." Contrary to the Lenders' assumption, however, under replacement or equitable subrogation a lender who refinances a senior mortgage has (in the best case) the same rights as—not more than—the original first position lender. If the lender loans additional money, the lender may then have the additional right to make an even larger credit bid. If, however, a lender could foreclose on the senior interest with a credit bid greater than what the original lender could have made, then it would lead to what the Lenders acknowledge (at 52) is a "parade of horribles."

The Lenders also contend (at 48-49) that "[b]ecause the Lenders were in fact exercising rights under the Replacement Deed of Trust (including the priority rights retained thereunder by virtue of replacement/subrogation), they were ***not limited*** to making a credit bid in an amount equal to the amount owed under the Original Deed of Trust.

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(Emphasis added.) But again, if that were the rule, intervening lenders could be unfairly wiped out through gamesmanship.

The Lenders' direct efforts to dismiss the example in the Opening Brief (at 50-52) fare no better. The Lenders first claim that "this is not a case where (i) the Lenders were only able to have the winning bid at the trustee's sale because they submitted a credit bid in excess of the priority amount or (ii) the Lenders were enabled to obtain property that was worth an amount in excess of the priority amount by submitting a bid in excess of that amount." But this argument ignores that the Lenders' own bid ***was*** in "excess of the priority amount." (Moreover, at the time, no one—not even them—believed they were foreclosing on an interest superior to Markham's.)

More fundamentally, the legal rules governing lien extinguishment should apply generally. Arizona law expressly limits a credit bid to the "amount of the contract or contracts secured by the trust deed . . . ." A.R.S. § 33-801(5). In cases such as this, a lender has every right to make a credit bid under the later subordinate mortgage. But if the lender makes a credit bid pursuant to rights it has only by virtue of the subordinate interest, as the Lenders did here, the lender must live with the consequences of

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foreclosing on the subordinate interest. Simply put, if the lender at a trustee's sale exercises a power that would not have been available to the original lender (whether that lender is the same or different), then it cannot claim the original lender's extinguishment rights. The same legal rule must apply to ***all*** trustee's sales.

Contrary to the Lenders' contention (at 53), this rule would not "seriously impair the certainty of title to real property obtained through a trustee's deed." Anytime a junior lienholder forecloses on property, the senior interests remain intact. A.R.S. § 33-811(E) (after foreclosure, the acquiring party takes the property "subject to all liens, claims or interests that have a priority senior to the deed of trust."). Moreover, certainty comes from rules that encourage everyone—including lenders—to make their claims known before a trustee's sale. A rule that incentivizes lenders to deceive intervening lienholders, like the Lenders' rule, creates uncertainty and inequities.

In a final effort to avoid the fatal flaw in their position, the Lenders mischaracterize Markham's position, and contend (at 54) that "any rights Markham may have with respect to the Lenders' 'excess' bid must be governed solely by the provisions of the statutory scheme governing

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trustee's sales." This argument mistakenly presupposes that the trustee did something wrong. It didn't. The Lenders had every right to make a credit bid for $3,175,000 under the 2008 Deed of Trust. The trustee could not prevent that. But having exercised that right available ***only*** pursuant to a deed of trust subordinate to Markham's lien, the Property remained subject to Markham's senior lien. A.R.S. § 33-811(E) (after foreclosure, the acquiring party takes the property "subject to all liens, claims or interests that have a priority senior to the deed of trust.").

CONCLUSION

Common sense and logic dictates that the Court should not adopt a rule that allows what occurred in this case to happen again. Accordingly, for the above reasons and those in the Opening Brief, the Court should reverse, remand, and award fees and costs (as set forth in the Opening Brief).

RESPECTFULLY SUBMITTED this 8th day of June, 2015.

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