Go to Table of Contents

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 OPENING BRIEF

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Click on the headings below to go to corresponding page

TABLE OF CONTENTS

Page

Click on the headings below to go to corresponding page

Go to Table of Contents

TABLE OF AUTHORITIES

Page

Cases

Go to Table of Contents

Statutes

Rules

Other Authorities

Go to Table of Contents

INTRODUCTION

This case involves whether contractor Markham Contracting Co., Inc. ("**Markham**") will be paid for the improvements it made to a 21-lot development in Scottsdale (the "**Property**"). Whether Markham will be paid turns on (1) whether a mechanic's lien held by Markham had priority over a deed of trust that secured a loan from two lenders (First Arizona Savings and Loan Association through receiver Federal Deposit Insurance Company and PrimeAZ/Libra, LLC) (collectively the "**Lenders**"), and (2) whether a trustee's sale the Lenders initiated extinguished Markham's lien.

It is undisputed that Markham held a valid lien for $341,777.25 with a priority date of June 10, 2008.[1] It is also undisputed that the deed of trust on which the Lenders foreclosed had a later priority date of September 9, 2008 (the "**2008 Deed of Trust**").[2] The Lenders nevertheless contended below that under the doctrine of equitable subrogation as set forth in

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

[2] APPV2_129 (Lenders' Response to Statement of Facts) ¶ 6 (Lenders admitting that the deed of trust "was recorded against the Property on September 9, 2008").

Restatement (Third) of Property: Mortgages § 7.6 (1997) (the "**Restatement**"), they became subrogated in the amount of $2,912,574.44 to a 2006 deed of trust, a deed of trust senior to Markham's lien (the "**2006 Deed of Trust**").

Under Restatement § 7.6, however, delay in "publicly asserting subrogation to the mortgage paid" may bar application of the doctrine of equitable subrogation. Restatement § 7.6 cmt. f. In this case, not only did the Lenders never record "a written assignment . . . to place others on notice of the [later claimed] subrogation," *Weitz Co. L.L.C. v. Heth*, 235 Ariz. 405, 409 ¶ 12 (2014), they also explicitly foreclosed on the 2008 Deed of Trust without saying anything about any subrogation right, which prejudiced Markham. Only after it became clear that Markham held a valid lien senior to that deed of trust did the Lenders begin claiming that they had (secretly) foreclosed on an interest they acquired via equitable subrogation in the 2006 Deed of Trust.

Their own conduct, however, shows that they necessarily foreclosed only on the 2008 Deed of Trust, not on any interest under the 2006 Deed of Trust. In particular, they acquired the Property at the trustee's sale with a credit bid that could have been made only under the 2008 Deed of Trust

because it exceeded the maximum credit bid available under the 2006 Deed of Trust. The Lenders acted inequitably in other respects too, all of which prejudiced Markham and thereby precludes application of the doctrine of equitable subrogation in this case. Because the superior court nevertheless found the doctrine applicable, and then concluded that the trustee's sale extinguished Markham's lien, it erred.

STATEMENT OF FACTS AND CASE

I. The Bella Sol Troon North development, the 2006 Loan, and Markham's mechanic's lien

In 2006, Troon Canyon Ventures, LLC ("**Troon**") set out to develop a 21-lot residential subdivision in North Scottsdale known as Bella Sol Troon North (the "**Property**").[3] To purchase the Property, Troon borrowed $4.1 million from First Arizona Savings (the "**2006 Loan**"), and the bank recorded the 2006 Deed of Trust to secure that loan.[4] The 2006 Deed of Trust states that the Borrower promised "to pay the debt in full not later than **May 01, 2008**."[5]

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[3] *See* APPV2_006 (Mike Markham, Jr. Aff.) ¶¶ 2-3; APPV2_128 ¶ 2 (Lenders' Response to Statement of Facts).

[4] APPV2_128 (Lenders' Response to Statement of Facts) ¶ 2.

[5] APPV1__030 (2006 Deed of Trust).

Pinnacle Point Developers LLC ("**Pinnacle**") served as the general contractor for the project, and hired Markham to do the initial development work (e.g., grading, sewer and road installation) for $1,286,845.84.[6] Markham "started work on the Project" on June 10, 2008, which under Arizona's mechanic's lien statutes became the priority date for Markham's mechanic's lien on the Property.[7] *See Scottsdale Mem'l Health Sys., Inc. v. Clark*, 157 Ariz. 461, 463 (1988) (holding that under A.R.S. § 33-992 the priority date for a mechanic's lien is "determined by the date on which [the contractor] commenced work, rather than the date on which the lien was recorded."). To ensure it could perfect its lien, on June 19, 2008 Markham served the owner or reputed owner with the initial preliminary 20-day notice under A.R.S. § 33-992, and on July 1, 2008 served First Arizona Savings with a First Amended Preliminary 20-day notice.[8]

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[6] APPV2_128-129 (Lenders' Response Statement of Facts) ¶¶ 2, 4.

[7] *Id.* ¶ 5 ("On June 10, 2008, Markham started work on the Project, which is the priority date for Markham's mechanics' lien.").

[8] *See* APPV1_080 ¶¶ 5-6 (Notice of Claim of Mechanics' and Materialmen's Lien noting service); APPV1_079-081 (the Preliminary Twenty Day Notice to First Arizona).

Anyone inspecting the Property would also have known Markham had begun to improve it.[9]

II. The 2008 Loan from two lenders

On August 25, 2008—after Markham began its work and after the paid-in-full date set forth on the 2006 Deed of Trust lapsed—Troon obtained a second loan for $4.8 million (the "**2008 Loan**") from First Arizona Savings (62.5%) and PrimeAZ/Libra, LLC (37.5%).[10] The Lenders secured the 2008 loan with the 2008 Deed of Trust.[11] In fact, the 2006 Loan had not been paid off by May 1, 2008. Instead, Troon purportedly used $2,816,728.50 of the proceeds of the 2008 Loan to pay off the 2006 Loan.[12]

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[9] *See* APPV1_074 (Markham, Jr. Aff.) ¶ 5 ("on June 10, 2008, Plaintiff MCCI installed a backflow preventer, which is used for the water for the grading operation. The backflow preventer is clearly visible to anyone going onsite"); APPV1-075 ¶¶ 6-7 (describing the visually observable blue staking work).

[10] *See* APPV1_049 (2008 Deed of Trust noting loan amount and each Lender's interest); *see also* APPV1_84 (Robert Ishii Declaration) ¶ 4.

[11] APPV1_049 (2008 Deed of Trust).

[12] *See* APPV2_151 (6/24/13 minute entry) ("The Defendants have been able to factually support and present evidence of a payment made to satisfy the First Arizona Deed of Trust in the amount of $2,816,728.50, and interest in the amount of $95,845.94"); APPV2_033 (HUD-1 showing payoff amount).

In connection with the 2008 Loan, First Arizona Savings asked the title company to "insure that this [2008 Deed of Trust] is a valid first lien with no exceptions outstanding . . . . ."[13] But because First Arizona had been served with Markham's preliminary twenty day notice, it should have known it was making a "broken priority" loan.[14] *Cf. In re Mortgages Ltd.*, 482 B.R. 298, 301 (Bankr. D. Ariz. 2012) ("When it made its construction loan and recorded its deed of trust, Mortgages understood that it was making a 'broken priority loan' because the construction work was already underway.").

Tellingly, although Markham had already begun working, the title commitment said that any improvements to the Property should occur ***after*** "the recordation" of the loan documents: "If a work of improvement is contemplated, ***no work is to be commenced or materials delivered to the Land the subject of this transaction prior to the recordation of the loan***

[13] APPV1_084 ¶ 5 (Ishii Declaration).

[14] APPV1_080 ¶ 6 (Notice of Claim of Mechanics' and Materialmens' Lien attesting that Markham served the First Amended Preliminary 20-day notice on First Arizona "on or about July 01, 2008"); APPV1_079-081 (the Preliminary Twenty Day Notice to First Arizona).

documents."[15] (Emphasis added.) Moreover, First Arizona could not advance the 2008 Loan to first position without Markham's consent because it exceeded the payoff amount from the 2006 Loan (and indeed exceeded the face value of the 2006 Deed of Trust.)[16] The Lenders accordingly asked Markham "to subordinate its lien position to the 2008 Loan," but Markham declined to do so.[17] From Markham's perspective—and the public record—Markham thus held a position senior to the 2008 Deed of Trust. *Cf. Mortgages Ltd.*, 482 B.R. at 308 ("Because Mortgages' deed of trust was not recorded until May, 2007, it is junior and subordinate to the mechanics' liens whose priority date [is] from October, 2005.").

III. The Lenders' failure to publicly assert any subrogation to the 2006 Deed of Trust

The Lenders proceeded to record the 2008 Deed of Trust on September 9, 2008, after the priority date for Markham's lien.[18] The

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[15] APPV1_095 (title insurance documents) (emphasis added).

[16] *See* APPV1_049 (2008 Deed of Trust securing loan of $4,800,000.00); APPV1_030 (2006 Deed of Trust securing loan of $4,100,000.00); APPV2_033 (HUD-1 showing payoff amount for 2006 Loan of $2,816,728.50).

[17] APPV2_128 ¶ 2 (Lenders' Response to Statement of Facts).

[18] *See* APPV1_049 (2008 Deed of Trust showing recordation date of "09/09/2008"); APPV2_129 ¶ 5 (Lenders' Response to Statement of Facts

recorded document nowhere indicates whether any of the proceeds from the 2008 loan were used to pay off the 2006 Deed of Trust, and if so how much.[19] Moreover, the Lenders did not record a written assignment to place others on notice of the subrogation. In fact, nowhere in the record is there anything that would have given anyone notice that the Lenders intended to obtain an assignment of any rights under the 2006 Deed of Trust in connection with the 2008 Loan—by operation of law or otherwise. To the contrary, the 2006 Deed of Trust indicates it would be paid off in May 2008,[20] and at the time the Lenders did nothing to "publicly assert[] subrogation to the mortgage paid." Restatement § 7.6 cmt. f. They instead recorded a "Deed of Release and Reconveyance" that expressly released "all right, title and interest which was heretofore acquired by said Trustee(s) under said Deed of Trust."[21]

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admitting that "[o]n June 10 , 2008, Markham started work on the Project, which is the priority date for Markham's mechanics' lien.").

[19] *See* APPV1_049 (2008 Deed of Trust).

[20] APPV1_030 (2006 Deed of Trust) ("Borrower has promised to pay this debt in regular Periodic Payments and to pay the debt in full not later than May 01, 2008.").

[21] APPV1_072. Although not in the superior court record (and although not necessary for the Court to reverse), for the Court's convenience the Appendix includes a copy of the Deed of Release and

IV. The Lenders' successful effort to convince Markham to continue improving the Property after the developer stopped paying and the Lenders' failure to pay Markham the proceeds from the construction loan account

In March 2009, after the real estate collapse, Pinnacle told Markham that it "did not have the money" to pay Markham's outstanding invoices (November through January).[22] For the next several months, Markham and the Lenders negotiated to ensure that the project would be completed and that Markham would be paid.[23] During these negotiations, First Arizona representatives Owen Moorhead and Peter Culley told Markham that it "would get paid in full for what it was owed for the work already done on the project,"[24] and reiterated that First Arizona wanted Markham to keep working.[25] Markham relied on these representations, and "continued to

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Reconveyance of the 2006 Loan. APPV1_072. Although the superior court record does not include this document, the Court may take judicial notice of the public records of state agencies. *See* Ariz. R. Evid. 201; *Jarvis v. State Land Dep't*, 104 Ariz. 527, 530 (1969); *Adams v. Bolin*, 74 Ariz. 269, 271 (1952); *Hernandez v. Frohmiller*, 68 Ariz. 242, 257, 258 (1949).

[22] APPV2_043 (Markham, Jr. Affidavit) ¶ 3.

[23] APPV2_044 ¶ 5-10.

[24] APPV2_077 (Mike Markham, Sr. Depo. at 19:10-13).

[25] APPV2_043 (Markham, Jr. Aff.) ¶ 3 (First Arizona told Markham "that the loan would continue to be funded, and Markham would be paid for any work that it performed under the loan, including retention . . . .");

work on the project."[26] As First Arizona representative Moorhead admitted in his deposition, "our goal [was] to finish the project," and to pay Markham upon completion.[27] But the Office of Thrift and Supervision decided to stop the project.[28] The Lenders failed to inform Markham of that fact, even though they knew Markham continued to work on the project.[29] When asked why First Arizona did not tell Markham about the change in plans, Moorhead explained that they "were told at that point we weren't to talk to any of our --."[30] In other words, they hoped Markham would continue working at its own expense.

At that time, $276,019.85 had been set aside for Markham in a construction account, of which $83,871.12 had been designated

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APPV2-044 ¶ 10 (First Arizona assured Markham that if it continued to work, "Markham would get paid . . . .").

[26] APPV2_044 ¶ 10.

[27] APPV2_121 (Moorhead Depo. at 109:3); *id.* (Moorhead Depo. at 109:11-18) (explaining that it was the intention to complete the project, and that "upon completion of the project, we would release the retention.").

[28] *Id.* (Moorhead Depo. at 109:14-18) ("Q. Did it come a point in time, prior to the OTS coming in, that the project was not going to be completed or were you moving forward towards completion? A. Yeah, it was our intention until we were – we were told to stop.").

[29] APPV2_122 (Moorhead Depo. at 110:4-8, 18-22).

[30] *Id.*

"Retention."[31] In many projects, including this one, the developer makes progress payments to the contractor as work is completed, and holds back a fixed percentage as "retention" to ensure the contractor completes its work. 1 Stein, Construction Law (2008) ¶ 3.01[2][e]. Generally any retention must be paid when "the contractor has fulfilled its responsibilities." *Id*.

In this case, the contract specified that "[a]fter the Work is fifty percent (50%) complete, the Owner shall withhold no additional retainage and shall pay the Contractor the full amount of what is due on account of progress payments."[32] When Lenders shutdown the project, Markham had completed more than 50% of the project, and the retention had become due and payable.[33] First Arizona even acknowledged that the retention was

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[31] *See* APPV2_116-120 (Moorhead Depo. at 104:15-108:3); APPV2_126 (FDIC document showing the account balances as of the date of the trustee's sale).

[32] R-49 Exh. 1.A (the Construction Agreement) at MCCI0027 § 9.2.4 governing "RETAINAGE".

[33] *See* APPV2_129 (Lenders' Response to Statement of Facts) ¶ 4 ("the total contract price [was] $1,286,845.84); APPV1_075-076 (Markham, Jr. Aff.) ¶¶ 10, 12 (explaining that Markham "has performed all conditions to the Agreement, entitling Plaintiff MCCI to payment as set forth therein" and submitted pay applications "deemed certified and approved pursuant to Arizona's Prompt Payment Statute"); APPV2_060 (July 28, 2009 letter

"money that we would all agree was earned."[34] Nevertheless, after the Lenders chose to stop the project, First Arizona kept Markham's money.[35]

V. The Lenders' notice of default and the $3.175 million appraisal

On August 25, 2009, after convincing Markham to keep working because it would be paid, the Lenders declared the 2008 Loan in default.[36] The Lenders demanded "Payment in full" by September 25, 2009.[37]

Markham proceeded to record its mechanic's lien on September 2, 2009.[38] Three days after the default date, the Lenders then obtained an appraisal valuing the Property at $3.175 million based on a bulk sale to a single purchaser after completion (rather than sold as lots as had been

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showing retention amount along with "a balance of $258,246.80 to finish the project").

[34] 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.").

[35] APPV1_076 (Markham, Jr. Aff.) ¶ 11 ("Plaintiff MCCI was left unpaid the principal amount of $341,777.25.").

[36] APPV2_040 (August 25, 2009 letter from Lenders' counsel declaring that "The Borrower is currently in default . . . .").

[37] *Id*.

[38] APPV1_079 (Notice of Mechanic's Lien showing recording date of "09/02/2009").

planned), and $2.375 million "as is."[39] At the time, Markham could have completed the project for $258,246.80.[40]

VI. The trustee's sale noticed pursuant to the 2008 Deed of Trust and Markham's assertion of its first position lien before the sale

In November 2009, the Lenders noticed a trustee's sale pursuant to the 2008 Deed of Trust.[41] At the time of the trustee's sale, Markham's lien had priority over the 2008 Deed of Trust, and, as required by law, Markham received notice of the sale.[42] The notice nowhere asserted any subrogation to the 2006 Loan, nor otherwise purported to exercise any power that may have existed under the 2006 Deed of Trust.

To ensure there would not later be any issue concerning priority, Markham gave notice of its priority position ***before*** the trustee's sale (correctly) explaining that "should this sale occur, the purchaser at the sale will take [the Property] subject to MCCI's Lien recorded on September 2,

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

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

[41] APPV2_094 (Notice of Trustee's Sale recorded on 11/19/2009).

[42] *See* APPV2_092 (showing notice sent to Markham and others).

2009 . . . ."[43] The Lenders responded explaining that they had obtained "an extended lender's title insurance policy . . . showing its deed of trust as a first lien" and accordingly "forwarded" Markham's "claim on to [their] title insurance company . . . ."[44] The Lenders stated, "[i]n the meantime, we will proceed with our foreclosure sale."[45]

Although Markham had never agreed to waive its lien rights (and indeed explicitly refused "to subordinate its lien position to the 2008 Loan"),[46] the Lenders said it was the "Bank's understanding that Markham Contracting did not retain, nor would it assert, any mechanic's lien."[47] They accordingly asked Markham to provide copies of the "20-day notices . . . sent to the Bank."[48] However, other than questioning whether Markham had served the twenty-day notice (which it had), the Lenders raised no defense to the lien, and did not suggest they had an interest senior to Markham's lien.

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[43] APPV2_105 (December 29, 2009 certified letter from Markham's counsel to the Lenders).

[44] APPV2_108.

[45] *Id.*

[46] APPV2_129 (Lenders' Response to Statement of Facts) ¶ 8.

[47] APPV2_108.

[48] *Id.*

VII. The trustee's sale conducted pursuant to the 2008 Deed of Trust

In February 2010, the trustee's sale occurred.[49] Because Markham held a position senior to the lien right being exercised at the trustee's sale (and therefore would keep its lien after the sale), Markham did not bid at the trustee's sale and did nothing to stop it.[50] As Mike Markham, Sr. testified in his deposition, the bank was "telling us we were in first position, and thus we did not bid against the bank because they assured us we were going to get paid."[51] At the time, Markham believed the Property was worth more than $3.175 million ***uncompleted***.[52]

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[49] APPV2_110 (Trustee's Deed stating "[t]he property was sold by Successor Trustee at public auction on February 23, 1010").

[50] *See* APPV2_078 (Markham, Sr. Depo. at 20:1-8).

[51] *Id.* (Markham, Sr. Depo. at 20:1-8, 16-20) ("And I guess my question was, What did Markham do in reliance on these promises by Owen Moorhead and Peter Culley? And I think one of the things you answered was, Well, you didn't bid at the trustee sale? A. Uh-huh.").

[52] *Id.* (Markham, Sr. Depo. at 20:12-14) ("It was – property was worth more than what they bid in at the time. Not now, but it was then. And so there was no need for us to [bid] because they were going to pay us."); APPV2_091 (*id.* at 45:1-12) (noting the appraisal showing that the "prospective market value based upon completion of construction is 3.175 which was the amount bid at the trustee sale" and Markham, Sr. agreeing that he believed "at the trustee sale . . . the property was worth at least and maybe more than 3.175 million" in an "[a]s is" state).

Although the Lenders later obtained appraisals showing the Property had declined in value since the default, they acquired the Property at the trustee's sale with a credit bid of $3.175 million—the amount in the earlier appraisal for the Property sold in "bulk."[53] Arizona law expressly permits a beneficiary under a deed of trust to acquire property with a "credit bid," but a credit bid may not exceed the "full amount of the contract or contracts [i.e. the underlying notes] secured by the deed of trust . . . ." A.R.S. § 33-801(5) ("'Credit bid' means a bid made by the beneficiary in full or partial satisfaction of the contract or contracts which are secured by the trust deed. Such credit bid may only include an amount up to the full amount of the contract or contracts secured by the trust deed, less [certain amounts]."); *see also* A.R.S. § 33-811(A) (allowing a credit bid at the trustee's sale).

In this case, and at the time of the trustee's sale, the Lenders knew that "full amount of the contract" secured by the 2006 Deed of Trust totaled

[53] *See* APPV2_110 (Trustee's Deed noting that the Lenders became "the purchaser of the Property described in the Notice of Trustee's Sale, and made payment therefor to Successor Trustee of the amount bid, namely $3,175,000.00, which payment was made by credit bid.").

$2,912,574.44 (payoff amount of $2,816,728.50 plus $95,845.94 in interest).[54] They also knew payments had been made on the 2008 Loan, which amount would reduce their subrogation claim. Accordingly, if the Lenders had proceeded to foreclose on their subrogated interest under the 2006 Deed of Trust, they would have been limited to a credit bid of less than $2.9 million. (In contrast, the amount secured by the 2008 Deed of Trust exceeded $4 million, meaning they could make a credit bid up to that full amount.)

If the sale had been conducted pursuant to an interest assigned under the 2006 Deed of Trust, then the Lenders would have had to have bid cash for any amount in excess of the amount to which they could claim subrogation (less than $2.9 million). *See* A.R.S. § 33-801(5). Markham would have received any cash bid in excess of that amount. *See* A.R.S. § 33-812 (specifying how to apply the sale proceeds). Accordingly, because Markham believed the Property was worth over $3.175 million *uncompleted*,[55] it would have been reasonable for Markham to make a bid to cover the value of its lien (or stop the sale).

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[54] *See* APPV2_151 (6/26/13 minute entry).

[55] APPV2_091 (Markham, Sr. Depo. at 45:1-12) (noting the appraisal showing that the "prospective market value based upon completion of

Although no one will ever know, if the sale had been conducted pursuant to an assignment of the 2006 Deed of Trust, others may also have participated in the sale. As noticed, however, anyone bidding at the trustee's sale would have believed that they would have acquired the Property subject to Markham's $341,777.25 lien (plus fees and interest) because the public record showed it as having a priority senior to the 2008 Deed of Trust.[56] *See* A.R.S. § 33-811(E) (property acquired at a trustee's sale remains "subject to all liens, claims or interests that have a priority senior to the deed of trust."). Consequently, by later claiming they were actually (secretly) exercising rights under the 2006 Deed of Trust assigned by operation of law, the Lenders in effect gave themselves well over a $300,000 bidding advantage at the sale; a buyer would need to conclude the

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construction is 3.175 which was the amount bid at the trustee sale" and Markham, Sr. agreeing that he believed "at the trustee sale . . . the property was worth at least and maybe more than 3.175 million" in an "[a]s is" state).

[56] *See* APPV1_079-080 (Lien notice showing lien of "$341,777.25, plus reasonable attorneys' fees pursuant to A.R.S. § 33-998(B) and the Prompt Payment Statute, along with 18% interest per annum pursuant to the Prompt Payment Statute" along with service of the 20-day notices by July 1, 2008; APPV1_049 (2008 Deed of Trust with recordation date of 09/09/2008).

Property was worth the amount bid by the Lenders ***plus*** an amount sufficient to cover Markham's $341,777.25 lien (plus fees and interest).

VIII. The lawsuit and the Lenders' later defense of equitable subrogation

In January 2010, Markham filed this lien foreclosure action and also asserted a variety of alternative theories of recovery.[57] Markham promptly obtained an uncollectable default judgment against Pinnacle.[58] With respect to the Lenders and Count Two (which is the subject of this appeal), Markham sought to foreclose on its lien, and asked for (1) a declaration that it has a valid lien on the Property for $341,777.25, and (2) that it be paid its lien amount, interest, and attorneys' fees in connection with the Property's sale.[59] On March 31, 2010, ***after*** holding the trustee's sale, the Lenders filed an answer and again said ***nothing*** about equitable subrogation or any assignment of the 2006 Deed of Trust.[60] Instead, they alleged Markham's "preliminary 20-day notice is defective"—a defense they later abandoned.[61]

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[57] *See* R-1 (Complaint).

[58] APPV1_082.

[59] R-1 (Complaint) ¶¶ 22-32; R-133 (First Amended Complaint) ¶¶ 23-33.

[60] R-15.

[61] *Id*. ¶ 8.

Eight months later, in November 2010, the Lenders sought "leave to file an Amended Answer and Counterclaim for declaratory relief and equitable subrogation."[62] Over Markham's objection, the superior court granted the motion, and the Lenders filed an amended answer and counterclaim alleging for the first time that "Plaintiff's claims are barred by the doctrine of equitable subrogation," and alleging a claim for "Equitable Subrogation" along with a request for "a declaration that the August 2008 DOT, with respect to the Property, is senior to and has priority over any lien that Plaintiff may have, and attaches as of the date of the April, 2006 DOT."[63]

Markham and the Lenders moved for summary judgment on Markham's Count Two and the Lenders' related counterclaims.[64] After briefing and argument, the superior court found that "Plaintiff Markham has a valid lien in the amount of $341,777.25," but that "a genuine issue of material fact exists as to whether or not equitable subrogation should

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[62] R-31.

[63] R-41 (2/3/2011 Amended Answer and Counterclaim) at 2-5.

[64] *See* R-48; R-57.

apply."[65] After the Supreme Court decided *Sourcecorp, Inc. v. Norcutt*, 229 Ariz. 270, 274 ¶ 16 (2012), the superior court found that "equitable subrogation does apply in this case," but that "prejudice remains a factor to be considered when applying any equitable subrogation."[66] It limited the amount of subrogation to "the amount of the first DOT in 2006."[67]

In June 2012, after the FDIC substituted in as the real party in interest for First Arizona Savings,[68] the Lenders filed another amended answer and counterclaim that included another new theory—that the 2010 trustee sale extinguished Markham's lien.[69] That pleading alleged for the first time that the "Lending Parties can, and hereby do, foreclose the equitable lien."[70] It further alleged, also for the first time, that "[a]s a result of foreclosure of the equitable lien and/or the 2/23/10 Trustee's Sale, Lending Parties own the

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[65] APPV2_148 (9/15/11 minute entry).

[66] R-122 (5/15/12 minute entry) at 2.

[67] *Id*. at 3.

[68] R-130 (6/8/12 order).

[69] *See* R-140 (6/29/12 Answer).

[70] *See id*. at 9 ¶ 19.

Property free and clear of any claim of Markham, [and] Markham's lien against the Property is extinguished . . . ."[71]

After further motions, the trial court granted summary judgment in the Lenders' favor on all but Count Two,[72] on which it found that the Lenders had presented evidence showing they had paid $2,816,728.40 toward the 2006 Deed of Trust, and thus with interest could assert a priority interest up to $2,912,574.44.[73] That ruling did not, however, resolve "whether the Plaintiff's mechanic's lien in the amount of $341,773.25 survive[d] the trustee sale and subsequent issuance of the trustee deed to the property . . . "[74]

After further briefing, the superior court ruled that "[t]he foreclosure of the subsequent mortgage [was] in effect a foreclosure of the earlier mortgage wiping out any junior liens" including Markham's lien (which was in fact senior to the mortgage upon which the Lenders foreclosed).[75] That ruling resolved the remaining issues in the Lenders' favor, after which

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[71] *See id*. ¶ 20.

[72] APPV2_150-154 (6/26/13 minute entry).

[73] APPV2_151.

[74] R-253 (10/31/13 Order) at 2.

[75] APPV2_164 (4/28/14 minute entry).

the superior court awarded the Lenders attorneys' fees and costs, and entered final judgment on October 13, 2014.[76]

Markham timely appealed on October 16, 2014.[77] The Court has jurisdiction under A.R.S. § 12-2101(A)(1).

STATEMENT OF ISSUES

1. A lender that delays in "publicly asserting subrogation to the mortgage paid" may lose the right to benefit from the doctrine of equitable subrogation. Restatement § 7.6 cmt f. In this case, the Lenders failed to publicly assert subrogation to the 2006 Loan until after they foreclosed on the 2008 Deed of Trust, which caused Markham and perhaps others to not participate in the 2010 trustee's sale to Markham's detriment. In light of that delay, did the Lenders lose the right to benefit from the doctrine of equitable subrogation?

2. Under Arizona law, "'[s]ubrogation will be recognized only if it will not materially prejudice the holders of intervening interests.' Restatement § 7.6 cmt. e." *Sourcecorp*, 229 Ariz. at 275 ¶ 25. In addition to the prejudice resulting to Markham from the trustee sale, the Lenders kept

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[76] R-329 (10/13/14 Judgment).

[77] R-334 (10/16/14 Notice of Appeal).

both the monies set aside to pay Markham and the Property improved by Markham. In light of that prejudice to Markham, did the Lenders lose the right to benefit from the doctrine of equitable subrogation?

3. Even if a party obtains an assignment to a priority interest by operation of law via equitable subrogation, that party does not necessarily have the right to foreclose on the assigned lien, and even if it does it must indicate publicly it is exercising the assigned right. In this case, the Lenders said nothing about exercising any assigned right under the 2006 Deed of Trust in connection with the 2010 trustee's sale, and instead later claimed they secretly exercised that right. In light of that, and even if the Lenders may have some right to subrogation, did the 2010 trustee's sale made pursuant to the 2008 Deed of Trust extinguish Markham's lien—an interest senior to the 2008 Deed of Trust?

STANDARD OF REVIEW

The Court should review de novo the trial court's conclusions of law and its interpretation of the pertinent statutes. *Pence v. Glacy*, 207 Ariz. 426, 428 ¶ 10 (App. 2004). The Court should also review de novo whether the trial court's "entry of [summary] judgment was proper." *Schwab v. Ames Constr.*, 207 Ariz. 56, 60 ¶ 17 (App. 2004). On review, the Court "view[s]

the evidence and reasonable inferences from it in the light most favorable to the non-moving party." *Allstate Indem. Co. v. Ridgely*, 214 Ariz. 440, 441 ¶ 2 (App. 2007).

ARGUMENT

I. Undue delay in publicly asserting equitable subrogation may bar its application, as does other prejudice to intervening lienholders

A. The applicability of subrogation depends on the particular facts and circumstances of each case

Generally, a mechanics' lien takes "priority over later-recorded encumbrances." *Cont'l Lighting & Contracting, Inc. v. Premier Grading & Utilities, LLC*, 227 Ariz. 382, 385 ¶ 9 (App. 2011); *see also* A.R.S. § 33–992(A) (generally giving mechanics' liens priority over "all liens, mortgages or other encumbrances upon the property attaching subsequent to the time the labor was commenced . . . ."). However, "Arizona [also] applies 'equitable subrogation' as set forth in Restatement (Third) of Property: Mortgages § 7.6(a) (1997)." *Weitz*, 235 Ariz. at 409 ¶ 12. That doctrine allows a judicial re-ordering of priority under certain limited circumstances. *See id.*

Although "no general rule can be stated which will afford a test [for equitable subrogation] in all cases," *Sourcecorp*, 229 Ariz. at 272 ¶ 7,

generally "[o]ne 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," *Weitz*, 235 Ariz. at 409 ¶ 12 (quoting Restatement § 7.6(a)). "[W]hether it is applicable or not depends upon the particular facts and circumstances of each case as it arises." *Sourcecorp*, 229 Ariz. at 272 ¶ 7 (quoting *Mosher v. Conway*, 45 Ariz. 463, 468 (1935)); *see also Weitz*, 235 Ariz. at 412 ¶ 26 ("whether equitable subrogation is warranted should hinge on the unique facts of each case."). "Subrogation will be recognized only if it will not materially prejudice the holders of intervening interests." *Sourcecorp*, 229 Ariz. at 275 ¶ 25 (quoting Restatement § 7.6 cmt. e).

"When equitable subrogation occurs, the superior lien and attendant obligation are not discharged but are instead assigned by operation of law to the one who paid the obligation." *Weitz*, 235 Ariz. at 410 ¶ 15. Whereas "conventional subrogation" may occur by voluntary assignment or agreement between the mortgagee and the payor," "equitable" or "legal" subrogation occurs "by operation of law" when permitted. Restatement § 7.6 cmt. a. "If equitable subrogation is permitted, the junior lienholder, now the subrogee, is entitled to obtain and record a written assignment of

the superior lienholder's rights to place others on notice of the subrogation." *Weitz*, 235 Ariz. at 409 ¶ 12; *see also* A.R.S. § 33-411.01 ("Any document evidencing the sale, or other transfer of real estate ***or any legal or equitable interest*** therein, excluding leases, shall be recorded . . . .") (emphasis added).*

For example, in *Lamb Excavation, Inc. v. Chase Manhattan Mortg. Corp.*, a contractor (Lamb) "filed an action to foreclose its lien" against the lender (Chase) and several other lien holders. 208 Ariz. 478, 479 ¶ 3 (App. 2004). After Lamb began its work, Chase made a permanent residential loan that paid off the initial construction loan from another lender (CFB), which loan the home builders had obtained before Lamb began work. *Id.* ¶ 2.

* The doctrine of replacement is an "analogous legal theory" that applies "in a single-lender refinancing." *Cont'l Lighting*, 227 Ariz. at 386 ¶ 12; *see also id.* ¶ 20 ("The rationale behind the doctrine of replacement is consistent with the rationale and policy considerations for equitable subrogation."); Restatement § 7.6 cmt. e (explaining 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," but that "[t]he result is analogous to subrogation, and under this Restatement the requirements are essentially similar to those for subrogation."). Although nothing in this case turns on the distinction, this case involved multiple-lender refinancing, making equitable subrogation the appropriate doctrine. In the briefing below, the parties referred to both doctrines, and sometimes used the term "subrogation/replacement."

Accordingly, CFB initially held an interest senior to Lamb's mechanic's lien. As a defense to Lamb's lien foreclosure action, Chase contended "its lien should be subrogated to the extent of the CFB lien." *Id.* ¶ 3. Finding that Lamb would suffer no prejudice from the doctrine's application, the Court found that Chase's lien should be so subrogated, and remanded for further proceedings. *Id.* at 484 ¶ 21. Tellingly, in that case Chase resolved the subrogation issue before any foreclosure occurred.

B. Delay in publicly asserting a right to subrogation may result in prejudice to others that precludes the delaying party from claiming subrogation

Although "[n]otice of subrogation to intervening claimants is not required" under Arizona law, *BAC Home Loans Servicing, LP v. Semper Investments 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. *See* Restatement § 7.6 cmt. f. Indeed, "[i]n virtually all cases in which injustice is found, it flows from a delay by the payor in recording his or her new mortgage, in demanding and recording a written assignment, ***or in otherwise publicly asserting subrogation to the mortgage paid***." *Id.* (emphasis added). When such delay occurs, subrogation does not apply, meaning the existing priorities should be left

intact. *See, e.g., Mortgages*, 482 B.R. 298, 312 (not applying subrogation, and thus giving contractors and lender the lien priority set forth by statute).

For example, applying this Restatement principle and Arizona law, *Mortgages Ltd.* held that a lender could not assert priority ahead of a superior mechanic's lien based on equitable subrogation because the lender "did absolutely nothing to give any notice to the subcontractors that it would [later] assert" that priority. 482 B.R. at 309. As Judge Haines emphasized, "[t]he Arizona Supreme Court made clear . . . that equitable subrogation is available only '*to the extent necessary* to prevent unjust enrichment,' and that it always 'depends on the facts of the particular case.'" *Id.* (quoting *Sourcecorp*, 274 P.3d at 1210 ¶ 27) (quoting Restatement § 7.6 (a) (emphasis supplied by Arizona Supreme Court)). Among other important factors in that case, the lender knew work had already begun, yet "did absolutely nothing to give any notice to the subcontractors that it would assert a priority ahead of them, based on a theory of subrogation." *Id.* Moreover, the lender "gave no notice when it foreclosed its deed of trust that was effectively also foreclosing its belatedly-claimed rights under" prior deeds of trust. *Id.* at 310. Meanwhile, the contractors continued to add value to the project. *Id.*

Because equitable subrogation is an equitable remedy, inequitable conduct other than delay may also preclude a party from benefiting from equitable subrogation. *Cf. Liberty Mut. Ins. Co. v. Thunderbird Bank*, 113 Ariz. 375, 377-78 (1976) ("he who seeks equity must do equity"). In *Mortgages Limited*, for example, Judge Haines also found troubling the fact that the lender "benefitted itself at the expense of the contractors" by taking back money it had already advanced that would have gone to the contractors. *Mortgages Ltd.*, 482 B.R. at 311.

II. In this case, the Lenders could not invoke equitable subrogation as a defense to Markham's lien priority because they failed to publicly assert any rights under the 2006 Deed of Trust until after they exercised their rights under the 2008 Deed of Trust

In this case, it is undisputed that the Lenders never recorded "a written assignment . . . to place others on notice of the [later claimed] subrogation." *Weitz*, 235 Ariz. at 409 ¶ 12. It is also undisputed that the Lenders asked Markham "to subordinate its position to the 2008 Loan," and Markham refused to do so.[78] Just as in *Mortgages Ltd.*, the Lenders "did absolutely nothing to give any notice to the subcontractors that it would assert a priority ahead of them, based on a theory of subrogation."

[78] APPV2_129 (Lenders' Response to Statement of Facts) ¶ 8; *see also* APPV2_007-008 (Markham, Jr. Depo.) ¶¶ 11-14.

482 B.R. at 309. The Lenders then convinced Markham to continue improving the Property, yet then took the monies in the construction account set aside to pay Markham, including money they admit Markham had already earned.

The Lenders then proceeded to notice a sale under the 2008 Deed of Trust, and again said nothing about any subrogation. *Cf. id.* at 310 (the lender "gave no notice when it foreclosed its deed of trust that was effectively also foreclosing its belatedly-claimed rights under" prior deeds of trust.). To top it off, they then exercised rights available only under the 2008 Deed of Trust by making a credit bid under that deed of trust.

In particular, the credit bid made under the 2008 Deed of Trust exceeded the ***maximum*** credit bid available under the 2006 Deed of Trust because the "full amount of the contract or contracts [i.e. the underlying notes] secured by th[at] trust deed" totalled approximately $2.9 million. *See* A.R.S. § 33-801 (5) (setting the maximum credit bid amount). In light of that, the Lenders could not have, as a matter of law, acquired the property pursuant to whatever rights they may have held under the 2006 Deed of Trust. Presumably for that reason, after holding the trustee's sale, the

Lenders filed their answer in this case and said nothing about any subrogation to the 2006 Deed of Trust.[79]

All of that badly prejudiced Markham. The Lenders took both the money set aside to pay Markham, as well as the improved property for itself. When the Lenders later claimed subrogation, they then claimed the ***full value*** of the 2006 Loan payoff amount, without any reduction for amounts paid toward the 2008 Loan, let alone the amount set aside ***to pay Markham***. *Cf. Brimet II, LLC v. Destiny Homes Mktg., LLC*, 231 Ariz. 457, 461 ¶ 21 (App. 2013) ("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."). They accordingly sought to "double dip" at Markham's expense.

In his deposition, Mike Markham, Sr. further testified that Markham decided "not to bid against the bank" at the trustee's sale because the bank was telling "us we were in first position."[80] (Although the Lenders

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[79] *See* R-15 (3/31/10 Answer).

[80] APPV2_077-078 (Markham, Sr. Depo. at 19:9-20:5); *see also id*. (at 20:16-20) ("Q. And I guess my question was, What did Markham do in

purported to "dispute" the fact that Markham did nothing to protect its interest on the basis of their representations, it merely argued that Mike Markham, Sr.'s testimony did not support that proposition and cited no evidence to the contrary.) Moreover, given the position taken by the Lenders ***before*** the trustee's sale, Markham had no reason to either bid at or enjoin the sale.

The Lenders' conduct also affected whether others would have participated in the sale. In particular, the public notices consistently indicated the Lenders planned to foreclose only on the 2008 Deed of Trust, not on any interest assigned under the 2006 Deed of Trust. Consequently, anyone participating in the sale would have believed that the Property would come subject to Markham's lien (plus fees and interest). So, for example, if the Lenders bid $3 million, another bidder would have to conclude the Property was worth at least $3.4 million (and probably more) given the size of Markham's lien. The Lenders therefore gave themselves a huge advantage at the trustee's sale, again at Markham's expense.

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reliance on these promises by Owen Moorhead and Peter Culley? And I think one of the things you answered was, Well, you didn't bid at the trustee sale? A. Uh-huh.").

Having never bothered to record "a written assignment . . . to place others on notice," *Weitz*, 235 Ariz. 409 ¶ 12, or otherwise publicly assert any right to subrogation until ***after*** the trustee's sale, the Lenders lost the right to claim subrogation. Simply put, their delay in "publicly asserting subrogation to the mortgage paid" caused prejudice thereby precluding the Lenders from claiming subrogation after the sale. Restatement ¶ 7.6 cmt. f. *See Mortgages Ltd.*, 482 B.R. at 309-12 (the lender "did not act equitably" by, among other things, doing "absolutely nothing to give any notice to the subcontractors that it would assert a priority ahead of them, based on a theory of subrogation" and also "did not give any public notice . . . that it would assert a priority"). *Irwin v. Pac. Am. Life Ins. Co.*, 10 Ariz. App. 196, 201 (1969) ("Equity aids the vigilant, not those who slumber on their rights.").

If the law were otherwise, it would wrongly incentivize lenders to engage in the gamesmanship that occurred in this case, rather than maximize the recovery from trustees' sales. Indeed, it is fundamental to the very concept of property rights that the rules governing them be made public to incentivize those with property interests to govern their behavior accordingly. *See, e.g.*, Lon L. Fuller, *The Morality of Law* 39 (Rev. ed. 1969)

(explaining that a system of legal rules may miscarry by way of eight fundamental defects including "a failure to publicize, or at least to make available to the affected party, the rules he is expected to observe" and "a failure of congruence between the rules as announced and their actual administration."). Arizona, for example, has adopted an extensive scheme for recording instruments that affect real property to ensure that everyone knows about the "legal" and "equitable" interests claimed. *See*, *e.g.* A.R.S. § 33-411.01 ("Any document evidencing the sale, or other transfer of real estate ***or any legal or equitable interest*** therein, excluding leases, shall be recorded . . . .") (emphasis added). If the Lenders wanted to benefit from a claimed equitable interest with priority senior to Markham's lien, they needed to record that interest or otherwise do something to publicly announce they were acting on an interest assigned from the 2006 Deed of Trust before the trustee's sale. By ruling otherwise—and effectively allowing the Lenders to foreclose on an assigned interest in secret—the trial court erred.

III. Even if the Lenders may benefit from equitable subrogation, the trial court erred by finding that the 2010 trustee's sale extinguished Markham's Lien

Before the superior court, the Lenders first said in 2012 that by foreclosing on their third position interest (the 2008 Deed of Trust), they extinguished Markham's senior lien. According to the Lenders, they could extinguish a second-position lien even though they purported to exercise their rights under their third-position interest, not any interest assigned under the 2006 Deed of Trust. The superior court accepted that argument, finding that "[t]he foreclosure of the subsequent mortgage is in effect a foreclosure of the earlier mortgage wiping out any junior liens."[81]

By so construing Arizona law, the trial court erred. Even if the Lenders were assigned by law an interest in the 2006 Deed of Trust, they elected to foreclose only on the 2008 Deed of Trust, not any assigned interest. Because Markham's lien had priority over the 2008 Deed of Trust, a trustee's sale pursuant to the powers in ***that deed of trust*** could not, as a matter of law, have extinguished Markham's lien. If the law were otherwise on this point, lenders could circumvent the carefully crafted

[81] APPV2_164 (4/23/14 Order).

statutory scheme governing trustees' sales to benefit themselves at the expense of intervening lienholders.

A. Arizona's carefully crafted statutory scheme governing trustee's sales requires lenders to make clear the rights they are exercising before the trustee sale, and limits what they may do on the basis of the right exercised

Pursuant to A.R.S. § 33–807, the Legislature has given trustees the power to foreclose against trust property when the trustor defaults. In connection with that power, lenders must strictly comply with the carefully crafted statutory scheme designed to ensure a transparent process. *See Patton v. First Fed. Sav. & Loan Ass'n*, 118 Ariz. 473, 477 (1978) ("lenders must strictly comply with the Deed of Trust statutes, and the statutes and Deeds of Trust must be strictly construed").

Every step of the non-judicial foreclosure process is set forth in detail. *See e.g.*, A.R.S. §§ 33–808 to –813. For example, written notice of the sale must be provided to ensure that others with interests in property understand how and whether their rights will be affected from a trustee sale. *See* A.R.S. § 33-808 (governing the notice of trustee's sale). Among other things, the notice must identify "[t]he original principal balance as shown on the deed of trust." A.R.S. § 33-808(C)(4). Because a lender may have more than one

deed of trust on a property, the statutorily "sufficient" form has a place to identify the record location of the particular deed of trust pursuant to which the trustee is acting. A.R.S. § 33-808(D) ("The following legally described trust property will be sold, pursuant to the power of sale under that certain trust deed recorded in" the following record). The trustee must send this notice to anyone with "an interest in any of the trust property." A.R.S. § 33-809(B)(2).

At the trustee sale, a beneficiary under a deed of trust may acquire the property with a "credit bid." A.R.S. §§ 33-801(5), 33-811(A). But the credit bid may not exceed the "full amount of the contract or contracts [i.e. the underlying notes] secured by the trust deed . . . ." A.R.S. § 33-801(5).

Upon completion, the trustee must then "execute and submit the trustee's deed to the county recorder for recording . . . ." A.R.S. § 33-811(B). The trustee's deed operates "to convey to the purchaser" the property, "including all interest or claim in the trust property acquired ***subsequent to*** the recording of the deed of trust and prior to delivery of the trustee's deed." A.R.S. § 33-811(E) (emphasis added). The property therefore becomes "clear of all liens, claims or interests that have a priority ***subordinate*** to the deed of trust . . . ." A.R.S. § 33-811(E) (emphasis added). However, the property

remains "***subject to all liens, claims or interests that have a priority senior to the deed of trust***." *Id.* (emphasis added).

The extinguishment of subordinate interests incentivizes those with such interests to bid for the property at the trustee's sale, and thereby maximize the recovery for the benefit of the debtor—just as intended by the statutes. *Cf. CSA 13-101 Loop, LLC v. Loop 101, LLC*, ___ Ariz. ____ ¶¶ 12-13, 2014 WL 7447778, at *2 (Ariz. Dec. 31, 2014) (noting that "the deed of trust framework generally, accords with Arizona's long-recognized public policy of protecting debtors" and discussing some of the provisions designed to prevent "below-market credit bids."). For example, consider a lender foreclosing a deed of trust securing a $1 million loan on property worth $2 million, with several subordinate mechanics' and judgment liens totaling $500,000. If the lender makes a credit bid totaling only $1 million, then those holding the subordinate interests will likely bid more than $1 million; otherwise, they would lose their interest. Alternatively, if the lender bids $2 million (a $1 million credit bid and the remainder a cash bid), then all of the junior interests would be paid and the borrower would receive the excess proceeds; the lienholders with subordinate interests would have no need to bid. *See* A.R.S. § 33-812(A)(2) (after the costs of the sale, the proceeds go

toward "the payment of the contract or contracts secured by the trust deed."); A.R.S. § 33-812(A)(5) (after paying association and other fees, proceeds go to the other "junior lienholders or encumbrances in order of their priority" and then "payment shall be made to the trustor . . . ."). For this reason, all parties with an interest in the property need to know what is happening.

B. The trustee's sale could not have extinguished Markham's interest because the Lenders told everyone that they were exercising their rights under the 2008 Deed of Trust and they acted inconsistently with whatever rights they may have had under the 2006 Deed of Trust

The trustee's sale in this case occurred exclusively pursuant to the powers granted under the 2008 Deed of Trust, not under any interest that may have been assigned under the 2006 Deed of Trust. For example, the notice of trustee's sale refers only to the 2008 Deed of Trust.[82] The Lenders then proceeded to acquire the Property at the sale with a credit bid of bid of $3,175,000.[83] The right to acquire the Property with a credit bid in this amount could come from only the 2008 Deed of Trust because it exceeded the "full amount of the contract" secured by the 2006 Deed of Trust ($2.9

[82] APPV2_094 (11/19/09 Notice of Trustee's Sale).

[83] *See* APPV2_110 (2/24/10 Trustee's Deed).

million), but not the "full amount" secured by the 2008 Deed of Trust ($4 million).

The trustee then recorded a trustee's deed that made clear the conveyance occurred "pursuant to the powers" of the 2008 Deed of Trust:

> This conveyance is made ***pursuant to the powers***, including the power of sale, ***conferred by that certain Deed of Trust . . . dated as of August 25, 2008***, and recorded on September 9, 2008, at Instrument No. 20080781186, in the Official Records of Maricopa County, Arizona (the "Deed of Trust") . . . .[84]

Thus, both the Lenders' credit bid and the resulting trustee's deed indicated unambiguously that the Lenders foreclosed only on the 2008 Deed of Trust, and not on any other interest. For this reason, the trustee's sale extinguished only interests subordinate to the 2008 Deed of Trust. A.R.S. § 33-811(E) (property acquired at a trustee's sale remains "subject to all liens, claims or interests that have a priority senior to the deed of trust."). As a matter of law, a trustee sale may extinguish only those interests subordinate to the particular deed of trust on which a lender foreclosed.

So construing Arizona law also accords with the general rule "that a person having an interest in property who pays off an encumbrance in

[84] APPV2_109 (2/24/10 Trustee's Deed) (emphasis added).

order to protect his interest is subrogated to the rights ***and limitations of*** the person paid." *Sourcecorp*, 229 Ariz. at 273 ¶ 5 (emphasis added). In other words, a party who wishes to claim the benefits of equitable subrogation must also live within the limitations governing the original lender, including the maximum credit bid available to that lender in connection with a trustee's sale. In this case, the Lenders made a credit bid under the 2008 Deed of Trust that exceeded what the original lender could have bid under the 2006 Deed of Trust. In doing so, they acted contrary to the "limitations" that would have been placed on the original lender. Accordingly, for purposes of determining whether the trustee sale extinguished Markham's lien under A.R.S. § 33-811(E), the Lenders cannot now claim that even though they publicly claimed to have foreclosed on an interest subordinate to Markham's lien, they secretly foreclosed on a superior interest under the 2006 Deed of Trust.

It is also worth noting that nothing in the concept of equitable subrogation requires finding that the trustee's sale extinguished Markham's lien. To the contrary, *Sourcecorp* recognized that a party may claim subrogation, but not have a right to foreclose on the lien:

> Recognizing that equitable subrogation depends on the facts of the particular case, *see Mosher*, 45 Ariz. at 468, 46 P.2d at 112, ***we conclude that it is not appropriate to confer on the Norcutts a right to "foreclose" on the interest to which they are subrogated***. Instead, the purposes of equitable subrogation are fully served by deeming the Norcutts to have a priority to proceeds from any sale of the property in the amount they paid to satisfy the debt, $621,000. Applying equitable subrogation in this manner does not eliminate Sourcecorp's judgment lien.

Id. at 276 ¶ 29 (citation omitted) (emphasis added). Although *Sourcecorp*, like all cases, turned on the unique facts of that case, it confirms that even if the Lenders may claim some interest by way of subrogation, it does not follow that they extinguished Markham's lien. Even if the Lenders acquired an interest assigned to them by operation of law that they could have foreclosed upon, they failed to do so. Accordingly Markham's lien must remain intact.

In sum, even if the Lenders had an interest in the 2006 Deed of Trust acquired via legal assignment, just as with a conventional assignment, a lender must make clear the rights it is exercising. Contrary to the superior court's conclusion, the right is not exercised when a lender purports to exercise different rights. Accordingly, because Markham's lien had priority over the 2008 Deed of Trust, the Lenders acquired the Property

"subject to all liens, claims or interests [including Markham's] that have a priority senior to the deed of trust." A.R.S. § 33-811(E).

C. An example shows the law cannot work in the manner the proposed by the Lenders

Although common sense suggests that anyone who seeks to foreclose on an interest acquired through equitable subrogation must say so before the trustee's sale, an example confirms that the superior court misconstrued Arizona law by concluding otherwise. Under the superior court's ruling, a lender may (1) foreclose on a junior deed of trust and acquire property with a credit bid in excess of the interest acquired through equitable subrogation, and then (2) proceed to use equitable subrogation to extinguish all intervening liens even though the lender never asserted a right under the assigned interest until after the trustee's sale. Such a rule, however, leads to absurd results because it means Arizona lenders could structure their loans to wipe out intervening liens in a manner that runs contrary to what the legislature intended. *Cf. State v. Barragan–Sierra,* 219 Ariz. 276, 282 ¶ 17 (App. 2008) (courts construe statutes "to avoid absurd results.").

For example, suppose Lender A loans Owner $5,000 secured by a first position deed of trust. Owner begins making improvements, which results in Contractor B asserting a mechanic's lien for $25,000 (a second position interest). Judgment Creditor C subsequently records a judgment for $25,000 (a third position interest). Lender D then loans Owner $60,000, $5,000 of which is used to pay off and satisfy the loan secured by the first position deed of trust. Under the doctrine of equitable subrogation, Lender D, therefore, obtains by operation of law an assignment of Lender A's position secured by the first position deed of trust. Owner then defaults on the loan from Lender D, at which time the property is worth only $50,000.

After these transactions (and assuming subrogation applies), we accordingly have the following priorities when the borrower defaults on the loan to Lender D:

Lender A	**$0 balance, but Lender D subrogated up to $5,000**	**Senior lien to which Lender D is subrogated**
Contractor B	$25,000	Second Position
Judgment Creditor C	$25,000	Third Position
Lender D	$60,000	Fourth Position

If, as Markham claims, D may only extinguish the intervening lien holders' rights (B and C) if D claims subrogation to Lender A at the time of the sale and limits its credit bid to $5,000 (with cash above that amount), then no one is unjustly enriched. For example, if D bids $50,000 ($5,000 credit and $45,000 cash), D gets the full benefit of its $5,000 subrogation right but nothing more. B would receive the full value of its lien ($25,000), and C would receive a portion of its lien ($20,000) as contemplated by A.R.S. § 33-812(A) (the statute specifying the "order of priority" from "the proceeds of the trustee's sale"). And, of course, if D only bid $10,000 ($5,000 cash and $5,000 credit), then either B or C could protect themselves by making a higher bid. No one is worse off due to equitable subrogation.[85]

But under the superior court's construction of Arizona law, D could effectively change its fourth position lien into a first position lien by

[85] This hypothetical presupposes that D has given notice that it intends to seek equitable subrogation for a portion of its deed of trust. Of course, if it fails to provide such notice, neither B or C (nor anyone else) would have any incentive to bid at the trustee's sale in an amount greater than the difference between the property's value and the amount of A's, B's and C's liens, because the trustee's deed would convey the property subject to those superior liens.

making a credit bid of $60,000—a bid that exceeds the property's value and one that neither B nor C would likely match because it exceeds the property's value. D could then claim that because B and C were junior to A (and even though it made a credit bid in excess of A's loan), B and C's liens are extinguished. D would be able to wipe out B and C, and become unjustly enriched at their expense. In effect, D could elevate the full amount of its $60,000 fourth-position loan to first position, just by paying off a $5,000 loan with first priority. That type of subrogation—the type Lenders claim exists—is not equitable, and would wreak havoc with Arizona's statutory scheme, as well as invite mischief from lenders. Simply put, the superior court's ruling leaves intervening lien holders vulnerable to being completely wiped out and powerless to do anything about it. That is not the "equitable" doctrine the Supreme Court recognized. *Liberty Mut.*, 113 Ariz. at 377-78 ("he who seeks equity must do equity").

REQUEST FOR ATTORNEYS' FEES AND INTEREST

Pursuant to A.R.S. § 33-998(B) and/or A.R.S. § 32-1129.01(S), Markham requests its attorneys' fees on appeal. Alternatively, it asks the Court to remand to the superior court to determine the full amount due Markham under its lien, including the attorneys' fees incurred in both the

superior court and this Court (along with interest and costs). Markham also requests costs on appeal pursuant to A.R.S. § 12-341.

CONCLUSION

After determining that Markham held a valid lien of $341,777.25 with a priority date of June 10, 2008, the superior court should have given Markham leave to proceed with a judgment that would order a sheriff's sale of the Property to pay off that lien along with the attorneys' fees and interest due. Accordingly, Markham asks the Court to reverse and remand with instructions to the superior court to determine the full amount due Markham under its lien (principal amount, attorneys' fees, costs, and interest) and enter a judgment ordering a sheriff's sale of the Property to pay the full amount due Markham. Markham also asks the Court to award attorneys' fees and costs, or remand to the superior court to determine the amount of fees on appeal to include in the amount Markham may recover from its lien in connection with a sheriff's sale of the Property.

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Go to Table of Contents

RESPECTFULLY SUBMITTED this 11th day of February, 2015.

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