IN THE COURT OF APPEALS OF TENNESSEE
AT JACKSON
January 25, 2001 Session

INDYMAC MORTGAGE HOLDINGS, INC. v. JOHN KAUFFMAN, EMMA JO KAUFFMAN, and JOE M. KIRSCH

An Appeal from the Chancery Court for Shelby County
No. Ch-00-0152-2 Floyd Peete, Jr., Chancellor

No. W2000-01453-COA-R3-CV - Filed December 21, 2001

This case involves the equitable subrogation of a mortgage. The plaintiff filed a complaint to enjoin the defendants from executing foreclosure on property and to request equitable subrogation, seeking to have priority over the defendants' lien, which was recorded first. The trial court granted the plaintiff's request for subrogation. The defendants appeal. We reverse, finding that the evidence does not support a grant of equitable subrogation.

Tenn. R. App. P. 3 Appeal as of Right; Judgment of the Chancery Court is Reversed and Remanded.

HOLLY KIRBY LILLARD, J., delivered the opinion of the court, in which W. FRANK CRAWFORD, P.J., W.S., and ALAN E. HIGHERS, J., joined.

John D. Horne, Memphis, Tennessee, for the appellants, John Kauffman, Emma Jo Kauffman, and Joe M. Kirsch.

Steven N. Douglass and Michelle H. Joss, Memphis, Tennessee, for the appellee, Indymac Mortgage Holdings, Inc.

OPINION

This case involves the equitable subrogation of a mortgage. Defendants John and Emma Jo Kauffman ("the Kauffmans") entered into an "owner-financed" transaction with Betru and Amsale Gebregziabher (collectively "Betru") wherein the Kauffmans would lend Betru $306,000 in order to buy a business owned by the Kauffmans. The parties executed a promissory note for the amount of the loan, secured by a deed of trust on Betru's Cordova residence and Germantown condominium ("the Kauffman Deed"). At the time the parties entered into the transaction, Betru advised the Kauffmans that Union Planters already held a 30-year mortgage on the Cordova residence in the amount of $176,000 with a 3.5% interest rate. The Union Planters mortgage had been placed against

the Cordova residence in 1993. On June 9, 1994, the Kauffmans recorded the Kauffman Deed with the Register's office.

Betru began payment to the Kauffmans according to the terms of the promissory note. However, as a result of various financial setbacks experienced by Betru, the Kauffmans later adjusted the note's terms to reduce the required monthly payments. In addition, in December of 1996, at Betru's request, the Kauffmans executed a Partial Release, releasing Betru's Germantown condominium from the Kauffman Deed. This Partial Release was also recorded with the Register's office. Betru later sold the condominium for $60,000, paying the Kauffmans approximately $20,000 of the profit. In 1998, Betru defaulted on the note payments. Betru also defaulted on an unsecured $35,000 consulting agreement with the Kauffmans, never making a single payment. As a result of Betru's default on both loans, in April or May 1999, the Kauffmans contacted an attorney to begin collection efforts. The Kauffmans did not pursue foreclosure at that time.

Meanwhile, in February 1999, Betru contacted Alliance Mortgage Services ("Alliance") seeking to refinance the mortgages on the Cordova residence. Alliance originates and brokers residential loans, specializing in B-C lending or sub-prime loans. Alliance brokered a loan between Betru and Indymac Mortgage Holdings, Inc. ("Indymac"). On the loan application, Betru disclosed that the Cordova residence had a total of $234,000 in liens against it, representing the Union Planter's mortgage and a third mortgage in favor of First Tennessee Bank that had been executed and recorded in 1998. Betru, however, did not disclose the Kauffman Deed to Alliance.

Alliance then contacted Transcontinental Title, Inc., ("Transcontinental") which closes and issues title insurance on mortgage loans and was to act as closing agent for Indymac. Transcontinental conducted a title search of the Cordova residence. Although Transcontinental discovered the Union Planters and First Tennessee mortgages in its title search, it failed to discover the Kauffman Deed. Transcontinental subsequently issued a commitment for title insurance to Indymac and on April 16, 1999, closed on the Indymac loan to Betru in the amount of $239,990 at a 7.625% interest rate. As part of its refinancing agreement with Indymac, Betru executed a promissory note in the amount of the loan and a deed of trust granting a lien on the Cordova residence in favor of Indymac. In turn, Indymac, through Transcontinental, paid Union Planters and First Tennessee the balance of the debt secured by their respective mortgages, $167,596.74 and $66,635.69. As a result, both Union Planters and First Tennessee released their mortgages on the Cordova residence. Indymac's Deed of Trust ("the Indymac Deed") was recorded in the Register's office on April 23, 1999.

In May 1999, Betru attempted to obtain a second mortgage through Alliance. Pursuant to another request from Alliance, Transcontinental again conducted a title search on the Cordova residence. However, in this title search Transcontinental discovered the Kauffman Deed. Transcontinental then contacted the Kauffmans and requested that they subordinate the Kauffman Deed. The Kauffmans refused.

In July 1999, after repeated attempts to collect payment directly from Betru had failed, the Kauffmans hired defendant Joe M. Kirsch ("Kirsch") to commence foreclosure on the Kauffman

Deed. In conducting a title search in preparation for the foreclosure sale, Kirsch learned that Betru had executed and recorded the Indymac Deed, and that the prior mortgages held by Union Planters and First Tennessee had been released. On August 16,1999, believing that the Kauffmans were in a "first position," Kirsch sent notice to Indymac and others with a recorded interest in the Cordova residence that he would conduct a foreclosure sale on September 17, 1999. However, on September 14, 1999, prior to the scheduled foreclosure sale, Betru filed Chapter 7 bankruptcy, automatically staying the foreclosure sale.

On October 14, 1999, the Kauffmans filed a motion for relief from the automatic stay, seeking permission to proceed with the foreclosure sale on the Cordova residence. This motion was granted by the bankruptcy court on November 9, 1999. On December 2, 1999, Indymac filed a similar motion with the bankruptcy court. Indymac's motion was also granted. In a letter dated December 30, 1999, Kirsch informed Transcontinental that the foreclosure sale of the Cordova property had been rescheduled for February 7, 2000. On January 5, 2000, Betru received a discharge of all his listed debts. On January 27, 2000, Indymac filed a complaint in Chancery Court, seeking to enjoin the scheduled foreclosure sale and requesting equitable subrogation. On January 31, 2000, the trial court entered a temporary restraining order, restraining the Kauffmans from conducting the scheduled foreclosure sale. Through two consent orders, the temporary restraining order was extended and the foreclosure was adjourned until after a trial on the merits of the case.

Trial was held on March 14, 2000. At the beginning of the trial, Indymac moved that evidence of title insurance be excluded based on Rule 411 of the Tennessee Rules of Evidence.[1] The trial court excluded the evidence, but allowed the Kauffmans to make an offer of proof as to the existence of the insurance. At trial, Mr. Kauffman testified that, despite the Kauffman Deed's second position, when he entered into the agreement with Betru, he still considered a junior mortgage in the Cordova residence good collateral because the low interest rate for the Union Planters mortgage would enable Betru to pay down the principal on that loan sooner. Mr. Kauffman asserted that Betru's default on the note had caused a severe financial burden on him and his wife. He said that the transaction with Betru had been structured so that the payments they received from Betru would be used to repay an obligation the Kauffmans had with First American Bank. Consequently, Betru's failure to make payments on the note had caused a significant negative impact on the Kauffmans' finances because of their continued obligation to First American. Mr. Kauffman also testified that he and his wife had incurred substantial expenses in pursuing collection from Betru and in attempting to enforce and foreclose on the Kauffman Deed.

---

[1] Tennessee Rule of Evidence 411 states:

> Evidence that a person was or was not insured against liability is not admissible upon issues of negligence or other wrongful conduct. This rule does not require the exclusion of evidence of insurance against liability when offered for another purpose, such as proof of agency, ownership, or control, or bias or prejudice of a witness.

On June 12, 2000, the trial court entered an order granting Indymac's request for equitable subrogation, stating that the Indymac Deed was entitled to the first priority mortgage position in the amount of $167,696.74. The Kauffmans now appeal.

On appeal, the Kauffmans first argue that the trial court erred in granting Indymac's motion to exclude evidence relating to title insurance issued on behalf of Indymac in its agreement with Betru. The Kauffmans next argue that the trial court erred in granting the Indymac Deed a superior position. They maintain that the Kauffman Deed is superior as a matter of law because it was recorded prior to the Indymac Deed. Therefore, when the Union Planters mortgage was released, the Kauffman Deed moved to a first position. The Kauffmans also assert that, based on the equities of the case and based on Indymac's culpable negligence in failing to discover the Kauffman Deed in its title search, the trial court erred in granting equitable subrogation to Indymac. They contend that the existence of the Kauffman Deed could have been disclosed by a casual inspection of the title considering that both the Kauffman Deed and partial release were recorded and the uniqueness of Betru's last name, Gebregziabher.

Indymac argues that equitable subrogation was appropriate because the Kauffmans are in no worse position than they were prior to the execution of the Indymac Deed. Indymac claims that the Kauffmans were aware when they executed their agreement with Betru that they held a second mortgage and understood the risks associated with being a second position. Therefore, the trial court's subrogation of the Indymac mortgage in the amount of $167,596.74, the remaining amount of the Union Planters mortgage at the time Indymac and Betru executed their agreement, places the Kauffmans in the same position for which they originally bargained. Indymac also alleges that, without subrogation, the Kauffmans will be unjustly enriched because they will profit from the failure to discover the Kauffman Deed and be placed in a better position than if the deed had been found. Indymac argues that allowing a foreclosure sale of the Cordova residence leaves it without a remedy because the property is not worth more than the amount the Kauffmans are owed. Indymac contends that the failure to discover the Kauffman deed is ordinary negligence and as such does not bar equitable subrogation.

Indymac also argues that the trial court properly excluded evidence of the title insurance because the existence of the insurance was irrelevant to whether Indymac was entitled to equitable subrogation. In the alternative, Indymac argues that even if the trial court erred in excluding the evidence, such error was harmless because evidence of title insurance ultimately found its way into the record through the Kauffmans' offer of proof.

Because this case was tried by the trial court sitting without a jury, we review the case *de novo* upon the record with a presumption of correctness of the findings of fact by the trial court. ***See*** Tenn. R. App. 13(d). Our review of the trial court's conclusions of law is *de novo* with no presumption of correctness. ***State v. Levandowski***, 955 S.W.2d 603, 604 (Tenn. 1997).

We first address the trial court's grant of equitable subrogation to Indymac. Generally, liens are given priority based on the order in which they are recorded; liens recorded first typically have priority over those recorded at a later date. ***See*** Tenn. Code Ann. § 66-26-105 (1993). Subrogation

is the substitution of a party in the place of a creditor, so that the party in whose favor subrogation is exercised succeeds the creditor in relation to the debt. ***Castleman Constr. Co. v. Pennington***, 432 S.W.2d 669, 674 (Tenn. 1968). Subrogation is a creature of equity; its purpose is to provide an equitable adjustment between the parties, based on the facts and circumstances of the case. ***Id.*** at 675; ***Lawyers Title Ins. Corp. v. United American Bank***, 21 F. Supp.2d 785, 792 n.2 (W.D. Tenn. 1998). It is not a right, but a remedy whose application depends on a balancing of the equities involved. ***See Lawyer's Title***, 21 F. Supp.2d at 792; ***Castleman Constr.***, 432 S.W.2d at 676. Subrogation is not appropriate where the equities of the parties are equal, where the parties' rights are not clear, or where it would prejudice the legal or equitable rights of another. ***Lawyer's Title***, 21 F. Supp.2d at 792. Relevant to this balancing of equities is the degree of negligence of the party seeking subrogation. ***Id.*** While ordinary negligence or mistake alone is usually not a bar to subrogation, especially where the equities weigh in the favor of the party seeking subrogation, culpable negligence will generally bar such a remedy. ***See Dixon v. Morgan***, 285 S.W. 558, 562 (Tenn. 1926).

In this case, the trial court granted Indymac equitable subrogation of its lien in the amount of $167,696.74, the remaining debt on the Union Planters mortgage. Indymac contends that the trial court's subrogation places the Kauffmans in no worse position than that for which they bargained. However, when the Kauffmans entered into the agreement with Betru, they understood that they would be in second position behind a thirty-year mortgage placed in 1993 with an interest rate of 3.5%. In contrast, the Indymac Deed is a thirty-year mortgage placed in 1999 at an interest rate of 7.625%. Therefore, subrogation places the Kauffmans in a slightly worse position, requiring them to stand in second place behind a longer mortgage with a higher interest rate. Moreover, Indymac's loss stems from its failure to discover the Kauffman Deed, despite Betru's unusual last name and the fact that more than one document was filed in connection with the Kauffmans' lien on the Cordova residence. ***See Castleman Constr.***, 432 S.W.2d at 676-77 (finding that it is appropriate to consider a complainant's negligence in conjunction with other evidence in determining whether subrogation is warranted). Under these circumstances, we find that the evidence does not support a grant of equitable subrogation.

Indymac argues that, absent subrogation, the Kauffmans would be unjustly enriched because they would be in a better position than if the Kauffman Deed had been found. However, a claim for unjust enrichment requires a legal or equitable obligation arising from some type of privity or transaction between the parties. ***See Leeper v. Cook***, 688 S.W.2d 94, 96 (Tenn. Ct. App. 1985). Here, there is no such privity. Therefore, Indymac has no claim for unjust enrichment against the Kauffmans.

The decision of the trial court is reversed and remanded consistent with this Opinion. Costs are taxed to the appellee, Indymac Mortgage Holding, Inc., for which execution may issue if necessary.

_____

HOLLY K. LILLARD, JUDGE