

Real Property, Probate & Trust



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Water Rights in Land Transactions, Trusts and Estates

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Until recently, water rights have not played a major role in most land transactions, conveyances or strategic planning for real estate. Today, competition for water resources and an increasingly complex regulatory environment have heightened the level of risks and benefits associated with interests in water rights. In this competitive environment, it is important for landowners and attorneys with areas of practice relating to real estate to understand that interests in water rights are property interests. Protection and preservation of those interests should be considered throughout the “life cycle” of land management – in strategic planning, agreements and conveyances, and allocation of real property assets in trust, estates and investment portfolios. This paper identifies key principles to consider when looking at water rights in the context of real estate planning and transactions.

I. Introduction

In recent years, landowners, developers and attorneys have paid increasing attention to water rights, especially in circumstances where water is needed for the development or use of the land and utility service is not available, or when landowners wish to sell interests in water rights to developers. In the current market, valid water rights are valuable assets, and in some circumstances, water rights appurtenant to the land, may be more valuable than the land itself. In this environment, understanding water rights in the context of transactions is important. In addition, given the attributes of water rights as property interests in Western water law, landowners should take steps to preserve and protect interests in water rights throughout the life cycle of land ownership. Without careful management on an ongoing basis, water rights may be unintentionally relinquished or otherwise reduced in value as an asset.

The principles discussed in this article are found in the State Water Code,¹ the State Ground Water Code,² an evolving body of case law interpreting statutory and common law principles, and state agency regulations, guidance and policy.

This article does not discuss issues relating to tribal or federally reserved interests in water. If the landowner or attorney has reason to believe that there may be underlying federal or tribal interests associated with the land or water, those issues should be researched carefully and considered prior to completion of agreements, conveyances and leases, or other disposition of interests in land and/or water rights.

Landowners or attorneys with areas of practice in real estate, trust and estates may wish to consult with an attorney who practices in water rights and water supply issues for an opinion as to the risks and benefits associated with property interests in water rights. The water attorney can also assist with negotiations and drafting for water-related agreements and conveyance instruments.

II. The nature of the property interest

An understanding of the nature of water rights as property interests is important in assessing the landowner’s assets. Unfortunately water rights as they appear “on paper” may not accurately represent the valid interests held by the water rights holder. Vested interests in water rights are a sort of “hybrid” property interest. They are property interests, but circumscribed by evolving common law, statutory principles and historic use. The complex nature of water rights can lead to misjudgments about the interests held, as discussed below.

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Water Rights in Land Transactions, Trusts and Estates

A. Water rights are property interests authorized by the State

In Washington state, the Water Code provides: "Subject to existing rights all waters within the state belong to the public, and any right thereto, or to the use thereof, shall be hereafter acquired only by appropriation for a beneficial use and in the manner provided and not otherwise; and, as between appropriations, the first in time shall be the first in right."³

Beneficial uses of water vested pursuant to Western water law principles before the adoption of the State's comprehensive Water Code in 1917 are evidenced in most cases by a claim filed during claims registry periods.⁴

Pursuant to the Water Code of 1917 and the Groundwater Code of 1945, most persons wishing to use water are required to submit an application to the Washington State Department of Ecology ("DOE"). In limited circumstances, State-issued permits are not required. Most notably, landowners who use groundwater "for stock-watering purposes, or for the watering of a lawn or of a noncommercial garden not exceeding one-half acre in area, or for single or group domestic uses in an amount not exceeding five thousand gallons a day... or for an industrial purpose in an amount not exceeding five thousand gallons a day," are exempt from the requirement to apply for a water right permit from DOE.⁵ Recent interpretations of authorized uses of groundwater under the "exempt well statute" should be consulted to insure that use of water is authorized without a permit. This exemption applies only to use of groundwater, and not to use of surface water.

To the extent that water has been put to full beneficial use consistent with the terms and conditions of a permit, real property interests are created in the holder. The Water Code provides that "the right to the use of water which has been applied to a beneficial use ... shall be and remain appurtenant to the land ... upon which the same is used."⁶ To the extent that water is used on land, it is not only appurtenant to that land, but "is considered as real property."⁷

To identify on a preliminary basis whether interests in water rights may exist in the context of a land transaction or disposition of real property assets, a list of water rights, and related file materials, can be obtained from the DOE regional office. The "paper water rights" from DOE's records can then be compared with the historic use of water to determine on a tentative basis whether the water rights have been exercised on a continuous basis, consistent with state authorizations. Records of water agreements and water right approvals may also be filed in the county land records. All of this information, taken together, will be useful in assessing, on a preliminary basis, the nature and extent of interests in water rights appurtenant to the land.

B. The right to use water is a usufruct right granted by the State

Under the prior appropriation system of Western water law, water rights are usufruct rights, requiring continuing beneficial use.⁸

If water is not used, it is made available to the next person "in line" for a beneficial purpose. This approach in Western water law favoring continuing beneficial use reflects the West's scarcity of water, and creates, ironically, both an ownership interest in rights to use water, and uncertainties about the continuing validity and extent of those ownership interests.

Questions as to the extent and validity of water rights arise from several factors, such as lack of continuing beneficial use by the rights holder, use inconsistent with the terms and conditions in the authorized water rights, or subsequent regulatory requirements. Uncertainty may arise even in the situation where the DOE has issued a certificate evidencing a vested interest in water rights. A finding that DOE issued a certificate in error before the water rights were vested by use may result in relinquishment or partial relinquishment of the right.⁹

C. Nonuse of water may result in relinquishment of water rights

Of particular concern to a water right holder is the possibility that interests in water rights "on paper" may have been relinquished by nonuse. State law provides that "a person entitled to divert ... waters of the state ... who voluntarily fails, without sufficient cause, to beneficially use all or part of said right ... for any period of five successive years ... shall relinquish such right or portion thereof ..."¹⁰ Nonuse may be excused by certain statutory exceptions to the requirement of beneficial use.¹¹ One example of an exception excusing nonuse is a "determined future development to take place ... within 15 years of the most recent beneficial use of the water right."¹² Other reasons justifying nonuse include, but are not limited to, drought, legal proceedings directly involving the water right, and power-development purposes. Common-law abandonment may also apply where nonuse is coupled with intent to abandon water rights.¹³

If it appears that significant periods of nonuse have occurred, the landowner or attorney may wish to make a preliminary evaluation of the possibility that nonuse can be justified under the statutory exemptions to relinquishment. If it appears that nonuse may have been excused, appropriate documentation should be assembled supporting reasons for the nonuse. Creating a record of continuing use or reasons for nonuse may be helpful, if the validity of the water rights is challenged in the future.

The placement of water rights in Washington state's trust water right program is one vehicle to consider as a means of preserving water rights.¹⁴ Under this statutory program, water rights are placed in trust for the benefit of a local stream and are

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thereby preserved—and the relinquishment “clock” tolled—unless and until the water rights are subsequently withdrawn from trust for beneficial use. Donations of water rights to the trust water right program may also allow the trustor/donor to qualify for federal tax benefits. It is important to note that DOE will undertake an assessment of the validity of water rights prior to placement of water rights in trust. Placing water rights in trust may also give rise to claims of impairment by downstream water users, who depend on return flows to support their own use of water.¹⁵

Maintaining water rights in active use should also be considered as a means to preserve and protect the value of the water rights. For example, where land will be held and managed passively, without continuing use of water, the owner may wish to lease the water rights to another party, either for use on the land that is identified as the place of use in the water right, or on other land through a transfer of water rights to a different place of use, to maintain the continuing validity of the interests. Or, in the case where land to which the water rights are appurtenant will be leased, both lessor and lessee may benefit by providing for the continuing exercise of the water rights during the term of the lease.

D. Regulatory programs may place limitations on water use or transfer

Area-specific regulatory schemes, such as the Columbia River Water Resource Management Program¹⁶ or local watershed plans¹⁷ may establish limitations on the exercise of interests in water rights. State and local agency websites are useful sources of information and can help identify regional and local plans.

E. Water rights may be changed or transferred

Because of the Northwest’s growing population, developers, businesses and municipalities are competing for limited water resources. As mentioned previously, depending on the locations and market conditions, valid water rights may have substantial value, either retained with the land, or transferred for use at a different location. In land transactions, the parties should consider whether water rights will be retained with the land, the effect of water rights on the price of the land, and whether potential future changes or transfers of water rights should be addressed in agreements and conveyance instruments.

A change in the place of use, point of diversion, or withdrawal, or purpose of use may be allowed:¹⁸ “If such change can be made without detriment or injury to existing rights ... [and] results in no increase in the annual consumptive quantity used.”¹⁹ Applications for change or transfer must be submitted to DOE along with supporting documentation. Once approved, DOE will record water right documents in the county land records.²⁰ In addition to the regulatory approval required, because real property interests are affected, agreements and conveyances relating to water rights should be carefully negotiated, drafted, and recorded in the county records.

For conveyances, allocation of risk should be considered both in the context of agreements relating to water, and by selection of appropriate conveyance instruments. Agreements relating to conveyance of interests in land or land with water rights, for example, might provide that the purchaser will accept interests in water rights conditioned upon review of information (such as information about continuous beneficial use) provided by the seller; or acceptance of interests in water rights might be made subject to conditions (such as approval of transfers by DOE). Additionally, the cost of preparing applications for change and providing supporting documentation for regulatory approvals of transfers might be allocated by the parties through an agreement.

Conveyance instruments should also be selected to reflect the preferred allocation of risk among the parties. A quitclaim deed can be used if the parties understand the risks involved or have otherwise addressed risks in an underlying agreement. A statutory

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warranty deed is probably an unsuitable conveyance instrument for most parties if water rights are conveyed separate from land, because of the types of warranties provided and the risks involved in defending interests in water rights. A special warranty deed is probably the best instrument for most parties, especially for conveyance of water rights separate from land. A special warranty deed can provide warranties appropriate to the characteristics of the specific water rights and the circumstances of the parties.

A change or transfer of water rights creates limitations as to the location of use and other conditions limiting the use of water, and may include new conditions reflecting current regulatory and policy directives.

Certain types of water rights may be changed or transferred only under very narrow circumstances. For example, water rights acquired under the Family Farm Act²¹ may be leased for any purpose, but may not be wholly conveyed and transferred, except under limited circumstances.

Permits and applications are personal property interests and must be assigned separately from land.²²

III. Granting security interests

In land conveyances, or in the course of carrying out the duties of a trustee, interests in land may be granted as security for a loan. Before a landowner or trustee grants a security interest in land, he or she should evaluate the effects on appurtenant water rights.

A. Considerations in granting security interests

The landowner or attorney may wish to consider whether granting security interests in land may unintentionally tie up water rights that might be more profitably used on different land or for different purposes through a lease or conveyance. In the extreme case, granting a security interest may prevent exercise of water rights, and the water rights may be relinquished. If the parties contemplate a transfer or change of water rights during the period during which a third party will hold a security interest in the land, interests in water rights should probably be reserved to the mortgagor and excluded from the security interests granted to the lender.

B. Existing security interests

Where existing deeds of trust are silent on disposition of water rights appurtenant to land, partial reconveyance of interests by the lender may be required, to allow the parties to carry out the intended disposition of water rights during the period in which the lender retains a security interest in the land.

IV. Tax issues

Real estate excise tax may be due on transfers of water rights at the time of transfer.²³ While DOE notifies the Department of Revenue of approval of transfers, there remain questions about

when the tax is due, valuation, and other issues. The seller/transferor is responsible for payment of real estate excise tax on land and water rights. If not paid, nonpayment will constitute a lien on the property, potentially limiting the disposition and use of water rights by the buyer.

Assessments of validity and valuation of water rights may be required in order to fulfill tax obligations, potentially including real estate excise tax, capital gains, income tax, or estate tax obligations.

V. Valuation

Valuation of water rights may be needed for several purposes including purchase and sale, lease, conveyance, granting of security interests, tax, or asset allocation. Valuation will depend principally on water right validity and local market conditions. Because water rights are generally excepted from coverage under title insurance policies, allocation of risks and benefits associated with valuation should be carefully considered, and risks allocated appropriately in transactions and conveyances.

VI. An example of the interaction between water rights and conveyance of interests in land

The following example illustrates some of the issues discussed above as they played out in an actual land transaction and related water right transfer.

A. Factual background

A farmer stopped farming in 1991, with the intention of developing his land. Before he stopped farming and sold his livestock and equipment, he took steps, along with his neighbors and business partners, to annex his land to a neighboring city. Through the SEPA process, it became clear that the city did not have sufficient water system capacity, including water rights, to provide water at full build-out of the land.

To address this lack of capacity pursuant to the city's ordinances and policies, the city required the farmer to transfer water rights to the city as a condition of development. The former farmer, now landowner/developer, worked with his business partners on all aspects of the development. As part of that effort, he met with the city several times over a period of years to discuss potential terms of transfer of water rights.

When the city issued conditional approvals for the development, the landowner sold his land to his development partners. The development partners pledged the land as security for a loan to purchase the land. Water rights were not excepted from the security interests granted to the lender. Following purchase of the land, the development partners completed an agreement for transfers of the water rights to the city. The agreement was duly approved and recorded.

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The city required that liens and encumbrances on the water rights be removed as a condition precedent to providing service connections to the development. In order to fulfill that condition, the development partners had to go back to the lender and convince it to reconvey its interests in the water rights. A partial reconveyance was executed, and the developer conveyed the water rights to the city. The city applied for changes to the water rights to allow for municipal use. The changes were granted by the DOE, and no appeals were filed during the 30-day statutory appeals period.

B. Analysis of key Issues

1. Validity of water rights

In this case, there had been a 14-year period of nonuse of water – exceeding the 5-year statutory limit for relinquishment. The continuing validity of the water rights had to be shown, in order for the water rights to be transferred to the city. The farmer/landowner's diligent work over the 14-year period to accomplish the planned development, and his continuing personal involvement in the development were critical factors in the DOE's determination that the water rights were valid and could be transferred to the city under the determined future development exception to relinquishment.²⁴

2. Security interests and partial reconveyance

Neither the developer who bought the farmer's land nor the bank that financed the purchase likely considered the effect of appurtenant water rights on the loan terms or security interests given. Nor did they likely consider that, if liens and encumbrances were not removed, the water rights might be without value. Without removal of liens and encumbrances, the "determined future development" exception to water right relinquishment would no longer exist, because the development would not be

viable, by the terms of the agreement between the city and the developer. In other words, the security arrangement itself would have resulted in the water rights having no value, and the water rights would most likely have been relinquished.

The developer in this case persuaded the bank that it was in the bank's best interest to release the water rights, so that the development could go forward. In a different case, where the parties' interests were not as well aligned, a lender might not be as willing to release its security interests, seeing value in retaining interests in the water rights as security for the loan.

This example illustrates the importance of the water in land transactions and conveyances. If land with appurtenant water rights secures financing, the parties and third party lenders should consider how disposition of interests in water rights may affect their interests.

To avoid tying water rights to the land as security for a loan, the parties may wish to reserve water rights to the seller in the context of the land transaction, or the bank may be willing to except interests in water rights from the security interests taken.

VII. Conclusion

If substantial interests in water rights may be appurtenant to land, careful evaluation of the existence and validity of the water rights, and consideration of the future use or disposition of the water rights, may help preserve and optimize the value of real property assets in the context of planning, transactions, conveyances, and asset allocation in trust, estates, and investment portfolios. Careful negotiation and drafting of agreements and conveyance instruments involving water rights should be based on an understanding and allocation of the risks involved. Allocation of risks by the parties based on this understanding may also help avoid later disputes among parties claiming interests in land.

1 RCW 90.03.

2 RCW 90.44.

3 RCW 90.03.010.

4 RCW 90.03.010; RCW 90.14.041 and RCW 90.14.068.

5 RCW 90.44.050.

6 RCW 90.03.380(1). See also *U.S. v. Ahtanum Irr. Dist.*, 124 F. Supp 818 (1954); *Foster v. Sunny Side Valley Irrigation Dist.*, 102 Wash 2d 395, 687 P2d 841 (1984); *Shuh v. State Dept. of Ecology*, 100 Wash 2d 180, 667 P.2d 64 (1983).

7 *Thompson v Short*, 106 P2d. 720, 6 Wash. 2d 71, 87 (1940).

8 *Neubert v. Yakima-Tieton Irrigation District*, 117 Wn. 2d 232, 814 P.2d 199 (1991).

9 See *Dept. of Ecology v. Theodoratus*, 135 Wn. 2d 582, 957 P.2d 1241. (1998).

10 RCW 90.14.160.

11 RCW 90.14.140.

12 RCW 90.14.140(2).

13 *PUD No. 1 of Pend Oreille County v. Dept. of Ecology*, 146 Wn. 2d 778, 51 P.3d 744 (2002).

14 RCW 90.42.

15 RCW 90.42.040(4).

16 RCW 90.90.

17 RCW 90.82.

18 RCW 90.03.380.

19 RCW 90.03.380(1).

20 RCW 90.03.330(1).

21 RCW 90.66.

22 *Stout v. Ecology*, PCHB No. 89-99 (1990).

23 RCW 82.45.

24 RCW 90.14.140.

The Death of Tort and the Triumph of the “Economic Loss Rule”

A fable by Gilmore Grant

A. Once upon a time

It was not that long ago that individuals, as well as corporations, had access to the courts. There was, in fact, a long tradition, traceable to pre-industrial England, of resolving private, non-contractual disputes (known as “tort cases”) through a system of courts maintained at public expense. This is the story of the “economic loss rule” and the beginning of the end of torts.

The “economic loss rule” was a subtle and powerful phrase, worthy of the infamous Karl Rove, chancellor to George II. But what was the source of its power? Perhaps it was its bold confidence, implying venerability and authority. It seemed to belong with other “rules” recognized by the Courts of Washington—“the parol evidence rule,” the “rule against perpetuities,” and the “collateral source rule,” to name a few. Some such rules were ancient, some merely old. Few knew that the “economic loss rule” had no such pedigree.¹

It is true that some objected to the phrase. Justice Chambers, in his concurrence in *Alejandro v. Bull*,² wrote: “The economic loss rule is a misnomer, and the majority mistakes the name of the doctrine for its function... I say the rule is unfortunately named because describing the ‘loss’ as economic is not particularly helpful and can be positively misleading.” It is unfortunate that Justice Chambers’ insight went unheeded, and the talismanic power of the phrase grew through the Court’s holding in that case.

B. The common-law “rule” that never was

So what was this “rule”? It was, most simply stated, “economic damages are not recoverable in a cause of action in tort.”³ The breadth of this statement! It spoke of a rule applicable to “tort” generally. Because the concept of “tort” was an ancient one, any proposition about “tort” in general would seem to be a profound statement about something deeply imbedded in the law. But the “economic loss rule” was nothing of the sort. How different the law might have been if the *Berschauer/Phillips* Court had said, in 1994, “Today we announce a new rule—that economic damages are not recoverable in tort”!

At that time, the statement that “economic damages are not recoverable in a cause of action in tort” was as false as it was broad. One might just as well have said, “the right to a jury trial was unknown at common law” or “the State may convict a person twice for the same crime.” There were many torts that produced no physical harm for which economic damages were recoverable—conversion, defamation, fraud, tortious interference with contract or business expectancy, legal malpractice, and wrongful discharge, to name a few. Even where there was physical harm, damages were awarded for economic loss—for example, for medical expenses, lost income, and the loss or diminution of the ability to earn income in the future. Indeed, the truth was the opposite of what the “economic loss rule” said. The recovery of economic losses in tort was the norm rather than the exception.

And yet, the “economic loss rule” would never have found its footing if it had not been a response to a real problem—the overlap of torts and contract. As the Court said in *Alejandro v. Bull*,⁴ “The economic loss rule maintains ‘the fundamental boundaries of tort and contract law’ (citing *Berschauer/Phillips*).”

C. Tort vs. Contract

In their purest forms, contract and tort are easily distinguished. The law of contracts allows persons to define mutual rights and duties by agreement—to make their own private law, enforceable through the courts. By contrast, tort duties are created by the courts based on precedent and policy. Contract duties arise only when the parties have first established a relationship; tort duties do not necessarily depend on any prior relationship.

Some overlap between torts and contract is inevitable because tort duties apply to everyone, including the parties to a contract. The overlap is greatest for torts based on the failure to act with reasonable care. In such cases, the courts of Washington have tended to favor contract over tort law, protecting the right to create private law by agreement against being subsumed into the universe of torts.⁵

1. Tort vs. Express Warranty

One of the early “economic loss rule” cases, *Griffith v. Centex Real Estate*,⁶ illustrates the priority of contract over tort. The defendant, Centex Real Estate, built and sold new homes. Warranties in the real estate purchase and sale agreements limited the remedies available if the siding failed. The plaintiff homeowners sought to avoid these limitations by bringing a claim for negligent misrepresentation. Citing the “economic loss rule,” the Court held that the contract provision that limited the buyers’ remedies prevailed over the inconsistent tort law.

Griffith v. Centex Real Estate required the Court to determine the duties between the parties when contract and tort overlapped. But the Court’s holding was based on the “economic loss rule,” which draws a distinction based on damages. It would have been more straightforward to base the decision on the customary priority of contract over tort. By contrast, relying on the “economic loss rule” opens the door to reversing this priority, though there is no apparent policy reason for doing so. For example, suppose that the defective siding in *Griffith* had caused physical injury rather than “economic” loss. Perhaps a board came loose and fell on the homeowner’s head. Under the “economic loss rule,” the homeowner would be free to sue for negligent misrepresentation or to bring other tort claims. The bargained-for limitations in the contract would be circumvented. This is the consequence of looking at damages to decide a question about duty.

2. Tort vs. Implied Warranty

In two other cases—*Stuart v. Coldwell Banker*⁷ and *Alejandro v. Bull*⁸—the conflict between tort and contract was subtle.

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The Death of Tort and the Triumph of the “Economic Loss Rule”

There was no warranty in the contract. There is, however, an implied warranty of habitability. This implied warranty is extremely limited. It applies only to the first sale of a new home by a person engaged in the business of selling new homes. If the tort claims in *Stuart* and *Alejandre* had been allowed, the effect would have been the same as if the warranties implied in the sale of real property had been greatly expanded. The Court was unwilling to do so. However, the Court’s preference for a contract law concept (the implied warranty of habitability) over a tort duty (negligent construction) did not serve to preserve and protect the parties’ bargain because the contractual duty did not derive from the bargain, the warranty of habitability is implied by law. Like many implied warranties, the warranty of habitability is similar to a tort duty to exercise reasonable care. In essence, in *Stuart* and *Alejandre* the Court resolved an inconsistency between the liability rules from two different bodies of judge-made law. Similar to *Griffith v. Centex Homes*, it was neither necessary nor desirable for the Court to invoke the “economic loss rule.” The “economic loss rule” only obscured the logic and motivation behind the decision.

3. Three-party Cases and Products Liability

In *Stuart*, *Alejandre*, and *Griffith* the contractual and tort duties ran between the same two parties. By contrast, the first non-products-liability case to invoke the “economic loss rule,” *Berschauer/Phillips*,⁹ was a three-party case—a construction dispute involving an owner, a contractor, and an architect. The contractor and the owner had a contract, the owner and the architect had a contract, but there was no contract between the contractor and the architect. When the aggrieved contractor sued the architect, it therefore sued in tort. This configuration of the parties invited comparison with products liability law, which involves a similar configuration: typically the manufacturer has a contract with the seller and the seller has a contract with the buyer, but there is no contract between the manufacturer and the buyer. Over the course of the 20th century, the courts of Washington and other states made the manufacturer liable to the buyer under various legal theories, primarily based in tort. The question in *Berschauer/Phillips*¹⁰ was whether such liability would be found in the commercial construction setting. The Court decided there was no tort remedy because of the “economic loss rule,” which it described as follows:

Economic loss is a conceptual device used to classify damages for which a remedy in tort or contract is deemed permissible, but are more properly remediable only in contract. *Washington Water Power Co. v. Graybar Elec. Co.*, 112 Wash.2d 847, 861 n. 10, 774 P.2d 1199, 779 P.2d 697 (1989).

It is ironic that the Court in *Berschauer/Phillips* based its decision on products liability law, since Washington’s common law of products liability did not follow the “economic loss rule.” *Berg v. General Motors*,¹¹ a 1976 case, had held that economic damages were recoverable in products liability cases under Washington’s common law. The case cited in the quoted passage, *Washington Water Power Co.*, construed a new statute—the Washington Products Liability Act. In *Washington Water Power*, the Court acknowledged that *Berg* stated the common law rule in Washington (that “economic losses” were recoverable in tort), but held that the Washington Product Liability Act had supplanted the common law rule. In other words, there never was an “economic loss rule” in Washington’s common law of products liability.

The three-party cases, like the two party cases, were about duty. They could have been decided without any reference to the type of damages incurred.

D. The rest is history...

And so, like a deadly flu virus jumping from avian to human host, the “economic loss rule” leapt from products liability law, to cases where contracts and torts overlapped, to tort law generally. It spread rapidly. After *Berschauer/Phillips* in 1994, the “economic loss” rule was mentioned in one reported case in 1997, once in 1998, then an average of four times per year from 1999 to 2007. It then insinuated itself into personal injury actions. But that is a story for another time.

“Gilmore Grant” is the pen name of G. Michael Zeno, Jr., who practices law in Kirkland, Washington.

1 The phrase did not appear in the Courts of Washington until 1993, in the products liability case of *Stanton v. Bayliner Marine Corp.*, 123 Wn.2d 64, 866 P.2d 15 (1993), and was first mentioned outside of the products liability realm in *Berschauer/Phillips Construction Company v. Seattle School District No. 1*, 124 Wn.2d 816, 881 P.2d 986 (1994).

2 159 Wn.2d 674, 153 P.3d 864 (2007).

3 *Berschauer/Phillips*, supra, at 825, citing *Stuart v. Coldwell Banker*, 109 Wn.2d 406, 745 P.2d 1284 (1987).

4 159 Wn.2d at 682, citing *Berschauer/Phillips*, 124 Wn.2d at 826.

5 Admittedly, this is not always the case. For example, in some cases, a contractual release of liability will not protect the tortfeasor from gross negligence or willful misconduct, even though the private law created by the parties says otherwise.

6 93 Wn.App 202, 969 P.2d 486 (1998).

7 109 Wn.2d 406, 745 P.2d 1284 (1987).

8 159 Wn.2d 674, 153 P.2d 864 (2007).

9 124 Wn.2d 816, 881 P.2d 986 (1994).

10 *Id.*

11 87 Wn.2d 584, 555 P.2d 818 (1976).

Recent Developments

Real Property

by Scott Osborne, K&L Gates

*Neither a borrower nor a lender be
For loan oft loses both itself and friend
And borrowing dulls the edge of husbandry.*
William Shakespeare, Hamlet, Act I, Scene 3

Also attributed to comments overheard from former subprime mortgage broker waiting to register for unemployment benefits.

There are two recent cases concerning real property lending transactions. These cases re-visit prior decisions, and, true to the maxim that “all good things come to those who watch and wait,” the Supreme Court availed itself of the opportunity to clarify what can charitably be termed unfortunate language contained in prior opinions.

Bank of America v. Prestance Corporation, 160 Wn.2d 560, 160 P.3d 17, 2007 Wash. LEXIS 390 (2007). Sakae and Yuko Sugihara obtained a 30-year home loan from Washington Mutual (“WaMu”) in the amount of \$543,150 on August 8, 1994. Over the next two years, Sugihara obtained a series of business and home-equity loans which involved granting mortgages on his house. In August, 1999, Bank of America made a revolving loan to Prestance Corporation, wholly owned by Sugihara, in the amount of \$400,000, which was secured by a deed of trust on the Sugihara residence.

In October 2000, Bank of America (“BofA”) granted Prestance and a related corporation an additional line of credit for \$1,000,000. The BofA deed of trust was amended to include this additional loan as an obligation secured by the deed of trust. The revolving line of credit matured in October 2001. In November 2001, Sugihara sought a \$1 million loan from Wells Fargo Bank West (an affiliate of Wells Fargo Bank) (“WFB-West”). At the same time, Sugihara obtained a \$500,000 loan from Wells Fargo Bank (“WFB”). A portion of the WFB loan was used to repay the original \$400,000 loan from BofA, but BofA did not reconvey its deed of trust because the line of credit had not been paid. It is not exactly clear from the opinion how this occurred, since it would be assumed that the satisfaction of the BofA deed of trust would have been a condition of closing the loan.

The WFB-West loan closed on December 21, 2001, and refinanced the WaMu first mortgage. At that time, WFB-West expected to have a first lien position, even though the preliminary title commitment for title insurance obtained by WFB-West showed the BofA loans. The WaMu loan was repaid and the loan officer for WFB-West assumed that the BofA deed of trust had been, or was being, reconveyed as a result of the WFB loan. At the closing of the WFB-West loan, however, the BofA deed of trust remained unsatisfied, WFB was in second position with its \$500,000 loan and the WFB-West loan was in third position in so far as order of recording.

The line of credit owed to BofA was never repaid, and BofA began foreclosure proceedings and a suit to collect a money

judgment, naming Sugihara, WFB and WFB-West. The trial court found that WFB-West was equitably subrogated to the lien position of WaMu in the amount of \$499,477, which was the balance paid with the WFB-West loan proceeds, and WFB-West had priority over BofA to this extent.

BofA appealed and the Court of Appeals, at *Bank of America v. Wells Fargo Bank*, 126 Wn.App. 710 (2005), reversed the trial court. The Court of Appeals relied on the holding in *Kim v. Lee*, 145 Wn.2d 79, 31 P.3d 665, 2001 Wash. LEXIS 624 (2001), in reaching this result.

Kim v. Lee, supra, for those who have not had the pleasure of reading the case, arose out of a priority dispute between the holder of a mortgage that refinanced a prior loan and an intervening judgment creditor. The title insurance company that insured the mortgage claimed that the refinancing mortgage had a first lien priority under the doctrine of equitable subrogation. The Court decided to utilize RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES §7.3 (1997) to resolve the claim, and concluded that the refinancing mortgage prejudiced the rights of the intervening lien holder, and subrogation should not be granted. The only problem with that analysis was that Section 7.3 of the Restatement dealt only with modifications and extensions by an existing mortgagee, not a refinance by a different mortgagee. Not content with creating one interpretation problem, the Court then continued on to hold that the knowledge of the title insurance company of the existence of the intervening lien prior to the issuance of the title policy prevented the application of the doctrine of equitable subrogation because of the application of Washington’s recording act:

... allowing subrogation in the face of actual knowledge would discount the purpose of the recording statute, RCW 65.08.070. The purpose of the recording statute is to make the deed first recorded superior to any outstanding unrecorded conveyance of the same property unless the mortgagee or purchaser had actual knowledge of the transfer not filed of record. *Kim, supra*, at p. 91.

As a final justification for the ruling, the Court concluded that somewhere in the refinancing process, the title insurance company had not measured up to the Court’s interpretation of the appropriate standard of conduct:

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Recent Developments: Real Property

Generally, the role of the title insurer is relied upon by the lender, judgment creditor, and other lienors. Just as a lender relies on the title insurer to commit that title is vested in its borrower, subject only to known exclusions, judgment creditors and other lienors rely on title insurers to prevent a debtor from conveying real property without first satisfying a perfected lien... With the information at hand, Yakima Title still issued the title policy insuring PHH's first lien position. Applying equitable subrogation to extend in favor of Yakima Title would result in alleviating Yakima Title of its own negligence and complete disregard of actual notice at the expense of an innocent judgment creditor. *Kim*, *supra*, at pp. 91-92.

Clearly, the Court in *Kim* was having difficulty separating the application of the doctrine of equitable subrogation for the benefit of a lien holder as opposed to the benefit of a title insurance company. This difficulty ultimately led the Court of Appeals astray in the *Bank of America* case.

When WFB and WFB-West appealed to the Supreme Court, Justice Sanders, author of the dissent in *Kim*, wrote for a 6-3 majority, and reversed the Court of Appeals. The Court adopted RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES §7.6 (1997), and found that the knowledge of WFB-West of the lien position of BofA did not prevent WFB-West from being equitably subrogated to the first lien position of WaMu. The Court reviewed three different positions taken by courts in other jurisdictions on the issue of knowledge of the intervening lien affecting the right to equitable subrogation. The RESTATEMENT position was that knowledge did not affect the right to assert equitable subrogation. The "minority" position was described as denying equitable subrogation to any mortgage creditor that had actual or constructive knowledge of the prior lien. The "majority" position was described as denying equitable subrogation to those mortgage creditors who had actual, as opposed to constructive, knowledge of the prior lien.

After reviewing the case law from other jurisdictions in support of all three different positions, the Court concluded that it was inappropriate to focus on the knowledge of the refinancing lender:

The rule requiring a subrogee have no knowledge of intervening interests is left over from an early mistrust of equitable subordination and was borrowed from courts applying subrogation as a restitution remedy. We abandon this rule since this early mistrust has abated, and we are concerned with refinancing mortgages, not restitution... .

Jurisdictions that continue to deny equitable subrogation when the plaintiff knows of intervening interests rely on cases discussing subrogation in the context of a mistake. Subrogation applies in many contexts, and while the overall purpose of preventing unjust enrichment is the same, many

times the requirements will be tailored to the particular nuances of the situation. When a lender paid off another's debt mistakenly believing there were no intervening interests, he would then have to appeal for equitable relief...

But in the context of refinancing, where mistake is not at issue, there is no reason to consider the subrogee's knowledge. *Bank of America*, *supra* at pp. 576-577.

The Court concluded that as long as the junior interests were not materially prejudiced, the doctrine of equitable subrogation maintained the proper lien priorities and worked to avoid unjust enrichment of the junior lienholder:

... while the recording act provides stability and notice to lenders (both vital elements to any successful real estate lending scheme), we cannot rigidly adhere to its strictures where it works an injustice. Furthermore, WFB West is not cutting in line; equity and the law are working toward the same end. While WFB West came along second, the mortgage it purchases from Washington Mutual came first, and Bank of America knew this mortgage had priority before its own. Equitable subrogation maintains the property scheme and the original priorities. *Bank of America*, *supra* at pp. 570-571.

The Court also noted two public policy reasons for the adoption of the RESTATEMENT position. First, applying the doctrine even if the refinancing lender had notice of the junior lien, encouraged refinancing of defaulted first mortgages. This preserved the borrower's equity in the property and made the holder of the junior lien more secure, since foreclosure of the first lien is avoided.

Second, the *Restatement* approach affords enormous financial benefits for many homeowners. A recent law review article [Citing Grant S. Nelson & Dale Whitman, *Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners*, 2006 BYU L. Rev. 305] explains how a liberal equitable subrogation doctrine can save billions of dollars by reducing title insurance premiums.

As for the Court's prior holding in *Kim*, reliance on that opinion was misplaced.

But our holding in *Kim* addressed whether a refinancing mortgagee's title insurer could benefit from equitable subrogation if the insurer had actual knowledge of intervening liens. The facts before us today are different and concern whether a refinancing mortgagee, not a title insurer, must be precluded from equitable subrogation if he has actual knowledge of intervening liens. *Bank of America*, *supra* at p. 564.

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For these reasons, the Court refused to accept BofA's "antiquated" argument that the knowledge of WFB West precluded application of equitable subrogation, and reinstated the trial court's decision.

Washington has unequivocally adopted RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES §§ 7.3 and 7.6, but the Court viewed the application of these rules as clearly within its equitable powers. Equitable considerations weighed heavily on the outcome of specific cases in which these doctrines have been applied. The Court has not overruled *Kim*, and it is unclear how the Court will apply the RESTATEMENT position on equitable subrogation if a title company is a party to the proceeding. As pointed out in the dissent in *Kim*, the involvement of the title insurer on behalf of its insured should be irrelevant, but the Court seemed intent on keeping this distinction available for future use.

Missing in this analysis was any appreciation for the reasonable expectations of junior lienholders. It is not unrealistic to assume that a junior lienholder dreams of someday becoming a senior claimant. It is not clear that a junior lender can ever improve its priority in the face of a constantly refinancing borrower under the rules adopted by the Washington Court. One final point is the irony of the Court's reliance on Professor Whitman's article in *Bank of America*. Following the initial publication of *Kim*, a motion for reconsideration was made. In support of the motion, Professor Whitman authored an *amicus* brief which suggested that the Court might at least use the correct RESTATEMENT section in its analysis, a suggestion that was ignored at the time.

Beal Bank SSB v. Sarich, 2007 Wash. LEXIS 699 (September 13, 2007). In 1990, the Court decided *Washington Mutual Savings Bank v. United States*, 115 Wn.2d 52, 793 P.2d 969, 800 P.2d 1124 (1990). The case considered the amount required to be paid by the IRS to redeem a property from a purchaser at a non-judicial deed of trust foreclosure sale. The purchaser of the property, Washington Mutual, held a \$29,000 deed of trust on the property that was junior to a first deed of trust securing \$41,000 held by Yakima Federal Savings & Loan. The IRS had a third lien in the amount of \$150,000. WaMu purchased the property at the foreclosure sale of the Yakima Federal deed of trust. The IRS then asserted the right to redeem the property from WaMu by paying the amount paid by WaMu at the foreclosure. WaMu asserted the right to include its debt in the amount the IRS had to pay. The *Washington Mutual* case was a federal court action certified to the Washington State Supreme Court by the Ninth Circuit. The Washington Court concluded that the amount required to be paid by the IRS included both the senior lien amount paid at the foreclosure sale and the unpaid balance of the WaMu loan. In order to reach this result, the Court had to conclude that Washington Mutual had no right to pursue a "deficiency" judgment:

Washington law provides that no deficiency judgment may be obtained when a deed of trust is foreclosed. In the present case, Yakima Federal and not Washington Mutual foreclosed on its deed of trust. The parties argue that the statutory bar to deficiency judgments following nonjudicial foreclosures applies only to foreclosing lienholders and not to a nonforeclosing junior lienholder who purchases the property to protect its lien at a nonjudicial foreclosure sale.

Washington law does allow a creditor to seek a deficiency judgment following a *judicial*, or mortgage, foreclosure. Such a judgment may be limited to the excess of the debt over the upset price or fair market value of the property sold. While Washington Mutual would apply a similar fair market value limitation here, the IRS argues that the fair market value limitation applies only to judicial foreclosures and is inapplicable in a nonjudicial foreclosure context.

We do not deem it necessary to determine how a deficiency judgment should be measured in this case since we hold here that none may be obtained by a nonforeclosing junior lienor following a nonjudicial foreclosure sale. There is simply no statutory authority for allowing such a judgment following a nonjudicial, or deed of trust, foreclosure. Indeed, the title to, part of the deeds of trust act, states flatly that "[d]eficiency decree precluded in foreclosure under this chapter." We decline to create an exception to this statutory bar by judicial fiat.

The result of our refusal to allow a nonforeclosing junior lienholder to pursue a deficiency judgment following a nonjudicial foreclosure sale is that the IRS will have to pay the full amount of Washington Mutual's lien in order to redeem the property. Support for this result may be found, by analogy, in the redemption procedures set forth in Washington's mortgage foreclosure act. In order to redeem property following a mortgage foreclosure sale, a lien creditor must pay off all prior liens on the property. Thus, if the purchaser of the property was a creditor with a lien by judgment or mortgage which has priority over the lien of the redemptioner, the redemptioner, unless it is the judgment debtor, must also pay the amount of the purchaser's lien with interest. *Washington Mutual* supra, pp. 58 – 59.

At the time *Washington Mutual* was decided, there was some commentary that the language of the Court stating that the nonforeclosing junior lienholder could not pursue a deficiency judgment might create some mischief in the future, notwithstanding the concurring opinion by Justice Guy that stated that the Court was holding that the junior lienholder could not sue on the debt it held. Seventeen years later, the Court's unfortunate choice of words required further clarification.

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Steven and Kay Sarich granted three deeds of trust on the same property to secure three different obligations. Washington Mutual held the first lien, which was granted on July 29, 2001; the second deed of trust was granted on September 26, 2001, to U.S. Bank to secure \$344,600.79 and the third deed of trust was also granted to U.S. Bank on September 24, 2002, to secure a \$420,000 commercial loan. U.S. Bank assigned its notes and deeds of trust to Beal Bank, and Beal Bank subsequently sued to collect the balances after Sarich defaulted. WaMu also foreclosed its deed of trust, which was completed for a sale price of \$1,648,630 on January 6, 2006. Beal Bank did not participate as a bidder at the sale. Following the sale, Beal moved for summary judgment on its notes, and the trial court denied the motion and subsequently granted Sarich's motion to dismiss based on the holding in *Washington Mutual, supra*. Beal appealed and direct review was granted by the Supreme Court.

The Supreme Court reversed:

We turn to the plain language of the relevant portion of RCW 61.24.100 and find the right of nonforeclosing junior lienholders and creditors is simply not implicated. To accept the Sariches' argument would render a result whereby all liens attached to security would be automatically extinguished upon foreclosure. We find nothing in the statutory scheme supporting this conclusion. While foreclosure eliminates the security of a junior lienholder, the debts and obligations owed to the nonforeclosing junior lienholder are not affected by foreclosure under the statutes. *Beal Bank supra*.

The Court continued with an explanation of its ruling in *Washington Mutual*. Although the question certified by the Ninth Circuit (In Washington, may a nonforeclosing junior lienor who purchases property at a nonjudicial foreclosure sale sue for a deficiency under Washington law, and, if so, what is the manner of computing the deficiency?) focused on the rights of the junior lienholder, the Court explained its ruling in terms of determining the appropriate redemption remedy under a statutory scheme that did not allow redemption:

Applying redemption principles, we held that to redeem the property the IRS was required to pay the combined total of both notes against the property. Hence, Washington Mutual does not stand for the principle that a junior note is extinguished; Washington Mutual supports the opposite conclusion that the obligation owed to the junior lienholder continues after a trustee's sale. *Beal Bank, supra*.

The trial court's reliance on *Washington Mutual* was misplaced, and "the nonjudicial foreclosure of a senior lienholder's deed of trust ... does not preclude an action by a nonforeclosing holder

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Notes from the Chair

I have completed my year as Chair of the Real Property Probate and Trust Section and I am truly honored to have been able to lead what is far and away the best Section in the Washington State Bar Association. This Section is not only the best bargain with dues of only \$15, but also the most active, most productive and historically best organized in the Washington State Bar Association. As an example of the leadership former chairs of the Section this past year served as President of the Washington State Bar Association (Ellen Dial) and a member of the Board of Governors (Doug Lawrence). The Section took a leadership role in amending RPC 1.15A. The Section also once again participated actively in legislative matters. This year the Section leadership is in the very capable hands of Al Falk and who will be followed by Tim Osborn and then by Tim Burkhart. The Midyear continues to be a huge success financially but more importantly as an educational service to our Section Members. If you are reading this article you are no doubt one of the lucky members of the largest Section in the Bar. Tell your colleagues to join you as a member of our Section!

Nominations for Executive Committee Positions

Pursuant to the Bylaws of the Real Property, Probate & Trust Section, Lora L. Brown, a member of the Section's Nominating Committee, is accepting nominations for two positions on the Probate and Trust Council, two positions on the Real Property Council, and the position of Director of the Probate & Trust Council, each for a 2-year term running from June 2008 to June 2010.

Nominations must be received by Lora no later than March 15, 2008. Each nominee must be a current member of the Section. A nomination must set forth the nominee's name and bar number, identify the position for which the nominee is nominated, include a brief statement of the nominee's qualifications for the position, and be accompanied by endorsements from three current members of the Section.

Nominations may be submitted to Lora L. Brown by email at lora@llbrownlaw.com or by mail or delivery to 1000 Second Avenue, Suite 3500, Seattle, WA 98104.

Technology Column Author

In the past this newsletter has featured a Technology column that addresses certain technology issues including helpful web pages, useful software or other technology tips for the readers. Please contact Aleana Harris at aharris@alcourt.com if you are interested in being featured as a regular author of the technology column.

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of a junior deed of trust to recover on a debt secured by a junior deed of trust on the same property.”

Although the Court attempted to explain its ruling in *Washington Mutual* in a manner consistent with the result in *Beal Bank*, the Court ignored the fact that the statutory scheme involved in *Washington Mutual* allowed the IRS to redeem the property for an amount equal to the purchase price paid by WaMu, plus any amount that could not be recovered as a deficiency. In effect, to reach the result advocated by WaMu, the Court had to conclude that WaMu could not recover a judgment on its junior lien, which is a result directly opposite the conclusion in *Beal Bank*. In any event, the Court has now clearly articulated the right of a junior lienholder to sue on its obligation after a nonjudicial foreclosure of a senior deed of trust.