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S.C. Supreme Court

THE STATE OF SOUTH CAROLINA
In The Supreme Court

APPEAL FROM HORRY COUNTY
Court of Common Pleas

W. Jeffrey Young, Circuit Court Judge

Opinion No. 2015-UP-126 (S.C. Ct. App. filed March 11, 2015)

First National Bank of the South, Successor in interest to
Carolina National Bank and Trust Company, ...Respondent,

v.

James T. Callihan a/k/a James Callihan; Edward L. Williams;
Frank J. Pennisi a/k/a Frank Pennisi; Dean J. Karavan
a/k/a D.J. Karavan; Charles T. Walls, Jr. a/k/a Charles Walls;
Robert S. Guyton; and Jeffrey H. Skelley, Defendants,

Of whom Frank J. Pennisi and Charles T. Walls are the .....Petitioners.

PETITION FOR A WRIT OF CERTIORARI

Thomas C. Brittain
The Brittain Law Firm
4614 Oleander Drive
Myrtle Beach, SC 29577
(843) 449-8562
Attorney for Frank J. Pennisi

C. Scott Masel
Newby, Sartip, Masel & Casper, LLC,
4593 Oleander Drive
Myrtle Beach, SC 29577
(843)449-9417
Attorney for Charles T. Walls.

Robert A. Kerr, Jr.
Moore & Van Allen, PLLC
78 Wentworth Street
Charleston, SC 29401
Attorney for Respondent

Amy Jowers Milell
Law Office of Amy Jowers Mikell, LLC,
895 Island Park Drive
Suite 202
Charleston, SC 29492

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CERTIFICATE OF COUNSEL

Counsel for Petitioners certify that the Petition for Rehearing was made and finally ruled on by the Court of Appeals on June 19, 2015.

QUESTIONS PRESENTED

1. Did Petitioners' Obligations as Guarantors Terminate Upon their Payment of $100,000.00 and Respondent's New Loan Transaction with the Borrower?

2. Did Petitioners' Obligations as Guarantors Terminate Just as Their Obligations Would have Terminated on a Negotiable Instrument?

3. Does Rule 25(c), SCRCP, Apply Solely to Parties or to Objects and Items Also?

STATEMENT OF THE CASE

Respondent filed this action to collect payment on personal guaranties signed by Petitioners and co-defendants. [R.p. 8-44]. Following a trial, the circuit court entered judgment for the Respondent in the amount of $358,166.76, which was affirmed by the Court of Appeals.

This matter presents novel questions of law pertaining to guarantor rights and whether Respondent is the proper party to prosecute this action. Initially, Petitioners' obligations under the guaranties should have been discharged because they paid $100,000.00 to Respondent to be released from their guaranties, constituting an enforceable termination or novation of their guarantor obligations. Second, Petitioners' obligations should have been discharged based on the common laws outlined in *The Restatement of the Law–Security, Suretyship and Guaranty*, which serve as the foundation for the existing statutory discharge of guarantor obligations on negotiable instruments in S.C. Code §36-3-605. Finally, Capital Bank, N.A., which is not a party to this case, is the true owner and holder of the guarantees, and this case provides the Court an opportunity to clarify that Rule 25(c) applies to parties not items or objects.

The background of this case consists of a series of transactions.

First Loan Transaction

On November 8, 2006, Carolina National Bank and Trust Company ("CNB"), loaned $400,000.00 to Sand Dollar Cottage, LLC (the "Company"), as evidenced by a written promissory note ("Original Sand Dollar Note").[R.p.210]. Although Sand Dollar applied for the loan to finance the purchase real property in the Bahamas, CNB did not secure the loan with a mortgage on the property. [R.p. 69, lines 10-13]. Instead, CNB obtained personal guaranties from each member of the Company, including Petitioners Frank Pennisi and Charles Walls ("Pennisi" and "Walls", respectively. [R.p.216-229]. On November 8, 2007, the maturity date of Original Sand Dollar Note expired without any principal payment by the Company, and therefore the Original Sand Dollar Note went into default. [R.p. 125, lines 13-24; p. 142, lines 21 – p.143, line 1; p. 210-211].

Second Loan Transaction

On December 21, 2007, the Company entered into a second loan transaction with CNB ("Second Note") [R.p. 212-213]. Although CNB labeled this transaction a "renewal" with the same loan number, the Second Note reflects the Company received a single advance of $400,000.00 on December 21, 2007. [Id.]. In this second transaction, the interest rate was changed and the maturity date was changed to March 21, 2008. [Id.]. CNB did not obtain new written guaranties from Pennisi and Walls in this second loan transaction.

Before the Second Note expired, Respondent purchased the assets of CNB. [R.p. 76, lines 4-21; p. 105, lines 1-15]. This resulted in a merger of CNB into Respondent effective February 18, 2008 [R.p. 199-202]. Approximately one month later, the maturity date of the Second Note expired

without full payment by the Company and therefore went into default. [R.p.125, line 19 – p. 126, line1-10; p. 212-213].

Payments by Pennisi and Walls

After the Company's second default, Respondent informed the Company that it would enter into a third loan transaction only upon the borrower's payment of $100,000. [R.p. 139, lines 18-24; p. 159, lines 2- p. 160, line 2; p. 175, line 7-24]. Walls testified that the Respondent's bank officer told him that if he and Pennisi paid $100,000, then the bank would be "satisfied" and the Appellants would be released and "free" from their guaranty obligations. [R.p. 176, line 3-20]. Additionally, Pennisi testified that he confirmed this understanding with Co-defendant Robert Guyton, who was also an owner in the Company and served as the bank's primary contact to facilitate the loan transactions. [R.p. 165, lines 4-10].

Based on this, Pennisi and Walls individually paid $100,000 to the Company which in turn paid the Respondent. [R.p. 123, line 22 - p. 124, line 12; p. 159, line 2 – p. 160, line 2; p. 162, line 2 – p. 164, line 25; p. 175, line 7 – p. 177, line 12].

Pennisi and Walls testified the only reason they agreed to pay $100,000 was so they would be released as guarantors. [Id.] There is no dispute that Respondent received and benefited from Pennisi and Walls' payment of $100,000.00 and there is no dispute that Pennisi and Walls supplied the funds to pay 25% of the Second Loan Balance when they only had 8% ownership each in the Company. [R.p. 109, line 4-9; p. 171, line 2-19]. On numerous occasions, Pennisi and Walls confirmed their understanding with Respondent that this payment was made in return for being released as guarantors by email and phone calls [Tr.p. 162, line 19 – p. 164, line 20, p. 177; p. line 4-12; p. 237-238]; however, guaranties of Pennisi and Walls were not released or terminated in writing by the Respondent.

Third Loan Transaction

After accepting the $100,000 payment, Respondent entered into a third loan transaction with the Company on April 30, 2008 ("Third Note"). [R.p. 214-215]. Respondent again labeled this transaction a "renewal" with the same loan number but the Third Note reflects the Company received a single advance of $300,000.00 on April 30, 2008. [Id]. The repayment terms changed again, including the interest rate, the loan amount, the payment schedule, and the maturity date [Id]. Respondent again failed to obtain new guaranties from the Company's members.

In 2009, the Third Note went into default, and Respondent filed this action against all guarantors on April 13, 2010 [R.p. 8-44; Tr.p. 27]. Respondent did not sue the Company.

Sale of Loan Documents

Approximately three months after filing this lawsuit, Respondent was put into FDIC receivership. [R.p.79, line 19-21]. As part of the receivership, the FDIC executed a Limited Power of Attorney, which authorized certain individuals to execute documents to facilitate the sale and transfer of Respondent's assets:

> "including the sale and transfer of any loans held by [Respondent] to NAFH National Bank pursuant to that certain Purchase and Assumption Agreement, dated as of July 16, 2010 between FDIC as Receiver of [Respondent] and NAFH National Bank." [R.p. 205-208].

However, Respondent failed to produce the Purchase and Assumption Agreement for the record in this case. Moreover, the Limited Power of Attorney requires that the Attorney(s)-in-Fact "shall" use the following form to endorse or prepare allonges to promissory notes:

> "Pay to the order of
>
> _____
> Without Recourse
> **FEDERAL DEPOSIT INSURANCE CORPORATION as**
> Receiver for **FIRST NATIONAL BANK OF THE SOUTH,**
> Spartanburg, South Carolina

By:_____
Name_____
Title: Attorney in Fact"

The Attorney in Fact for the FDIC failed to endorse the Sand Dollar note(s). [R. p. 121, line 9-14]. Moreover, the Attorney in Fact failed to prepare an allonge to the note(s). [R.p. 112, line 4-15]. Instead, on June 28, 2011, the Attorney in Fact executed an Assignment of Promissory Note and Guaranty Agreements, purporting to sell the loan documents to NAFH National Bank [R.p. 209].

Two (2) days later, Capital Bank merged with and into NAFH National Bank, with the resulting bank name of Capital Bank N.A. [R.p. 203]. At trial, Respondent's witness testified that Capital Bank, N.A. is the owner and holder of the Sand Dollar note and guaranties [Tr.p. 84, line 13-17]. Nonetheless, Capital Bank is not a party to this case.

ARGUMENT

1. PETITIONERS' OBLIGATIONS UNDER THEIR GUARANTIES TERMINATED UPON THEIR PAYMENT OF $100,000 TO RESPONDENT AND RESPONDENT'S THIRD NOTE WITH THE COMPANY.

Petitioners entered into an agreement with Respondent to be released from their guaranties upon payment of $100,000.00. Respondent accepted the $100,000 and entered into a new loan transaction with the Company. As such, Petitioners claim their payment together with Respondent's acceptance of that payment and Respondent's new note with the Company acted to extinguish Petitioners' obligations under their guaranties.

A novation is an agreement between all parties concerned for the substitution of a new obligation between the parties with the intent to extinguish the old obligation. *Ophuls & Hill Inc. v. Carolina Ice & Fuel Co.*, 160 S.C. 441, 158 S.E. 824 (1931). The burden of proving novation is

on the party asserting it. *Superior Automobile Inc. Co. v. Maners*, 261 S.C. 257, 199 S.E.2d 719 (1973); *Pee Dee State Bank v. Prosser*, 295 S.C. 229, 367 S.E.2d 708 (Ct.App.1988).

In this case, there were new obligations created when Respondent entered into the Third Note. First, the creditor changed from CNB to Respondent following the merger. Second, the loan amount changed. Third, the note, while termed a renewal, reflects that the new loan amount is a new advance and therefore a new Company obligation. Fourth, the interest rate changed. Fifth, the maturity date changed. Moreover, importantly, Respondent entered into this new transaction only on the condition that Petitioners pay $100,000.

This case is not unlike the facts of *Wayne Dalton Corp. v. Acme Doors*, 302 S.C. 93 (Ct.App. 1990). In *Wayne Dalton*, a company entered into a loan transaction guaranteed by the company owners. When the owners sold the company to a third party, they paid the lender an amount of commissions to keep them "out of the situation" with the company. The lender accepted the payment and entered into a new loan transaction with the company under new terms and conditions which even included a credit for the payment made by the owners. When the lender sued the owners under their guaranties after the company later went into default, the Court of Appeals concluded the owners "tried to resolve the matter of their guaranties by agreeing to give up their commissions" to the lender and parties' actions were a novation of the guaranties.

Just as in *Wayne Dalton*, Pennisi and Walls paid $100,000 to resolve their guaranties which Respondent accepted and credited toward the new loan with the Company. Moreover, as in *Wayne Dalton*, Respondent entered into a new loan transaction under different and new loan terms. Based on the above, Petitioners believe their payment and the third loan transaction terminated their obligations under their guaranties.

2. PETITIONERS' OBLIGATIONS UNDER THEIR GUARANTIES SHOULD HAVE BEEN TERMINATED JUST AS THEIR OBLIGATIONS WOULD HAVE BEEN TERMINATED ON A NEGOTIABLE INSTRUMENT.

Guarantors can be discharged from their obligations on negotiable instruments under certain circumstances pursuant to S.C. Code 36-3-605. However, Pennisi and Walls did not sign a negotiable instrument and therefore the U.C.C. does not apply. The Official Comments to S.C. Code 36-3-605, however, show that the statutory grounds for guarantor discharge on negotiable instruments follow closely and are based on the common law grounds for discharge for other guarantors:

> These rules essentially parallel modern interpretations of the law of suretyship and guaranty that apply when a secondary obligor is not a party to an instrument. See generally *Restatement of the Law, Third, Suretyship and Guaranty* (1996). Of course, the rules in this section do not resolve all possible issues concerning the rights and duties of the parties. In the event that a situation is presented that is not resolved by this section (or the other related sections of this Article), the resolution may be provided by the general law of suretyship because, pursuant to Section 1-103, that law is applicable unless displaced by provisions of this Act.
> *Official Comment* #1 to S.C. Code 36-3-605.

Appellants have not identified any South Carolina case law applying the general laws of suretyship directly pertaining to the facts of this case; however, because the general laws of suretyship should be applicable to this case and are encompassed in the *Restatement of Suretyship and Guaranty* Sections 40 and 41, which serve as the basis for guarantor remedies under the U.C.C. and are thus consistent with existing law, Appellants submit the following is applicable.

a. Extension of Time

As similarly found in S.C. Code 36-3-605, Section 40 of *The Restatement of the Law–Security, Suretyship and Guaranty* states that "If the obligee [bank] grants the principal obligor [borrower] an extension of the time for performance of its duties pursuant to the underlying obligation... (b) to the extent that the secondary obligor [guarantor] has not performed its duties

pursuant the secondary obligation, it is discharged from those duties to the extent that the extension would otherwise cause the secondary obligor a loss."

The Second and Third Loan Transactions extended the time for performance by the Company. On the Third Note, the bank conditioned a new loan transaction upon payment of $100,000.00. Of course, Defendants Walls and Pennisi suffered a loss, as they paid the $100,000 to be relieved of any further obligations and they testified that they would have never paid that money but for securing their release from the debt. Additionally, they were told by the bank that the bank would be "satisfied" and the Appellants would be released and "free" from their guaranty obligations upon said payment. Finally, not only do Appellants' losses translate into an unfair benefit to the creditor, but also to the co-guarantors who are now less liable than they would have been under the CNB Note. Therefore, Appellant's obligations as guarantors should be discharged.

b. <u>Substituted Contract.</u>

Again, as similarly found in SC Code 36-3-605, Section 41 of *The Restatement of the Law– Security, Suretyship and Guaranty* states that "If the principal obligor and the obligee agree to a modification, other than an extension of time or a complete or partial release, of the principal obligor's duties pursuant to the underlying obligations: ...(b) the secondary obligor is discharged from any unperformed duties pursuant to the secondary obligation: (i) if the modification creates a substituted contract or imposes risks on the secondary obligor fundamentally different from those imposed pursuant to the transaction prior to modification; (ii) in other cases, to the extent that the modification would otherwise cause the secondary obligator a loss".

The series of loan transactions meet this ground for discharge. First, each loan transaction should be deemed a "substituted contract" for the prior loan transaction. In this regard, there was a mutual agreement between the lender and borrower that there was a discharge of a valid existing

obligation by the substitution of a new valid obligation on the part of the debtor. As discussed above, each prior Note had already matured and was in default, each subsequent Note reflected a new loan advance and new obligation to be repaid, and each subsequent Note had new obligations as to interest rates, maturity dates and repayment schedules.

Moreover, Pennisi and Walls suffered a loss, as they paid the $100,000, relying on statements of the bank to be relieved of any further obligations and they testified that they would have never paid that money but for securing their release from the debt. Not only does their loss translate into a direct benefit to the Respondent, but also to the co-guarantors who are now less liable than they would have been under the First or Second Notes. Because the Second and Third Notes act as new agreements with new loan advances and creating new obligations, and because the Notes changed the terms (including a different entity advancing the loan, interest, maturity, payments and a payment of $100,000.00), and causing a loss to Pennisi and Walls, their obligations as guarantors should be discharged.

3. THE CASE WAS NOT PROSECUTED BY A PROPER PARTY, AS RULE 25(c), SCRCP, APPLIES TO PARTIES ONLY, NOT ITEMS AND OBJECTS.

After this case was filed, ownership of the loan documents was transferred by the FDIC to Capital Bank. This transfer established Capital Bank as the entity which owned and was entitled to enforce those obligations." Even though Respondent has not, and has never been, related by merger or similar transfer of corporate ownership with Capital Bank, the trial court found Respondent could continue as the plaintiff pursuant to Rule 25(c), SCRCP, which states, "In case of any transfer of interest, the action may be continued by or against the original party, unless the court upon motion directs the person to whom the interest is transferred to be substituted in the action or joined with the original party."

Petitioners submit that Rule 17, SCRCP mandates that only a real party in interest may prosecute a case, and Rule 25 applies only when the original party ceases to exist or is otherwise incapable to prosecute or defend their own case. For example, section (a) applies when a party dies. Similarly, section (b) applies when a party becomes incompetent, and section (d) applies when a public officer dies or leaves office. If Rule 25(c) is to be applied consistent with the remaining provisions of the Rule, then it should apply only to corporate entities that are no longer capable to prosecute or defend a case because its existence has been transferred to a new or different corporate entity.

"Rule 25(c) applies to the transfer of interest from one corporation to another with which the first merged." *Bryant v. Waste Management, Inc.* 342 S.C. 159, 536 S.E.2d 380 (S.C.App. 2000). In *Bryant*, the Court of Appeals noted the original defendant had been subsumed by another company which had in turn merged with Waste Management. In other words, the original party ceased to exist. The *Bryant* Court explained that substitution from the original defendant to Waste Management under Rule 25(c) was appropriate because one of the distinguishing characteristics of a merger is that the surviving corporation has all the liabilities and obligations of each corporation party to the merger.

Petitioners contend that applying Rule 25 to miscellaneous objects and items, whether a loan package or a car, rather than to an existing *party* to the case, exceeds the proper scope of the rule. Indeed, Rule 25 pertains to the *party*, and unless the *party* is no longer capable to prosecute or defend, then Rule 17 remains the applicable rule. Here, Respondent and Capital Bank are unrelated. The two entities did not merge and there was no transfer of ownership. Instead they merely engaged in a sale of documents through the FDIC.

Because Respondent contends Capital Bank owns the notes and guaranties, and because the transfer of interest only pertained to pieces of paper rather than an existing party to the case, Capital Bank is the real party in interest as required by Rule 17 and Rule 25(c) is inapplicable.

CONCLUSION

Petitioners seek the Supreme Court's review of the final decision of the Court of Appeals to address Petitioner's obligations under novation and the facts of this case, to recognize that guarantor rights under the common law are consistent with those found for guarantors on negotiable instruments, and to clarify that of Rule 25(c), SCRCP applies to parties and not items or objects.

Thomas C. Brittain
The Brittain Law Firm
4614 Oleander Drive
Myrtle Beach, SC 29577
(843) 449-8562
Attorney for Appellant Frank J. Pennisi

C. Scott Masel
Newby Sartip Masel & Casper, LLC
4593 Oleander Drive
Myrtle Beach, SC 29577
(843) 449-9417
Attorney for Appellant Charles T. Walls, Jr.

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Defendants,

Of Whom Frank J. Pennisi and Charles T. Walls are the Petitioners.

CERTIFICATE OF SERVICE

I certify that I am an employee of the law firm of Newby Sartip Masel & Casper, LLC, and that I have served a copy of the Petition for Writ of Certiorari, Appendix, and related documents, jointly prepared by Thomas C. Brittain and C. Scott Masel, upon counsel for the Respondent named below by depositing a copy of the same in the United States Mail, postage prepaid, on July 10, 2015, addressed as follows:

Robert A. Kerr
Moore & VanAllen
78 Wentworth Street
Charleston, SC 29401

Karen Madert
Karen Madert