THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM FAIRFIELD COUNTY
Court of Common Pleas

Carol A. Tolen, Special Referee
Trial Court Case No. 2012-CP-20-00132

Appellate Case No. 2018-000230

ArrowPointe Federal Credit Union, Respondent,

v.

Jimmy Eugene Bailey; Laura Jean Bailey; and U.S. Bank National Association not in its individual capacity but solely in its capacity as Indenture Trustee for WVUE 2015-1, Defendants,

Of which U.S. Bank National Association not in its individual capacity but solely in its capacity as Indenture Trustee for WVUE 2015-1 is the Appellant.

INITIAL BRIEF OF APPELLANT

Drew B. Walker, Esq., SC Bar No. 78271
Shaun C. Blake, Esq.
Rogers Lewis Jackson Mann & Quinn, LLC
PO Box 11803
Columbia, SC 29211
P: 803-256-1268
F: 803-252-3653

Sean Foerster, Esq.
Rogers Townsend & Thomas, PC
PO Box 100200
Columbia, SC 29202
Phone: 803-744-1855
Attorneys for Appellant

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Other Authorities

STATEMENT OF ISSUES ON APPEAL

I. WHETHER THE SPECIAL REFEREE ERRED IN HOLDING THAT SOUTH CAROLINA DOES NOT AND SHOULD NOT RECOGNIZE THE DOCTRINE OF REPLACEMENT MORTGAGE AS FORECASTED IN THE SUPREME COURT'S MATRIX FINANCIAL SERVICES, CORP. V. FRAZER OPINION AND AS ESPOUSED IN THE RESTATEMENT THIRD OF PROPERTY.

II. WHETHER THE SPECIAL REFEREE ERRED IN HOLDING THAT RESPONDENT WAS MATERIALLY PREJUDICED BY THE APPELLANT'S MORTGAGE WHEN RESPONDENT WAS ON RECORD NOTICE THAT THE AMOUNT SECURED BY APPELLANT'S MORTGAGE COULD INCREASE.

III. WHETHER THE SPECIAL REFEREE ERRED IN HOLDING THAT THE EXISTENCE OF SOME MATERIAL PREJUDICE NECESSARILY DEFEATS THE PRIORITY OF THE REPLACEMENT MORTGAGE AND CANNOT BE CURED BY A REDUCTION OF THE EXTENT OF THE REPLACEMENT MORTGAGE'S LIEN PRIORITY.

STATEMENT OF THE CASE

This appeal arises from the Special Referee's Order Granting Plaintiff's Motion for Summary Judgment and Order of Foreclosure ("Order") dated January 18, 2018 in favor of ArrowPointe Federal Credit Union ("ArrowPointe"). The basis of the appeal of U.S. Bank National Association not in its individual capacity but solely in its capacity as Indenture Trustee for WVUE 2015-1 ("U.S. Bank") involves the Special Referee's grant of lien priority in favor of ArrowPointe in the Order.

The underlying civil action commenced on March 27, 2012 in the Fairfield County Court of Common Pleas, Case No. 2012-CP-20-00132. ArrowPointe filed a Lis Pendens, Summons and Complaint seeking to foreclose a Revolving Credit Mortgage ("Revolving Credit Mortgage") given by Jimmy E. Bailey and Laura Jean Bailey ("Baileys") to ArrowPointe. The real property subject to the foreclosure action is commonly known as 247 Morninglow Drive, Winnsboro, South Carolina ("Subject Property").

ArrowPointe named the Baileys and JPMorgan Chase Bank ("Chase") as Defendants. Chase held a mortgage given by the Baileys to Quicken Loans ("Replacement Mortgage") when ArrowPointe filed the underlying action. On May 14, 2012, Chase filed an Answer and Counterclaim, alleging, in part, that the Replacement Mortgage held a senior lien priority position ahead of the ArrowPoint Mortgage. On September 5, 2012, a Consent Order of Reference was entered into by Chase and ArrowPointe referring the action to Carol A. Tolen, as Special Referee for Fairfield County.

The Replacement Mortgage and the loan it secures have been assigned to several different lenders during the course of the underlying lawsuit and this appeal. Chase assigned the Replacement Mortgage back to its original holder Quicken Loans, Inc. ("Quicken"), and the

Circuit Court entered a Consent Order Substituting Real Party in Interest and Amending Caption on October 17, 2013.

Chase filed a Notice of Motion and Motion for Summary Judgment with supporting affidavits concerning the lien priority issue on July 24, 2013. ArrowPointe filed a Memorandum in Opposition on September 17, 2013. The Special Referee heard oral arguments on September 19, 2013, and allowed the parties additional time to submit written memorandum for her consideration after the hearing. Chase filed a Memorandum in Support of its Motion for Summary Judgment on October 2, 2013.

After an unusually-long period between oral arguments and ruling, the Court denied Chase's Motion for Summary Judgment by order dated March 19, 2015 and filed on April 2, 2015. Quicken, who held the Replacement Mortgage by the time of the decision in 2015, served a Motion for Reconsideration on April 10, 2015. The Court heard oral arguments on the Motion for Reconsideration on May 26, 2015. Though a written order does not appear to have been filed, the Special Referee denied the Motion at the hearing and after arguments [Page 17; Line 11; Motion for Reconsideration Hearing Transcript].

Quicken assigned the Chase Mortgage to DLJ Mortgage Capital, Inc., ("DLJ"), and the court entered an Order Substituting Defendant, Amending Caption, and Permitting Amendment on January 21, 2016. On January 29, 2016, DLJ filed a Lis Pendens, Amended Answer, Counterclaim, and Cross-Claim, seeking foreclosure of the Replacement Mortgage and a declaration that its Replacement Mortgage was senior in priority under the replacement mortgage doctrine or, alternatively, equitable subrogation. DLJ assigned the Replacement Mortgage to U.S. Bank, and on March 16, 2018, the Court entered the Order substituting U.S. Bank for DLJ.

The Baileys did not appear in the action and were held in default. Neither U.S. Bank nor ArrowPointe sought a deficiency judgment.

ArrowPointe served a Motion for Summary Judgment concerning the lien priority issue on October 12, 2016 along with supporting memorandum. DLJ filed a Memorandum in Opposition to Plaintiff's Motion for Summary Judgment on March 13, 2017.

DLJ and ArrowPointe filed a Joint Stipulation on March 13, 2017. The Special Referee heard oral arguments on ArrowPointe's summary judgment motion on that same day. The Joint Stipulation and its exhibits were entered into the record at the hearing and recorded that same day. At the same hearing, the Special Referee also heard an uncontested motion to substitute U.S. Bank as the real party in interest for DLJ, as well as uncontested testimony from both U.S. Bank and ArrowPointe on the respective debt of their loans, as well as their rights to foreclose their mortgages.

The Special Referee signed the Order on January 18, 2018. The Order held, among other things, that ArrowPointe's Revolving Credit Mortgage held priority over U.S. Bank's Replacement Mortgage and that the Revolving Credit Mortgage could be foreclosed. The Order also substituted U.S. Bank[1] as the real party in interest and established debt figures for both the ArrowPointe loan and the U.S. Bank loan. U.S. Bank's counsel received notice of the Order on January 22, 2018, and filed and served its Notice of Appeal on February 16, 2018. On March 16, 2018, Appellant served a Motion for Superseadas seeking the stay of the sale of the Subject Property during pendency of the instant appeal[2].

[1] It has come to U.S. Bank's counsel's attention that the Replacement Mortgage and the loan it secures has recently been assigned to a new lender, the particular details of which are still forthcoming.

[2] As of the filing of this Initial Brief, the lower court has not set a hearing or ruled on U.S. Bank's Motion for Supersedeas.

STATEMENT OF THE FACTS

U.S. Bank and ArrowPointe agree on the facts in the underlying case as illustrated in the Joint Stipulation.

The Baileys hold title to Subject Property and have owned it during all relevant times in this matter [Joint Stipulation 1]. The Baileys gave a mortgage to Quicken that was recorded on October 15, 2009 (the "Replaced Mortgage") [Joint Stipulation 2 and Exhibit A of the Joint Stipulation]. The Replaced Mortgage was in a senior lien priority position on the Subject Property at the time of its recording. Id.

The Replaced Mortgage secured a Note in the principal amount of $256,500.00, plus interest ("Replaced Note") [Id. and Joint Stipulation 3]. Additionally, the "Transfer of Rights in the Property" section of the recorded First Mortgage, states "This Security Instrument secures to Lender: (i) the repayment of the Loan, and all renewals, extensions and modifications of the Note . . .". Id.

Subsequently, the Baileys gave ArrowPointe the Revolving Credit Mortgage securing an Open-End Home Equity Credit Agreement in the principal amount of $99,000.00 to make improvements and additions to their home on the Subject Property [Joint Stipulation 5, 6 and Exhibits C - I]. The Revolving Credit Mortgage was duly recorded on November 4, 2009. Id.

When ArrowPointe obtained the Revolving Credit Mortgage from the Baileys, the parties to the transaction intended that the Revolving Credit Mortgage be a junior mortgage on the Subject Property second in lien priority position behind the Replaced Mortgage [Joint Stipulation 13].

The Baileys then entered into a subsequent loan transaction with Quicken, its successors and assigns, on November 23, 2009 [Joint Stipulation 14 and Exhibit J, K, L and P of the Joint Stipulation]. The Baileys obtained a new loan from Quicken through a Note in the principal

amount of $296,000.00 plus interest in this transaction ("Replacement Note"). Id. The proceeds from the Replacement Note were used to pay off the loan secured by the Replaced Mortgage in the amount of $257,459.04. Id. As part of the same transaction, the senior Replaced Mortgage was released of record, and then a new mortgage in favor of Quicken was recorded, the Replacement Mortgage. Id. The Replaced Mortgage was of record at all times until the Replacement Mortgage was recorded on December 15, 2009. Id. Quicken intended that the Replacement Mortgage replace the Mortgage and retain Quicken's senior lien position. Id.

A licensed South Carolina attorney, Stacey E Besser f/k/a Stacey Pope Gardner, supervised the loan closing for the Replacement Mortgage [Joint Stipulation 16]. Attorney Besser witnessed and notarized the Replacement Mortgage. Id. Attorney Besser remains licensed and in good standing with the South Carolina Bar in the present day. Id.

Quicken did not have actual knowledge that the Revolving Credit Mortgage existed at the time it conducted the Replacement Mortgage transaction. [Joint Stipulation 17]. Quicken was on record notice of the Revolving Credit Mortgage at the time it conducted the Replacement Mortgage transaction. Id. During the Replacement Mortgage transaction, the Baileys executed a Title Company Client Acknowledgment that represented by affidavit that "there are no outstanding home improvement loans, mortgages, deeds of trust, or equity lines of credit, recorded or unrecorded" other than the Replaced Mortgage [Joint Stipulation 17 and Exhibit K of Joint Stipulation]. The Baileys misrepresented the truth when they told Quicken that there are no equity lines of credit secured by the Subject Property [Joint Stipulation 17].

Thereafter, the Replacement Mortgage went through a series of assignments [Statement of the Case, supra, and Joint Stipulation 19 and Exhibits M-O in Joint Stipulation]. U.S. Bank's debt on the Replacement Note secured by the Replacement Mortgage was $436,609.23, as of March

13, 2017, with amounts of the debt continuing to accrue as stated in the Order [Order at ¶9 and Joint Stipulation 27 and Exhibit V to the Joint Stipulation]. ArrowPointe's debt on its note secured by the Revolving Credit Mortgage is $187,201.60 as of March 13, 2017 with amounts of the debt continuing to accrue as stated in the Order [Order at ¶5 and Joint Stipulation 29 and Exhibit X to the Joint Stipulation].

ArrowPointe continued to believe that it was in junior lien position until July 2011 when it discovered the Replacement Mortgage had replaced the Replaced Mortgage [Joint Stipulation 13 and Rule 30(b)(6) ArrowPointe Deposition Transcript of James R. Price, P. 48, Lines 20-23].

Standard of Review

"An action to establish lien priorities is an action in equity." Friarsgate, Inc. v. First Federal Sav. & Loan Ass'n, 317 S.C. 452, 456, 454 S.E.2d 901, 904 (Ct. App. 1995). In an action in equity referred to a master or special referee for final judgment with direct appeal to the Court of Appeals, the appellate court may view the evidence to determine facts in accordance with its own view of the preponderance of the evidence, though it is not required to disregard the findings of the master or special referee. Id.

ARGUMENTS

I. THE LOWER COURT ERRED IN HOLDING THAT SOUTH CAROLINA DOES NOT AND SHOULD NOT RECOGNIZE THE DOCTRINE OF REPLACEMENT MORTGAGE.

The doctrine of Replacement Mortgage presents a legal issue that South Carolina appellate courts have not yet ruled upon. See Matrix Financial Services Corp. v. Frazer, 394 S.C. 134, 138, 714 S.E.2d 532, 534 (2011) (holding "We do not decide whether a lender that refinances its own debt could attain priority under the theory of replacement and modification illustrated in section

7.3 of the Restatement (Third) of Property (Mortgages)"). The underlying case presents an opportunity to make such a determination.

The Baileys entered into three successive financing transactions. Quicken recorded the Replaced Mortgage on October 15, 2009. ArrowPointe recorded the Revolving Credit Mortgage on November 4, 2009. Quicken recorded the Replacement Mortgage on December 15, 2009. U.S. Bank now holds the Replacement Mortgage. Applying the stipulated facts to the legal principles espoused in the Restatement (Third) of Property (Mortgages), in South Carolina case law and common law, and in other jurisdictions, this Court should reverse the trial court by applying the doctrine of Replacement Mortgage and ordering foreclosure and sale of the Subject Property in favor of U.S. Bank.

a. THE RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) SUPPORTS THE DOCTRINE OF REPLACEMENT MORTGAGE.

The Restatement (Third) of Property recognizes the Replacement of Senior Mortgages and its effect on intervening interests as follows:

> (a) If a senior mortgage is released of record and, as part of the same transaction, is replaced with a new mortgage, the latter mortgage retains the same priority as its predecessor, except
>
> (1) to the extent that any change in the terms of the mortgage or the obligation it secures is materially prejudicial to the holder of a junior interest in the real estate, or
>
> (2) to the extent that one who is protected by the recording act acquires an interest in the real estate at a time that the senior mortgage is not of record.

See Restatement (Third) of Property (Mortgages) § 7.3 (1997).

The Comments to this Restatement section acknowledge that the replacement of senior mortgages is commonplace in lending transactions involving real property. See Id. at cmt. a. Further, the commentators state that "[r]equiring the consent of junior interests for such transactions might deny the parties needed flexibility in dealing with changing economic and business conditions. This section aims at resolving those problems in a manner that protects the

legitimate expectations of the holders of junior interests, while at the same time denying them the ability to veto workouts or other flexible restructuring arrangements between mortgagors and senior lenders." See Id. Simply put, junior mortgagees do not have veto authority on a financing transaction between a senior mortgagee and its borrower. The junior mortgagee's position should not materially worsen due to the transaction, but the senior mortgagee will retain priority to the extent of the replaced mortgage.

Additionally, if the original mortgage puts language in the public record that demonstrates the senior mortgagors ability to increase the amount secured by its current or future loans, then the intervening lienholder is on notice that the senior debt can increase and should temper its lending decisions accordingly. See Reporters' Note, cmt. d, Restatement (Third) of Property (Mortgages) § 7.3 (1997).

b. SOUTH CAROLINA LAW SUPPORTS THE DOCTRINE OF REPLACEMENT MORTGAGE.

South Carolina case law and common law support the doctrine of Replacement Mortgage. Additionally, Replacement Mortgage has been favored and ordered in the Circuit Courts of this State.

1. South Carolina Appellate Court holdings support the doctrine of Replacement Mortgage.

The South Carolina Supreme Court applied the Restatement (Third) of Property (Mortgages) Section 7.6 in its majority opinion in Matrix. This Restatement section recognizes an equitable doctrine known as equitable subrogation, which is an exception to the race notice statute that typically determines priority by the earlier date of recording. Restatement (Third) of Property (Mortgages) § 7.6 (1997). Much like Replacement Mortgage, Section 7.6 allows a refinancing

lender that is different from the original senior mortgagee to retain its priority to the extent the subrogee pays off the prior mortgage. See Id.

Prior to the Restatement (Third), many states allowed the same lender to refinance its own mortgage, including South Carolina, and retain priority through the doctrine of equitable subrogation. The Restatement opines that, for practical purposes and by definition, a lender cannot be subrogated to itself. Therefore, the commentators conclude that Replacement Mortgage is the more appropriate doctrine for a mortgagee to retain priority through a new loan that pays off its own prior loan. Restatement (Third) of Property (Mortgages) § 7.6 (1997).

Seeing no practical difference other than the titles of these two theories, some states still allow a lender to refinance its own mortgage and retain priority over junior mortgagees under the title of equitable subrogation. However, following the guidance of the Restatement (Third) commentators, South Carolina's Supreme Court in Matrix opted to follow the Restatement (Third) of Property (Mortgages) § 7.6 while acknowledging the Restatement (Third) of Property (Mortgages) § 7.3 that discusses Replacement Mortgage. The Matrix majority alludes to the Replacement Mortgage theory in dicta but does not make a ruling based on the principle because "Matrix is not asserting priority under a theory of replacement and modification." See Id. 394 S.C at 138, 714 S.E.2d at 534.

In discerning the logic of the majority with regard to Replacement Mortgage, the dissenting opinion of Justice Pleicones sheds light on the majority's seeming propensity to favor Replacement Mortgage in South Carolina. "It appears that the majority would agree with me that a refinancer has a right to lien priority, if that refinancer uses the theory of 'replacement and modification' rather than equitable subrogation. Heretofore, South Carolina has used the doctrine of equitable subrogation to restore a refinancer's lien to priority, and I would not reverse this because (Matrix)

used this theory rather than the **newly announced 'replacement and modification' rule.**" Matrix, 394 S.C. at 141, 714 S.E.2d at 535-36 (emphasis added). While the majority did not, admittedly, specifically announce a new rule in its opinion, Justice Pleicones clearly received the impression that the majority favors Replacement Mortgage and would adopt it with the appropriate procedural backdrop.

Recognizing U.S. Bank's priority here: (a) reduces foreclosures and facilitates refinancing, (b) reduces title insurances premiums, (c) establishes that our Courts do, in fact, recognize replacement mortgage theory, and (d) accomplishes the equitable maxim that no one (ArrowPointe) should be enriched by another's loss. See Matrix, 394 S.C. 134, 714 S.E.2d 532; see also, Sovereign Bank v. Gillis, 432 N.J. Super. 36, 48, 74 A.3d 1, 8 (N.J. Supr. Ct. App. Div. 2013.

"The purpose of subrogation (replacement here) is to prevent a junior lien holder from converting the mistake of the lender into a magical gift for himself." Matrix, (Pleicones, J., dissenting) (citing United States v. Baran, 996 F.2d 25 (2nd Cir. 1993) (parenthetical added). Here, the mistake would seemingly be Quicken's failure to locate the publicly recorded Revolving Credit Mortgage and ask ArrowPointe for a legal subordination document. Restatement § 7.3 does not require, and actually denounces, such a request from a junior lienholder. Further, equitable principles excuse a title abstracting oversight and allow the senior mortgagee to retain its priority. Quicken did obtain a sworn affidavit from the Baileys that no lien such as the Revolving Credit Mortgage existed [Joint Stipulation 17 and Exhibit K of the Joint Stipulation]. Even if Quicken had actual knowledge of the Revolving Credit Mortgage, which it did not [Joint Stipulation 17], the Restatement (Third) of Property (Mortgages) § 7.3 does not require ArrowPointe's permission or allow ArrowPointe "the ability to veto workouts or other flexible restructuring arrangements

between mortgagors and senior lenders." See Restatement (Third) of Property (Mortgages) § 7.3 (1997), cmt. a; see also, Sovereign Bank, 966 F.2d 25.

ArrowPointe should not receive a magical gift. The equitable principles espoused in the Restatement (Third) of Property regarding Replacement Mortgages should be applied here in order to establish the priority of the Replacement Mortgage.

2. Common law principles in South Carolina support the doctrine of Replacement Mortgage.

The lower court, when issuing the Order, stated that "[t]he theory of replacement mortgage is espoused not in the case law or statutory law of South Carolina, but in the Restatement Third of Property." [Order at Page 5, ¶1, 1st Sentence]. The lower court went on to hold that US Bank's "argument is based on the Restatement and not existing precedent. The Restatement is not the law of South Carolina, and no appellate court has *yet* adopted the concept of replacement mortgages. Therefore, DLJ (now, U.S. Bank) cannot use this principal [sic] to claim priority over an earlier mortgage lien" [Order at Page 6, Section 1] (emphasis and parenthetical added). The lower court erred in its reasoning that South Carolina's common law cannot espouse Replacement Mortgage simply because it has never been ruled upon by our appellate courts.

As an initial matter, U.S. Bank contends that the lower court mistakenly focused on whether the South Carolina Supreme Court has adopted a cause of action or theory *entitled* "Replacement Mortgage." However, the Restatement's (or the common law's) current title for a parties' theory of recovery is irrelevant. "The facts alleged, not just the name of the cause of action used, should be examined in assessing whether a valid claim has been asserted." Gignilliat v. Gignilliat, Savitz & Bettis, L.L.P., 385 S.C. 452, 459-60, 684 S.E.2d 756, 760 (2009). South Carolina has long recognized that equity provides a lender, such as U.S. Bank, relief when it claims a right to subordinate another, such as ArrowPointe, after paying off a first position mortgage over

a lender who knowingly took a second position mortgage, and has otherwise done nothing to advance its priority. See United Carolina Bank v. Caroprop, Ltd., 316 S.C. 1, 4, 446 S.E.2d 415, 417 (1994) ("Finally, our holding imposes no injustice upon [the second mortgage holder], it having knowingly taken a *second* mortgage from [a co-tenant]. [The other co-tenant's] payment of the [first] mortgage in no way disadvantages [the second mortgage holder], which has done nothing to advance its priority."). Thus, although South Carolina courts have not explicitly entitled certain relief granted as "replacement mortgage", there is nothing to indicate that this Court would not recognize the theory of "replacement mortgage", now articulated in Restatement (Third) of Property (Mortgages) § 7.3 (1997).

Regarding South Carolina courts' adoption of the rationale provided by the Restatements, it is clear from prior decisions that South Carolina's common law is broader than simply the causes of action explicitly named in prior decisions. Indeed, South Carolina has previously recognized that its common law is often "rooted" in the Restatements. See, e.g., Johnson v. Robert E. Lee Acad., Inc., 401 S.C. 500, 504, 737 S.E.2d 512, 514 (Ct. App. 2012) ("The recognition of a voluntarily assumed duty in South Carolina jurisprudence is rooted in the Restatement of Torts . . .") (footnote omitted); see also, Kolstad v. Am. Dental Ass'n, 527 U.S. 526, 527, 119 S. Ct. 2118, 2121, 144 L. Ed. 2d 494 (1999) ("The Court's discussion of this question is informed by the general common law of agency, as codified in the Restatement (Second) of Agency . . .").

In fact, and as discussed above, the Supreme Court of South Carolina has specifically relied on provisions of the Restatement (Third) of Property in recent opinions in the context of mortgages, thereby using the same to articulate, clarify, and refine South Carolina's common law. See Matrix at 138, 714 S.E.2d at 534 (2011) (using the Restatement (Third) of Property (Mortgages) in support of the Court's decision). The Supreme Court's—and this Court's—reliance on the Restatement

appears in a variety of contexts. See Matthews v. Dennis, 365 S.C. 245, 249, 616 S.E.2d 437, 439 (Ct. App. 2005) (the Supreme Court citing to the Restatement (Third) Property to discuss the different types of implied easements); Howard v. Nasser, 364 S.C. 279, 288, 613 S.E.2d 64, 68 (Ct. App. 2005) (discussing the Restatement when seeking authority in support of the application of presumption to contested will cases); Goodwin v. Johnson, 357 S.C. 49, 55, 591 S.E.2d 34, 37 (Ct. App. 2003) (using the factors articulated by the Restatement for guidance in determining what to consider when establishing an easement by necessity).

Finally, in the event that this Court is persuaded that the principle now referred to as "replacement mortgage" is not currently a part of the common law of South Carolina, then this court should take the opportunity to recognize "replacement mortgage." The South Carolina Supreme Court has stated: "The common law changes when necessary to serve the needs of the people and we have not hesitated to act in the past when it has become apparent that the public policy of this State is offended by outdated rules of law." Marcum v. Bowden, 372 S.C. 452, 458, 643 S.E.2d 85, 88 (2007) (quoting Russo v. Sutton, 310 S.C. 200, 422 S.E.2d 750 (1992)). Similarly, "equity exists to correct mistakes and prevent windfalls." Wachovia Bank, N.A. v. Coffey, 404 S.C. 421, 427, 746 S.E.2d 35, 39 (2013) (Pleicones, J. dissenting); e.g. McNair v. Rainsford, 330 S.C. 332, 499 S.E.2d 488 (Ct. App. 1998) (unjust enrichment/constructive trust used to recover money from innocent third party where third party would be unjustly enriched by a windfall actually owed to plaintiff).

It would be an inequitable windfall for this Court to construe our common law to allow ArrowPointe, who knowingly took a second position mortgage, to become a senior lienholder through a technicality when Quicken refinanced its senior mortgage. "[S]uch crude application of the principles of the common law must yield to common sense." State v. Langford, 55 S.C. 322,

33 S.E. 370, 371 (1899). Allowing ArrowPointe to obtain a windfall and a first priority position under these circumstances is a result that must yield to common sense.

If the Court considers this case as the formal recognition of "replacement mortgage", this recognition is not "a break from precedent" and therefore should be given retroactive application because of the Court's long-standing practice of providing equitable relief to subrogate lenders who otherwise would obtain an inequitable windfall by advancing priority upon the payoff of a first priority lien. Miranda C. v. Nissan Motor Co., 402 S.C. 577, 588, 741 S.E.2d 34, 40 (Ct. App. 2013); see also Carolina Chloride, Inc. v. S.C. Dept. Trans., 391 S.C. 429, 433–34, 706 S.E.2d 501, 503 (2011) (finding judicial decision should be applied retroactively when it created no new right or cause of action; rather, it abandoned former test and restated the focus for what a landowner must prove to entitle him to damages in an inverse condemnation action); Osborne v. Adams, 346 S.C. 4, 12–13, 550 S.E.2d 319, 323–24 (2001) (finding retroactive application of case law clarifying which professional relationships created a non-delegable duty in common law negligence cases was appropriate because case law neither created a new cause of action nor abolished any existing immunities).

In sum, the courts of this State often look to the Restatement to establish and refine the common law of South Carolina. In the instant case, the trial court's failure to apply such guidance resulted in an error that should be reversed.

3. South Carolina's Circuit Courts have supported Replacement Mortgage Doctrine.

Recently, and in accord with the rationale described herein, the Master-in-Equity for Beaufort County, the Honorable Marvin H. Dukes, III, considered similar facts and legal arguments in a motion for summary judgment and found that the equitable principles of Replacement Mortgage should be applied to establish the priority of the replacement mortgage at

issue [Exhibit Z to Defendant DLJ Mortgage Capital Inc.'s Memorandum in Opposition to Plaintiff's Motion for Summary Judgment; CBC Nat. Bank v. Miller, 2015-CP-07-02081 (January 19, 2017 Order)]. While not controlling law, it appears that South Carolina's equity courts are willing to apply the equitable principles espoused in the Restatement regarding Replacement Mortgage.

c. SISTER JURISDICTIONS SUPPORT AND ESPOUSE THE DOCTRINE OF REPLACEMENT MORTGAGE.

Since the Restatement (Third's) publication in 1997, numerous jurisdictions have adopted Restatement (Third) of Property (Mortgages) § 7.3.

In Sovereign Bank v. Gillis, the Superior Court of New Jersey's Appellate Division adopts Restatement (Third) of Property (Mortgages) § 7.3 on Replacement and Modification in the context of a refinancer of its own loan to replace priority. 432 N.J. Super. at 39, 74 A.3d at 2. The court notes that there are certain equitable considerations to be taken into account when looking at the general propositions of a race-notice state, like New Jersey (and South Carolina). Id. at 43, 74 A.3d at 5. "An exception to the normal 'race-notice' determination of mortgage priorities can sometimes occur when a third-party advances money to pay off a mortgage." Id. at 44, 74 A.3d at 6. In adopting the Replacement Mortgage doctrine, the Sovereign Bank court takes the third-party analysis a step further by granting priority to a refinancer of its own loan under the principles of Replacement Mortgage. Id. at 46-48, 74 A.3d at 6-8. The court also opines that a replacement mortgagee's actual knowledge of the intervening lien is not detrimental to replacement priority so long as the intervening junior mortgagee is not materially prejudiced. Id. In the instant case, ArrowPointe and U.S. Bank agree that Quicken did not have actual knowledge of the Revolving Credit Mortgage when it recorded the Replacement Mortgage [Joint Stipulation 13]. In fact, ArrowPointe continued to believe that it was in junior lien position until a short sale was suggested

in July 2011, which led to its discovery that the Replacement Mortgage had replaced the Replaced Mortgage [Joint Stipulation 17 and Rule 30(b)(6) ArrowPointe Deposition of James R. Price, P. 48, Lines 20-23]. One of the stated purposes for the adoption of Replacement Mortgage theory was to avoid the junior mortgagee from "reap[ing] an undeserved windfall" by virtue of the senior mortgage being paid off by the new mortgagee. Sovereign Bank, 432 N.J. Super. at 51.

Appellate courts from Michigan and Arizona have also adopted Replacement Mortgage theory, and specifically § 7.3. See CitiMortgage, Inc. v. MERS, 295 Mich. App. 72, 77 (Mich. Ct. App. 2011) (holding ". . . because § 7.3 of the Restatement reflects the present law in Michigan, we hereby adopt it."); see also Markham Contracting Co., Inc. v. FDIC, 240 Ariz. 360, 379 P.3d 257 (Ariz. Ct. App. 2016); Brimet II, LLC v. Destiny Homes Marketing, LLC, 231 Ariz. App. 457, 460, 296 P.3d 993 (Ariz. Ct. App. 2013) (holding that "[w]hen the lenders are of the same identity, priorities are determined under replacement and not equitable subrogation."); BAC Home Loans Servicing, LP v. Semper Invs. L.L.C., 230 Ariz. 587, 277 P.3d 784 (Ariz. Ct. App. 2012).

Additionally, Illinois courts have espoused the principles of replacement mortgage for over 100 years.

> Indeed, the legal doctrine [the replacement mortgage party] invoked has existed in Illinois case law for over 100 years, and it is not limited to the third-party situation described by Union. In Shaver, the supreme court held that a lender's refinancing of a debt secured by a mortgage, coupled with a simultaneous release of the original mortgage held by the lender, did not disturb the previous priority of liens on the land, where an intervening lienor took his lien with knowledge of the original mortgage.
>
> UnionBank v. Thrall, 374 Ill. App. 3d 785, 790 (Ill. App. Ct. 2007).

The UnionBank court further stated that "[t]he authors of the Restatement (Third) of Property prefer the term 'replacement of senior mortgages' rather than 'conventional subrogation'. . ." and that, "[r]egardless of the label, however, it is clear that the doctrine remains valid under Illinois

law and that [the replacement mortgage party] properly raised it before the trial court." UnionBank, 374 Ill. App. 3d at 791.

Finally, Restatement § 7.3 has case citations from the following state and federal jurisdictions that apply the Restatement of Replacement Mortgage in determining the holdings of their decisions: California; Hawaii; Massachusetts; Missouri; New Hampshire; Connecticut; Florida; Kentucky; Nevada; Ohio; Oklahoma; Texas; Utah; Vermont; and Washington. Restatement (Third) of Property (Mortgages) § 7.3 (1997). U.S. Bank is unaware of a jurisdiction that has outright rejected Restatement (Third) of Property (Mortgages) § 7.3. In sum, the doctrine of Replacement Mortgage priority as provided in the Restatement is widely-recognized and favored in courts across the country.

II. THE LOWER COURT ERRED IN RULING THAT ARROWPOINTE SUFFERED MATERIAL PREJUDICE BY REPLACEMENT MORTGAGE WHEN ARROWPOINTE WAS ON RECORD NOTICE THAT THE AMOUNT SECURED BY QUICKEN'S MORTGAGE COULD INCREASE.

The Replacement Mortgage doctrine lists two exceptions: (1) material prejudice and (2) the replaced mortgage not being of record when the intervening lien is recorded. Restatement (Third) of Property (Mortgages) § 7.3 (a) (1997). The second exception is not at issue here because ArrowPoint agrees that the Replaced Mortgage was recorded at the time it recorded its Revolving Credit Mortgage and that it had the expectation of being in a junior lien position [Joint Stipulation 2 and 13].

As to the first exception concerning material prejudice, the Special Referee erroneously held that the "...language in the [Replaced] Mortgage would not allow DLJ to increase the balance secured by its [Replaced] Mortgage in a subsequent replacement mortgage [Order Page 6, Section 2]. Further, the Special Referee held that the increase in the principal owed in the Replaced

Mortgage of $256,550.00 to $296,000.00 in the Replaced Mortgage (a difference of $39,500.00) constituted material prejudice. The Restatement commentators and sister jurisdictions disagree.

The first exception of material prejudice requires analysis. The Replaced Mortgage, which irrefutably held priority, contained language that put ArrowPointe on notice that "This Security Instrument secures to Lender: (i) the repayment of the Loan, **and all renewals, extensions and modifications of the Note;...**" [Joint Stipulation Exhibit A, Third Page, Transfer of Rights in the Property Section] [emphasis added]. Under the Restatement §7.3, ArrowPointe should have tempered (and likely did) its lending decision by acknowledging that the amount secured by the senior mortgagee could increase. Essentially, ArrowPointe knew or should have known during its underwriting by virtue of the publicly recorded Replacement Mortgage that additional sums of money could be advanced by Quicken to the Baileys and given priority. While ArrowPointe argues that this unilateral ability between the senior mortgagee and its borrower is penal, the Restatement disagrees. If the original mortgage validly secures future loans or monetary advances in its recorded mortgage, then the intervening lienholder is on notice that the senior debt can increase and should temper its lending decisions accordingly. See Reporters' Note, cmt. d, Restatement (Third) of Property (Mortgages) § 7.3 (1997).

ArrowPointe makes a semantic argument that the Replacement Mortgage was not a "renewal, extension or modification". However, the Restatement aims to arrive at the equitably appropriate result. If the junior mortgagee had notice that future loans or monetary advances could be made in any fashion, the fact that it was a new loan is immaterial. A noteworthy treatise and case law support this theory on post-mortgage transactions affecting priority.

> As a general rule, entering satisfaction of a mortgage and taking a new one, when designated by the parties to be merely a continuation of the first mortgage and when the two acts are practically simultaneous or parts of the same transaction, is not an extinguishment of the mortgage but merely a

> renewal and does not give priority to an intervening judgment or mortgage creditor of the mortgagor, especially where it is done in good faith, in ignorance of the existence of the intervening lien, and without any intention to release the lien of the mortgage.

59 C.J.S. Section 320, Renewal or Substitution of Mortgages (emphasis added). The Corpus Juris Secundum commentators view the Quicken transaction as a mere renewal, which places it under the gambit of the language in the Replacement Mortgage, and certainly under the spirit of Restatement (Third) of Property (Mortgages) § 7.3. A New Jersey court has applied similar rationale: "This "new loan" was in effect a "modification" as well as a "renewal" ... the court finds that the proceeds of the (Replacement) mortgage were used to take the place of the original (replaced) mortgage, which was a superior lien by recordation and by agreement to plaintiff's mortgages." See UPS Capital Business Credit v. Abbey, 975 A.2d 548, 551 (N.J. Super. Ct. Ch. Div. 2009). The Restatement's Illustration 5 outlines a similar scenario regarding priority when language discussing additional amounts to be secured in the future is present in the replaced mortgage.[3]

"For purposes of equitable subrogation, prejudice is determined by evaluating the risk undertaken by the intervening lienholder *at the time it made the loan."* Markham Contracting, 379 P.3d 257, 261-62 (also holding that they are assigning the title "equitable subrogation" interchangeably with "replacement mortgage" for purposes of that opinion due to the similar

[3] Illustration 5: Mortgagor borrows $15,000 from Mortgagee-1 and gives Mortgagee-1 a promissory note for that amount secured by a mortgage on Blackacre. The mortgage states "this mortgage shall also secure all future loans or advances made by Mortgagee to Mortgagor." The obligation is due and payable in five years. The mortgage is immediately recorded. Two months later, Mortgagor borrowers $10,000 from Mortgagee-2 and gives Mortgagee-2 a promissory note for that amount secured by a mortgage on Blackacre. The latter mortgage is promptly recorded. A year later, Mortgagor and Mortgagee-1 agree to restructure their loan agreement. As a result of this agreement, Mortagee-1 lends an additional $20,000 to Mortgagor. Mortgagee-1 then releases its original mortgage of record and, a few days later, Mortgagor delivers to Mortgagee-1 a $35,000 promissory note secured by a mortgage on Blackacre. The latter mortgage obligation carries the same interest rate and the full $35,000 is due and payable five years thereafter. It does not secure future advances. The mortgage is promptly recorded. Mortgagee-1's $35,000 mortgage is senior to Mortgagee-2's.

analysis). Because ArrowPointe had notice at the time of its underwriting that the secured debt could increase, the Replacement Mortgage should be given full priority because the expectations of ArrowPointe did not change and it has not been materially prejudiced. For these reasons, U.S. Bank should be granted priority and any potential foreclosure sale of the Subject Property should be subject to the Replacement Mortgage.

III. THE LOWER COURT ERRED IN HOLDING THAT THE EXISTENCE OF SOME MATERIAL PREJUDICE NECESSARILY DEFEATS THE PRIORITY OF THE REPLACEMENT MORTGAGE AND CANNOT BE CURED BY A REDUCTION OF THE EXTENT OF THE REPLACEMENT MORTGAGE'S LIEN PRIORITY.

In the alternative that this Court disagrees with the Second Argument, *supra*, and holds that ArrowPointe did suffer material prejudice even in light of the language in the Replaced Mortgage that allows amounts secured by the replacing party to increase, then further analysis is required to determine the extent of the prejudice. The Special Referee's holding that any ounce of material prejudice is fatal to U.S. Bank's replacement mortgage position is erroneous and inconsistent with the law and the Restatement (Third) of Property (Mortgages) § 7.3(a). The Special Referee incorrectly held "I have considered whether South Carolina courts would interpret the Replacement Mortgage to hold priority over the (Revolving) Credit Mortgage, but only to the extent of the debt secured by the Replaced Mortgage. I believe and hold that South Carolina courts would reject this interpretation and, rather, would hold that *any material prejudice is fatal to Replacement Mortgage*" [Order 6, § 3 (emphasis added)]. Further, the holdings in the final paragraph of the Order on Page 6 that follows onto Page 7 represent an incomplete and incorrect interpretation of the Restatement (Third) of Property (Mortgages) § 7.3(a).

Under the Restatement, the extent of the prejudice affects the priority determination. First, as to the principal amount due, there is an increase of $39,500.00 from the Replaced Mortgage to

the Replacement Mortgage. As to the increased time of maturity[4], it is an inconsequential, immaterial month (November 1, 2039 in the Replaced Mortgage and December 1, 2039 in the Replacement Mortgage), which was not raised as an issue of prejudice by ArrowPointe in the lower court. Finally, ArrowPointe did not raise interest as a prejudicial element in the lower court, and for good reason. Neither the Replaced Mortgage nor the Replacement Mortgage stated an interest rate on its face, and ArrowPointe decided to move forward with its junior Revolving Credit Mortgage without any regard for the interest in the Replaced Mortgage. The face of the documents clearly show that the Replaced Mortgage interest was an adjustable rate, which put ArrowPointe on further notice that Quicken's secured debt could increase, and that the Replacement Mortgage had a fixed interest rate [Exhibit A, Page 2, §H and Exhibit L, Page 2, §H of Joint Stipulation]. The Replacement Note shows a fixed interest rate of 4.875% [Exhibit J, Page 1, §2 of Joint Stipulation].[5] Given ArrowPointe's disregard for Quicken's interest rate in its underwriting of the Revolving Credit Agreement transaction, U.S. Bank believes an application of the 4.875% interest rate affords an equitable result. Finally, ArrowPointe did not challenge U.S. Bank's right to collect unpaid late fees, escrow advances and attorney's fees as ruled upon and awarded in the Order. See also [Exhibits V, AA and BB from the March 13, 2017 Hearing Transcript].

U.S. Bank's debt on the Replacement Note secured by the Replacement Mortgage was $436,609.23 as of March 13, 2017 with amounts of the debt continuing to accrue as stated in the Order ("U.S. Bank's Total Debt") [Order at ¶9 and Joint Stipulation 27 and Exhibit V to the Joint

---

[4] "The drafters suggest that a mere extension of time resulting from the refinancing is generally not regarded as seriously prejudicial to holders of intervening interest. *Third Restatement 7.6* cmt. e. In fact, such an extension of time on the senior loan is often advantageous to junior lien creditors because the extension can forestall what otherwise would be a foreclosure on the senior debt that would extinguish the junior lien." Sovereign Bank, 74 A.3d 1, 7. Here, the month is practically inconsequential due to the fact that both loans are in foreclosure in the underlying matter.

[5] BAC Home Loans, provides strong analysis on why a move from an adjustable interest rate to a fixed interest rate (a modest rate of 4.875% in the Bailey's case) is typically a favorable position for intervening parties such as ArrowPointe, and not materially prejudicial. 230 Ariz. 587, 277 P.3d 784 (Ariz. Ct. App. 2012).

Stipulation of Facts]. U.S. Bank's Total Debt includes $289,175.07 in principal due and $81,550.23 in interest from June 1, 2011 through March 13, 2017 at 4.875%. Id. If this Court finds that ArrowPointe suffered material prejudice, which U.S. Bank denies, then it should remand the matter to the Special Referee to adjust the Replacement Note principal down to $256,500.00 (amount of principal in the Replaced Note) and make a new determination of Principal and Interest (applied at 4.875%) by adjusting for payments from the inception of the loan as if the original principal amount was $256,500.00. The Special Referee could then reduce U.S. Bank's Total Debt by the new Principal and Interest Amount that was calculated ("Adjusted U.S. Bank Total Debt"). ArrowPointe would be entitled to any surplus sale proceeds in excess of the Adjusted U.S. Bank Total Debt, and U.S. Bank would be entitled to the balance between U.S. Bank's Total Debt and the Adjusted U.S. Bank Total Debt in the unlikely event that there are additional surplus proceeds in excess of ArrowPointe's Debt as reflected in the Order. Under this alternative argument, such a determination affords an equitable result to both U.S. Bank and ArrowPointe as shown in Comment B, Illustration 2[6] of the Restatement (Third) of Property (Mortgages) § 7.3 (a).

In Paragraph 20 of Exhibit A to ArrowPointe's Memorandum in Support of its Motion for Summary Judgment, ArrowPointe's Vice President admits that the extent of its prejudice is $38,540.96. This amount reflects the difference between the principal amount of the Replacement

[6] **Illustration 1, with the caveat of Illustration 2, below**: Mortgagor borrows $50,000 from Mortgafee-1 and gives Mortgagee-1 a promissory note for that amount secured by a mortgage on Blackacre. The mortgage obligation carries a fixed rate of interest and is to be amortized by fixed payments over 15 years. The mortgage is immediately recorded. Thereafter, Mortgage borrows $10,000 from Mortgagee-2 and gives Mortgagee-2 a promissory note for that amount secured by a mortgage on Blackacre. The latter mortgage is promptly recorded. Two years later, when the balance on Mortgagee-1's mortgage is $49,000, Mortgagor and Mortagee-1 agree to a replacement mortgage. Mortgagee-1 releases its original mortgage of record and Mortgagor delivers to Mortgagee-1 a new promissory note for $49,000 secured by a mortgage on Blackacre. The mortgage obligation carries the same fixed rate of interest as its predecessor and is evenly amortized over 20 years. A few days later, Mortgagee-1 records the replacement mortgage. The latter mortgage is senior to Mortgagee-2's mortgage. **Illustration 2:** The facts are the same as Illustration 1, except that the replacement mortgage delivered to Mortgagee-1 secures a $60,000 obligation. Mortgagee-1's replacement mortgage is senior to Mortgagee-2's mortgage except to the extent of $11,000 and accruing interest thereon.

Mortgage and the payoff of the Replaced Mortgage [Exhibit P, Line 1501 of Joint Stipulation]. ($296,000 - $257,459.04 = $38,540.96). Relevantly, Mr. Price quantifies the extent of his perceived, alleged damages from the Replacement Mortgage transaction: "The refinance damaged the Credit Union's equity position by $38,540.96." See Exhibit A to ArrowPointe's Memorandum in Support of Plaintiff's Motion for Summary Judgment, Para. 20. Under no circumstance could ArrowPointe argue that it was damaged to an extent greater than $38,540.96 under the Restatement analysis, which would minimally grant U.S. Bank priority up to $257,459.04 in the alternative to the Adjusted U.S. Bank Total Debt analysis.

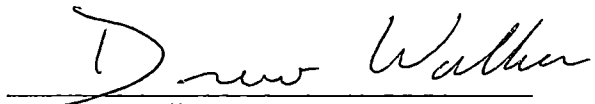
For the reasons stated above, the Special Referee erred when she ruled that any material prejudice is fatal to the priority of replacement mortgages. In the alternative that this Court believes ArrowPointe suffered material prejudice, which U.S. Bank denies for the reasons stated in the Second Argument, then this matter should be remanded for a determination of the Adjusted U.S. Bank Total Debt.

CONCLUSION

ArrowPointe should not receive a magical gift. The equitable principles espoused in the Restatement (Third) of Property regarding Replacement Mortgages should be applied here in order to establish the priority of the Replacement Mortgage.

This Court should reverse the findings made by the lower court and establish that South Carolina courts have adopted the doctrine of replacement mortgage, applying such decision retroactively, and should further find that ArrowPointe suffered no material prejudice by the Replacement Mortgage. In the alternative, this matter should be remanded to determine the Adjusted U.S. Bank Total Debt.

Respectfully Submitted,



Drew B. Walker (SC Bar No. 78271)
Shaun C. Blake
Rogers Lewis Jackson Mann & Quinn, LLC
PO Box 11803
Columbia, SC 29211
P: 803-256-1268
F: 803-252-3653

Sean Foerster, Esq.
Rogers Townsend & Thomas, PC
PO Box 100200
Columbia, SC 29202
Phone: 803-744-1855

Attorneys for Appellant

April 18, 2018

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM FAIRFIELD COUNTY
Court of Common Pleas

Carol A. Tolen, Special Referee
Trial Court Case No. 2012-CP-20-00132

Appellate Case No. 2018-000230

ArrowPointe Federal Credit Union, Plaintiff,

v.

Jimmy Eugene Bailey; Laura Jean Bailey; and U.S. Bank National Association not in its individual capacity but solely in its capacity as Indenture Trustee for WVUE 2015-1, Defendants,

Of Whom U.S. Bank National Association not in its individual capacity but solely in its capacity as Indenture Trustee for WVUE 2015-1 is the Appellant,

and Of Whom ArrowPointe Federal Credit Union is the Respondent.

CERTIFICATE OF SERVICE

I certify that I have served a copy of *Initial Brief of Appellant* by depositing a copy of the same in United States Mail, postage prepaid, on April 18, 2018, to Appellants' Attorney of record, listed herein:

Christy C. Jones, Esq.
Sherpy & Jones, P.A.
PO Box 2599
Lexington, SC 29071
Attorney for Respondent

Christopher L. Boguski, Esq.
Rogers Lewis Jackson Mann & Quinn, LLC

April 18, 2018

ROGERS LEWIS

ATTORNEYS AT LAW

Drew B. Walker, Esq.
dwalker@rogerslewis.com

April 17, 2018

Via Hand-Delivery to:
Honorable Jenny Abbott Kitchings
Clerk, South Carolina Court of Appeals
1220 Senate Street
Columbia, SC 29201

RE: Arrowpointe Federal Credit Union v. Jimmy Eugene Bailey, et al.
Case No. 2018-000230

Dear Ms. Kitchings:

Enclosed please find and original and one copy of the Initial Brief of Appellant and Designation of Matter for filing in the above referenced matter.

Should you have any questions, please contact my office.

Sincerely,

Drew B. Walker

DBW/pdb

Enclosure(s)

cc: Christy C. Jones, Esq.
Sean Foerster, Esq.