THE STATE OF SOUTH CAROLINA

IN THE SOUTH CAROLINA COURT OF APPEALS

APPEAL FROM HORRY COUNTY

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

vs.

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 Appellants.

Appellate Case No.: 2013-001483

The Honorable W. Jeffrey Young
Horry County
Trial Court Case No.: 2010CP2603170

FINAL BRIEF OF APPELLANTS

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STATEMENT OF ISSUES ON APPEAL

1. WHETHER THE COURT ERRED IN FINDING THAT THE GUARANTIES APPLIED TO THE SECOND AND THIRD LOAN TRANSACTIONS.

2. WHETHER THE COURT ERRED IN FINDING THAT THE BANKS' ACTIONS DID NOT RELEASE THE GUARANTORS.

3. WHETHER THE COURT ERRED IN FINDING THAT THE CASE WAS PROSECUTED BY A PROPER PARTY.

STATEMENT OF THE CASE

Respondent filed this action seeking to collect payment on personal guaranties signed by Appellants and co-defendants. [R.p. 8-44]. Appellants answered denying Respondent's claims and asserting numerous affirmative defenses. [R.p. 45-61]. Respondent filed two (2) motions for summary judgment, both of which were denied by the trial court. A trial was conducted on May 20, 2013, and by Order filed June 28, 2013, the trial court ruled in favor of Respondent and entered judgment against Appellants and the co-defendants in the amount of $358,166.76. [R.p.2-7]. This appeal follows.

FACTS

Neither the original lender nor the Respondent/Plaintiff claim ownership of the note(s) and guaranties which are the subject of this case. Instead, Respondent asserts that Chase Bank, N.A. ("Chase Bank"), which is not a party to this case, is the owner and holder of the note(s) and guaranties. Moreover, Appellants claim that they have paid $100,000.00 to the bank(s) to be released from their guaranties, which was received by and was a benefit to the bank(s), and that they have already paid more than their share of the alleged debt.

First Loan Transaction

The original lender, Carolina National Bank and Trust Company ("CNB"), loaned $400,000.00 to Sand Dollar Cottage, LLC (the "Company"), as evidenced by a promissory note dated November 8, 2006 ("Original Sand Dollar Note").[R.p.210]. Although the purpose of the loan was to 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 Appellants and the co-defendants. [R.p.216-229].

By its own terms the Original Sand Dollar Note matured, and the principal loan amount was due in full, on November 8, 2007. [R.p. 210]. The maturity date expired without any principal payment by the Company, and by its own terms 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]. CNB labeled this transaction a "renewal" with the same loan number; however, the Original Sand Dollar Note was already in default and had expired, and the Second Note reflects that 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.]. At this time, CNB failed to obtain new written guaranties from the Company's members.

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]. Shortly thereafter, the Second Note matured, and the principal loan amount was due in full, on March 21, 2008. [R.p. 212-213]. The maturity date expired without any principal payment by the Company, and by its own terms, the Second Sand Dollar Note went into default. [R.p.125, line 19 – p. 126, line1-10; p. 212-213].

Payments by Appellants

After the Second Note matured and went into default, Respondent informed the Company that it would enter into a third loan transaction only upon the borrower's payment of $100,000.00. [R.p. 139, lines 18-24; p. 159, lines 2- p. 160, line 2; p. 175, line 7-24]. Appellant Walls testified that the Respondent's bank officer told him that if he and Appellant Pennisi paid $100,000.00, 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, Appellant 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, Appellants paid that sum of money 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]. Appellants testified that 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 Appellants' payment of $100,000.00 and there is no dispute that Appellants 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, the Appellants 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, Appellant's guaranties were not released or terminated in writing by the Respondent.

Third Loan Transaction

After Appellants agreed to pay $100,000.00 toward the Second Note balance, and Respondent accepted their money, the Company entered into a third loan transaction with Respondent on April 30, 2008 ("Third Note"). [R.p. 214-215]. Respondent again labeled this transaction a "renewal" with the same loan number even though the Second Note was in default and had already expired. Moreover, the Third Note reflects that the Company received a single advance of $300,000.00 on April 30, 2008. [Id]. The repayment terms changed again, and this time the interest rate was changed, the loan amount was changed, the payment schedule was

changed, and the maturity date was extended to May 3, 2011 [Id]. As with the Second Note, 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 provides 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].

STANDARD OF REVIEW

An action for breach of contract is an action at law." Electro Lab of Aiken, Inc. v. Sharp Constr. Co. of Sumter, Inc., 357 S.C. 363, 367, 593 S.E.2d 170, 172 (Ct.App.2004). "In an action at law, on appeal of a case tried without a jury, the appellate court's standard of review extends only to the correction of errors of law." Id. "The trial judge's findings of fact will not be disturbed upon appeal unless found to be without evidence which reasonably supports the judge's findings." Id.

ARGUMENT

1. THE COURT ERRED IN FINDING THAT THE GUARANTIES APPLIED TO THE SECOND AND THIRD LOAN TRANSACTIONS.

Appellants do not dispute that their guaranties applied to the Original Sand Dollar Note. However, the bank(s) failed to obtain new guaranties upon entering into the Second and Third Notes, and therefore Appellants' guaranty obligations terminated.

Each subsequent transaction had the effect of a brand new transaction; each was a novation of, and a substitution to, the prior transaction. The Supreme Court has stated as follows:

> "A novation may be broadly defined as a substitution of a new obligation for an old one, which is thereby extinguished. More specifically, novation is the substitution *by mutual agreement*, of one debtor, or one creditor, for another, whereby the old debt is extinguished, or the substitution of a new debt, or obligation for an existing one, which is thereby extinguished. It is a mode of extinguishing one obligation by another; the substitution, *not of a new paper, or note, but of a new obligation* in lieu of an old one-the effect of which is to pay, dissolve, or otherwise discharge it." 46 C. J. pp. 573, 574.
>
> "Novation exists only by reason *of an agreement and in the absence of such an agreement there can be no novation of the character now under consideration.* Hence, in order to effect a novation by the substitution of a new obligation between the same parties *there must appear the consent of both contracting parties* that the new agreement is to have this effect. *The sole intention of the obligor that the existing contract should be discharged by the new agreement is not sufficient; the creditor must concur in this.*" Ibid.
>
> The novation of a contract is thus defined in 20 R. C. L. 360, quoted with approval in Smith Bros. Grain Co. v. Adluh Milling Company, 128 S. C. 434, 122 S. E. 868: "A mutual agreement between all parties concerned for a discharge of a valid existing obligation by the substitution of a new valid obligation on the part of the debtor." 20 R. C. L. 363; 29 Cyc. 1130."
>
> Greenwood Cotton Mill v. Pace, 172 S.C. 531, 174 S.E. 473 (1934)(italics in original).

The trial court erred in finding that the Second and Third Loan Transactions were mere extensions, renewals or replacements. To the contrary, the evidence shows that each said transaction unambiguously extinguished the prior obligations with new obligations.

In this regard, the First Note shows that the Company received a single advance in the amount of $400,000.00 on November 8, 2006. Conversely, the Second Note states that the Company received a single advance in the same amount on December 21, 2007. The Second Note by its own terms shows the bank documented the transaction as a new advance and therefore a new Company obligation.[1] This is supported by the fact that the First Note had

[1] Appellants do not contend that the Company received a total of $800,000 as a result of the first two loan transactions. Instead, the new advances acted as a credit toward or discharge of the old obligations and/or otherwise expressly creating the new obligations set forth in each subsequent loan transaction.

already expired by its own terms and was in default. Moreover, the Second Note additionally changes the Company's obligations with regard to the interest rate and maturity date.

Similarly, the Third Note states that the Company received a single advance in the principal sum of $300,000.00 on April 30, 2008. Again, the Third Note by its own terms shows this is a new advance and therefore a new Company obligation.[2] Likewise, the new advance is supported by the fact that the Second Note had already expired by its own terms and was in default. The Third Note also reflects that Respondent is the Lender rather than CNB (thus showing a new entity issued the single advance on April 39, 2008) and further changes the Company's obligations with regard to the interest rate and maturity date. Finally, importantly, the Third Note was conditioned upon payment of $100,000.00, which was paid by Appellants and shows that the Third Note was truly a new transaction undertaken by Respondent only upon additional and new obligations that did not before exist.

Of note, the Guaranties given to CNB in 2006 pertain to "Note Number 400378400 dated 11/08/2006 and any extensions renewals or replacements thereof." As discussed above, the Second and Third Notes were more than simple extensions, renewals or replacements of the First Note, as new advances were made and new obligations were created in each transaction rather than mere maintenance and uninterrupted continuity of the original obligations to CNB. Indeed, Respondent sued Appellants claiming a debt due and obligations arising under the Third Note, not for obligations arising from the First Note (because those obligations ceased to exist with

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[2] Appellants do not contend that the Company received a total of $1,100,000.00 over a series of three (3) loan transactions. Instead, the new advances acted as a credit toward or discharge of the old obligations and/or otherwise expressly creating the new obligations set forth in each subsequent loan transaction.

new advances and a payment of $100,000.00 by Appellants, and were thus substituted by the new terms contained in the Second and Third Notes).[3]

Because the Second and Third Notes created new obligations and were therefore new or substituted contracts, and because the lenders failed to obtain new guaranties upon each new contract, the Trial Court's decision should be reversed.

2. THE COURT ERRED IN FINDING THAT THE BANKS' ACTIONS DID NOT RELEASE THE GUARANTORS.

Guarantors can be discharged from their obligations on negotiable instruments under certain circumstances pursuant to S.C. Code 36-3-605. However, the guarantors in this case 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*

[3] Respondent's classification of the series of loan transactions as a mere "renewals" of an original, single loan obligation ignores its own documents showing new advances and the new loan obligations imposed by the lenders. "The court of equity looks through the form to the substance, takes into account all the circumstances, and from all the facts determines the nature of the transaction and the rights of the parties." *Livingstain v. Coumbia Banking & Trust Co.*, 81 S.C. 244 (1908).

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 Transaction extended the time for performance by Sand Dollar, LLC. On the Third Note, the bank conditioned the extension 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. Substituted Contract.

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 in the above Argument, 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, Appellants 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 Plaintiff, 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 Appellants, their obligations as guarantors should be discharged.

Appellants obligations as guarantors should be discharged as set forth above, and the Trial Court's decision should be reversed.

3. THE COURT ERRED IN FINDING THAT THE CASE WAS PROSECUTED BY A PROPER PARTY.

During the pendency of the case, Respondent assigned the loan documents to Capital Bank. The Court found "that Capital Bank, N.A. is the owner of the Note, as renewed, and the Guaranty Agreements, and is entitled to enforce those obligations."

a. Respondent Failed to Prove that Capital Bank is the Owner of the Note and Guaranty Agreements.

In *Citizens Bank of Darlington v. McDonald*, 202 S.C. 244 (1943) the plaintiff's burden of proof is explained:

> "And in 11 C.J.S., Bills and Notes, § 659 subsec. b, page 92, we find: "If the ownership of the instruments on which plaintiff brings his action is properly put in issue, the burden of establishing ownership is on plaintiff, *** and this burden rests on him throughout the case. Accordingly, *** it is generally held that the burden of proving such matters is on plaintiff where by proper pleading, as by a plea of want of ownership, or the like, defendant puts in issue the indorsement, assignment, or delivery to plaintiff."

When Respondent failed and was put into FDIC receivership, its assets were subject to the terms and conditions of the receivership. In this case, only those loans held by Respondent pursuant to the Purchase and Assumption Agreement dated July 16, 2010 could be sold or transferred to NAFH. However, at trial, Respondent failed to produce the Purchase and Assumption Agreement. By failing to produce that Agreement, there is no evidence that the Sand Dollar loans were held by Respondent pursuant to that Agreement and therefore the court erred in finding that Respondent proved that Capital One is the owner of the loan documents.

Moreover, the Attorney in Fact for the FDIC failed to prepare an allonge to the notes and failed to endorse the Sand Dollar notes as required by the Limited Power of Attorney. Therefore, the transfer of the loan documents exceeded the express provisions of the Limited Power of

Attorney and the court erred in finding that Respondent proved that Capital One is the owner of the loan documents.

b. Respondent Failed to Prove that it is the Proper Party Pursuant to Rule 25(c), SCRCP.

The Trial Court erred in finding that Respondent was the proper party to prosecute the case under Rule 25(c) on behalf of Capital Bank because the entities are not, and have never been, related by merger or similar transfer of corporate ownership.

Of course, every civil action must be prosecuted in the name of the real party in interest. Rule 17(c), SCRCP. In this case, Respondent does not assert that it is the real party in interest, but instead seeks to prosecute this case based Rule 25, SCRCP.

Appellants submit that Rule 25 applies when the original party ceases to exist and all of its rights and liabilities vest in a successor entity. Rule 25(c) provides: "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."

"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). This is consistent with the remainder of the Rule, in that substitution is proper when the original party has ceased to exist or becomes incompetent and another party becomes its successor. In this case, Respondent did not merge with NAFH nor Capital Bank. Neither NAFH nor Capital Bank is the successor to Respondent. Instead, Respondent purported to sell the loan documents while in FDIC receivership. Therefore, Rule 25(c) is inapplicable and the court erred in its conclusion that Capital Bank owns the loans but Respondent is the proper party to bring this case.

CONCLUSION

For the above reasons, the trial court erred and its decision should be reversed.

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CERTIFICATE OF COUNSEL

The undersigned certify that this Final Brief complies with Rule 211(b), SCACR.

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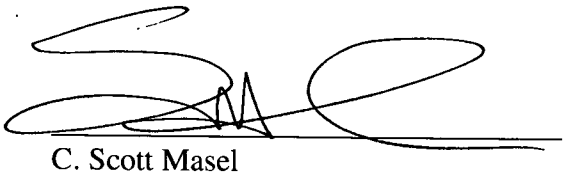

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