THE STATE OF SOUTH CAROLINA

In The Court of Appeals

APPEAL FROM FAIRFIELD COUNTY

Court of Common Pleas

Carol A. Tolen, Special Referee

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SC Court of Appeals

Case No. 2012-CP-20-00132

Appellate Case No. 2018-000230

Arrowpointe Federal Credit Union, Respondent,

v.

Jimmy Eugene Bailey; Larua 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

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PETITION FOR REHEARING

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PETITION FOR REHEARING & MEMORANDUM IN SUPPORT

Per Rule 221(a), Appellant asks the Court for a rehearing. Rule 221(a), SCACR. A Petition for Rehearing shall be in accordance with Rule 240. Id. Therefore, a Petition for Rehearing shall be written, state the grounds for the petition, and comply with Rule 267. See Rule 240(c), SCACR. All petitions shall have a certificate of service and a memorandum with citations of authority. See Rule 240(c)(1)-(2), SCACR.

"The purpose of [] a petition is to aid the court in deciding correctly a case heard by it." Arnold v. Carolina Power & Light Co., 168 S.C. 163, 167 S.E. 234, 238 (1933). It would be improper to, and Appellant does not, submit this petition to have the case tried in this court a second time. Id. To prevail on this petition for rehearing, Appellant must demonstrate how the Court overlooked or misapprehended its argument. Kennedy v. S.C. Ret. Sys., 349 S.C. 531, 532, 564 S.E.2d 322, 322 (2001).

Appellant believes the Court overlooked or misapprehended five foundational points to Appellant's argument. First, South Carolina's definition of equitable subrogation prompts the need for an equitable remedy that applies to scenarios wherein equitable subrogation is unavailable. "Equitable subrogation is simply not a remedy available to a lender that refinances the original debt owed to it." Matrix Financial Serv. Corp. v. Frazier, 394 S.C. 134, 138 714 S.E.2d 532, 534 (2011). "Equity owes its birth to the desire to look beneath the rigid rules of the law–to seek substantial justice." State ex rel. Daniel v. Strong, 185 S.C. 27, 192 S.E. 671, 681 (1937). South Carolina courts recognize the doctrine of equitable subrogation in the context of a third-party refinancer when the third-party has constructive notice but not actual notice of an intervening lien. Matrix Financial Serv. Corp. v. Frazier, 394 S.C. 134, 137-38 714 S.E.2d 532, 533-34. Yet, the Court here denies lien priority to a first-party refinancer that had constructive notice, but not actual

notice, of Respondent's intervening lien. Arrowpointe Federal Credit Union v. Jimmy Eugene Bailey, Op. No. 5784 (S.C. Ct. App. filed Nov. 25, 2020) (Shearouse Adv. Sh. No. 46 at 8) (Quicken did not have actual notice). The Court does so without distinguishing why a first-party refinancer (Appellant "replacing" its own mortgage) should be dealt with more harshly than a third-party refinancer who can subrogate to its predecessor's lien priority position. Id. at 16 ("Because [1] Appellant had constructive notice and [2] under our race-notice statute [Respondent] has priority, we agree with [Respondent] that this matter is for our legislature."). Further, the Court's opinion did not analyze Enterprise Bank v. Fed. Land Bank, cited by the undersigned at oral argument, whereby our Supreme Court gave priority to a first-party refinancer over an intervening second mortgage lien. 139 S.C. 397, 138 S.E. 146 (1927); see also James v. Martin, 150 S.C. 75, 147 S.E. 752 (1929); see also Matrix, 394 S.C. 134, 141-42, 714 S.E.2d 532, 536 (Pleicones, J., dissenting). It is not clear why constructive notice is fatal to a first-party refinance (Replacement Mortgage), but not to a third-party refinance (Equitable Subrogation).

Second, the definitions of replacement and modification were muddled by Respondent, which in turn jumbled the distinctions between equitable subrogation, replacement, and modification. This confusion resulted in the Court misapprehending Respondent's slippery use of these concepts and overvaluing Respondent's rejoinders.

The Supreme Court of New Jersey made clear that the Third Restatement of Property (Mortgages) provides frameworks for assessing priority problems involving a "replacement" mortgage and priority problems involving a mortgage "modification". The term "replacement" refers to a refinance, which describes a satisfaction of the original loan and the replacement of that original loan with a new loan, all of which is part of the same transaction. Sovereign Bank v. Gillis, 432 N.J. Super. 36, 50, 74 A.3d 1, 9 (App. Div. 2013) (citing Third Restatement of Property

(Mortgages) §7.3(a)). The term "modification" refers to an amendment to the terms of the original loan rather than the scenario that accompanies a refinance. Id., 432 N.J. Super. 36, 51, 74 A.3d 1, 9 (citing Third Restatement of Property (Mortgages) § 7.3(b) and (c)). The case of Sovereign Bank v. Gillis was cited in a subsequent decision, wherein the Supreme Court of New Jersey underlined the fact that the two terms refer to two different principles: "In Gillis, we relied on principles of 'replacement' and 'modification' that are technically distinguishable from the traditional application of equitable subrogation." Ocwen Loan Servs., LLC v. Quinn, 450 N.J. Super. 393, 399, 163 A.3d 349, 352 (App. Div. 2016). An appellate court in Arizona has also endeavored to make this distinction clear.

> The practical differences between the two [principles and loans] are as follows: replacement occurs when a lender releases its original lien of record, discharging it with the proceeds of the second loan secured by a new mortgage that is recorded either immediately or shortly after releasing the initial loan as part of the same replacement loan transaction. Restatement § 7.3 cmt. a; Grant S. Nelson & Dale A. Whitman, *Real Estate Transfer, Finance, and Development,* 835–36 (7th ed. 2006). In contrast, modification occurs when the senior lienholder and the debtor agree to modify the terms of the senior mortgage or the obligation it secures. The original mortgage remains of record and the modifications are reflected in an amendment agreement that also is recorded. Restatement § 7.3 cmt. b; Nelson & Whitman, *supra,* at 837.

Cont'l Lighting & Contracting, Inc. v. Premier Grading & Utilities, LLC, 227 Ariz. 382, 387 n. 3, 258 P.3d 200, 205 n. 3 (Ct. App. 2011), as corrected (June 1, 2011).

Despite what is above, Respondent suggests that "replacement mortgage theory should only be used with regard to true loan modifications". Respondent's Brief, p. 11. This suggestion demonstrates Respondent's failure to distinguish the principles of "replacement" from "modification". The Matrix Court refers to, and the principles of Section 7.3 of the Third Restatement of Property (Mortgages) apply to, two distinct loan scenarios. Matrix 134 at 138, 714

S.E.2d 532, 534 (citing § 7.6 of the Restatement in support of its definition of equitable subrogation and indicating that § 7.3 of the Restatement applies to the distinct concepts of replacement and modification). Respondent also sought to undermine Appellant's citation of Sovereign Bank v. Gillis by pointing out that New Jersey has a statute that addresses the priority of mortgage modifications. Respondent's Brief, pp. 14-15. But the Gillis Court did not rely on, or even mention, this statute when it adopted "replacement" mortgage. And Respondent does not seem to realize that the loan under consideration in Gillis was a refinance, not a modification. Sovereign Bank v. Gillis, 432 N.J. Super. 36, 40, 74 A.3d 1, 3.

The misunderstanding that Respondent created led the Court to conflate equitable subrogation with replacement mortgage and mortgage modification. The conflation is shown by the Court's reliance on: (1) a University of Baltimore law review article and (2) the aforementioned New Jersey statute dealing with modifications, which this Court cites immediately following its once sentence holding rejecting replacement mortgage. The Court looked to this law review article for guidance about the Restatement's replacement mortgage doctrine, but the article attacked the Restatement's approach to equitable subrogation and a wholly distinguishable (junior lienholder not allowed to litigate priority issues prior to foreclosure sale) Maryland case concerning equitable subrogation, General Electric Capital Mortgage Services, Inc. v. Levenson, 338 Md. 227, 657 A.2d 1170 (MD. 1995); Gregg H. Mosson, Equitable Subrogation in Maryland Mortgages and the Restatement of Property: A Historical Analysis for Contemporary Solutions., 41 U. Balt. L. Rev. 709, 733 n. 13 (2012) (citing Restatement (Third) of Prop.: Mortgs. § 7.6(a) (1997)).

The scholarly—though inapt—law review article brings us to the third point overlooked or misapprehended by the Court. The Court states that "replacement mortgage is an equitable doctrine". Arrowpointe, supra, (Shearouse Adv. Sh. No. 46 at 16). Appellant agrees. But the Court

then suggests that the Restatement's rationale and approach is "without equity" when it cites such language from the Mosson law review article. Id. (citation omitted). These inconsistent sentences suggest the Court was swayed by the article's indication that the Restatement's approach is "without equity" and therefore is unjust. See Mosson, Equitable Subrogation in Maryland, 41 U. Balt. L. Rev. 709, 715 ("Equity is a 'positive jurisprudence' of 'important principles' founded upon 'eternal verities of right and justice.'") (footnote omitted). This idea that the Restatement's approach is "unjust" probably tainted the Court's view of replacement mortgage.

Appellant will demonstrate that the Restatement's replacement mortgage doctrine is not unjust. Although Appellant does not waive its arguments concerning the fact that Respondent was on notice that the amount secured by Appellant's replaced mortgage could increase, Appellant's Brief, pp. 18-21, Appellant will offer its Argument concerning the extent of priority to demonstrate the justice of the Restatement's approach. Id., pp. 21-25. In this case, the replaced mortgage secured a note in the principal amount of $256,500. Appellant's Brief, p. 5. The replacement mortgage secured a note in the principal amount of $296,000. Id., p. 6. At the time of the replacement mortgage, $257,459.04 remained on the replaced mortgage and was paid off by the Appellant's replacement mortgage loan proceeds. Id. Section 7.3 indicates that "an increase in the principal amount will prejudice the holders of junior interests...[because] [u]nless the original mortgage validly secures future advances...it would be *unfair* to subordinate the intervening lienor to a replacement mortgage balance that it would have no reason to anticipate." Third Restatement of Property (Mortgages) §7.3(Comment b.) (emphasis added).[1] As Illustration 2 makes clear,

[1] "This result is consistent with the treatment afforded an intervening lienor under Subsection (b) of this section, where the principal amount of a senior mortgage obligation is increased by modification rather than as part of a replacement transaction." Third Restatement of Property (Mortgages) §7.3(Comment b.).

however, Appellant's replacement mortgage retains priority up to the amount of the difference between the principal amount of the replacement mortgage and the amount remaining on the principal of the replaced mortgage, plus interest accruing thereon. Third Restatement of Property (Mortgages) §7.3 (Comment b.) (Illustration 2). The difference in this case amounts to $296,000 minus $257,459.04, totaling $38,540.96. Therefore, Appellant's replacement mortgage, at a minimum, is senior to Respondent's mortgage in the amount of $257,459.04 (loan proceeds actually funded by Appellant), and Respondent is entitled to priority of the next $38,540.96 and interest accruing thereon. Id.

This result is consistent with the aim of the Restatement, which is to resolve priority 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." Id. (Comment a.) (emphasis added). Respondent cannot claim to have legitimately expected to gain priority over the amount of the replaced mortgage. Respondent intended its mortgage to be behind the replaced mortgage, second in priority. (R. p. 166, Joint Stipulation 13). Respondent's Vice President even admits that the extent of the material prejudice is $38,540.96 (referred to as the damage to Respondent's "equity position"). Appellant's Brief, p. 24 (citing R. p. 290).

The Restatement's approach does not favor either party. Replacement mortgage seeks to enforce a junior lien holder's legitimate expectation, "prevent[ing] a junior lien holder from converting the mistake of the lender into a magical gift for himself." Matrix Fin. Servs. Corp. v. Frazer, 394 S.C. 134, 141, 714 S.E.2d 532, 535 (Pleicones, J., dissenting) (discussing the purpose of equitable subrogation). One could argue that enforcing legitimate expectations fairly and preventing undeserved gifts is "doing justice." See Mosson, Equitable Subrogation in Maryland,

41 U. Balt. L. Rev. 709, 737 ("In terms of jurisprudential analysis, one can argue that subrogation has never been a tool of legislating fixes to statutory real-property laws, but of doing justice.").

The fourth point overlooked or misapprehended by the Court is the source of its equitable powers. The Court suggests the Legislature must adopt an equitable remedy. Arrowpointe Federal Credit Union v. Jimmy Eugene Bailey, Op. No. 5784 (S.C. Ct. App. filed Nov. 25, 2020) (Shearouse Adv. Sh. No. 46 at 16) (citing a New Jersey statute concerning mortgage modifications as opposed to mortgage refinances). In fact, "Courts have the inherent power to do all things reasonably necessary to ensure that just results are reached to the fullest extent possible." Regions Bank v. Wingard Properties, Inc., 394 S.C. 241, 252, 715 S.E.2d 348, 354 (Ct. App. 2011). Equitable subrogation, for example, is a judicially created exception to the legislatively adopted race-notice statute. Arrowpointe Federal Credit Union v. Jimmy Eugene Bailey, Op. No. 5784 (S.C. Ct. App. filed Nov. 25, 2020) (Shearouse Adv. Sh. No. 46 at 12). Our Courts have not deferred to the legislature in their common law recognition of equitable subrogation of a third-party refinancer. This Court's deference to the legislature involving a first-party refinancer indicates a misapprehension of the similarities between the doctrines of equitable subrogation and replacement mortgage.

Fifth and finally, like equitable subrogation, replacement mortgage should be recognized as part of this Court's common law as a judicially created exception to the race notice statute in order to promote justice. While the Court could adopt the Restatement 7.3 wholesale, it does not have to "substitute a black letter test" to balance equities and reach justice. Id., Op. No. 5784 (S.C. Ct. App. filed Nov. 25, 2020) (Shearouse Adv. Sh. No. 46 at 16) (citation omitted). The Court could hold that actual knowledge is fatal to the application of replacement mortgage, which would be consistent with this Court's common law of equitable subrogation and a departure from

Restatement 7.3 of Property. To hold, as the Court does, that constructive knowledge of an intervening lien is fatal to replacement mortgage seems to be a misapprehension by the Court and a departure from its common law jurisprudence concerning lien priority and equitable subrogation. Id., Op. No. 5784 (S.C. Ct. App. filed Nov. 25, 2020) (Shearouse Adv. Sh. No. 46 at 16) ("Because Appellant had constructive notice...we agree with [Respondent] that this matter is for our legislature.").

To conclude, the Court overlooked and misapprehended Appellant's argument. The Court conflated the separate scenarios in which equitable subrogation, replacement mortgage, and mortgage modification apply. This ultimately resulted in the Court declining to adopt replacement mortgage while relying on an inapplicable New Jersey statute concerning modifications and a University of Baltimore law review article concerning equitable subrogation. Replacement mortgage is not unjust; it seeks an equitable and therefore just result between a first-party refinancer that would be senior but for a mistake and an intervening lien holder who only leapfrogged to a prior-in-time position because of the refinance.

In addition, Appellant asks the Court to rule upon Appellant's second and third arguments concerning prejudice, which the Court declined to do in its initial opinion. Arrowpointe Federal Credit Union v. Jimmy Eugene Bailey, Op. No. 5784 (S.C. Ct. App. filed Nov. 25, 2020) (Shearouse Adv. Sh. No. 46 at 17); Linda Mc Co. v. Shore, 390 S.C. 543, 558, 703 S.E.2d 499, 506–07 (2010) ("An argument not made to an intermediate appellate court *and ruled on by that court* is not preserved for review in this Court.") (emphasis added), overruled on other grounds by Gordon v. Lancaster, 425 S.C. 386, 823 S.E.2d 173 (2018).

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Appellant petitions the Court to rehear the argument.

Respectfully submitted,

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December 9, 2020

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CERTIFICATE OF SERVICE

I hereby certify that I served a copy of Appellant's Petition for Rehearing upon Respondent by depositing a copy of the document in the U.S. mail, postage prepaid, on November 30, 2020 and addressed to:

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