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S.C. SUPREME COURT

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. 2021-000149

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.

BRIEF OF APPELLANT

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QUESTIONS PRESENTED

1. Did the lower courts err in holding that the equitable Replacement Mortgage Doctrine is not the common law of South Carolina, believing that unintended windfalls in favor of junior creditors must be addressed by the Legislature?
2. Did the Court of Appeals err in not reaching the issue of prejudice and failing to conclude that ArrowPointe suffered no material prejudice in this matter, or at least no prejudice sufficient to bar the equitable application of the Replacement Mortgage Doctrine?

STATEMENT OF THE CASE

This appeal pits competing lien priority claimants against one another; it arises from the Special Referee’s order granting summary judgment in favor of Respondent (“*ArrowPointe*”), a home equity line lender, which followed an order denying summary judgment to the purchase refiner, Appellant (“*U.S. Bank*”). (App. 109-119; 120-123). The error of law lies in the lower courts’ refusal to recognize the equitable doctrine of replacement mortgage as the common law of South Carolina.

On March 27, 2012, ArrowPointe initiated this action in the Fairfield County Court of Common Pleas, Case No. 2012-CP-20-00132, seeking to foreclose a mortgage securing an equity line of credit (the “*LOC Mortgage*”) given by Jimmy E. Bailey and Laura Jean Bailey (“*Baileys*”) to ArrowPointe. (App. 124-132). As a part of its foreclosure, ArrowPointe sought

declaration that the LOC Mortgage was a first lien with priority over all others. (Id.). U.S. Bank opposed ArrowPointe's claim for declaratory relief and sought to foreclose its mortgage (the "*Refi Mortgage*") granted by the Baileys together with a declaration that the Refi Mortgage was senior to the LOC Mortgage under the equitable doctrine reflected in the Restatement (Third) of Property (Mortgages) § 7.3 (1997) (the "*Replacement Mortgage Doctrine*"). (App. 133-153). The Special Referee denied U.S. Bank's motion for summary judgment, concluding that the Replacement Mortgage Doctrine is not South Carolina's common law. (App. 120-123).

U.S. Bank and ArrowPointe submitted a Stipulation of Facts on March 13, 2017. (App. 272-278). After considering the Stipulation of Facts and other evidence submitted, the Special Referee granted ArrowPointe's Motion for Summary Judgment pursuant to the 2018 Order. (App. 109-119). The 2018 Order recognized that, as of March 13, 2017, U.S. Bank's debt on its note secured by the Refi Mortgage was \$436,609.23, plus accrual, and ArrowPointe's debt on its note secured by the LOC Mortgage was \$187,201.60, plus accrual. (App. 111-112).

The Court of Appeals affirmed the judgment of the Special Referee in this matter. ArrowPointe Fed. Credit Union v. Bailey, Op. No. 5784 (S.C. Ct. App. filed Nov. 25, 2020) (App. 1-10) (the "Opinion"). This Court granted U.S. Bank's petitioner for a writ of certiorari on December 10, 2021.

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 COURTS SHOULD HAVE HELD THAT SOUTH CAROLINA'S COMMON LAW PERMITS THE REPLACEMENT MORTGAGE DOCTRINE TO AVOID UNINTENDED, INEQUITABLE WINDFALLS IN FAVOR OF JUNIOR CREDITORS.

This case turns solely on a novel question of law left unresolved by Matrix Fin. Services Corp. v. Frazer, 394 S.C. 134, 138, 714 S.E.2d 532, 534 (2011). In Matrix, three (3) members of this Court concluded that the lender was not entitled to priority lien status under the doctrine of equitable subrogation because “equitable subrogation is simply not a remedy available to a lender that refinances the original debt owed to it.” Id. The majority opinion explicitly noted: “Matrix is not asserting priority under a theory of replacement and modification. ... 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).” Id. In his dissenting opinion, Justice Pleicones recognized the import of this statement:

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 order because it used this theory rather than the newly announced “replacement and modification” rule.

Id. at 141, 714 S.E.2d at 535–36.

A. The Replacement Mortgage Doctrine.

This Court has favorably relied upon the Restatement (Third) of Property in discussing South Carolina's common law. *See, e.g., Id.* at 138, 714 S.E.2d at 534 (quoting Restatement (Third) of Property (Mortgages) § 7.6 cmt. e (1995)); *see also* Simmons v. Berkeley Elec. Coop., Inc., 419 S.C. 223, 234, 797 S.E.2d 387, 392 (2016) (quoting Restatement (Third) of Property (Servitudes) § 2.17(h) (2000)); Boyd v. Bellsouth Tel. Tel. Co., 369 S.C. 410, 418, 633 S.E.2d 136, 140 (2006) (quoting Restatement (Third) of Property: Servitudes § 2.12 (2000)). The Restatement recognizes the Replacement Mortgage Doctrine as follows:

- 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
 - 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
 - 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.

Restatement (Third) of Property (Mortgages) § 7.3 (1997) (the “*Restatement*”).

The Comments to the Restatement provide additional guidance on the Replacement Mortgage Doctrine. The first Comment to the Restatement acknowledges that the replacement of senior mortgages is commonplace in lending transactions involving real property. *See* Restatement, Cmt. a. That Comment concludes junior mortgagees should not have the ability to block, by the refusal to contractually subordinate, a financing transaction between a senior mortgagee and its borrower. The first Comment recognizes that the junior mortgagee's position should not materially worsen due to the transaction, but the senior mortgagee must retain priority

to the extent of the replaced mortgage.

The fourth Comment further acknowledges that senior mortgagees often find it advantageous to include a provision in the senior mortgage that authorizes the mortgagor and mortgagee to make future modifications in the mortgage and the obligation it secures. *Id.*, Cmt. D. “The purpose of such a provision is to put subsequent lienors and other parties on notice of the potential for modification, and therefore to defeat any claim that the senior’s priority has been lost or diminished if a modification occurs.” *Id.* For this reason, “no loss of priority will occur if the mortgage contains a clause reserving the right to modify, the modification is within the scope of the clause, and the clause’s operation has not been terminated by notice from the mortgagor.” *Id.*, Cmt. c.

B. U.S. Bank’s indisputable priority under the Replacement Mortgage Doctrine.

Under the Replacement Mortgage Doctrine, U.S. Bank prevails in this case. At all pertinent times, the Baileys owned 247 Morninglow Drive in Winnsboro, South Carolina (the “*Subject Property*”). (App. 272-273.). The Baileys gave a first mortgage to U.S. Bank in October 2009 (the “*First Mortgage*”), which was in senior lien priority position on the Subject Property at the time of its recording. (App. 273, 425-428). The First Mortgage secured a note in the principal amount of \$256,500.00 plus interest. (App. 165). The First Mortgage specifically stated it “secures to Lender: (1) the repayment of the Loan, and all renewals, extensions and modifications of the Note....” (*Id.*).

A week after the recording of the First Mortgage, the Baileys gave ArrowPointe the LOC Mortgage, which secured an equity line of credit in the principal amount of \$99,000.00. (App.

273, 468-474). The Baileys and ArrowPointe “intended the [LOC Mortgage] to be a junior mortgage on the Subject Property second in lien priority position behind the [Purchase] Mortgage.” (App. 274). ArrowPointe recorded the LOC Mortgage on November 4, 2009. (Id.).

Nineteen (19) days later, the Baileys refinanced, paid off, and replaced their first note with U.S. Bank, then totaling \$257,459.04, with a note to U.S. Bank in the principal amount of \$296,000.00. (App. 274-275, 476-481, 511-512). As part of this transaction, the senior First Mortgage was replaced by the Refi Mortgage, with the First Mortgage remaining of record until it was replaced by the recording of the Refi Mortgage on December 15, 2009. (App. 274-275, 485-510). Notably, U.S. Bank relied upon a licensed South Carolina attorney, Stacey E. Besser, Esq., f/k/a Stacey Pope Gardner, Esq., to conduct this transaction. (App. 275).

While U.S. Bank was on record notice of the LOC Mortgage recorded earlier that month, U.S. Bank did not have actual knowledge of the LOC Mortgage when it refinanced the Bailey’s note and replaced its First Mortgage with the Refi Mortgage. (App. 275). Moreover, during the diligence portion of the refinance transaction, the Baileys signed an affidavit misrepresenting the truth to U.S. Bank, indicating that “there are no outstanding home improvement loans, mortgages, deeds of trust, or equity lines of credit, recorded or unrecorded” other than the First Mortgage. (App. 275, 370). ArrowPointe continued to believe that it was in junior lien position until July 2011 when it learned the First Mortgage was replaced by the Refi Mortgage. (App. 319).

If the trial court or the Court of Appeals had applied the Replacement Mortgage Doctrine, then U.S. Bank would have prevailed in this case. The lower courts erred by failing to recognize

the Replacement Mortgage Doctrine and failing to find that U.S. Bank's Refi Mortgage was the first priority lien on the Subject Property (App. 120-123).

C. The overwhelming weight of common law supports South Carolina formally acknowledging the Replacement Mortgage Doctrine.

As recognized in Matrix, the doctrine of equitable subrogation has long been the common law of South Carolina. 394 S.C. at 138, 714 S.E.2d at 534 (quoting the Restatement (Third) of Property (Mortgages) Section 7.6). The doctrine of equitable subrogation is an exception to the race-notice statute that typically determines priority by the earlier date of recording. Id. Much like the Replacement Mortgage Doctrine, the doctrine of equitable subrogation allows a refinancing lender that is different from the original senior mortgagee to retain that original lender's priority to the extent the subrogee pays off the prior mortgage. Id.

Prior to the Restatement, 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, by definition, a lender cannot be subrogated to itself. Therefore, the commentators conclude that the Replacement Mortgage Doctrine is the more appropriate doctrine for a mortgagee to retain priority through a new loan that pays off its own prior loan, e.g. a refinance transaction.

"The purpose of subrogation is to prevent a junior lien holder from converting the mistake of the lender into a magical gift for himself." Matrix, 394 S.C. at 141, 714 S.E.2d at 535 (Pleicones, J., dissenting) (quoting United States v. Baran, 996 F.2d 25 (2nd Cir. 1993) (parenthetical added)). There is no reason why equity would avail a refiner who repays the debt and replaces the mortgage of another first lien holder but would utterly frustrate a refiner

who refinanced and replaced its own. For that reason, many states still allow a lender to refinance its own mortgage and retain priority over junior mortgagees under the title of equitable subrogation. Regardless of the name given to the doctrine, the same equitable and public policy rationales apply; protecting the priority of a refinancing lender: (a) reduces foreclosures and facilitates refinancing, (b) reduces title insurance premiums, (c) preserves the priorities intended by the recording order, and (d) accomplishes the equitable maxim that no one should be enriched by another's loss. Matrix, 394 S.C. at 142, 714 S.E.2d at 536 (J. Pleicones, J. dissenting) (citing Bank of America v. Prestance Corp., 160 P.3d 17 (Wash. 2007)); Sovereign Bank v. Gillis, 74 A.3d 1, 8 (N.J. Supr. Ct. App. Div. 2013).

South Carolina has long recognized that our equitable common law provides relief under the race-notice statute by subordinating a junior creditor who knowingly took a second position mortgage and has otherwise done nothing to advance its priority. *See* Dodge City of Spartanburg, Inc. v. Jones, 317 S.C. 491, 454 S.E.2d 918 (Ct.App.1995) (providing the same equitable relief sought by Petitioner here; holding Carolina First enjoyed the priority held over an intervening lien when its refinance transaction paid off its own prior debt and mortgage, as well as one held by First Federal); *see also* Indep. Nat. Bank v. Buncombe Prof'l Park, LLC, 411 S.C. 605, 769 S.E.2d 663 (2015) (granting a writ of certiorari, reversing the Court of Appeals' decision, and finding petitioner to be equitably subrogated to the original first mortgage on the property.); 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.”); Meaders Bros. v. Skelton, 234 S.C. 134, 107 S.E.2d 1 (1959) (holding, *per curiam*, where property was subject to duly recorded first and second mortgages and loan was made to mortgagor to pay off first mortgage, lender was subrogated to first mortgagee's lien and lender's lien was superior to that of second mortgagee to extent of payment of principal and interest on first mortgage); James v. Martin, 150 S.C. 75, 147 S.E. 752, 758 (1929) (“One satisfying a lien note at the request of the property owner, upon the understanding that he is to have new security upon the property released, acting in ignorance of a second mortgage lien upon the property, although it is on record, is entitled to subrogation to the rights of the first lien holder.”); Enter. Bank v. Fed. Land Bank, 139 S.C. 397, 138 S.E. 146 (1927) (holding that a lender who pays the original mortgage itself, or furnishes money to the mortgagor to pay off an existing mortgage, pursuant to an agreement by which the lender will give a new mortgage, has the equitable right to be subrogated to the paid-off mortgage).

The Court of Appeals recognized that there exists “the trend toward adopting some form of replacement mortgage doctrine in sister states” (App. 8); however, this appears to be an understatement. *See Burney v. McLaughlin*, 63 S.W.3d 223, 231 (Mo. Ct. App. 2001) (stating that the rule stated in § 7.3 of the Restatement is consistent with Missouri common law and noting, “cases in which a junior mortgage lien is elevated above the paramount mortgage are the exception and not the rule.”); *see also Bay Minette Prod. Credit Ass'n v. Citizens' Bank*, 551 So. 2d 1046, 1048 (Ala. 1989) (replacement mortgage filed by a mortgagee does not “release” an original first lien so as to render the replacement mortgage subordinate to an intervening lien);

Cont'l Lighting & Contracting, Inc. v. Premier Grading & Utilities, LLC, 258 P.3d 200, 207 (Ariz. Ct. App. 2011) (adopting the Replacement Mortgage Doctrine as stated in §7.3); Home Fed. Sav. & Loan Ass'n v. Citizens Bank of Jonesboro, 861 S.W.2d 321, 323 (Ark. App. 1993) (Arkansas common law has long recognized the Replacement Mortgage Doctrine); Nikooie v. JPMorgan Chase Bank, N.A., 183 So. 3d 424, 429 (Fla. Dist. Ct. App. 2014) (recognizing that Restatement §7.3 is consistent with Florida common law); UnionBank v. Thrall, 872 N.E.2d 542, 546-47 (Ill. App. Ct. 2007) (stating the Replacement Mortgage Doctrine has been the common law of Illinois for over 100 years); Jackson & Scherer, Inc. v. Washburn, 496 P.2d 1358, 1366 (Kan. 1972) (holding that the replacement mortgage retains priority absent an intention to give priority to the intervening lien and absent paramount equities); Wells Fargo Fin. Kentucky, Inc. v. Thomer, 315 S.W.3d 335, 340 (Ky. Ct. App. 2010) (relying on § 7.3 in determining the priority of senior mortgage vis-à-vis junior lien interest); E. Bos. Sav. Bank v. Ogan, 701 N.E.2d 331, 334 (Mass. 1998) (acknowledging Massachusetts recognizes Restatement § 7.3); CitiMortgage, Inc. v. MERS, 813 N.W.2d 332, 335 (Mich. App. 2011) (stating §7.3 of the Restatement reflects Michigan common law); Sovereign Bank, 74 A.3d at 8 (N.J. Supr. Ct. App. Div. 2013) Resolution Tr. Corp. v. Barnhart, 862 P.2d 1243, 1248 (N.M. Ct. App. 1993) (stating “where a senior mortgagee discharges its mortgage of record and contemporaneously takes a new mortgage, the senior mortgagee's lien is not subordinated to intervening liens in the absence of (1) evidence of an intent to subordinate, or (2) paramount equities in favor of junior lienholders that justify subordinating the senior mortgagee's lien.”); Norstar Bank v. Morabito, 201 A.D.2d 545, 547 (N.Y. App. 1994) (retaining priority for a replacement mortgage in refinance

transaction); Shanks v. Phillips, 55 S.W.2d 258, 261 (Tenn. 1932) (mortgagee who replaces its prior lien in the same transaction as new lien does not lose priority absent paramount equities); Sheppard v. Interbay Funding, LLC, 305 S.W.3d 102, 107 (Tex. App. 2009) (citing with favor § 7.3); Nature's Sunshine Prod., Inc. v. Watson, 174 P.3d 647, 652 (Utah Ct. App. 2007) (relying on Restatement §7.3 as controlling law in Utah); Chase Manhattan Bank, N.A. v. Miller, 39 V.I. 123, 128 (Terr. V.I. 1998) (stating Restatement §7.3 undoubtedly applies in the Virgin Island territories); Kim v. Lee, 43 P.3d 1222 (Wash. 2001) (adopting the Replacement Mortgage Doctrine as stated in § 7.3); Iowa Cty. Bank v. Pittz, 211 N.W. 134, 137 (Wis. 1926) (replacement mortgage filed by mortgagee permitted to retain his first lien status except to the extent of prejudice suffered by intervening lien holder).

In contrast, while the South Carolina Court of Appeals refers to the replacement mortgage doctrine as the “minority approach,” Petitioner is unaware of **any** jurisdiction that has plainly rejected Restatement (Third) of Property (Mortgages) § 7.3, and the Court of Appeals’ Opinion cited to none.

If this Court considers this case as the first formal recognition of “replacement mortgage”, this recognition is not “a break from precedent” and should be given retroactive application because of this 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).

II. The Lower Courts should have held that ArrowPointe suffered no material prejudice, or at least no prejudice sufficient to wholly defeat the equitable application of the Replacement Mortgage Doctrine.

The Restatement §7.3(a)(1) states that the Replacement Mortgage Doctrine is limited 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. U.S. Bank appeals the Special Referee’s alternative determination that any material prejudice wholly bars the Replacement Mortgage Doctrine (App. 114). The Court of Appeals did not reach this issue because it concluded that the Replacement Mortgage Doctrine is not a part of South Carolina’s common law. (App. 9).

In this instance, the Refi Mortgage did not materially prejudice ArrowPointe, who took a junior lien with knowledge that the First Mortgage was an adjustable-rate mortgage that specifically secured “the repayment of the Loan, and all renewals, extensions and modifications of the Note....” (App. 273). “[P]rejudice is determined by evaluating the risk undertaken by the intervening lienholder at the time it made the loan.” Markham Contracting Co. v. Fed. Deposit Ins. 379 P.3d 257, 262 (Ari. Ct. App. 2016) (internal quotation omitted). The notes to

Restatement §7.3 observe that when, as here, the original mortgage puts language in the public record that demonstrates the senior mortgagee's ability to increase the amount secured by its current or future loans, then the intervening junior lienholder is on notice that the senior debt can increase and should temper its lending decisions accordingly. Reporters' Note, cmt. d, Restatement (Third) of Property (Mortgages) § 7.3. There is no substantive difference between a "modification" and "new loan" in this context. *See* UPS Capital Business Credit v. Abbey, 975 A.2d 548, 551 (N.J. Super. Ct. Ch. Div. 2009). ("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 also* Restatement (Third) of Property (Mortgages) § 7.3, cmt. B and illus. 5; 59 C.J.S. Mortgages § 331. Because ArrowPointe knew and intended its lien to be subordinate to any rate changes or increases in the principal debt secured by the First Mortgage, ArrowPointe suffers no prejudice by the Refi Mortgage being given full priority.

However, even if this Court differs with the reasoning of the Restatement § 7.3 and determines that a junior lien holder with prior notice of a senior lien securing a variable interest rate and any future modification suffers some material prejudice if the replacement mortgage secures additional principal or a fixed rate of interest following the refinance transaction, then the potential prejudice in this instance is not so substantial so as to wholly prevent the equitable application of the doctrine of replacement mortgage entirely. In this case, ArrowPointe states that Petitioner's refinance impaired its equity position by \$38,540.96 (App. 398). If this Court

determines that ArrowPointe's equity position was materially impaired, then both the Restatement and South Carolina's equitable common law provides that the Refi Mortgage retains its first position except to the extent of the impairment - \$38,540.96. *See* Restatement (Third) of Property (Mortgages) § 7.3, cmt. B and illus. 2; Meaders Bros., 234 S.C. 134, 137, 107 S.E.2d 1, 2-3 (1959).

CONCLUSION

Our common law should not be contorted to allow ArrowPointe to convert an accident into an inequitable "magical gift," as Justice Pleicones stated in Matrix, particularly when that gift comes at the expense of sound public policy. Equitable doctrines exist to avoid abhorrent windfalls, and the Restatement's approach to the Replacement Mortgage Doctrine furthers important public policy objectives by "facilitating more refinancing," "stem[ming] the threat of foreclosure," and saving homeowners "billions of dollars" on "title insurance premiums." Prestance Corp., 160 P.3d at 28.

Respectfully, this Court should reverse the lower courts, recognize formally the Replacement Mortgage Doctrine, and remand this case to the trial court with instructions to enter judgment in accordance with this Court's finding that U.S. Bank's Refi Mortgage is the first priority lien and ArrowPointe has not suffered material prejudice as a matter of law.

Respectfully submitted,

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