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Security Transactions

Coleman Karesh
University of South Carolina School of Law

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COLEMAN KARESH*

MORTGAGES

Defense Against One Not Holder in Due Course

The case of *South Orange Trust Company v. Conner*[1] was one involving the foreclosure of a mortgage. The principal issues were those concerned with agency and negotiable paper, and on their resolution depended the ultimate issue of the enforceability of the mortgage. The defense was that the note and mortgage had been procured by fraud on the part of one alleged to be the plaintiff's agent. The counter-contention of the plaintiff was that it was an innocent assignee or holder in due course. The evidence was against this contention, however: a finding that the fraud was committed by an agent was sustained on appeal, with the result that the plaintiff, not having qualified as an innocent holder, could not foreclose the mortgage.[2]

Res Judicata as to Foreclosure Action

In *Antrum v. Hentsville Production Credit Assn.*[3] the doctrine of *res judicata* was held to bar a mortgagor who sought to set aside a foreclosure sale. The mortgagor had defaulted in pleading to the complaint for foreclosure and had allowed the mortgaged property to go to sale. On a rule to show cause for the issuance of a writ of assistance to put the purchaser in possession the mortgagor resisted the writ on the ground of alleged impropriety in the sale and was overruled without a hearing on the merits. From this there was no appeal. Thereafter the mortgagor brought this proceeding to have the sale vacated, alleging again the impropriety of the sale and also asserting fraud in the mortgage and other possible defenses. The court, affirming the lower court, held that the earlier proceedings down through the writ were *res judicata* not only as to issues actually raised but as to those which might have been raised in the action. With respect to the latter, it is stated "While the doctrine [*res ju-*

*Professor of Law, University of South Carolina.

1. 228 S.C. 218, 89 S.E. 2d 372 (1955).
2. The cases are numerous in which unenforceability has attended a mortgage securing negotiable paper in the hands of one who, for one reason or another, could not qualify as a holder in due course. In most the assignee had acquired the paper after maturity. Typical of them are Williams v. Weekley, 100 S.C. 28, 84 S.E. 299 (1914); Willoughby v. Ray, 131 S.C. 317, 127 S.E. 441 (1924).
3. 228 S.C. 201, 89 S.E. 2d 376 (1955).

dicata] has been generally said to bar relitigation not only of issues actually decided, but also of such issues as could have been presented for decision, the application of the defensive bar to the latter rests, strictly speaking, upon the doctrine of estoppel rather than that of *res judicata.*"[4]

Effect of Purchase by Mortgagor at Tax Sale

Adverse Possession by Mortgagee

The rather frequent problem of the effect of the purchase by the mortgagee at a tax sale of the mortgaged property is presented in *Dunham v. Davis,*[5] as is also the usually related problem of adverse possession by the mortgagee against the mortgagor. In this case heirs of a mortgagor sought to recover property in possession of the mortgagee. The answer set up title by virtue of a tax deed and through adverse possession, and fell back upon the mortgage in the event it should be held that the plaintiffs had an interest in the property. In the trial of the case the presiding judge ruled against the claim of title under the tax deed and left the issue of adverse possession to the jury. The jury found in the defendant's favor but the judge granted the plaintiff's motion for judgment notwithstanding the verdict. The action of the lower court was affirmed.

After holding that the tax sale in question was invalid under applicable statutes (which are not relevant here), the court held that apart from such considerations "the tax sale was ineffective, of itself, to vest title in appellant, since he was a mortgagee and therefore his purchase will be deemed to have been for the protection of his lien, and not to have defeated respondents' title."[6]

Failing thus in his assertion of title by acquisition of the property at tax sale, the mortgagee claimed to have acquired it by adverse possession, but the lower court's view of the facts was upheld on

4. It has been held that on a motion for a writ of assistance a defendant cannot resist on grounds known to him at the time the report on sale was confirmed, and that he is concluded by the order of confirmation. LeConte v. Irwin, 23 S.C. 106 (1884). Such an order operates as an estoppel. Murchison v. Miller, 64 S.C. 425, 42 S.E. 177 (1902). It does not appear from the record of the case under review whether there was an order of confirmation. The failure to obtain an order of confirmation is no longer fatal to the finality of a decree of sale, at least as to *bona fide* purchasers. § 10-1790, CODE OF LAWS OF SOUTH CAROLINA, 1952, and see Wooten v. Seanch, 187 S.C. 219, 196 S.E. 877 (1938). Such orders are not, however, eliminated by the statute, and it may be assumed that once obtained they have the effect of conclusiveness as to the validity of the sale.

5. 229 S.C. 29, 91 S.E. 2d 716 (1956).

6. Citing DeLaine v. DeLaine, 211 S.C. 223, 44 S.E. 2d 442 (1947). See also Ham v. Flowers, 214 S.C. 212, 51 S.E. 2d 753, 7 A.L.R. 2d 1124 (1949), and annotation 140 A.L.R. 294.

the appeal. For although a mortgagee may perfect a title by adverse possession "the adverse acts relied upon by the former must be such as to give notice that he is claiming not as mortgagee but as owner."[7] The facts necessary to constitute an adverse holding were not present and the circumstances were on the whole compatible with rights as a mortgagee as distinguished from acts of ownership. The case was remanded for purposes of the accounting which would be entailed by reason of the outstanding mortgage interest.[8]

SURETYSHIP

Surety's Defense Arising from Act of Creditor

The case of *City Lumber Company v. National Surety Corp.*[9] is an interesting one of considerable novelty in this state — at least as to the facts. The defendant was surety on a construction bond, under which the contractor and surety were obligated to pay for all labor, material and equipment. A painting subcontractor had bought material from the plaintiff on the purchase of which a large balance was owed. The subcontractor, in need of funds, and the plaintiff's manager urged the prime contractor to make a payment to the subcontractor on his contract. A check for more than the amount owing by the prime contractor to the subcontractor was drawn by the prime contractor payable to the joint order of the subcontractor and the plaintiff and delivered to the subcontractor. The check bore a notation "advance on contract." The subcontractor asked the plaintiff for permission to endorse its name on the check, so that he might collect it and pay labor bills and promised to make a substantial payment on the plaintiff's account. On subsequent failure by the subcontractor and the prime contractor to pay the account in full to the plaintiff, action was brought against the surety, which defended on the grounds of payment, estoppel and waiver. On a jury trial verdict was for the plaintiff. On appeal the judgment below was reversed.

In reversing, the court did not rest its decision on the ground of actual payment but concluded that the only reasonable inference to be drawn from the circumstances was that the check had been made out to the joint payees in order to enable the plaintiff to collect

7. Citing Ham v. Flowers, note 6, *supra;* Knight v. Hilton, 224 S.C. 452, 79 S.E. 2d 871 (1954). See also Fogle v. Void, 223 S.C. 83, 74 S.E. 2d 358 (1952), where ownership was perfected by adverse possession.

8. The relationship of mortgagee in possession would involve a mutual accounting under the rules set out principally in Ham v. Flowers, note 6, *supra,* and Knight v. Hilton, note 7, *supra.*

9. 229 S.C. 115, 92 S.E. 2d 128 (1956).

its unpaid bills and that it was bound to have known that purpose. The crux of the court's reasoning leading to the conclusion that on that account the surety was relieved is to be found in the following language: "The $3,500 check was given for the purpose of satisfying claims which the prime contractor and its surety were obligated under the terms of the bond to pay. The source of the money was known to the respondent. The surety was equitably entitled to the discharge of the debts for which it was bound,[9a] but this was not done because of the negligence of respondent in empowering [the subcontractor] to use the funds for any purpose which he desired. This is not a case of nonaction on the part of the creditor, but positive and affirmative action injuriously affecting the surety."[10]

9a. The court evidently has in mind here the principle or an analogous one which has found application in cases in which a creditor having two or more claims against a principal receives money from the contract for which a surety is bound and applies the payment to claims arising out of the other contract or contracts. In South Carolina the cases seem to hold that such a payment to the creditor is impressed with an equity in the surety's favor to have the funds applied on the debt for which he is liable, certainly if the creditor knows the source of payment. See Southern States Supply Co. v. Union Indemnity Co., 161 S.C. 219, 159 S.E. 532 (1931); Boyce Plumbing Co. v. American Surety Co., 162 S.C. 239, 160 S.E. 593 (1931). The result is not everywhere the same. See generally, RESTATEMENT OF SECURITY, § 142; 41 A.L.R. 1297, supplemented in 130 A.L.R. 198; 21 A.L.R. 704, supplemented in 49 A.L.R. 952, 60 A.L.R. 203.

10. The court here has reference to the ancient rule running through the cases that a surety is not discharged by passivity or inaction on the part of the creditor, and that "to effect the discharge of a surety, the act complained of on the part of the creditor must be of a positive character or an omission to perform some act, when required by the surety, which equity enjoined upon him and the omission of which proved injurious to the surety." Brannan v. Harris, 117 S.C. 423, 109 S.E. 396 (1921); Lang v. Brevard, 3 Strobhart's Equity 59 (S.C. 1849); Jackson v. Patrick, 10 S.C. 197 (1878). Thus indulgence to or failure to sue the debtor is no defense to the surety. Witte v. Wolfe, 16 S.C. 256 (1881); Edwards v. Dargan, 30 S.C. 177, 8 S.E. 858 (1888); Gardner v. Gardner, 23 S.C. 588 (1885) — a few of many such cases. And see RESTATEMENT OF SECURITY, § 130. But a binding extension of time without the surety's consent discharges, either on the ground of alteration of the contract or interference with the right of subrogation. Smith v. Tunno, 1 McCord's Equity 443 (S.C. 1826); Gardner v. Gardner, *supra;* Providence Machine Co. v. Browning, 70 S.C. 148, 49 S.E. 325 (1904); RESTATEMENT OF SECURITY, § 129. The rule here may vary as to a compensated surety, where the result will depend on the extent to which the surety is injured. State A. & M. Society v. Taylor, 104 S.C. 167, 88 S.E. 372 (1915); RESTATEMENT OF SECURITY, § 129. And the creditor is not compelled to accept security or additional security from the debtor. Smith v. Tunno, *supra;* Falk v. Cruickshanks, 4 Richardson 243 (S.C. 1851); Rouss v. King, 69 S.C. 168, 48 S.E. 220 (1903). But if the creditor releases or surrenders a security or lien which he holds, the security is discharged to the extent of the value of the security surrendered. Smith v. Tunno, *supra;* Rouss v. King, 74 S.C. 251, 54 S.E. 615 (1906); Twiggs v. Bank, 26 S.C. 612, 2 S.E. 698 (1886); Greenville v. Ormand, 51 S.C. 121, 28 S.E. 147 (1897); RESTATEMENT OF SECURITY, § 132. A failure by the creditor to retain percentages contracted for is treated variously as alteration of contract, as release of security, or as a positive act causing injury to the surety, the theory, however, being important in determining the extent of the surety's discharge. Greenville v. Ormand, *supra;* Mack Mnfg. Co. v. Mass. B. & I. Co., 114 S.C. 207, 103

Having determined that for the reasons given the surety was discharged, the court proceeded to broaden the holding in these words:

> No case has been cited, and we have found none in our own research, involving the precise question before us, but we think applicable to some extent is the general rule that where the creditor has within his control funds of the principal debtor which may properly be applied toward the payment of the obligation, but fails to do so, the surety is discharged. See annotation in 115 Amer. St. Reports, beginning on page 95; 50 Am. Jur., Suretyship, Sec. 116. In *Commercial National Bank v. Henninger,* 105 Pa. 496, the court said: "The rule is well settled that 'when a creditor has in his hands the means of paying his debt out of the property of his principal debtor, and does not use it, but gives it up, the surety is discharged. It need not be actually in the hands of his creditor; if it be within his control, so that by the exercise of reasonable diligence he may have realized his pay out of it, yet voluntarily and by supine negligence relinquished it, the surety is discharged'."

It seems to this writer that the statements just made, and particularly that quoted from the Pennsylvania case, go too far unless qualified and would appear to commit the South Carolina court to views at variance with its own intimation in the present case that there must be an equity in the funds in favor of the surety and that the act complained of must be positive in its character and not simply an act of omission. In the annotation mentioned, in which the *Commercial National Bank* case is cited, there is this restrictive language: "But in order to make it incumbent upon the creditor to apply funds or property in his possession upon the debt of the principal, the creditor must have some such lien on or interest in the property or fund that it is charged with a trust in favor of the surety." Identical language is used in the section in American Jurisprudence which

S.E. 499 (1919) (compensated surety); Pickens County v. National Surety Co., 13 Fed. 2d 758 (C.C.A. 4 Cir., W.D.S.C. 1926) (compensated surety). But failure to enforce the security will not discharge the surety. Wayne v. Kirby, 2 Bailey 551 (S.C. 1831); Miller v. White, 25 S.C. 235 (1886). The rule may be different as to *pledged* property because of the duty owed by the pledgee to the pledgor. See Montague v. Stelts, 37 S.C. 200, 15 S.E. 968, 34 Am. St. Rep. 736 (1891); annotation 51 A.L.R. 609. The creditor's failure or delay in recording a mortgage securing the debt for which the surety is liable, absent a demand by the surety that he do so, will not discharge the surety either wholly or *pro tanto* to the extent of the loss. Arthur v. Brown, 91 S.C. 316, 74 S.E. 652 (1912); Brannan v. Harris, *supra.* There are views elsewhere to the contrary. See, annotation 37 L.R.A. (N.S.) 699; RESTATEMENT OF SECURITY, § 132.

is referred to. Since the reservation to the rule is as well established as the rule itself, and just as in the sources of reference mentioned it accompanies the statement of the rule, it may well be that the court treats the statement of the reservation as unnecessary or as implicit. The matter is thus dealt with in Stearns, Law of Suretyship:[11]

> A surety cannot claim his discharge in every instance when the creditor voluntarily relinquishes property of the principal which he holds. His right to discharge requires that the property be so placed that the creditor is bound to hold it in special trust to pay the particular debt for which the surety is liable. It is not enough that the creditor has in his possession the means of satisfying the debt, but he must have the right, conferred upon him by law or contract, to so apply the property.
>
> If the creditor holds funds of the principal arising out of some other transaction, he need not apply the funds to the debt for which the surety is liable, but may pay the principal and proceed against the surety. The creditor's right of set-off against the principal is one that he may use or not, as he chooses."[12]

The language quoted from the Pennsylvania case does not carry qualifying language and is used to support the conclusion in that case that when a bank fails to appropriate the deposit of a debtor whose debt to it is secured by the obligation of a surety, the surety is discharged. On this point the cases are in conflict, but the majority view is that the bank is under no duty to a surety or endorser to make such an appropriation — that it has the power but not the duty. The Pennsylvania cases, including this one, fall in the minority.[13] It is in the bank cases that most of the problems involving the application of the rule relied on by the court in the instant case arise.[14] A technical reason frequently advanced in support of the majority view is that, although the bank may set off or appropriate, the surety

11. 5th Ed. (1951), § 6.51.

12. See also, as stating one aspect of this rule RESTATEMENT OF SECURITY, § 143: "Where the creditor is indebted to a principal whose duty to the creditor is secured by the obligation of a surety, payment of his indebtedness by the creditor to the principal before or after maturity of the principal's duty does not discharge the surety."

13. See annotation 70 A.L.R. 339.

14. See RESTATEMENT OF SECURITY, § 143, which follows the majority rule as to bank deposits and sets out the exceptions. One exception seems to be where the note is payable at the bank, Stearns, *op. cit.* § 6.51. There are no South Carolina cases dealing specifically with the effect on a surety of a bank's failure to appropriate the principal's deposit, but there is a fringe treatment of the matter in Bank of Spartanburg v. Mahon, 78 S.C. 490, 59 S.E. 31 (1907), and a dictum approving discharge of the surety in Greenville v. Ormand, note 10, *supra,* at page 128 of 51 S.C., citing a Delaware case which treats the bank's right of set-off as a lien and failure to appropriate the deposit as a surrender of security.

has no interest in the deposit to which he would be subrogated on payment by him.[15]

The *qualified* rule finds support in a South Carolina case of some age. In *Beaubien v. Stoney*,[16] a surety sued on a note pleaded discharge because the payee who owed the principal on a building contract paid him on the contract before its completion. The contention was "that by the terms of the building contract, the defendant was entitled to hold the whole price of the work until it should be finished, and, therefore, held a security in his hands, which, to the extent of the sums above mentioned, he parted from, and thereby discharged the plaintiff." The court, after pointing out that the contract on which payment to the principal had been made was independent of the contract on which the surety was bound, dismissed the surety's contention, saying: "The surety, in order to claim a discharge, must have some connexion [*sic*] with the money paid over, or security parted from."[17] Clearly then, accepting this last statement as South Carolina law, the court's statement in the present case touching the creditor's control of the debtor's funds must be trimmed to meet the law in the *Beaubien* case. In any event the result does fit that principle because of the court's prior pronouncement of the surety's equity attaching to the fund in the creditor's hands.

Another reason announced by the court in support of its finding for the surety was that the creditor's acts brought the case under the "well established principle that where one of two innocent parties must suffer a loss, it must be borne by that one of them, who, by his conduct, has rendered the injury possible."[18]

There is a dissent by the Chief Justice taking issue with the majority statement that the only inference to be drawn was that the check in question had been made payable to the co-payees to enable the plaintiff to collect its claim. There is further dissent with respect to the issue of estoppel arising out of negligence and the application of the "two innocent parties" principle.

15. Davenport v. State Banking Co., 126 Ga. 136, 54 S.E. 977, 8 L.R.A. (N.S.) 944, 115 Am. St. Rep. 68, 7 Ann. Cas. 1000 (1906).

16. Speers' Equity 508 (S.C. 1844).

17. This case is commented on and differentiated in Greenville v. Ormand, note 10 a, *supra*, at page 128 of 51 S.C. It is also cited in STEARNS, LAW OF SURETYSHIP as supporting the qualified rule as quoted here in the text, and also in SIMPSON ON SURETYSHIP (1951) § 76, in the same manner.

18. For a case in which a creditor was estopped by conduct, see Pittsburgh Steel Co. v. Standard Accident Ins. Co., 55 F. Supp. 36 (E.D. S.C. 1948), where creditor at request of sub-contractor furnished prime contractor with affidavit that all claims it held against the sub-contractor had been paid (where in fact they had not) and the prime contractor thereupon relinquished retained percentages.