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Contracts

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CONTRACTS

I. MATERIAL ALTERATION RULE: PROTECTION FOR SUBORDINATED PURCHASE MONEY MORTGAGES

In *Citizens & Southern National Bank v. Smith*,[1] the South Carolina Supreme Court held that a seller's purchase money mortgage had priority over a subsequent mortgage despite a valid subordination agreement with the debtor. The new mortgagee lost its priority by materially altering the terms of its loan without the knowledge or consent of the subordinated purchase money mortgagee. In this decision, the court adopts a new rule to protect sellers who have subordinated purchase money mortgages.

The dispute in this case arose from a complex real estate transaction. In December 1973, LaBorde sold undeveloped land to developers Smith and Williams in return for a purchase money mortgage.[2] LaBorde agreed to subordinate his mortgage to enable the developers to obtain money to develop the land. This agreement also contained a written provision whereby LaBorde agreed to execute any documents necessary to perfect subordination.[3] When LaBorde learned that the developers had granted an additional mortgage to Citizens & Southern National Bank (C & S) without advising him, he filed a *lis pendens*.[4]

In March 1974, LaBorde and the developers reached a settlement, agreeing that the purchase money mortgage would be

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1. ___ S.C. ___, 284 S.E.2d 770 (1981).

2. The land, located in Richland County, consisted of three parcels. Two of the parcels were conveyed directly by LaBorde to Smith and Williams by deed dated December 11, 1973. The third parcel was the subject of this litigation. LaBorde gave a portion of this third parcel to three charities and retained title to the remaining portion. On the same day, all of these portions were deeded to Smith and Williams by LaBorde and the three charities in exchange for purchase money mortgages. Brief for Appellant at 3-5. The three charities appealed only the value and apportionment of the various mortgages.

3. On appeal to the supreme court, C & S asserted that this original subordination agreement was self-executing. LaBorde contended that the provision required his written consent for the subordination to be effective. ___ S.C. at ___, 284 S.E.2d at 771. The court, however, found it unnecessary to resolve this issue. *See infra* note 5 and accompanying text.

4. Brief for Respondent LaBorde at 3.

satisfied and replaced by a new mortgage. LaBorde also agreed to subordinate this new mortgage to any future mortgages provided the developers satisfied the C & S mortgage by June 7, 1974 and paid LaBorde $4,000.[5] LaBorde complied fully with the terms of the agreement. The developers, however, obtained an extension of the loan from C & S postponing repayment for one year. LaBorde was not advised of this extension. When the developers failed to satisfy the outstanding purchase money mortgage and pay LaBorde $4,000 pursuant to the March agreement, LaBorde foreclosed.[6]

The issue of priority was first determined by a master in equity. The master found there was no evidence showing that the extension of time by C & S prejudiced LaBorde[7] and denied him priority. On appeal, the trial judge, finding prejudice to LaBorde, held that his mortgage had priority over the C & S mortgage.[8] The supreme court affirmed.[9]

The supreme court reasoned that C & S lost its priority because it modified the terms of its mortgage in a manner that prejudiced LaBorde's rights without his knowledge or consent.[10] The court cited the rule that: "[If] the terms of the debt are materially altered without the subordinated mortgagee's consent, the priority of the mortgages will be reversed in favor of the subordinated purchase money mortgage."[11] The court then stated that the finding of prejudice by the trial judge was supported by evidence that LaBorde considered repayment of the C

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5. ___ S.C. at ___, 284 S.E.2d at 771-72. The court found it unnecessary to resolve whether the original subordination agreement was self-executing because LaBorde acknowledged the superiority of the C & S mortgage in this subsequent agreement. *Id.* at ___, 284 S.E.2d at 771-72. *See supra* note 3.

6. Brief for Respondent LaBorde at 4.

7. Record at 459.

8. The trial judge noted that extension of the repayment date "reduced the chances of a successful recovery by suit of LaBorde." Record at 532.

9. C & S has filed a petition for rehearing.

10. ___ S.C. at ___, 284 S.E.2d at 772.

11. *Id.* at ___, 284 S.E.2d at 772. In support of this rule, the court cited Remodeling & Construction Corp. v. Melker, 270 A.D. 1053, 65 N.Y.S.2d 738 (1946); 59 C.J.S. *Mortgages*, § 276 (1979); G. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES § 121 (2d ed. 1970). The court also quoted from Gluskin v. Atlantic Savings & Loan Ass'n, 32 Cal. App. 3d 307, 315, 108 Cal. Rptr. 318, 323 (1973): "[A] lender and a borrower may not bilaterally make a material modification in the loan to which the seller has subordinated without the knowledge and consent of the seller to that modification, if the modification materially affects the seller's rights."

& S debt on June 7, 1974 a material inducement for subordinating his purchase money mortgage. Accordingly, LaBorde's priority over C & S was affirmed.[12]

The material alteration rule on which the court based its decision is generally applied in land development financing disputes.[13] Typically, a purchase money mortgagee sells to a developer who then takes a loan from a lender to finance development of the land. By law, the seller's purchase money mortgage has priority.[14] Subordination by the seller is necessary to allow the lending bank to obtain the requisite first priority lien to secure its loan.[15] The seller, however, risks being denied full satisfaction of the debt by subordinating his lien.[16] Other courts have used the material alteration rule to protect sellers in this vulnerable position.[17]

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12. ___ S.C. at ___, 284 S.E.2d at 772.

13. *See generally* G. OSBORNE, *supra* note 11, § 212, at 387; Note, *Subordination of Purchase-Money Security*, 52 CAL. L. REV. 157, 157 (1964); Miller, Starr, & Regalia, *Subordination Agreements in California*, 13 U.C.L.A. L. REV. 1298, 1298-300 (1966).

14. ___ S.C. at ___, 284 S.E.2d at 771; Crystal Ice Co. v. First Colonial Corp., 273 S.C. 306, 310, 257 S.E.2d 496, 498 (1979). In *Crystal Ice*, the court found two reasons for purchase money mortgage priority: (1) the executions of the deed and purchase money mortgage are simultaneous acts and no mortgage arising through the mortgagor can attach before the purchase money mortgage; (2) the seller would not have parted with his property without having recourse if buyer defaulted and equity favors granting priority to the purchase money mortgage. *See also*, G. OSBORNE, *supra*, note 12 at § 213.

15. Generally, banks and other lending institutions must obtain first lien rights in order to secure a loan with realty. *See* S.C. CODE ANN. § 34-13-20 (1976); S.C. CODE ANN., BANKING, COMMERCIAL PAPER AND FINANCE R. 15-9 (1976); 12 U.S.C. § 1464(c)(1971)(limits on federally chartered lenders).

16. Problems arise when the sum of the seller's and lender's mortgages is greater than the value of the property. In the event of default and a foreclosure sale, the proceeds cannot satisfy both mortgages. Since the subordinated seller holds a junior lien mortgage, he will be denied full satisfaction of his debt.

17. *See, e.g.*, Gluskin v. Atlantic Sav. & Loan Ass'n, 32 Cal. App. 3d 307, 108 Cal. Rptr. 318 (1973). Courts have also protected sellers by requiring specificity of terms in the subordination contract. *See, e.g.*, Handy v. Gordon, 65 Cal. 2d 578, 581, 422 P.2d 329, 330-31, 55 Cal. Rptr. 769, 770-71 (1967).

California seems to have had more litigation concerning subordination than any other state. One California commentator writes:

> Subordination has received sparse treatment by legal writers, and the cases are not numerous. The law that does exist has evolved almost entirely since 1954, and the opinions indicate that an "equitable" result has often been more important than the reasoning by which that result was achieved. In a series of consistent efforts to relieve the seller from a disastrous bargain the cases have cast serious doubt upon the efficacy of the subordination procedure.

Note, *Subordination of Purchase-Money Security*, 52 CAL. L. REV. 157, 159 (1964).

The court's view of prejudice to the seller in *Smith* indicates broad protection of a subordinated purchase money mortgage. In finding prejudice, the court did not undertake a factual analysis beyond indicating that LaBorde considered timely repayment of the bank's loan a material inducement for subordinating his mortgage.[18] This subjective view of prejudice does not examine whether modification actually increased LaBorde's risk of loss. On the contrary, extension by C & S would allow the debtors to avoid default and foreclosure, thereby decreasing LaBorde's risk of loss as a junior lienholder.[19] The court's analysis seems to imply that a modification without consent is itself sufficient to constitute prejudice.

In conclusion, *Citizens & Southern National Bank v. Smith* should serve to warn lending institutions that they have a duty not to prejudice the rights of a purchase money mortgagee holding a subordinated lien. Extension of the repayment date on the lender's mortgage seems to constitute prejudice and the court appears willing to grant priority to a subordinated purchase money mortgage if consent has not been obtained.

II. GUARANTOR DISCHARGE BY CREDITOR'S RELEASE OF SECURITY

In *Edge v. Klutts Resort Realty*,[20] the South Carolina Supreme Court acknowledged a mortgagee's right to ignore the mortgage and sue the maker of the debt for collection on the note alone.[21] The court also joined a majority of American juris-

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18. ___ S.C. at ___, 284 S.E.2d at 772.

19. *See supra* note 16. Other courts have found that a subordinated mortgagee is prejudiced when modification results in a shortened term for repayment because the likelihood of the debtor's default is enhanced. *See, e.g.*, Gluskin v. Atlantic Sav. & Loan Ass'n, 32 Cal. App. 3d 307, 315, 108 Cal. Rptr. 318, 325 (1973); Remodeling & Construction Corp. v. Melker, 270 A.D. 1053, 65 N.Y.S.2d 738, 741 (1946).

20. 276 S.C. 389, 278 S.E.2d 783 (1981).

21. *See, e.g.*, United States v. Sims, 586 F.2d 580, (5th Cir. 1978); Fidelity Sav. Bank v. Wormhoudt Lumber Co., 251 Iowa 1121, 104 N.W.2d 462 (1962); Sterling Factors Corp. v. Freeman, 50 Misc.2d 715, 271 N.Y.S.2d 343, *aff'd* 27 A.D.2d 856, 279 N.Y.S.2d 577 (1966); Warren v. Washington Trust Bank, 92 Wash. 2d 381, 598 P.2d 701 (1979). *See* 10 WILLISTON ON CONTRACTS § 1232 (3d ed. 1957); RESTATEMENT OF SECURITY § 132, Comment b (1941); G. BRANDT, THE LAW OF SURETYSHIP AND GUARANTY VOL. I, § 480 (3D ED. 1905). *See generally*, 38 AM. JUR. 2D *Guaranty* § 84 (1968); 38 C.J.S. *Guaranty* § 81 (1943).

dictions in holding that a creditor's release of a security without the guarantor's consent discharges the guarantor only to the extent of the value of the security, or the amount by which he was actually injured.[22]

In 1972, defendant Klutts Resort Realty (Klutts Realty) executed a promissory note to plaintiff Edge to obtain funds to build a condominium. The note was secured by a purchase money mortgage on a four acre tract of land. As agreed, plaintiff subordinated his mortgage to one given to North Carolina National Bank Mortgage Corporation (N.C.N.B.). Two years later, Edge agreed to further subordinate his mortgage to a second N.C.N.B. mortgage in return for personal guarantees given by J. V. Klutts and P. W. Bradham, the two co-directors of Klutts Realty.

As a result of financial difficulties, Klutts Realty conveyed to N.C.N.B. the property securing the plaintiff's note in lieu of foreclosure by N.C.N.B. and in consideration for releasing J. V. Klutts and P. W. Bradham from personal liability. Simultaneously, Edge cancelled his mortgage at N.C.N.B.'s request. Edge, however, by explicit language, did not cancel the debt owed to him by Klutts Realty. As consideration for the mortgage cancellation, N.C.N.B. paid Edge a sum and agreed to pay him a percentage of the proceeds from condominium sales. After applying amounts received from N.C.N.B. to the note, the plaintiff brought an action against Klutts Realty as the maker of the note and J.V. Klutts and P.W. Bradham as guarantors to recover the balance due. The trial judge granted summary judgment for all the defendants, holding that when a creditor releases a security without the guarantor's consent, the debt is discharged. On appeal, the supreme court reversed and remanded.[23]

In reversing summary judgment for Klutts Realty, the supreme court held that a mortgagee can ignore the mortgage and sue the maker of the debt for collection on the note alone.[24] Although the court did not expressly state the reason for this rule, it is consistent with the court's holding in *Perpetual Building &*

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22. 276 S.C. 393, 278 S.E.2d at 785.

23. *Id.* at 390, 278 S.E.2d at 784.

24. *Id.* at 392, 278 S.E.2d at 785. *See* L. JONES, A TREATISE ON THE LAW OF MORTGAGES OF REAL PROPERTY VOL. III, § 1572 (8th ed. 1928); *See generally*, 55 AM. JUR.2D *Mortgages* § 536 (1971); 59 C.J.S. *Mortgages*, § 4895 (1949).

Loan Ass'n v. Braun.[25] In *Perpetual Building*, the court reasoned that a mortgage is not payment of an obligation, but security for it.[26] The supreme court's recognition of this independence of security and debt suggests that a debt can be satisfied by looking to either the note, as evidence of the debt,[27] or to the mortgage as security for the debt.[28]

In deciding the issue of whether Klutts and Bradham, as individual guarantors, had consented to the plaintiff's release of the mortgage, the supreme court also reversed summary judgment and remanded the case to the trial court for a determination of the factual issue of consent. The court concluded that, in any event, the plaintiff's failure to obtain the guarantors' consent prior to releasing the mortgage would only discharge the debt to the extent of the value of the security surrendered, or the amount by which the guarantors were actually damaged.[29] This is the rule in a majority of American jurisdictions.[30] Based on principles of equity, the rule stems from the possible impairment of a guarantor's right to subrogation;[31] that is, the right to use the security to satisfy the debt.

The court's decision in *Edge* raises questions concerning the either-or formulation of this rule of guaranty law. As stated by the court, the guarantor is discharged by the amount of the actual injury to his financial status or by the value of the security. Conceptually, the two amounts are different sides of the same coin. Because the security represents the guarantor's right to subrogation, a diminution in the value of the security should cause an equal diminution in the financial status of the guarantor. Therefore, the guarantor is injured by the amount that the security is diminished. However, a practical difference may exist between the two methods for determining the amount of discharge. The value of the security would be determined by look-

25. 270 S.C. 338, 242 S.E.2d 407 (1978).

26. *Id.* at 340, 242 S.E.2d at 408.

27. *See, e.g.*, Riegel v. Belt, 1190 Ohio St. 369, 379, 164 N.E. 347, 350 (1928); Anderson v. Warren, 196 Okla. 251, 253, 164 P.2d 221, 223 (1945).

28. *See, e.g.*, Pioneer Credit Co. v. Latendresse, 286 N.W.2d 445, 447 (N.D. 1979); Mardirossian v. Wilder, 76 N.J. Super. 37, 40, 183 A.2d 761, 762 (1962); Matthews v. Hinton, 234 Cal. App. 2d 736, 742, 44 Cal. Rptr. 692, 696 (1965).

29. 276 S.C. at 393, 278 S.E.2d at 785.

30. *See supra* note 21.

31. *See* WILLISTON, *supra* note 21, G. BRANDT, *supra* note 21.

ing to its market value,[32] while injury to the guarantor might be determined by examining the change in the guarantor's financial or legal status. In *Edge*, the court seems to have chosen the latter approach by focusing on the actual effect of the creditor's actions on the guarantors' financial status.[33]

Edge v. Klutts Resort Realty evidences the South Carolina Supreme Court's recognition that a note and a mortgage furnish a creditor with separate and distinct causes of action. This case further suggests the court's concern for an equitable resolution of the guarantor's rights based on a factual determination of actual injury.

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32. *See, e.g.*, Sterling Factors Corp. v. Freeman, 50 Misc. 2d 715, 271 N.Y.S.2d 343, *aff'd* 27 A.D.2d 959, 279 N.Y.S.2d 577 (1966).

33. The court found that Klutts and Bradham were not injured by the mortgage cancellation. Indeed, the cancellation brought about the advantages of releasing them from personal liability on the debt to N.C.N.B. and reduction of the debt owed to Edge. Thus, the court disapproved of their attempt to receive the additional benefits of release from the note. 276 S.C. at 393, 278 S.E.2d at 785.