July 2009

UPDATE ON RECENT CASE LAW

Over the last 18 months, the courts of Mississippi and Tennessee have rendered several decisions which should serve as lessons for lenders reentering the credit arena. In several cases, courts have ruled on defences to repossession and recovery, the validity of unrecorded instruments and the level of inquiry which a lender may be required to make with regard to borrowers' financial condition.

In this issue, we have picked a few of the decisions which have the greatest impact on lenders and have provided synopses and some observations. While many of the holdings are obvious, some of the surrounding facts should be examined in depth and applied to current practice.

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Some Lessons in Extended Litigation

Lenders have often expressed their frustration regarding all the dilatory tactics available to postpone or even defeat collection efforts. Of course, the basis of all of these delays is due process, a notation so ingrained in American thought as to be instinctive, and seldom analytically applied. Because our laws are so skewed towards individual rights, we often have to take the bad with the good. Excessive litigation delays can render the most favorable outcomes a pyrrhic victory.

BALLARD v. COMMERCIAL BANK OF DEKALB
991 So.2d 1201 (MS 2008)

Ballard is unremarkable in that it is basically a case where a grandfather mortgaged land twice for his grandson's timber operations. When the time came to pay for such a good deed, claims of invalidity (based on a failure of the first deed of trust to specifically identify the debt secured), fraud and lack of consideration all failed. The Mississippi Supreme Court did allow a loose standard to the introduction of extrinsic evidence in determining the intent of the first deed of trust, and the case may later be cited for the proposition that some omissions can be filled in by the court.

However, what might be of special interest to lenders is the fact that the original deed of trust was entered into on June 29, 2001 and the second deed of trust was November 28, 2003. The Grandson filed for bankruptcy in October, 2004, and it should be assumed that the Bank began its collection efforts at about that time. This decision is dated October 9, 2008, and it is this decision which finally allows the bank to proceed to foreclosure. On top of that, the Grandfather died January 20, 2007. While there is no indication that he or his estate had any personal liability for the grandson's debts, this occurrence could further hinder the collection efforts of the bank.

The Result? Good news, the bank wins. Bad news is that winning means that what might have been a rock solid loan to value ratio has been delayed into the recession, Grandson's debts are discharged, and Grandfather is beyond any legal process. What a difference four years can make! From the case, there do not appear to be any sure fire ways the bank could have avoided this result; after all, they were right. Some of the defenses to the note appear flimsy, but absent a showing of bad faith of the most egregious kind, there aren't many counter punches to a suit such as this. A sense of justice would indicate that the Grandfather's estate ought to have some responsibility to make the Bank whole, but there is no cut and dried procedure for such an action.

But four years is nothing. Consider:

DEERE & COMPANY AND PARKER TRACTOR & IMPLEMENT COMPANY, INC.
v.
FIRST NATIONAL BANK OF CLARKSDALE AND EDWARD J. JOHNSON, JR. d/b/a F & E FARM.
No. 2007-IA-01362-SCT.

In the words of the court:

> The initial appearance of complexity is due to the procedural wrangling that has been complicated with nearly simultaneous filings, trials, appeals, rehearings, and further appeals in both state and federal court, all arising from the same nucleus of operative fact.

But those facts are not so simple. Debtor bought a combine in 1994, and used it for three seasons contending all along that it did not work properly and paying about one fifth of the purchase price. In September, 1995, Deere sued the Debtor in the US Federal Court for the Northern District of Mississippi. In October, 1995, the Debtor sued Deere, more intelligently (in retrospect) in the Coahoma County Circuit Court. In 1996, Deere actually repossessed the combine, and in 1998, a judgment of $90,000 was entered in favor of the debtor by the Circuit Court. While this judgment was on appeal, the federal case was tried and on appeal, in November of 2001, the Fifth Circuit Court of Appeals affirmed a take-nothing judgment on the matter. In January 2002, the Supreme Court of Mississippi affirmed (on rehearing) the judgment of the circuit court. Deere then sought to collaterally attack the judgment of the Supreme Court by a new federal action in the Northern District of Mississippi, which was denied and affirmed in 2003.

Now comes the current case. Apparently, First National Bank of Clarksdale, sued the Debtor in 2001 and sought to garnish the $90,000 judgment for another unrelated debt, and upon execution found Deere to be less than agreeable to paying the same. Again the matter was appealed through the Mississippi State Court System to the effect that the Mississippi Supreme Court, with little effort to hide its displeasure with yet another effort to impose the Federal Court judgment over its 2002 decision, stated:

> The underlying case has been decided to final judgment. Deere refuses to accept, and in fact completely ignores, the rulings of this Court, the Fifth Circuit Court of Appeals, the Federal District Court for the Northern District of Mississippi, the Circuit Court of Coahoma County, and the Coahoma County Court, each of which has stated explicitly that this Court's judgment is res judicata on the issue of Deere's liability. Deere has been found liable for $90,000 in favor of Johnson. The current suit to enforce collection through writ of garnishment is proper and may not be dismissed on summary judgment because Deere prefers the take-nothing judgment rendered, and later implicitly declared moot, by the federal courts.

A dispute over whether a combine worked as advertised and a simple repossession is now a fourteen year saga. One lender, Deere, has learned the cost of not accepting no as an answer. If Deere's fees involved in the fourteen year period were less than the $90,000 it would be astonishing. A second lender has been delayed in a simple garnishment action for eight years. The borrower seems to be the only party coming out ahead in the transaction. He at least had a semi-working combine for three years for free (after netting his payment against his ultimate judgment)

Miscommunications from Bank Employees

Regardless of training and experience, often borrowers will be able to solicit representations from Tellers or other bank employees who my not be empowered to make certain commitments regarding loans, or who may not have sufficient knowledge about a particular credit to make any representations. Often, too, the alleged representations are merely fabrications born of excessive wishful thinking.

TOMMY THOMPSON, APPELLANT,
v.
FIRST AMERICAN NATIONAL BANK,
APPELLEE.
No. 2008-CA-00244-COA.

The borrower was often in arrears under his loan for the purchase of 112 acres for during the latter part of 2002 and the early part of 2003. The bank began foreclosure proceeding one June 3, 2003 and conducted the foreclosure sale on July 8, 2003. However, the Borrower indicated that he had visited with a bank teller and had asked if the payment of less than the full amount of arrearages would be sufficient to postpone the foreclosure. The Borrower indicated that the teller had confirmed that this was so, although the teller was later to testify that she had no knowledge of the foreclosure.

Fortunately, the court took the position that even if the event occurred as the borrower alleged, a summary judgment confirming the foreclosure was proper. In order to so find, the court had to determine that there was no consideration for accepting less than all that was owed, that there was no fraud being perpetrated as a result of the teller's statement, and that the teller had no authority to make such representation. However, it is important to note that the Court did say:

> It is common knowledge that a bank teller is not a bank officer and that the job of a bank teller does not encompass making decisions in mortgage foreclosure matters. Further, the bank teller did not foreclose on Thompson's property and had no authority to do so. Maybe we would have a different situation if it were the president of First American that had made the promise or if there were any evidence that the bank teller was authorized to speak for First American, but we do not. Therefore, there is no genuine issue of material fact regarding whether First American ever promised Thompson anything regarding its willingness to forgo foreclosure proceedings in exchange for his making only two of the four installments that were already past due.

Action against a nominee (MERS)

In another case, the Mississippi Supreme Court upheld the action of a Circuit Court in setting aside a default judgment against Mortgage Electronic Registration Systems, Inc. (MERS).

LUBERTHA WELCH, APPELLANT
v.
BANK ONE NATIONAL ASSOCIATION, AS TRUSTEE APPELLEE
No. 2007-CA-01475-COA.

In what must be an early use of MERS (which was basically created to provide flexibility in the transfer of mortgage backed securities) an action to invalidate a MERS foreclosure was successful on default, since service to MERS gave no notice to the true party in interest on the home loan (or the foreclosed property). As a result, the true lender, Bank One had no notice an was not able to appear. The court was properly liberal in setting aside the default, and the case was reported only as a result of a dismissal later granted as a result of the plaintiff to properly pursue the action, but the case should serve as a heads up in the event any lender should have retained servicing or put obligations with respect to securitized loans. In the event the loans or the foreclosed property should return to the lender, care should be taken to see that record title to the property or the mortgage thereon is proper.

Unrecorded Instruments in Tennessee

In Tennessee, recent case law seems to indicate that the courts may require an extremely high level of due diligence in reviewing an applicant's file during the extension of credit, even a level of due diligence which might require conjuring up an unrecorded deed of trust, notwithstanding a title search.

MANUFACTURERS ACCEPTANCE CORPORATION v. U.S. BANK NATIONAL ASSOCIATION
No. E2008-00122-COA-R3-CV
COURT OF APPEALS OF TENNESSEE, AT KNOXVILLE
2008 Tenn. App. LEXIS 723
July 22, 2008, Session
November 14, 2008, Filed

Actually, the Tennessee Court of Appeals for the eastern district found that a sufficient issue of fact existed as to whether a prudent lender would look for an unrecorded deed. However, it is interesting to note that the trial court (Knox County) found that as a matter of law, where a credit report contained cryptic references to the terms “transfer” and a “real estate mortgage”, and where the earlier dismissed Chapter 13 schedule had indicated (prior to amendment) that a prudent lender would know of an unrecorded mortgage. This seems a rather low level of notice and imposes a level of prescience on a lender which might be unattainable. However, the opinion seems to leave out a great deal of the facts, and there may be more than meets the eye.

Another recent Tennessee case has addressed the issue of unrecorded instruments, this time in connection with subordination agreements.

WASHINGTON MUTUAL BANK v.
N.K.T. LAND ACQUISITIONS INC., ET AL.
No. M2007-02040-COA-R3-CV
COURT OF APPEALS OF TENNESSEE, AT NASHVILLE
2008 Tenn. App. LEXIS 414
March 25, 2008, Session
July 23, 2008, Filed

Two mortgage holders were in a priority fight. It was clear that one mortgage was recorded ahead of the other, but what was at issue was a subordination agreement which made the second mortgage superior. Needless to say, the subordination agreement was not recorded, and to make matters more interesting, the holders of the two mortgages were both assignees of the original parties to the subordination.

The Tennessee court of Appeals for the middle district had no problem holding that as a matter of law (though it did have a problem reaching this conclusion succinctly), subordination agreements must be recorded. The only issue in the case was the determination of whether the holder of the subordinated mortgage had actual notice of the subordination. Of special interest is the court’s treatment of inquiry notice as a subset of actual notice. The court is clear that constructive notice is the notice people receive from the fact that a document is recorded. Inquiry notice is defined by the court as quasi-actual notice, and under the facts of this case, certain items (such as the relative sizes of the mortgages and the fact that the subordinated loan was an existing home equity loan which advanced in priority due to a refinance of the acquisition loan.) Unlike the Manufacturers Acceptance case above, it appears that the holder of the subordinated mortgage actually knew of the subordination, or at least suspected it.

Discharging a Revolving Line in Tennessee

Another Tennessee case serves as a warning to those who might be paying off a revolving line of credit with a new loan. Tennessee law has provided for open ended mortgages for several years, and such mortgages have been used in the consumer area in connection with home equity lines. However, some of these mortgages require not only the payoff of sums due under the line, but a specific request that the line be terminated as well. Failing that, the line of credit and the open end mortgage will remain in place, and in addition, subsequent advances may prime the refinancing lien.

WASHINGTON MUTUAL BANK, F.A. v.
ORNL FEDERAL CREDIT UNION, ET AL.
No. E2007-02421-COA-R3-CV
COURT OF APPEALS OF TENNESSEE, AT KNOXVILLE
2008 Tenn. App. LEXIS 360
April 22, 2008, Session
June 24, 2008, Filed

Such an occurrence was exactly the case above. The court noted specifically that the terms of the line of credit (open end) mortgage specifically provided that a termination of the line was a prerequisite to the release of the lien. Because the refinancing lender had both constructive (in the form of recordation) and actual knowledge of not only the lien, but the terms under which it is to be released, the new lender cannot claim any priority over the future advances made under the line after the refinance. The lesson to lenders is that the terms of any debt being discharged with loan proceeds need to be carefully examined. Keep in mind that releases from existing mortgagees are not required at closing. The chicken and egg issue of prior lien releases has long been settled in practice to the point that a pay-off statement usually suffices to write a title policy over the paid off lien when evidence of the payoff is included in the title file. If the lien being paid off is not being released, and is to stand with priority for future advances, this could be a nasty surprise to parties who have operated under general assumptions over the years.

Financing and Creditors Rights

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