DROPPING THE HAMMER: WHY THE SOUTH CAROLINA SUPREME COURT'S DECISION IN *MATRIX FINANCIAL SERVICES CORP. V. FRAZER* HARMS REFINANCING LENDERS AND CONSUMERS

*Josh Crowfoot**

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I. INTRODUCTION

On August 8, 2011, the South Carolina Supreme Court reissued its opinion in a controversial case, *Matrix Financial Services Corp. v. Frazer*,[1] the implications of which have great potential to wreak havoc in the mortgage refinance industry within the state. In its original majority opinion (*Matrix I*), the court narrowly interpreted some of the requirements of equitable subrogation, making it virtually unavailable as a remedy to refinancing lenders in a priority dispute against third party lienholders (i.e., judgment creditors). In *Matrix I,* the court's stance on equitable subrogation eroded certainty as to whether refinancing lenders have a truly secure interest in the property that collateralizes their loans.

In addition, the court announced a new rule in *Matrix I* that any refinancing lender who engages in the unauthorized practice of law (UPL) will not have a remedy in equity.[2] While the court's new rule sounded good in theory, its implementation in *Matrix I* proved overly harsh, allowing a third party to recover a windfall.

In its reissued opinion (*Matrix II*), the court's majority does three things: (1) limits the availability of equitable subrogation only to those refinancing lenders who are *not* refinancing their original mortgage; (2) removes unclean hands as a basis for deciding the case; and (3) reiterates the ruling from *Matrix I* that

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1. No. 26859, 2010 S.C. LEXIS 289, at *1 (Aug. 16, 2010), *rev'd on reh'g*, 2011 S.C. LEXIS 258, at *1 (Aug. 8, 2011).

2. *Id*. at *8 (Pleicones, J., dissenting).

parties that participate in UPL will not find a relief in equity.[3]

Although *Matrix II* provides clearer direction to refinancing lenders, it provides little salve for them or consumers because many of the possible negative repercussions from the court's opinion in *Matrix I* still remain in *Matrix II*.

As in *Matrix I*, the ruling in *Matrix II* still likely increases the rate of foreclosure in the state because lenders will have further reason to avoid helping borrowers at risk of defaulting on their current mortgage. In addition, *Matrix II* definitively puts a refinancing lender on notice that if it ever needs or chooses to refinance a borrower's mortgage, and it is also the lender holding the original mortgage, then it will not have priority in any dispute against third party lienholders like judgment creditors or bankruptcy trustees who record their interest after the original mortgage is recorded. In other words, simply because the lender happens to be refinancing its own original mortgage, and because it is not a new third party lender, it cannot avail itself of equitable subrogation.

Also, as in *Matrix I*, the court's ruling in *Matrix II* increases the cost imposed on consumers to refinance their homes because lenders will perceive an increased risk when performing such transactions within the state. Finally, in *Matrix I*, the court's retroactive punishment of Matrix Financial Services Corporation (Matrix) for the unauthorized practice of law related to a loan that closed before the court clarified that such rules applied to refinancing lenders called into question the security such lenders had in their current loans. In *Matrix II*, the majority opinion states that the language in *Buyers Service*[4] clearly put lenders on notice that the extent of attorney supervision required for purchase money mortgages also applied to mortgage refinance transactions, too. Of course, this statement runs contrary to the court's own declaration that it decides matters relating to UPL on a case-by-case basis. Prior to deciding *Doe v. McMaster*[5] in 2003, the court had not specifically addressed the case of a refinancing lender participating in UPL. It would be unfair

3. *Id*. at *1 (majority opinion).
4. State v. Buyers Serv. Co., 357 S.E.2d 15 (S.C. 1987).
5. Doe v. McMaster, 585 S.E.2d 773 (S.C. 2003).

retroactively to apply the consequences of UPL to refinance closings, such as the one that took place in *Matrix*, which occurred after the 1987 ruling in *Buyers Service* but before *Doe v. McMaster*'s decision in 2003.

This Note discusses the majority, concurring, and dissenting opinions of *Matrix I* and recommends a return to a more reasonable interpretation of equitable subrogation that will aid lenders and, ultimately, consumers. In addition, this Note offers a solution as to how the courts can reprimand lenders for the unauthorized practice of law without unduly punishing them and unjustly enriching third parties in the process. Last, this Note discusses the relevant changes in the court's reasoning in *Matrix II* and how the opinion still proves inadequate to protect refinancing lenders and consumers in the state.

II. THE ORIGINAL *MATRIX* OPINION

A. Background

The dispute in *Matrix* began in 1998 when Matthew Kundinger filed suit against Louis and Linda Frazer in California.[6] The Frazers did not resolve the lawsuit, and two years later they moved to Greenville, South Carolina, where they purchased a home in January 2001.[7] In June 2001, the Frazers' mortgage was assigned to Matrix, and in September 2001, Matrix and the Frazers refinanced the original mortgage.[8] Meanwhile, Kundginer obtained a default judgment against the Frazers in California.[9]

On September 18, 2001, Matrix performed a title search prior to its refinance of the Frazers' mortgage and found no lien on their home.[10] It was not until October 31, that Kundinger enrolled his judgment against the Frazers in Greenville County.[11] On November 26, the Frazers closed on the refinance

6. *Id.*
7. *Id.*
8. *Id.* at *1–2.
9. *Id.*
10. *Id.*
11. *Id.*

of their mortgage with Matrix.[12] There was no evidence in the record that when Matrix closed on the refinance it had any notice of the judgment enrolled against the Frazers in Greenville County.

On April 3, 2002, Matrix recorded its mortgage.[13] The Frazers later filed for bankruptcy, and Matrix sought to foreclose on its November 2001 mortgage.[14] Kundinger counterclaimed, asserting that his judgment had priority over Matrix's mortgage because it had been recorded first.[15] In response, Matrix sought equitable subrogation over Kundinger's judgment lien.[16] The master-in-equity granted Matrix's request.[17] The South Carolina Supreme Court certified the case for review and reversed the master-in-equity's ruling.[18]

B. The Majority's Decision Regarding Equitable Subrogation

The Restatement (Third) of Property explains subrogation in the context of mortgage law as follows: "One who fully performs an obligation of another, secured by a mortgage, becomes by subrogation the owner of the obligation and the mortgage to the extent necessary to prevent unjust enrichment."[19] In *Matrix I*, the court held that Matrix did not meet the requirements under South Carolina law to be entitled to equitable subrogation.[20] Using *Dedes v. Strickland*,[21] the court listed the requirements that a mortgagee (refinancing lender) must meet to qualify for equitable subrogation:

> (1) the [lender] has paid the debt; (2) the [lender] was not a volunteer, but had a direct interest in the discharge of the debt or lien; (3) the [lender] was secondarily liable for the debt or for

12. *Id*.
13. *Id*.
14. *Id*.
15. *Id*.
16. *Id*.
17. *Id*.
18. *Id*. at *7.
19. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6(a) (1997).
20. *Matrix*, 2010 S.C. LEXIS 289, at *3–4.
21. 414 S.E.2d 134 (S.C. 1992).

> the discharge of the lien; (4) no injustice will be done to [an intervening lienholder] by the allowance of equitable subrogation; and (5) the [lender] asserting the doctrine did not have actual notice of the prior mortgage.[22]

In addressing why Matrix could not use the remedy of equitable subrogation, the court focused on the second (volunteer) and third (secondary liability) requirements.[23] The court stated:

> To meet the criteria for equitable subrogation, a party [Matrix] must have liability for the debt other than a voluntary agreement to refinance its own earlier mortgage. Otherwise, a lender can simply refinance the debt at any time to prevail over an intervening lienholder [Kundinger], rendering the requirement of secondary liability meaningless.[24]

In *Matrix I*, the majority took the broad view that whenever a lender performs a refinance transaction, it has no "direct interest necessitating discharge of [a] debt."[25] Thus, the refinancing lender acts as a volunteer when it pays off a borrower's original mortgage and cannot avail itself of the remedy of equitable subrogation.[26]

In addition, the court found that Matrix introduced no evidence that it had any "liability for the *original* mortgage before it voluntarily refinanced the balance owed. Thus, Matrix had no obligation to pay off its existing mortgage."[27] The court noted that the absence of *any* liability with the *initial* mortgage precluded it from later establishing that it had any *secondary* liability to meet the requirements of equitable subrogation.[28]

22. *Matrix*, 2010 S.C. LEXIS 289 at, *3 (quoting *Dedes*, 414 S.E.2d at 136).
23. *Id*. at *3–4.
24. *Id*.
25. *Id*. at *3 (citing *Dedes*, 414 S.E.2d at 136) (internal quotations omitted).
26. *Id*. at *4.
27. *Id*. (emphasis added).
28. *Id*.

C. The Majority's Decision Regarding Unclean Hands

In *Matrix I*, the court held that even if Matrix had met the requirements of equitable subrogation, Matrix would have still been denied equitable relief because it had unclean hands.[29] The court ruled that Matrix had unclean hands because it committed the UPL by closing a refinance loan without supervision of an attorney.[30]

Citing *Doe v. McMaster*,[31] *Ingram v. Kasey's Associates*,[32] and *Wachovia Bank v. Coffey*,[33] the court reiterated that (1) real estate and mortgage loan closings, including refinances, must be supervised by an attorney; (2) lenders that perform a title search, prepare loan and title documents, or close a loan without supervision of an attorney commit UPL; and (3) a party that commits UPL with respect to a home loan closing has unclean hands and will be barred from equitable relief.[34]

The court held that Matrix participated in UPL when it hired LandAmerica OneStop, a title company, "to perform the title search, prepare the documents, and close the refinance loan" without supervision of an attorney.[35] In vigorous defense of the majority's reasoning, Chief Justice Toal remarked that "[t]he dissent's protestations aside, a party cannot violate the law and expect not to bear the consequences of its actions. This Court will not grant a discretionary, equitable remedy to a party who refused to follow the laws of this state."[36] Justice Kittredge concurred but saw "no need to reach the broader question of the underlying efficacy of a real estate mortgage secured through [UPL] and the general availability of foreclosure relief in such circumstances."[37] Justice Kittredge wrote that it was enough to simply deny Matrix the remedy of equitable subrogation because

29. *Id*. at *6.
30. *Id*.
31. 585 S.E.2d 773 (S.C. 2003).
32. 531 S.E.2d 287 (S.C. 2000).
33. No. 4685, 2010 S.C. App. LEXIS 78 (May 6, 2010).
34. *Matrix*, 2010 S.C. LEXIS 289, at *5 (quotations omitted).
35. *Id*. at *6.
36. *Id*.
37. *Id*. at *7 (Kittredge, J., concurring).

"the mortgage was secured through [UPL]."[38]

D. Justice Pleicones's Dissent

Justice Pleicones believed the majority's reasoning was flawed for two different reasons: (1) the majority misunderstood the requirement of secondary liability as it relates to a party asserting the doctrine of equitable subrogation, and (2) "in dicta, the majority create[d] a new rule that equity [would] not aid a party that violated South Carolina law in closing a mortgage because the party [had] unclean hands, a rule . . . [that] may have chaotic unintended consequences."[39]

1. The Majority's Misapprehending of Equitable Subrogation

In his dissent, Justice Pleicones stated that the majority erred in how it approached the issue as to whether Matrix was entitled to equitable subrogation.[40] Rather than focus on whether Matrix should be punished for UPL, Pleicones opined instead that the majority should have addressed more carefully the issue of whether Matrix should be equitably subrogated to Kundinger's judgment lien.[41] Thus, while it was clear to Justice Pleicones that Matrix needed to be punished for UPL, the trickier issue was whether the facts of *Matrix* warranted a complete bar to the remedy of equitable subrogation.

Unlike the majority, Justice Pleicones found that Matrix, as a refinancing lender, *was* secondarily liable for the payoff of the Frazers' original mortgage.[42] Using *Enterprise Bank v. Federal Land Bank*[43] rather than *Dedes*—which Pleicones thought the majority misread—Pleicones stated:

> In [a refinance], the lender furnishing the money is *not* a volunteer, and becomes secondarily liable for the discharge of the first mortgage under the instruments creating the *new*

38. *Id*.
39. *Id*. at *8 (Pleicones, J., dissenting).
40. *Id*. at *9.
41. *Id*.
42. *Id*. at *11.
43. 138 S.E. 146 (S.C. 1927).

> mortgage which require the *satisfaction of the first mortgage* as a *condition* of the giving of the second.[44]

Thus, Justice Pleicones recognized what the majority seemed to have missed. Rarely does a refinancing lender ever *volunteer* to refinance the mortgage of a borrower without having some security interest in real property to collateralize its loan. Justice Pleicones stated: "Matrix was not a volunteer but was directly interested in the discharge of the original mortgage, and was secondarily liable for its discharge by virtue of its agreement to make a new loan to the Frazers conditioned on the payoff of the first mortgage."[45]

The dissent also cited *James v. Martin* to support the argument that refinancing lenders deserve to be equitably subrogated to intervening lienholders.[46] Under *James*, a party that satisfies a lien at the request of the property owner without having notice of any other lien on the property—although it is on record—and who does so with the understanding that he will have a security interest in the property, will be subrogated to the rights of the lienholder.[47]

Under the rule fashioned by the majority regarding refinancing lenders and equitable subrogation, Justice Pleicones astutely observed that "[a] rule that *only* lenders *forced* to refinance an existing mortgage are *not* volunteers would effectively eliminate the availability of the equitable subrogation remedy."[48] In addition to citing South Carolina case law that supports the availability of the equitable subrogation remedy for refinancing lenders in their ordinary course of business, Justice Pleicones mentioned that the Restatement (Third) of Property section 7.3 supports such a notion.[49] Referring to a Washington Supreme Court case that follows the Restatement, Pleicones

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44. *Matrix*, 2010 S.C. LEXIS 289, at *11 (Pleicones, J., dissenting) (emphasis added).

45. *Id*. at *12.

46. 147 S.E. 752 (S.C. 1929).

47. *Matrix*, 2010 S.C. LEXIS 289, at *11 (Pleicones, J., dissenting) (quotations omitted) (citing *James*, 147 S.E. at 758).

48. *Id*. at *12 n.1 (emphasis added).

49. *Id*. at *12–13.

wrote:

> As the Washington Supreme Court explained, the . . . following policy considerations support a rule that, absent material prejudice to a junior lienholder, equitable subrogation should be automatically available to a mortgage refinancer who can show it expected to have first priority:
>
> > (1) Equitable subrogation preserves priorities by keeping mortgages and other liens in their proper recordation order;
> >
> > (2) Equitable subrogation accomplishes substantial justice and rests on the maxim that no one (here, the junior lienholder) should be enriched by another's loss;
> >
> > (3) Facilitating refinancing helps prevent foreclosures; and
> >
> > (4) A liberal equitable subrogation policy reduces title insurance premiums.[50]

Because South Carolina law supports the availability of equitable subrogation for refinancing lenders acting in their ordinary course of business and because persuasive authority like the Restatement lists sound policy reasons for following such a course of action, Justice Pleicones argued that Matrix should have been equitably subrogated to the rights of Kundinger, the intervening lienholder.[51]

2. Unclean Hands Has Potential Chaotic Consequences

Although Justice Pleicones agreed with the majority that Matrix's closing of its refinance loan was unlawful because it did not involve the supervision of an attorney, he did not find that Kundinger could assert unclean hands because he was not a party directly involved in the refinance transaction between Matrix and the Frazers.[52] "[C]lean hands means a clean record with respect to the transaction with the defendants themselves

50. *Id.* at *13 (internal quotations omitted) (quoting Bank of Am. v. Prestance Corp., 160 P.3d 17 (Wash. 2007)).

51. *Id.* at *14.

52. *Id.*

and not with respect to others."[53] The Justice stated, "It is unclear to me how [Kundinger], a stranger to the mortgage transaction, is in a position to assert 'unclean hands' with respect to the closing."[54] While Matrix might have deserved punishment, Justice Pleicones expressed concern about the majority's application of the unclean hands defense:

> The majority does not explain why appellant [Kundinger] may assert "unclean hands" with respect to the mortgage between Matrix and the Frazers, leaving the reader to assume the Court is altering the requirement that only a party to the transaction may assert the bar. I am not comfortable altering the principles of equity in the absence of a persuasive policy reason.[55]

Thus, Justice Pleicones did not find the doctrine of unclean hands applicable under the facts of this case where a third party, an intervening judgment creditor, was asserting it as a defense.[56]

However, what Justice Pleicones found more troubling than altering a time-honored equitable doctrine was the majority's creation of a new, harsh rule that would punish lenders by denying them the ability to foreclose on a property if any aspect of the closing was found to be "unlawful."[57] Justice Pleicones wrote:

> Perhaps more disturbingly, the impact of a decision holding that equity will not aid a mortgagee when the closing was unlawful will be devastating, undermining lender confidence in an already unstable market, and making title insurance virtually unavailable in South Carolina. Even if we were to adopt such a harsh rule, the Court should acknowledge in fairness and equity, that the law has been evolving in the area of residential real estate closings, and thus many mortgagees may hold mortgages that were closed "unlawfully."[58]

53. *Id*. (quoting Arnold v. City of Spartanburg, 23 S.E.2d 735, 738 (S.C. 1943) (internal quotations omitted)).

54. *Id*.

55. *Id*. at *14–15.

56. *Id*.

57. *See id*. at *14–16.

58. *Id*. at *15 (citing State v. Buyers Serv. Co., 357 S.E.2d 15 (S.C. 1987);

To understand the import of Justice Pleicones's words, some context about how the South Carolina Supreme Court has treated the unauthorized practice of law with regard to real estate transactions is important. In a commentary about the potential significance of the *Matrix* case for practicing attorneys in South Carolina, two attorneys from Nelson, Mullins, Riley & Scarborough, LLP, best summarize the patchwork quilt that is the development of law pertaining to UPL and real estate transactions:

> In 1992, the South Carolina Supreme Court declined to adopt comprehensive rules governing the unauthorized practice of law, opting instead to promulgate UPL rules through litigation: "We are convinced . . . that it is neither practicable nor wise to attempt a comprehensive definition by way of a set of rules. Instead, we are convinced that the better course is to decide what is and what is not the unauthorized practice of law in the context of an actual case or controversy." Consequently, South Carolina's UPL rules governing mortgage loan closings have developed in an evolving fashion, on a case-by-case basis. By definition, this case-and-controversy approach has lagged marketplace practices, so that it is almost inevitable that there are mortgage loan refinances, home equity lines of credit, and other real-estate-secured loans that were closed in a manner *only later* determined by our court to constitute the unauthorized practice of law. Holders of such loans are at risk of never being able to enforce their mortgages through foreclosure.[59]

The case-by-case approach that the South Carolina Supreme Court has adopted towards UPL in real estate transactions allows lenders to be punished for acts that occurred prior to any clarification by the court on exactly what constitutes the unauthorized practice of law. In fact, this is exactly what

Doe v. McMaster, 585 S.E.2d 773 (S.C. 2003); Doe Law Firm v. Richardson, 636 S.E.2d 866 (S.C. 2006)).

59. Rush Smith & Emma Dean, *South Carolina Supreme Court Holds That Closing a Loan Without a Lawyer's Supervision Constituted Unclean Hands, Barring the Lender from Seeking Equitable Relief,* NELSON MULLINS RILEY & SCARBOROUGH LLP 1 (Aug. 16, 2010) (quoting *In re* Unauthorized Practice of Law Rules, 309 S.C. 304, 305, 422 S.E.2d 123, 124 (1992), *available at* http://www.nelsonmullins.com/DocumentDepot/Smith_Matrix_Commentary.pdf).

happened to Matrix.[60] Matrix refinanced the Frazers' loan in November 2001.[61] However, it was not until 2003, in *Doe*, that the South Carolina Supreme Court ruled that the requirements for refinance mortgages were the same as those for purchase-money mortgages when it came to avoiding the unauthorized practice of law.[62]

When Justice Pleicones wrote that it was important to avoid "undermining lender confidence in an already unstable market" and that "fairness and equity" dictate the consideration that "the law has been evolving in the area of residential real estate closings," he rightly expressed concern about the court adopting a policy that would punish lenders for behavior that was not clarified as improper when it originally happened.[63]

E. The South Carolina Supreme Court's View of Equitable Subrogation in *Matrix I* and How It Harmed Both Lenders and Consumers

The South Carolina Supreme Court's ruling on equitable subrogation for refinancing lenders steered away from recognized case law in South Carolina. With its interpretation of the requirements of "volunteer" and "secondary liability" for equitable subrogation in *Matrix I,* the court effectively removed the available remedy of equitable subrogation for refinancing lenders.[64]

Many jurisdictions adhere to the principle that a lender who discharges its mortgage of record and records a replacement mortgage retains priority as against intervening lienholders unless the lender intended a subordination of its mortgage[65] or

60. *Id*. at 1 n.2.

61. *Matrix*, 2010 S.C. LEXIS 289, at *2.

62. *Doe*, 585 S.E.2d at 776 ("In sum, refinancing affects identical legal rights of the buyer and Lender as initial financing and protection of these rights is the crux of the practice of law.").

63. *Matrix*, 2010 S.C. LEXIS 289, at *15 (Pleicones, J., dissenting).

64. *Id*. at *12 n.1.

65. *See, e.g.*, Stephens Wholesale Bldg. Supply Co. v. Birmingham Fed. Sav. & Loan Ass'n, 585 So.2d 870, 872–73 (Ala. 1991); Home Fed. Sav. & Loan Ass'n v. Citizens Bank of Jonesboro, 861 S.W.2d 321, 323 (Ark. Ct. App. 1993); Rebel v. Nat'l City Bank, 598 N.E.2d 1108, 1110 (Ind. Ct. App. 1992); Fin.

"paramount equities" exist.[66] In addition, many courts recognize that there is a strong presumption that when a lender refinances a mortgage, it lends money to satisfy the original mortgage with the intent that the new mortgage will secure the same lien position as the original mortgage.[67] Otherwise, it would be a risky proposition to lend the money in the first place. The Restatement supports this argument.[68]

As Justice Pleicones noted in his dissent, "Equitable subrogation is a remedy favored by the courts, and it is to be liberally and expansively applied."[69] It is a remedy meant to protect refinancing lenders, not work against them. As mentioned in the dissent, not only does South Carolina law support the idea that equitable subrogation should be automatically available to a mortgage refinancer who can show it expected to have first priority, but it is supported in the Restatement as well.[70] Several states have adopted the

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Acceptance Corp. v. Garvey, 380 N.E.2d 1332, 1336–37 (Mass. App. Ct. 1978); Norstar Bank v. Morabito, 607 N.Y.S.2d 426, 427 (N.Y. App. Div. 1994).

66. *See, e.g.*, Jackson & Scherer, Inc. v. Washburn, 496 P.2d 1358, 1366 (Kan. 1972); Greenfield v. Petty, 145 S.W.2d 367, 370 (Mo. 1940); Mackiewicz v. J.J. & Assocs., 514 N.W.2d 613, 620 (Neb. 1994); Houston Lumber Co. v. Skaggs, 613 P.2d 416, 417–18 (N.M. 1980); Kellogg Bros. Lumber Co. v. Mularkey, 252 N.W. 596, 597–98 (Wis. 1934).

67. Grant S. Nelson & Dale A. Whitman, *Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners*, 2006 BYU L. Rev. 305, 314 n.39 (2006) (citing Lamb Excavation, Inc. v. Chase Manhattan Mortg. Corp., 95 P.3d 542 (Ariz. Ct. App. 2004); E. Sav. Bank v. Pappas, 829 A.2d 953 (D.C. 2003) (dictum); Wilkins v. Gibson, 38 S.E.2d 374 (Ga. 1901); Bank of N.Y. v. Nally, 820 N.E.2d 644 (Ind. 2005); Klotz v. Klotz, 440 N.W.2d 406 (Iowa Ct. App. 1989); E. Boston Sav. Bank v. Ogan, 701 N.E.2d 331 (Mass. 1998); Burney v. McLaughlin, 63 S.W.3d 223 (Mo. Ct. App. 2001); Houston v. Bank of Am., 78 P.3d 71 (Nev. 2003); Providence Inst. for Sav. v. Sims, 441 S.W.2d 516 (Tex. 1969); Farm Credit Bank v. Ogden, 886 S.W.2d 305 (Tex. App. 1994); Chi. Title Ins. Co. v. Lawrence Inv., Inc., 782 S.W.2d 332 (Tex. App. 1989) (additional citations omitted)).

68. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.3 (1997). An "intent on the part of the senior mortgagee . . . will not be inferred. Only express and unambiguous evidence of such intent will suffice . . . . [C]ourts . . . recogniz[e] a presumption that the mortgagee intended a result that would be most beneficial to its security interest." Id. § 7.3 Reporter's Note cmt. b.

69. *Matrix*, 2010 S.C. LEXIS 289, at *8 (Pleicones, J., dissenting) (citing S. Bank & Trust Co. v. Harrison Sales Co., 328 S.E.2d 66 (S.C. 1985)).

70. *Id*. at *13–14.

Restatement's approach that equitable subrogation should be a readily available remedy against intervening lienholders.[71] The South Carolina Supreme Court would be wise to either revert to the reasoning of prior case law[72] or simply adopt the Restatement's stance on equitable subrogation being a readily available remedy for refinancing lenders.

The South Carolina Supreme Court's position in *Matrix I*, that any lender who refinances a mortgage does so as a volunteer and cannot expect to retain the lien position of the original mortgage, promoted a policy that would make it difficult for borrowers to refinance onerous mortgages because lenders who seek to do business in the state would see only added risk in performing such refinance transactions. In effect, the court advocated a policy that would increase the foreclosure rate in the state because refinancing lenders would want to steer clear of any properties that might have liens recorded against them. In addition, the cost of consumer refinancing in South Carolina would increase under *Matrix I* because if lenders take the risk of refinancing a borrower out of a disadvantageous mortgage, there is no guarantee that it would have first priority against an intervening lienholder should the property ever necessitate foreclosure. Lenders would "price in" this risk into their cost of doing business, and consumers in South Carolina would experience higher costs in doing a mortgage refinance.

F. How to Punish Lenders Who Unlawfully Close Loans Without Unjustly Enriching a Third Party in the Process

Equitable subrogation is a remedy based in restitution.[73] It is meant to be a remedy that prevents a third party, such as an intervening lienholder, from recovering a windfall at the expense of another (e.g., a refinancing lender); it is meant to be an

71. Nelson & Whitman, *supra* note 67, at 314 n.39.

72. *Matrix*, 2010 S.C. LEXIS 289, at *14 (Pleicones, J., dissenting) (citing Enter. Bank v. Fed. Land Bank, 138 S.E. 146 (S.C. 1927); James v. Martin, 147 S.E. 752 (S.C. 1929); Dodge City of Spartanburg, Inc. v. Jones, 454 S.E.2d 918 (S.C. Ct. App. 1995)).

73. 1 DAN D. DOBBS, DOBBS LAW OF REMEDIES: DAMAGES-EQUITY-RESTITUTION 604 (2d ed. 1993).

equitable remedy that prevents unjust enrichment.

South Carolina case law recognizes that a relief in equity is always discretionary.[74] This means that a court makes the decision as to how and when equitable relief will be provided. With its decision in *Matrix I*, the South Carolina Supreme Court curtailed the use of the remedy of equitable subrogation in a fashion that prejudiced lenders who chose to refinance residential mortgages. The court's approach in *Matrix I* caused a refinancing lender to lose both the principal and interest that it lent to a borrower even if the lender had no idea that the loan was closed unlawfully (e.g., without the supervision of an attorney).[75] In these situations, the lender can lose everything, and a third party, such as an intervening lienholder, recovers the spoils.

A less draconian approach to reprimanding lenders would be fairer to all parties involved. For example, if a refinancing lender closed a loan unlawfully, it makes sense that it should not *profit* from its transaction. In such a case, the lender should lose its *interest* on any funds loaned to a borrower. However, the *principal* should be returned to the lender absent any extenuating circumstances such as fraud. The part of a loan that serves as principal represents a sum of money that was never really owned by the borrower in the first place. For a lender to not recover money that it lent to a borrower, losing it instead to a third party, allows the latter to recover a windfall. Whenever a bank lends money to a borrower to pay off its existing mortgage, it expects to take the senior lien position on the mortgage that is secured by property that acts as collateral for the loan.[76] Returning that sum of money to lenders is only fair.

74. *Matrix*, 2010 S.C. LEXIS 289, at *5 (citing Ingram v. Kasey's Assocs., 531 S.E.2d 287 (S.C. 2000)).

75. *Id.* at *15–16 n.3 (Pleicones, J., dissenting).

76. Nelson & Whitman, *supra* note 67, at 305 n.2. "Priority is critical to mortgage lenders because, in the event of foreclosure, liens having higher priority are paid out first out of the foreclosure proceeds. Hence, if an intervening lien, such as a judgment, a mechanic's lien, or the like, acquires priority over the refinancing mortgage, the risk is increased that the foreclosure proceeds will be insufficient to pay the mortgage in full." (citing 1 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW 1.1 (4th ed. 2001)).

Although lending institutions are easy scapegoats for the economic woes of the mortgage crisis of recent years, banks for the most part do not refinance borrowers into loans worse than the ones they previously had.[77] Borrowers recognize that it does not make sense for them to refinance their current mortgage unless they need money for emergency reasons, to make improvements on their home, to take advantage of a fixed rate, or to lower their monthly mortgage payment.[78] In light of this, the courts of South Carolina should promote a policy that allows banks to remain financially sound. South Carolina should adopt a policy that continues to allow lending institutions to help borrowers refinance their homes if borrowers are in a bad financial situation. As Justice Pleicones stated in his dissent, a policy adopted by the courts that allows lenders to be overly punished for the unauthorized practice of law will only increase costs for all parties involved.

The South Carolina Supreme Court's majority decision in *Matrix I* did not provide the most equitable resolution for lenders who unlawfully closed a loan. Rather than imposing a reasonable punishment on refinancing lenders who close a loan without the supervision of an attorney, the court promoted a policy akin to swatting a fly with a sledgehammer.

III. THE REISSUED MATRIX OPINION AND WHY NEW DEVELOPMENTS STILL DO NOT PROTECT REFINANCING LENDERS AND CONSUMERS

In *Matrix II*, the court's majority does three things: (1) limits the availability of equitable subrogation only to those refinancing lenders who are *not* refinancing their original mortgage;[79] (2) removes unclean hands as a basis for deciding the case;[80] and (3)

77. *Are Lenders Responsible For a "Tangible Net Benefit,"* THE MORTGAGE PROFESSOR'S WEB SITE, (Apr. 18, 2005, Revised Dec. 1, 2006, July 9, 2007 and Oct. 28, 2010), http://www.mtgprofessor.com/A%20-%20Predatory%20Lending/should_lenders_be_responsible_if_borrowers_don't_benefit.htm.

78. *Id.*; DAVID REED, MORTGAGES 101: QUICK ANSWERS TO OVER 250 CRITICAL QUESTIONS ABOUT YOUR HOME LOAN 145–46 (2004).

79. No. 26859, 2011 S.C. LEXIS 258, at *3 (Aug. 8, 2011).

80. *Id.* at *18.

reiterates the ruling from *Matrix I* that in the future parties that participate in the unauthorized practice of law (UPL) will not find a relief in equity.[81]

A. Loan Modification or Replacement: A Potential Way Around the Equitable Subrogation Problem for Refinancing Lenders

In *Matrix II*, the majority opinion clarifies the definition of equitable subrogation by again returning to the court's opinion in *Dedes*, stating that "the heart of its reasoning was that the bank could not be subrogated to the rights of its own prior mortgage" and that "[t]his conclusion comports with the general view that equitable subrogation contemplates a third party satisfying the original mortgage, not the same party to whom the original debt is owed."[82] The court notes that because Matrix was a lender refinancing its own original mortgage, it could not avail itself of equitable subrogation.[83] So, in *Matrix II*, rather than limiting equitable subrogation for all refinancing lenders, the court narrows the scope of its holding on equitable subrogation from *Matrix I* by stating that the remedy could be a possibility only for a third party lender who did not hold the original mortgage.[84]

While stating that "section 7.6 of the Restatement stand[s] for the proposition that a lender [who] refinances its own debt is not entitled to equitable subrogation," the majority curiously notes that "[w]e 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)."[85] In reading the text of section 7.6 of the Restatement, comment. e, that the majority cites in its opinion, the reader will see this sentence following immediately afterward:

81. *Id*. at *20.

82. *Id*. at *17 (citing RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6 cmt. e (1997) ("Obviously subrogation cannot be involved unless the second loan is made by a different lender than the holder of the first mortgage; one cannot be subrogated to one's own previous mortgage.")).

83. *Id*.

84. *Id*. at n.1.

85. *Id*. at *18.

> Where a mortgage loan is refinanced by the same lender, a mortgage securing the new loan may be given the priority of the original mortgage under the principles of replacement and modification of mortgages; see section 7.3. The result is analogous to subrogation, and under this Restatement the requirements are essentially similar to those of subrogation.[86]

This is in direct contravention of what the majority relies upon in its opinion. Section 7.6 of the Restatement states that the outcome achieved through loan replacement or modification by a lender who is refinancing its original mortgage is analogous to the result that comes about from subrogation (i.e., when a third party or new lender is paying off the obligation for a senior mortgage rather than a lender paying off its own original mortgage). In theory, if Matrix had pled a defense premised on replacement or modification of its senior mortgage rather than equitable subrogation, then even though it had refinanced its own original mortgage, it might have been victorious on the issue of taking priority over Kundinger's recorded lien. Pleading replacement or modification of a senior mortgage rather than equitable subrogation may have yielded a different outcome.[87] This has far reaching consequences for how lenders plead or defend in a case. It appears that simply premising a refinance as a loan modification or replacement mortgage rather than a regular refinance transaction, and avoiding the terminology of "subrogation" would yield a different outcome for a refinancing lender who has refinanced its original mortgage and is attempting to assert priority over a third party intervening lienholder. In South Carolina, *Matrix II* proves that a claim of equitable subrogation does not win. But, as the court points out, that does not necessarily apply to a claim of loan replacement or loan modification.[88]

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86. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.6 cmt. e (1997).

87. Here, "outcome" refers to the likelihood that Matrix would have taken priority ahead of Kundginer's lien position. The author does not suggest that pleading loan modification or replacement would have affected the overall outcome of the case in light of Matrix's participation in the unauthorized practice of law.

88. Matrix Fin. Servs. Corp. v. Frazer, No. 26859, 2011 S.C. LEXIS 258, at *5–6 (Aug. 8, 2011).

In reading section 7.3(a) of the Restatement (Third) of Property (Mortgages), that deals with replacement and modification of senior mortgages, it states:

> 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 (1) 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.[89]

This provision sounds like it would have buttressed Matrix's argument in asserting priority over Kundinger's lien. But what does section 7.3 of the Restatement (Third) of Property (Mortgages) say about replacement or modification of senior mortgages, and what does it mean for a junior interest to be materially prejudiced?

On the concept of replacement mortgages, section 7.3, comment. a states:

> Replacement of senior mortgages is commonplace . . . . [A] senior mortgagee and a mortgagor frequently agree to a variety of modifications in the terms of the mortgage and the obligation it secures. Such modifications may entail an extension of the term [and] a change in the interest rate . . . . Often such modifications arise out of a mortgagor default or financial distress.[90]

The Frazers were definitely in financial distress. After all, their filing for bankruptcy is what prompted Matrix's attempt to foreclose on its mortgage. It seems like a loan replacement or loan modification would have benefited the Frazers. But how does modification or replacement of a mortgage differ in substance from a refinance transaction? The answer: there is no difference. In fact, when a borrower modifies his mortgage with a lender, he is in essence refinancing his mortgage. Whether you call it a "loan modification" or a "refinance," in reality it is the same thing.

89. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.3(a) (1997).
90. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.3 cmt. a (1997).

But section 7.3 states that the replacement or modification of a mortgage is only appropriate when it does not materially prejudice a junior interest in the real estate. In comments a and b of section 7.3, the following are discussed as items that could materially prejudice a junior interest in real estate: (1) an increase in the principal amount of the mortgage;[91] (2) an increase in the interest rate of fixed rate mortgage;[92] and (3) any term that would increase the senior obligation with respect to the junior interest in real estate.[93] In its attempt to refinance the Frazers out of their original mortgage, there is no evidence that Matrix was trying to do any of the prohibited actions listed above. Under the language of the opinion, Matrix could have succeeded in asserting priority over Kundinger's lien if it had sought loan modification or replacement of its mortgage rather than equitable subrogation. In essence, if Matrix had simply attached a different label of "replacement" or "modification" as a basis for priority over Kundinger's lien rather than "equitable subrogation," it may have yielded a different outcome.

In regards to the effect that modifying a senior mortgage would have on an intervening interest, comment. c of section 7.3 states:

> A modification of a mortgage will ordinarily cause it to lose priority to junior interests to the extent that the modification is materially prejudicial to those interests. [However], [e]ven when material prejudice exists . . . no loss of priority will occur if [(1)]the mortgage contains a clause reserving the right to modify, [(2)]the modification is within the scope of the clause, and [(3)] the clause's operation has not been terminated by notice from the mortgagor.[94]

Lenders who want to avoid Matrix's fate should take notice. What the Restatement says is that if you are a lender and want to be able to assert priority over an intervening interest, then it is essential to have a modification clause in the language of the mortgage as a trump card over a claim of priority by a third party

91. *Id*. § 7.3 cmt. b.
92. *Id*.
93. *Id*.
94. *Id*. § 7.3 cmt. c.

lienholder. There is a lesson to be learned here by refinancing lenders in this state: if you choose to refinance the original mortgage of a previous borrower, and a third party lienholder asserts priority in an interest in the subject property because he has recorded his interest before the new mortgage for the refinance has been recorded, a claim of equitable subrogation will not work. However, a claim of loan replacement or loan modification might.

B. The Court Removes Unclean Hands as a Basis for Deciding Its Reissued Opinion

Although the majority did not give any explanation behind it abandoning unclean hands as a basis for deciding *Matrix II,* presumably, Justice Pleicones's argument that only a party to the disputed transaction, and not a third party, can assert the equitable defense of unclean hands proved persuasive enough to change the majority's mind.

C. The Court Formally Approves the UPL Holding from *Wachovia v. Coffey*

In *Matrix II*, the court states that "[w]e take this opportunity to definitively state that a lender may not enjoy the benefit of equitable remedies when that lender failed to have attorney supervision during the loan process as required by our law. We apply this ruling to all filing dates after the issuance of this opinion."[95] This ruling in effect codifies into law the holding of *Wachovia v. Coffey*, that a lender who participates in UPL will not be granted the equitable remedy of foreclosing on a mortgage.[96]

95. Matrix Fin. Servs. Corp. v. Frazer, No. 26859, 2011 S.C. LEXIS 258, at *20 (Aug. 8, 2011).

96. 698 S.E.2d 244 (S.C. Ct. App. 2010).

IV. CONCLUSION

In *Matrix I*, the South Carolina Supreme Court departed from established case law and interpreted the requirements of equitable subrogation in such a narrow fashion that virtually no refinancing lender in South Carolina would be able to avail itself of the remedy in any priority dispute against intervening lienholders. In *Matrix II*, the court retracted the scope of its holding on equitable subrogation in *Matrix I* such that only lenders who refinanced their own original mortgage would not be able to avail themselves of equitable subrogation in a priority dispute against third party intervening lienholders.

In *Matrix I*, the court's holding that equity will not aid a lender who closed a home loan unlawfully would likely have increased the level of uncertainty that banks experience in lending money to borrowers in South Carolina who seek to refinance their mortgage. This is because under *Matrix I*, the court made it possible that liability for UPL could attach to lenders who participated in refinance closings without supervision of an attorney after the court issued its opinion in *Buyers Service* but before it clarified that the principles of that case applied to refinance transactions, too, as explained in its 2003 decision, *Doe v. McMaster*. In *Matrix II*, the majority's opinion makes it clear that lenders who participated in UPL in refinancing closings before *Doe* will still be held liable for any problems arising from those transactions. This creation of uncertainty for lenders doing business in South Carolina who closed refinance transactions without supervision of an attorney before 2003 will cause them to "price in" this risk of doing business in South Carolina. This only makes it more difficult and expensive for borrowers in the state to refinance into a better mortgage or to avoid foreclosure of their current mortgage.

Lenders should be punished for closing loans without the supervision of an attorney in South Carolina, but the example that the court makes of Matrix is overkill. Repaying a third party intervening lienholder with a bank's principal in a priority dispute because the lender practiced UPL would only allow that third party to be unjustly enriched. The court would be better to adopt an approach that punishes refinancing lenders who engage

in UPL by taking away their profit but not their principal. After all, equity abhors a forfeiture. However, a forfeiture seems to be exactly what the court imposes on refinancing lenders with its decision in *Matrix II*.