IN THE UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF ARKANSAS
HOT SPRINGS DIVISION

IN RE: CHARLES RAY FRANCIS and RHONDA KAY FRANCIS, Debtors **No. 6:07-bk-73901**
Ch. 7

GMAC MORTGAGE, LLC **PLAINTIFF**

v. **6:09-ap-7119**

SUMMIT BANK, N.A.; RHONDA KAY FRANCIS; CHARLES RAY FRANCIS; and FARMERS BANK & TRUST *f/k/a* SOUTHERN STATE BANK **DEFENDANTS**

PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

Before the Court is the Amended Complaint of GMAC Mortgage, LLC [GMAC] and the answers filed by Summit Bank, N.A. [Summit] and Farmers Bank & Trust [Farmers].[1] The debtors, Charles Ray Francis and Rhonda Kay Francis, did not file an answer or other responsive pleading to GMAC's complaint, but did participate in the trial, which was held on October 20, 2011. At the conclusion of the trial, the Court allowed the parties an additional 25 days to submit post-trial briefs in lieu of argument.

Previously, on July 19, 2011, the Court found that the complaint before the Court is not a core proceeding but is related to a case under title 11. The Court has jurisdiction of the matter under 28 U.S.C. § 1334 and 28 U.S.C. § 157. The Court will submit its proposed findings of fact and conclusions of law in accordance with 28 U.S.C. § 157(c) to the United States District Court for a final order in the adversary proceeding.[2] The following

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[1] Farmers Bank & Trust is the successor-in-interest to Southern State Bank. For the remainder of this opinion, any reference to Southern State Bank also includes Farmers's successive interest.

[2] After considering the parties' stipulations concerning jurisdiction, the Court cannot determine whether the parties consented to the Court entering a final order in this case. *See* 28 U.S.C. § 157(c)(2). Accordingly, the Court will proceed under 28 U.S.C.

opinion constitutes proposed findings of fact and conclusions of law in accordance with Federal Rule of Bankruptcy Procedure 7052.

Simply stated, this is a proceeding to determine the validity, priority, or extent of GMAC's interest in real property located in Hot Springs County, Arkansas. GMAC argues that the Court should apply the state law doctrine of equitable subrogation to establish GMAC's priority position in the subject property consisting of 22.06 acres, without regard to otherwise properly perfected security interests that currently exist. In the alternative, GMAC argues that the Court should reform GMAC's mortgage based on the debtors' and GMAC's intent and mutual mistake to describe properly the debtors' home and 22.06 acres. Summit and Farmers, as the properly perfected claimants, object to GMAC's proposed equitable treatment; Summit also raises the affirmative defense of laches in its answer. Based on the testimony and other evidence presented at trial, the Court finds that the doctrine of equitable subrogation does not apply in this instance and reformation of the existing mortgage is not appropriate.

In October 2005, GMAC, through its subsidiary ditech.com, refinanced the subject property for the debtors. Initially, the property consisted of 22.06 acres and was owned by Francis Construction Company [FCC]. The debtors' residence was located on the 22.06 acre parcel. On January 28, 2005, FCC transferred the property to the debtors, who then mortgaged the entire 22.06 acres to Southern State Bank [Southern State] in exchange for a loan from Southern State. On October 14, 2005, the debtors obtained a loan from GMAC for the purpose of satisfying the debt to Southern State and refinancing with GMAC at a more favorable rate of interest. The debtors and GMAC agree that at the time the initial loan was refinanced through GMAC, the debtors and GMAC intended for the entire property consisting of 22.06 acres to secure the refinancing. However, when GMAC drafted the mortgage, it apparently used the wrong legal description for the property, using instead the legal description for a contiguous 11.16 acre parcel that was

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§ 157(c)(1).

not owned by the debtors.[3]

Ray Francis testified that he noticed the reduced acreage at closing but the notary public who handled the closing did not know why only approximately 11 acres was described on the mortgage. After Francis later determined that the legal description described his neighbor's property, he attempted to have GMAC correct the error but was not successful.[4] Believing that perhaps GMAC had reconsidered and only intended to secure the note with approximately 11 acres, Francis offered to replat the 22.06 acre parcel into two separately described parcels, which he did. After the new survey was complete, one of the parcels contained 10.55 acres and the debtors' residence [Parcel A], and the other parcel contained 11.51 acres [Parcel B]. He then faxed a copy of the survey to GMAC with the correct legal description for Parcel A. At GMAC's request, Francis also had the tax assessor issue new tax parcel cards indicating the split. Despite his attempts, Francis testified that he could not get GMAC to correct the problem with the legal description, even with the new tax parcel number.

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[3] FCC transferred the contiguous 11.16 acre parcel to another party (the Staffords) on June 24, 2003.

According to the mortgage document (Pl's. Ex. 12), GMAC's mortgage was prepared by Danny Haynes, a loan processor who also appeared as a witness at the hearing as a representative from GMAC. He testified that a ditech.com loan originator takes the initial application from the customer and orders the title work from another company based on the property address and the tax parcel number. The title work and borrower's information is then forwarded to the loan processor to be placed in the proper order. This information is then provided to an underwriter for verification and approval. GMAC does not provide the title company with the legal description; rather, the title company provides the loan processor what it believes to be the correct legal description.

[4] Francis testified that he called GMAC and faxed documents to GMAC after the closing. Danny Haynes, the loan processor from GMAC who appeared at the trial, stated that he did not recall speaking to the debtors after the loan closed and that there was no notation in GMAC's Eclipse notes that Francis had called. He also stated that it is customary practice that all contacts with customers are listed on the Eclipse notes, but later testified that not everything is noted within Eclipse notes. The Court finds that the debtor's testimony at trial regarding his communication with GMAC was credible.

On February 27, 2006, the debtors mortgaged Parcel A to Summit for the purpose of refinancing three previous loans and providing additional collateral. According to Francis, he told Summit about refinancing his prior mortgage with GMAC. Don Tackett, a representative from Summit, also testified that at the time of Summit's refinance, based on the debtors' disclosure, Summit was operating under the assumption that GMAC had a superior position on Parcel A, the 10.55 acre parcel. In fact, Summit's records indicate that it was taking a second position. (Pl's. Exs. 39, 40.) The debtors and Summit entered into a Modification of Mortgage on May 21, 2007, and again on May 21, 2009. When the mortgage was modified on May 21, 2007, the related title work indicated that the mortgage given to Summit was a first mortgage, not a second mortgage.

On October 16, 2007, approximately one month before filing their voluntary bankruptcy petition, the debtors again mortgaged Parcel A, this time to Southern State. Francis testified that he also told Southern State of his dealings with GMAC and that after three or four attempts to have GMAC correct the problem, he was under the impression GMAC did not believe Francis or was not interested in correcting the problem. The corresponding note with Southern State recognizes the mortgage as a second mortgage (behind Summit); two years later--up to the approximate date the debtors filed their bankruptcy petition--GMAC had never corrected its error to properly identify the subject property or perfect its interest in the property.

On May 22, 2007, the debtors mortgaged Parcel B to Elk Horn Bank. Later that same year, on November 5, 2007, the debtors mortgaged Parcel B to Southern State. The corresponding note with Southern State refers to the mortgage as a first mortgage based on a refinanced line of credit formerly with Elk Horn Bank.

The doctrine of equitable subrogation has been recognized in Arkansas for more than a century. In 1913, the Supreme Court of Arkansas stated the doctrine thus:

> The equity arises when one not primarily bound to pay a debt, or remove an incumbrance, nevertheless does so; either from his legal obligation, as

> in the case of a surety, or to protect his own secondary right; or *upon the request of the original debtor, and upon the faith that, as against the debtor, the person paying will have the same sureties for reimbursement as the creditor for payment.*

Newberry v. Scruggs, 986 S.W.2d 853, 857 (Ark. 1999) (quoting *Southern Cotton Oil Co. v. Napoleon Hill Cotton Co.*, 158 S.W. 1082 (Ark. 1913) (emphasis added)). In applying the principles announced in *Southern Cotton*, the *Newberry* court further held that

> [o]ne who advances money to pay off an incumbrance on realty, at the instance either of the owner of the property or the holder of the incumbrance, either on the express understanding or under circumstances from which an understanding will be implied, that the advance made is to be secured by a first lien on the property, is not a mere volunteer; and, *in the event the new security is, for any reason, not a first lien on the property*, the holder of such security, if not chargeable with culpable and inexcusable neglect, will be subrogated to the rights of the prior incumbrancer under the security held by him, and to this end equity will set aside a cancellation of such security, and revive the same for his benefit.

Id. at 857-58 (citations omitted) (emphasis added). According to this statement from *Newberry*, for equitable subrogation to apply, GMAC must show that (1) it advanced money to pay off an incumbrance with the understanding that it would then be secured by a first lien on the property, (2) that the new security was, for any reason, not a first lien on the property, and (3) that GMAC is not chargeable with culpable and inexcusable neglect. Because the parties agree that the debtors and GMAC understood that GMAC paid the debtors' note with Southern State in October 2005 with the understanding GMAC would be secured by a first lien on the 22.06 acres, the first requirement has been met.

The second requirement that the new security was, for any reason, not a first lien on the property is problematic. The cases that address equitable subrogation in Arkansas have in common one fact that is not present in this case: an intervening event that occurred between the granting of the first mortgage and the subsequent refinancing. In these cases, absent equitable subrogation, this intervening event was the reason the new

security did not become a first lien on the property. For example, in *Newberry*, an initial mortgage on real property was given to Worthen Bank in January 1994. Subsequent refinancing with Pulaski Mortgage Company occurred in December 1994. However, between January and December, two judgments attached to the real property that were not discovered by the title company that performed the title search prior to closing the refinancing with Pulaski Mortgage Company. *Id*. at 854-55. Without the use of equitable subrogation, the two judgments would have had priority over the Pulaski Mortgage Company lien that attached when the property was refinanced in December. The court found that Pulaski Mortgage Company was an innocent party in the transaction and applied the doctrine of equitable subrogation to preserve the first mortgage position previously held by Worthen Bank. *Id.* at 858. The intervening judgments were subordinated to Pulaski Mortgage Company's interest in the property. *See also Cooper v. Home Owners' Loan Corp.*, 126 S.W.2d 112, 114 (Ark. 1939) (holding subsequent lienholder subrogated to rights of original lienholder despite absence of spouse's valid signature on subsequent lienholder's note and prior release of original lien); *Home Fed. Sav. & Loan Ass'n v. Citizens Bank of Jonesboro*, 861 S.W.2d 321, 324-25 (Ark. Ct. App. 1993) (citing *Wooster v. Cavender*, 15 S.W. 192 (Ark. 1891)) (recognizing long standing rule in Arkansas that when first mortgage is satisfied "in ignorance of the existence of an intervening mortgage," equity will restore the first mortgage lien in the absence of culpable negligence).

In the case before the Court, the Court is not aware of an intervening event between the debtors' initial financing with Southern State and their subsequent refinancing with GMAC that would have prevented GMAC from obtaining a first position mortgage. At the time the GMAC loan closed, there appears to have been no interest superior to GMAC's right to a first lien on the subject property after Southern State was satisfied. Had GMAC used the correct legal description, it would have been in a priority position with regard to the 22.06 acres, which was the debtors' and GMAC's intent. An intervening event did not prevent GMAC from obtaining a first mortgage; rather, GMAC's lack of action to correct the mistake after Francis's repeated attempts was the

primary cause for not obtaining a first mortgage. Without the intervening event, the Court holds that equitable subrogation does not apply in this instance.

Further, even in the event an intervening lienor were not required for a court to apply the doctrine of equitable subrogation, the Court also finds that GMAC's culpable and inexcusable neglect would prevent this Court from using the doctrine to equitably subrogate GMAC's interest to that of Summit and Southern State. Culpable negligence is defined as "the omission of something that a reasonable, prudent, and honest person would do, or the doing of something that such a person would not do, under all circumstances surrounding each particular case." *Newberry*, 986 S.W.2d at 858 (citing *Home Fed. Sav. & Loan Ass'n v. Citizens Bank of Jonesboro*, 861 S.W.2d 321 (Ark. Ct. App. 1993)). In this instance, the debtors advised GMAC of its error; offered to correct the legal description for GMAC and provide it with the correct description; replatted the property to determine the meets and bounds description for the property; obtained a new tax parcel card; and informed subsequent mortgage holders of the debtors' discussions with GMAC, including the intent of the debtors and GMAC. And yet, GMAC took no action to correct its error or otherwise perfect its interest in any part of the 22.06 acres, before or after the property was replatted. It was GMAC's failure to correct the legal description on its mortgage--despite Francis's attempts to have GMAC do so--that allowed a subsequent "second" mortgage to prime GMAC's alleged interest in either the 22.06 acres, Parcel A, or Parcel B.

GMAC argues in its post-trial brief that equitable subrogation is also appropriate because neither Summit nor Southern State are bona fide "creditors" under Arkansas law; the debtors put both Summit and Southern State on notice of the alleged prior interest held by GMAC. *See Bill's Printing, Inc. v. Carder*, 161 S.W.3d 803, 807 (Ark. 2004) (stating that bona fide *purchaser* must take property in good faith, for valuable consideration, and without notice of a prior interest (emphasis added)). A subsequent creditor has actual notice if it "is aware of such facts and circumstances as would put a [person] of ordinary intelligence and prudence on such inquiry that, if diligently pursued, would lead to

knowledge of those prior interests." *Massey v. Wynne*, 791 S.W.2d 368, 369 (Ark. 1990). GMAC argues that because each bank had actual notice of GMAC's alleged interest, neither bank would be prejudiced if the Court applied the doctrine of equitable subrogation. However, even with undisputed actual notice, Summit's and Southern State's obligation was to pursue diligently knowledge of the prior interest. In this instance, Summit and Southern State would have been charged with "the knowledge which [they] would have thus obtained had [they] made that inquiry." *Neas v. Whitener-London Realty Co.*, 178 S.W. 390, 394 (Ark. 1915). Without a prior recorded mortgage containing the correct legal description, the required inquiry would not lead to any knowledge of GMAC's alleged prior interest in either Parcel A or Parcel B.

GMAC also argues that the Court should reform GMAC's mortgage based on the debtors' and GMAC's mutual mistake regarding the initial legal description. Reformation of a mortgage is not absolute and the bankruptcy court, as a court of equity, must proceed with great caution. *Weiss v. Turney*, 173 F.2d 617, 619 (8th Cir. 1949) (applying Arkansas law). The alleged mutual mistake must be clearly established by "clear, convincing, unequivocal and decisive" evidence. *Id*. In this instance, GMAC and both debtors agree that the intent of the parties was for the debtors to give GMAC a mortgage on the entire 22.06 acres. Although the acknowledged intent may be enough for the Court to find a mutual mistake between the parties, it is not sufficient for the Court to reform the existing mortgage to the detriment of Summit and Southern State.

In its answer to GMAC's complaint, Summit asserts as an affirmative defense the doctrine of laches.[5] According to the Supreme Court of Arkansas, laches is

> based on the assumption that the party to whom laches is imputed has knowledge of his rights and the opportunity to assert them, that by reason of his delay some adverse party has good reason to believe those rights are

[5] The doctrine of laches is applicable when equitable relief is sought by the plaintiff. *Rogers Iron & Metal Corp. v. K & M, Inc.*, 738 S.W.2d 110, 111 (Ark. Ct. App. 1987).

> worthless or have been abandoned, and that because of a change of conditions during this delay it would be unjust to the latter to permit him to assert them.

Goforth v. Smith, 991 S.W.2d 579, 586-87 (Ark. 1999). Based on the facts before the Court, it is appropriate for the Court to impute laches to GMAC. First, GMAC had knowledge of its rights and ample opportunity to assert them. As detailed above, Francis testified that he attempted on numerous occasions and by various methods to have GMAC correct the legal description of its mortgage so its lien would be properly recorded. Second, GMAC's inaction after being informed of the problem by Francis would have given Summit and Southern State, as subsequent lienors, good reason to believe that GMAC had abandoned or otherwise satisfied its rights or simply did not care. The debtor frankly informed both Summit and Southern State of GMAC's alleged interest in the subject property; however, the land records never reflected constructive notice of GMAC's interest. Finally, it would be unjust to reform the existing mortgage and allow GMAC to prime the interests of Summit and Southern Bank considering GMAC's lack of action after being notified of its error.[6] Based on the proposed findings of fact stated above, the Court imputes laches to GMAC and denies its request to reform the mortgage.

For the reasons stated above, the Court concludes as a matter of law and recommends to the United States District Court the following:

1. Equitable subrogation does not apply because (a) there was no intervening event between the debtors' initial financing with Southern State and their subsequent refinancing with GMAC such that equitable subrogation is the appropriate remedy, and (b) GMAC is charged with culpable and inexcusable neglect by not correcting its mistake after the mistake was brought to its attention by the debtors

[6] The general rule in Arkansas is that reformation of an instrument "relates back to, and takes effect from, the time of its original execution, especially as between the parties thereto and purchasers with notice." *Mauldin v. Snowden*, -- S.W.3d --, No. CA 11-204, 2011 WL 5080663, at *10 (Ark. Ct. App. Oct. 26, 2011).

on a number of occasions.

2. GMAC is not entitled to have its current mortgage reformed to express properly GMAC's and the debtors' intent to encumber the subject 22.06 acres because laches is imputed to GMAC for its lack of action after the mistake was initially brought to its attention.

The Court will forward these proposed findings of facts and conclusions of law to the United States District Court for the Western District of Arkansas, Hot Springs Division, for a final order in accordance with 28 U.S.C. § 157(c)(1).

Ben Barry
United States Bankruptcy Judge
Dated: 01/11/2012

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