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Southside v. 803 Development Group

SOUTHSIDE L.L.C., Plaintiff, v. 803 DEVELOPMENT GROUP, LTD., Defendant
Court of Common Pleas of the 39th Judicial District of Pennsylvania,

Franklin County Branch
Civil Action - Law, No. 1999-20258, In Mortgage Foreclosure

Dual motions for summary judgment; Mortgage foreclosure; Future advance/dragnet clauses; Relatedness rule

1. A dragnet clause is a provision in a mortgage which allows a mortgage lien to be expanded to cover not only the initial advances but also other advances made at a later time; it allows a lender to secure future advances of money with previously pledged collateral.

2. Courts disfavor dragnet clauses because they can be abused, allowing a lender to bring within the shelter of his security arrangements claims against the debtor which are unrelated to the financing contemplated by the parties.

3. Courts apply the "relatedness rule" to limit a dragnet clause's application to those future advances which are clearly related to the primary transaction. The court examines (i) whether the other indebtedness allegedly covered by the mortgage containing the dragnet clause is specifically expressed in the mortgage; (ii) whether the other indebtedness allegedly covered is of the same class as the debt referenced in the mortgage; (iii) whether the other indebtedness was intended to be separately secured; and (iv) whether the mortgagee relied on the clause in making further loans.

4. A mortgage containing a future advance clause could not be expanded to become security for a later debt which was not between the original parties to the note and mortgage and was not envisioned when the mortgage was first created. Absent specific dealings between the current owner of the property and the prior creditor/noteholder, it could not be inferred that the current owner accepted the later debt owed to the prior creditor/noteholder simply because it purchased the property.

Appearances:

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OPINION

Herman, J. June 28, 2002

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Background

Before the court are reciprocal motions for summary judgment in this mortgage foreclosure action. Counsel submitted briefs and the court held argument. This matter is ready for decision.

On November 16, 1974, David and Gilda Herndon executed a mortgage note for $50,000 payable to the First National Bank of Mercersburg (note #1). On that same date, the Herndons delivered to the

Bank a mortgage to a property in Mercersburg.[1] The mortgage contained the following language:

> The Note secured hereby shall evidence and this Mortgage shall cover and be security for any future loans or advances that may be made by Mortgagee [the Bank] to Mortgagor [the Herndons] at any time or times hereafter and intended by Mortgagor or Mortgagee to be so evidenced and secured, and such loans and advances shall be added to the principal debt...This obligation shall bind the Undersigned and the Undersigned...assigns, and the benefits hereof shall inure to the payee hereof and its...assigns.

No further advances were ever made to the Herndons by the Bank. The real estate became the property of one Duane Dillard through a 1984 sheriff's sale.

In May of 1986 in Virginia, Dillard borrowed $28,000 from one Jay Turner. Dillard gave a note and mortgage to Turner on a parcel of Virginia real estate as security. Dillard eventually had to sell his Virginia property but still could not pay off his debt to Turner. Turner agreed to release his mortgage if Dillard secured the loan with other property which Dillard might acquire in the future. At that point Dillard owed Turner $25,306.94 plus interest, amounting to a total debt of $30,200. Neither Dillard nor Turner were then aware of the Herndon mortgage and note #1 pertaining to the Mercersburg property.

Dillard later experienced more financial problems and again approached Turner for help. He asked Turner to stop a foreclosure action brought by the First National Bank of Mercersburg as to the Mercersburg property which Turner agreed to do. On April 21, 1989 Dillard signed a document entitled "Mortgage Note" (note #2) under which he promised to pay Turner $30,200, with that amount being the principal and interest due on the $28,000 debt from 1986. The Mortgage Note provided: "The said principal and interest shall be payable under the terms and conditions of the Mortgage Note and Mortgage dated November 16, 1974...to which Note and Mortgage the undersigned [Dillard] is party." On that same date, Dillard signed a Guaranty and Suretyship Agreement on the back of note #1. Therefore on April 21, 1989, three documents were executed: (1) Dillard's Guaranty of note #1; (2) Dillard's execution of the Mortgage Note (note #2); and (3) Turner's receipt of the Assignment of Mortgage from the original mortgagee, the First National Bank of Mercersburg.

Dillard conveyed approximately 24.4 acres of the Mercersburg property to defendant on August 10, 1994. The deed appears in the Franklin County Deed Book at Volume 1227, Page 524.

The mortgage held by Turner was assigned to one Melba Brodie, then became the property of one Bobby Rock (plaintiff's manager) and finally became the property of plaintiff in June of 1998. Plaintiff also at that point became the owner of note #2. Therefore by June of 1998, plaintiff held the mortgage and note #2 and defendant was the owner of the Mercersburg property. On December 9, 1998 a Partial Release of the Lien of Mortgage between the Herndons as mortgagors, the First National Bank of Mercersburg as mortgagee and the plaintiff as assignee was executed whereby plaintiff received $27,500. The release specified that it did not apply to the 24.4 acres which defendant acquired from Dillard on August 10, 1994. [2]

Plaintiff's motion for summary judgment is based on the following: defendant admits it owns the property subject to the mortgage and that note #1 was secured by the mortgage. The specific language in note #2 indicates that Dillard intended both notes to be secured by the mortgage. Defendant as the later purchaser of the property had notice of this recorded security interest which Turner had and plaintiff now has in the mortgage, yet has not paid the amounts due under that mortgage.[3]

Defendant's motion is based on the following: Turner did not advance any funds to Dillard in 1989 through note #2, and even if he did, the language of note #2 was insufficient to cause it to be secured by the mortgage and therefore defendant is not in default under note #2. Nor is there a balance currently due on note #1 insofar as plaintiff already received $27,500 in the 1998 transaction which was more than sufficient to pay off the amount then due under note #1.

Discussion

Preliminarily we take note of Pennsylvania Rule of Civil Procedure 1035.2 governing summary judgment which provides:

> After the relevant pleadings are closed, but within such time as not to unreasonably delay trial, any party may move for summary judgment in whole or in part as a matter of law (1) whenever there is no genuine issue of any material fact as to a necessary element of the cause of action or defense which could be established by additional discovery or expert report, or (2) if, after the completion of discovery relevant to the motion, including the production of expert reports, an adverse party who will bear the burden of proof at trial has failed to produce evidence of facts essential to the cause of action or defense which in a

jury trial would require the issues to be submitted to a jury.

The nonmoving party must come forward with evidence showing the existence of facts essential to its cause of action or defense. At the same time, the court in considering the motion must view the record in the light most favorable to the nonmoving party and all doubts as to the existence of a genuine issue of material fact must be resolved against the moving party. Ertel v. Patriot-News Co., 674 A.2d 1038, 1041 (Pa. 1996).

Enforceability of the Future Advance Clause

At issue is the law of advance clauses, also known as dragnet clauses. A dragnet clause is a provision in a mortgage which allows a mortgage lien to be expanded to cover not only the initial advances but also other advances made at a later time. The clause allows a lender to secure future advances of money with previously pledged collateral. If a piece of real estate is then sold and that property is subject to a mortgage with a dragnet clause, the proceeds from the sale may apply not only to the initial amount advanced by the creditor but to subsequent amounts advanced by the lender.

Dragnet clauses have historically been disfavored by the courts because they cloud title and hold the potential for abuse. In re Shapiro, 109 B.R. 127 (Bankr.E.D.Pa.1990). A dragnet clause is abused "where a lender, relying on a broadly drafted clause, seeks to bring within the shelter of his security arrangements claims against the Debtor which are unrelated to the course of financing that was contemplated by the parties...[N]o matter how the clause is drafted, the future advances to be covered must be...so related to it that the consent of the Debtor to its inclusion may be inferred." In re Gibson, 249 B.R. 645, 656 (E.D. Pa. 2000). This is the "relatedness test," which limits the application of a future advance or dragnet clause to those advances which are of the same class as the primary transaction. In applying this test the court examines: (1) whether the other indebtedness allegedly covered by the mortgage containing the dragnet clause is specifically expressed in the mortgage; (2) whether the other indebtedness allegedly covered is "of the same class" as the debt referenced in the mortgage; (3) whether the other indebtedness was intended to be separately secured; and (4) whether the mortgagee relied on the clause in making further loans. Id. Loans are "related" if they have been secured to provide working capital for the same business venture. Kitmitto v. First Pennsylvania Bank, N.A., 518 F.Supp. 297 (E.D.Pa.1981).

Advance or dragnet clauses are enforceable under the Uniform Commercial Code. "A security agreement may provide that collateral secures...future advances or other value, whether or not the advances or value are given pursuant to commitment." 13 Pa.C.S.A. section 9204(c). The relatedness rule has nevertheless survived the enactment of this section as a guide. Potomac Coal Co. v. $81,961.13 in the Hands of an Escrow Agent, 679 A.2d 800 (Pa.Super. 1996); Gibson, supra.

For the reasons that follow we find that the plaintiff has failed to come forward with any evidence to support a genuine issue of material fact which would entitle the plaintiff to apply the future advance clause in question to collect payment from the defendant on the note held by the plaintiff. Plaintiff argues as follows: the April 21, 1989 Guaranty and Suretyship Agreement which Dillard signed on the back of note #1 made him, and now defendant, unconditionally liable for payment of note #1. The specific language in note #2 links it to note #1 and the 1974 mortgage: "The said principal and interest shall be payable under the terms and conditions of the Mortgage Note and Mortgage dated November 16, 1974 and recorded in the Office of the Recorder for the County of Franklin, in the Commonwealth of Pennsylvania, Vol. 338, Page 975, to which Note and Mortgage the undersigned [Dillard] is party." According to the mortgage's dragnet clause, defendant is liable for "all additional loans or advances and all other sums paid by any holder of said Note to or on behalf of the maker thereof pursuant to the terms of said Note or the Mortgage securing the same." Turner took the Assignment of Mortgage on the condition that the balance of Dillard's 1986 debt would be transferred to note #2 which would also be secured by the property referred to in the mortgage. Therefore, plaintiff argues, the clear intent of Dillard and Turner in 1989 was to make the mortgage and the land secured by that mortgage serve as security for Dillard's timely payment to Turner under both note #1 and note #2.

While this may be evident it is not the "clear-understanding" reached by Dillard and Turner that is material to this issue. In the cases cited by counsel and those reviewed by the court the parties were charged with the knowledge of the purpose and effect of future advance clauses primarily because they were the original parties to the financing agreements. They had intended to include these clauses for a specific purpose and/or utilized them for subsequent financing. Even then the clauses were subject to close scrutiny. In the instant case the subject property changed hands two times after the initial mortgage document containing the future advance clause was created. In essence the plaintiff has failed to come forward with any evidence that the original purpose of the clause was ratified in any way by subsequent owners and their creditors. This is the second criteria noted in Gibson and the most important in this analysis. In fact counsel for both parties appear to have overlooked the express intent of the original

mortgage document which was placed in writing on the last page. "...funds to be advanced by the Mortgagee are for the purpose of financing the construction of an addition to the house situated on the within described real estate." [Plaintiff's Complaint, Exhibit A.] Certainly it could not be argued that First National Bank of Mercersburg and the Herndons intended to collateralize a debt which was unknown to them between Dillard and Turner. Looking at it from another perspective -- could it reasonably be argued, given this record, that the defendant 803 Development intended to look to First National, Bobby Rock, Southside L.L.C. or any note holder for future financing for construction of additions to residential housing on its property. Indeed 803 purchased the property in 1994 at a Sheriff's sale. There is no evidence of any understanding concerning the future advance clause between 803 and any of the subsequent note holders. It is noteworthy that Rock and Southside L.L.C. did not come on the record as owners of the mortgage note until 1998. There is no evidence that any of the record parties utilized this advance clause for future financing (the fourth criteria of the relatedness rule) with the exception of the Dillard/Turner deal. The purpose of that deal cannot be imputed to the present owner, 803. The mortgage cannot be expanded to become security for a debt which was not envisioned at the time the mortgage was created or a debt which was not between the original parties to the note and mortgage and was not even made in the same state without express and direct terms so indicating. The four criteria of the "relatedness test" are not subject to easy application in this case simply because the plaintiff is trying to stretch the future advance clause too far. This is precisely what the rule was intended to prevent.

As the defendant points out, that even if Turner did make an advance of funds to Dillard through note #2, the language of that note is insufficient to cause the 1974 mortgage to secure payment of any such advances. This is so because Dillard's prior indebtedness to Turner dating from 1986 was not specifically or even generally expressed in the terms of the mortgage. Specifically the mortgage does not indicate that it secures advances made by later holders of the original mortgage note, nor does it contain a provision concerning loans made to guarantors of that first note; i.e., the "undersigned" referred to in note #1 is the Herndons in their transaction with the First National Bank of Mercersburg, not Dillard. The Guaranty and Suretyship Agreement executed on April 21, 1989 by Dillard applies only to sums due on note #1, or to additional loans or advances to the maker of note #1, not to loans made to Dillard. Dillard was not the mortgagor and Turner was not the mortgagee, and Dillard did not "become" the undersigned or the maker of note #1 merely because he became the guarantor or obligor of payment.

Plaintiff argues it is clear from the April 21, 1989 settlement that all three documents signed that day relate to Dillard's business dealings with Turner and therefore the "other indebtedness" covered by the mortgage is of the same class as the debt referred to in the mortgage. The parties to both notes and the mortgage are identical -- Dillard and Turner. Once Turner took the Assignment of Mortgage, he became the mortgagee, and once Dillard signed note #2, he became the mortgagor. Also, there was no separate mortgage executed along with note #2 because the terms of note #2 are expressly grounded on the terms and conditions in note #1.

Once again the total effect of this evidence is to show that Dillard and Turner intended to collateralize an old debt, which debt had nothing to do with the purpose of the advance clause in the original mortgage. Even if we accepted the argument of the plaintiff (which we do not) that this operated as a novation and allowed the parties to begin anew under the advance clause of the mortgage, there is still no evidence that Dillard and Turner intended the purpose of that to be to secure future advances. It was nothing more than a method for Turner to secure an old debt. The language in the document identified as note #2 that the principal and interest will be payable under the same terms and conditions as in the original Mortgage given by the Herndons does not satisfy the requirement of the relatedness rule that the future advances pursuant to a dragnet clause must be so related that the consent of the debtor can be inferred. Absent some specific business dealings between the defendant and the noteholders we cannot infer the defendant accepted the debt Dillard owed to Turner simply because the defendant purchased the property.

Even if we were to conclude that the future advance clause was given continued life by the Dillard/Turner transaction, this device for advancing future monies on the same collateral would still have to meet the criteria for relatedness in the subsequent transactions. There is no evidence that this advance clause had any purpose or was intended to be used once the subject property was sold to the defendant, 803, at a sheriff's sale in 1994. As noted even if the clause had validity in the prior transaction, by 1994 Dillard the mortgagor/debtor is out of the picture. This effectively disables the future advance clause unless an intent to do business can be evidenced between Turner and 803. There is no evidence of an intention to use or evidence of a purpose for the original future advance clause between the defendant and Turner or the defendant and the subsequent assignees. The fact that the plaintiff moved into its present position by purchasing the rights of others in the usual course of business does not mean by that process alone he can collect a debt that the current owner of the property had no intention of shouldering or indeed was even aware of. The acceptance of the relatedness rule in the law implies that these clauses are not to automatically be given effect just because they suddenly appear (even legitimately through assignment or purchase of real estate) somewhere downstream in the everyday flow of business and commerce.

Plaintiff attempts to distinguish this case from Gibson in which the court found the dragnet clause unenforceable under the relatedness rule. The court stated because there were different parties involved in the loan transactions and because the later transactions were memorialized by separate mortgages and were subject to separate payment schedules and financing the dragnet clause was not enforceable. In Gibson there was clear evidence that the later transactions were intended to be separate and unrelated. In the instant case the result must be the same because the lack of any transactions and the lack of evidence that the present parties intend to give effect to the dragnet clause is just as persuasive that the debtor in this case, 803, did not consent to assume responsibility for debts previously incurred under the 1974 mortgage.

Plaintiff contends that Turner became the mortgagee once he took an assignment from the original mortgagee, the First National Bank of Mercersburg, on April 21, 1989. Unlike in Gibson where the debtor had no actual knowledge of the existence of the dragnet clauses in the loan documents or that the debtor intended the later properties to be used to secure other debts, Dillard clearly knew that a dragnet clause was part of the 1974 note and mortgage insofar as note #2 specifically referred to that mortgage and indicated that note #2 would be secured by that same mortgage. Plaintiff further argues the 1974 mortgage specifically extends to the undersigned and the undersigned's assigns, with its benefits running to the payee and the payee's assigns. As we stated previously, however, these facts alone have served merely to put the plaintiff in a position to make a claim. The claim's validity depends on the relatedness rule and the claim fails under that analysis.

Amount Due on the Note

We have concluded that the defendant is correct, as noted in Part I, that the 1974 mortgage serves as collateral only for note #1. Defendant now argues the balance under that note has been paid in full, the mortgage has been satisfied and there is no balance due. The record shows the balance on note #1 as of April 21, 1989 when Turner paid off the original lender, the First National Bank of Mercersburg, was $6,000 -- $9,000. The record also shows plaintiff received $27,500 in June of 1998. Plaintiff's own amortization schedule for note #1 shows a balance in the amount of $26,558.01 was due on note #1 as of August 1, 1998. According to defendant, if the $27,500 had been properly applied to note #1 that payment was more than sufficient to pay the balance due under note #1.

Plaintiff maintains that it acted within its proper discretion in applying the $27,500 to satisfy note #1 rather than note #2 insofar as both notes were secured by the same mortgage. Plaintiff also questions whether the amounts it received as of 1998 were in fact sufficient to pay the balance due insofar as defendant's failure to pay under the mortgage has resulted in additional interest, late charges and fees. Plaintiff argues the $27,500 which plaintiff received in June of 1998 was in exchange for the partial release of the mortgage lien which specifically provided that the release did not apply to the property at issue in this foreclosure action. The partial release contained the following language:

> It is expressly understood that this release of the lien of the mortgage shall only pertain to that real estate subject to and sold by the Sheriff of Franklin County on June 13, 1997, and shall not pertain to a prior conveyance by Duane P. Dillard to 803 Development Group, Ltd., by Deed dated October 8, 1994 and recorded in Franklin County Deed Book Volume 1227, Page 524, upon which real estate the Mortgage of Southside, L.L.C. shall remain a mortgage lien.

This notation on the release given by Southside L.L.C., if it has any legal effect at all, has served merely to put the plaintiff in a position to make a claim on the note it purchased. The notation is nothing more than a statement by the plaintiff that it believes the claim regarding the Dillard/Turner debt is valid. As we have previously held the claim is unenforceable under the criteria of the relatedness rule. Therefore the plaintiff's entire claim can only consist of any balance due on the mortgage outside of the Dillard/Turner debt. As the defendant points out, according to the plaintiff's own records the payment received in the amount of $27,500 in approximately December of 1998 was sufficient to cover the estimated principle, any interest, and late payment fees due on the original balance of the mortgage debt.

Plaintiff's argument that it had a right to apply the payment of $27,500.00 to note #2 is of no consequence since that claim, predicated on the Mortgage Note given by Dillard to Turner, is not enforceable against the property held by the defendant and therefore the only debt to which the payment could have applied was that existing on note #1. In view of that, the plaintiff's note was satisfied by the payment of $27,500.00 in 1998 and the mortgage should have been marked satisfied at that time.

The court will enter an appropriate Order denying the plaintiff's motion for summary judgment and granting the defendant's motion for summary judgment and further ordering that the plaintiff's Complaint in Foreclosure be dismissed and the plaintiff will be directed to mark the mortgage satisfied in accordance with this Opinion.

ORDER OF COURT

Now this 28th day of June 2002, in accordance with the Opinion attached hereto the plaintiff's Motion for Summary Judgment is denied and the defendant's Motion for Summary Judgment on grounds that the future advance clause at issue is unenforceable given the record evidence is granted, and it is further ordered that the defendant's Motion for Summary Judgment on grounds that the mortgage at issue has been fully paid given the evidence of record is also granted.

It is hereby ordered that the plaintiff's Complaint in Mortgage Foreclosure is dismissed and the plaintiff is directed to mark the mortgage as satisfied in accordance with this Opinion.

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[1]This mortgage was recorded in Franklin County Mortgage Book, Volume 338, Page 975.

[2]The partial release was filed on December 16, 1998 and appears in Franklin County Deed Book, Volume 1410, Page 139.

[3]There is evidence in Bobby Rock's deposition that in fact the defendant, 803, did not have notice because the pertinent documents were missed in the title examination obtained by 803 when it purchased the property in 1994.