

Mississippi's Superpriority Security Interest, or Why Credithrift Needs to be Downsized

By *W. Rodney Clement, Jr.*

Sometimes we hear references to “superpriority” liens by people who think that federal tax liens or environmental liens have some mystical superpriority that allows these liens to take priority over all other liens. In Mississippi, the real “superpriority” is enjoyed by any deed of trust that has a future advances clause. This “superpriority” was not created by the Legislature, but by the Mississippi Supreme Court in *Schutze v. Credithrift*, 607 So. 2d 55 (Miss. 1992).

Facts

The facts of this case are not complicated. In 1981, Credithrift made a loan to the Gentrys in the original principal amount of \$23,679. The loan was secured by a deed of trust on the Gentrys' home. In 1983, Credithrift and the Gentrys amended the note to change the principal amount to \$14,150 and filed a second deed of trust. In 1984, Schutze obtained and enrolled a judgment in the amount of \$4,541.78 against the Gentrys. In 1985, the Gentrys executed a new note to Credithrift for \$14,150, which note included the remaining unpaid balance of \$11,215 from the 1983 note and new money in the amount of \$2,784. Credithrift filed a new deed of trust. The Gentrys defaulted and Credithrift foreclosed. At the foreclosure sale Credithrift was the sole bidder and bought the property for the amount of its indebtedness, leaving nothing for Schutze.

Schutze filed an action in chancery court asserting that he was entitled to part of the foreclosure proceeds because his judgment was recorded prior to the 1985 note amendment. The chancery court held that Credithrift's deed of trust had priority over Schutze's judgment because

Credithrift did not have actual knowledge of the judgment at the time it made the amendment.

Schutze appealed to the Mississippi Supreme Court. The issue was straightforward: whether Schutze's judgment had priority over that part of the 1985 note that represented new money (\$2,784).

The Mississippi Supreme Court held that Credithrift's deed of trust had priority over Schutze's judgment based on the future advances clause, which provided that the deed of trust secured any future advances. The court first determined that the amendment constituted a future advance that was secured by the deed of trust. The question then was the priority of this “future advance” against Schutze's judgment lien.

Prior to *Credithrift*, Mississippi courts followed the common-law rule regarding the priority of future advances, as described in *North v. McClintock*, 44 So.2d 412 (Miss. 1950). Under the common-law rule, the priority of future advances depended on whether the advance was optional or obligatory. The priority of obligatory advances (that is, advances that the lender was required to make at the time the deed of trust was filed) related back to the time of filing of the deed of trust, while the priority of optional advances (advances that the lender was not required to make at the time the loan was made, but that the lender subsequently decided to make) was fixed at the time the optional advances were made. In other words, obligatory advances had priority over intervening liens and creditors, and optional advances were subject to intervening liens and

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deeds of trust. The terms of the note determined the priority of the deed of trust securing the note.

Under the common-law rule, Schutze's judgment would have had priority over the new \$2,784 that *Credithrift* advanced in 1985 because the 1985 advance of new money was optional rather than obligatory. The *Credithrift* court determined that *North v. McClintock* was flawed because it ignored *Witczinski v. Everman*, 51 Miss. 841 (1876), and that the *Witczinski* rule should control. The *Witczinski* rule held that, as long as the deed of trust stated on its face that it secured all future advances, the priority of any additional money advanced should relate back to the time of the filing of the deed of trust, regardless of whether such advances were optional or obligatory. Since *Credithrift's* deed of trust stated that it secured future advances, the *Credithrift* court reasoned, the priority of the 1985 note related back to 1981, the date *Credithrift's* deed of trust was filed, and thus the deed of trust had priority over Schutze's lien. The court noted that an exception to this priority rule exists for construction loans.

The *Credithrift* court then suggested that it might adopt a new rule for future advances that was consistent with Section 9-301(4) of Mississippi's version of the Uniform Commercial Code. Under Section 9-301(4) (now Section 9-323(b)), the priority of an advance made more than 45 days after a lien is filed is subject to the priority of the lien unless the advance is made without knowledge of the lien or pursuant to a commitment entered into without knowledge of the lien.

Term loans and lines of credit

In order to understand what a mess this decision created, one must understand an elementary principle regarding loans. There are basically two types of loans: term loans and lines of credit. In a term loan, the lender will advance the entire amount of the loan at the time the loan is made. Most home loans and car loans are term loans. With a line of credit, the lender is obligated to advance the princi-

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pal at the time the loan is made, but only advances the principal when the borrower requests it. Construction loans and credit cards are examples of lines of credit. The important distinction is that at the time the line of credit loan is made, the lender and borrower intend to make advances of principal at a later time. In a term loan, the parties do not intend to make additional advances of principal. The common law protected the priority of future advances under lines of credit because they were obligatory as to the lender; otherwise

lenders would never make such loans. The form of the indebtedness determines the priority, not the wording of the deed of trust.

The basic problem with the *Credithrift* case is that the court confused an amendment of a term loan with a future advance under a line of credit. All of the notes executed by the Gentrys were term notes. The court bootstrapped the traditional priority rules for lines of credit onto a term loan. Moreover, under *Credithrift*, the determinative factor is not the terms of the note, but the terms of the deed of trust (whether it has a future advances clause). Under *Credithrift*, amendments of term loans to increase the amount of principal have the same priority as future advances under letters of credit.

Consequences of *Credithrift*

One predictable result of this case is that future advances clauses have become boilerplate in deeds of trust, regardless of whether the deed of trust secures a term loan or line of credit. If you are representing a lender making a term loan, why wouldn't you toss in a future advances clause? By adding a future advances clause to a deed of trust securing a term note, the lender has just supersized the priority of its deed of trust to cover any amendments that increase the amount of the principal.

Another result of this case is that it makes it easy for a lender with the first deed of trust securing a term loan to completely suck all of the equity out of a property at the expense of subordinate lenders and creditors by amending the notes to increase the amount of principal. *Credithrift* creates a "superpriority" security interest in favor of the first lender because it allows the first lender to wipe out the interests of subsequent lenders and creditors after their deeds of trust or liens have been filed by changing the terms of its loan to make additional optional advances of principal.

Prior to *Credithrift*, the priority of such subsequent optional advances would have been subject to intervening lenders and creditors. The *Credithrift* court opined that third parties can protect themselves from being wiped out like this by inquiring of the lender the amount of the existing loan. This suggestion is not practical for three reasons. First, a judgment

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creditor does not have the luxury of checking the land records before filing his judgment. Second, the first lender has no common-law duty to disclose the amount of debt secured by its lien, and furthermore is prohibited by bank privacy laws from disclosing this information without the borrower's consent. Third, mere inquiry will not protect a prospective second lender if the first lender subsequently advances additional principal. Only an agreement between the first lender and the second lender to the effect that the first lender will not make any more advances of principal (or that such subsequent advances will be subordinate in priority to the second lender's interest) will protect the second lender. Such intercreditor agreements can be difficult to negotiate and, of course, the borrower has to pay these costs. *Credithrift* facilitates collusive arrangements between the first lender and the borrower to wipe out the interests of junior lenders and creditors.

This superpriority lien is not only tough on subordinate lenders and creditors, but it also is a potential problem for borrowers. Suppose a borrower's assets are encumbered by a deed of trust with a future advances clause. The borrower goes to his existing lender to borrow additional money, and the lender declines to make the additional loan or will only make the additional loan on above-market terms. Even if the borrower has substantial equity in its collateral after the existing first deed of trust, any other lender will be hesitant to make a loan because of the possibility that this equity could be wiped out by additional advances on the first deed of trust. There is no common-law or statutory right to prepay a loan in Mississippi. The future advances clause thus can be a pair of fur-lined handcuffs for the borrower.

Credithrift also is inconsistent with Mississippi's race-notice statutes, Miss. Code Ann. Sections 89-5-1 and 89-5-3, which provide that the first person to file has priority unless he has actual knowledge of another lien. The *Credithrift* court relied on the fact that *Credithrift* had no actual knowledge of Schutze's judgment at the time it amended its note, but *Credithrift* undoubtedly had constructive notice of the judgment.

Importing UCC priorities into real estate law

The *Credithrift* court suggested that it might in the future adopt the UCC priority scheme for determining priorities in real estate. The *Credithrift* court stated that it could perceive no good reason why the UCC priority rules should apply to personal property and not real estate. Applying the UCC priority rules to real estate, however, would be contrary to Mississippi statutes. The *Credithrift* court only discussed Section 9-301(4), which addresses the priority of future advances as against lien creditors, which was the issue in that case, but the UCC distinguishes between the priority of future advances as to lien creditors and as to secured parties.

In general terms, a secured party under the UCC is one who has made a loan to the borrower, while a lien creditor has obtained a judgment or other interest by attachment or levy. The current version of the UCC in Sections 9-322(a) and 9-323(a) provides a pure race system for determining priorities among secured par-

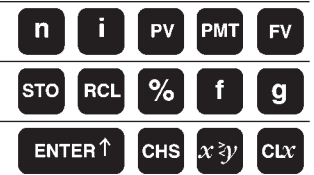
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ties; that is, future advances made by the first lender to file a financing statement will always have priority over the security interest of the lender who files a subsequent financing statement, regardless of knowledge. Such a race system for determining priorities is contrary to Mississippi's race-notice statutes. In addition, making new distinctions between the priorities of secured creditors and lien creditors in real estate arguably is a policy decision that should be made by the legislature rather than the courts.

***Credithrift* stifles competition**

The *Credithrift* court justified its decision in part on the basis that its new rule giving perpetual priority to any future advances over any lien would save the time and money of additional title searches and closings. The court stated, "There is no reason why our law should demand new title searches incident to each advance." But the common-law optional/obligatory test did not require title searches prior to each advance of a true line of credit (except in the construction

loan context) in order to maintain priority. Of course, if the *Credithrift* rule stifles the secondary lending market, there will be fewer closings, but is this a good thing? Arguably it is better public policy to make it easier for borrowers to have competing sources for funds.

Consider, for example, the relatively recent phenomenon of home equity lines of credit secured by a second deed of trust on the home. The availability of these loans is based on the existence of equity in the property after the first deed of trust on the home. But if a prospective third-party lender knows that the existing first lender can wipe out this equity by amending its note to increase the principal, the prospective lender will be hesitant to make the loan. This uncertainty gives the existing first lender an advantage over the third-party lender in making a home equity loan based on the legal advantage created by *Credithrift* rather than based on which lender offers the best terms. *Credithrift* thus limits a homeowner's choices for a home equity loan.

A Missed Opportunity

By treating the amendment of the note to increase the amount of principal as a future advance, the Mississippi Supreme Court missed an opportunity to address the broader question of when an amendment to a note will cause a loss of priority to intervening creditors. This is an issue that begs for clarification under Mississippi law. There are a handful of cases that deal with whether an amendment constitutes novation, but novation rarely is deemed to have occurred. The real issue is priority to intervening lenders and creditors. If a lender amends his loan to increase the interest rate or extend the term, will this amendment cause his deed of trust to lose priority to intervening creditors? It is regretful that the *Credithrift* court did not take advantage of the opportunity to establish a general rule regarding the effect of amendments of notes on the priority of deeds of trust.

A Proposal

Here is a modest proposal: The priority of future advances should relate back to the filing of the deed of trust only if the loan is in fact a line of credit and the deed of trust so states. The Mississippi legislature already has defined a "line of credit" in Sections 89-1-49 and 89-5-21 of the Mississippi Code. Requiring lenders to state on the face of the deed of trust that the deed of trust secures a line of credit does not create any additional work for lenders. Sections 89-1-49 and 89-5-21 already require lenders to state that the deed of trust secures a line of credit in order to avoid the zero balance problem. If the lender of a term loan wants to "change the deal" by advancing additional principal, it should not be able to do so to the prejudice of existing subordinate lenders and creditors of the borrower. The lender can avoid this risk simply by updating the title work it obtained at the time it made the original loan. In most cases, this is not going to be expensive or time-consuming.

Conclusion

The *Credithrift* decision is flawed because the court did not distinguish between term loans and lines of credit. The Mississippi Supreme Court should take the earliest opportunity to modify *Credithrift* and adopt a rule regarding the priority of future advances that protects the legitimate interests of all parties. Absent action by the Mississippi Supreme Court, the legislature should codify a reasonable alternative to the *Credithrift* rule. ■

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