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Two and Done? The Court of Appeals Suggests That Lenders May Only Get Two Shots at Foreclosure

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Have you ever started a foreclosure, only to work something out with your borrower and dismiss the proceeding? Have you ever done that twice? If so, you should be aware of a recent decision by the North Carolina Court of Appeals. The opinion held that a lender who has twice initiated and dismissed a foreclosure special proceeding is barred from filing a third special proceeding based on the same deed of trust. Moreover, the reasoning behind the decision disproved assumptions held by many lenders and their counsel concerning the procedure applicable to foreclosure special proceedings in North Carolina.

In North Carolina, civil court actions generally take one of two forms: (1) civil actions or (2) special proceedings. A "civil action" is a typical full-blown lawsuit. A plaintiff files a complaint against a defendant, the defendant answers, and you are off to the races. From beginning to end, the parties prosecute a civil action according to the North Carolina Rules of Civil Procedure. The Rules of Civil Procedure impose obligations on the parties that can be onerous. For example, during discovery, a party may be required to submit to days of depositions or to turn over thousands of pages of business records to the opposing party.

A "special proceeding," on the other hand, is understood as fundamentally and procedurally different from a civil action. Special proceedings include matters such as adoptions, guardianship proceedings, and foreclosures by trustees under deeds of trust. These matters are resolved by the Clerk of Superior Court rather than by a judge of District or Superior Court, and the applicable procedure is provided by statute and relatively simple and straightforward. In the case of foreclosures under a deed of trust, there is a statutory framework that sets forth a very efficient process to initiate, prosecute, and complete a foreclosure special proceeding.

The special proceeding foreclosure process commences when a lender files a petition requesting a foreclosure —also called a "Notice of Hearing"—and then serving it on the grantor of the deed of trust, any debtors who are not grantors, and any persons owning an interest in the collateral encumbered by the deed of trust. Among other legally required notifications, the Notice of Hearing provides notice that a hearing will be held before the Clerk of Superior Court at a particular time and the facts entitling the lender to foreclose—i.e., the details of the debt, the default, the collateral, and the lender's right to sell the collateral. In the majority of foreclosures, these facts are not in dispute and the lender can obtain an order allowing the sale of its collateral without the time and expense of a full-blown lawsuit. If any of these facts are in dispute, a grantor can always appear before the Clerk of Court to present evidence as to why the lender should not be allowed to foreclose or, in the alternative, the grantor can file a lawsuit against the lender seeking to prevent foreclosure.

For various reasons, often to spur a borrower into compliance with its obligations, a lender will initiate a

foreclosure only to dismiss it before hearing or sale. For example, the parties may enter into a forbearance arrangement or the borrower may simply reinstate the note by making all past due payments. Or, during the foreclosure process, the lender may discover an environmental or title issue that requires resolution before it can safely foreclose. This can take considerable time, maybe even years. In these cases, lenders and their counsel have generally assumed that a foreclosure special proceeding may be dismissed and refiled as many times as necessary without prejudicing the lender's right to commence a new foreclosure.

This is not the case with an ordinary civil action. North Carolina has what can be called the "two-dismissal rule." It bars a plaintiff who has twice filed and then dismissed an action from filing a third action based on the same claim. This rule was generally thought inapplicable to special proceedings. But this assumption has proven to be incorrect.

In August 2014, the North Carolina Court of Appeals held in the case of Lifestore Bank v. Mingo Tribal Preservation Trust that the "two-dismissal rule" invalidated a lender's foreclosure special proceeding because the lender had previously filed and dismissed two other foreclosure special proceedings based on same deed of trust. The Court based its ruling on a determination that the North Carolina Rules of Civil Procedure generally apply to all special proceedings unless made inapplicable by another statute. The silver lining to the decision, if one could call it that, was that the lender was not barred from filing a lawsuit for a more cumbersome, time-consuming, and expensive judicial foreclosure. The Court of Appeals' reasoning was that a judicial foreclosure is considered to involve a broader claim than the one advanced in the streamlined special proceeding. Of course, the obvious downside to the lender is that it was now going to be subjected to the time and expense of a full-blown lawsuit, complete with pleadings, discovery, and maybe trial by jury.

The immediate impact of the Court of Appeals' ruling is that lenders and their counsel should pay close attention to their foreclosure and workout strategies. Before dismissing any foreclosure special proceeding, it must be understood that dismissal may leave the lender with only one more opportunity to foreclose (outside of judicial foreclosure). Lenders should consider incorporating a provision in any workout agreement that waives this rule—even though we cannot be certain that the waiver will be honored by the courts. Lenders should also consider trying to put foreclosure proceedings on inactive status, rather than dismissing them outright.

The bigger long-term concern for lenders, and the issue we will be watching closely, is whether the courts start to incorporate other parts of the North Carolina Rules of Civil Procedure into foreclosure proceedings, especially those dealing with discovery. If that occurs, the current foreclosure process will take much more time and will be much more expensive and involved for lenders.

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