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New Default Allows New Foreclosure: Erosion of the Two-Dismissal Rule

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On June 2, 2015, the North Carolina Court of Appeals issued an opinion that provides some protection for lenders foreclosing on real property collateral. In the case of In re Foreclosure of Beasley, the Court of Appeals held that a lender may start and dismiss multiple foreclosures so long as each new foreclosure is based on a different default. In other words, a lender will not be punished for dismissing a foreclosure as part of a forbearance agreement or after an agreed-upon reinstatement by the borrower. The lender will still have the right to foreclose if there is a future default.

The Beasley decision is a welcome ruling from the Court of Appeals because it tempers statements made by the Court in a case last year that was cause for concern to lenders. In that decision, Lifestore Bank v. Mingo Tribal Preservation Trust, the Court stated, although the issue was not directly before the Court, that a lender who has twice initiated and dismissed a foreclosure special proceeding would be barred from filing a third special proceeding based on the same deed of trust.

To understand these decisions, it helps to know a little about court actions in North Carolina. They generally take one of two forms:

- Civil actions; or
- 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 North Carolina Rules of Civil Procedure ("Rules") govern a civil action. The Rules 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. The Clerk of Superior Court—not a judge—resolves these matters. The applicable procedure, provided by statute, is relatively straightforward. For foreclosures under a deed of trust, the statutory framework establishes an efficient process to initiate, prosecute, and complete the proceeding.

The special proceeding foreclosure process commences when a lender files a petition requesting a foreclosure—also called a "Notice of Hearing"—and then serves 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. For any number of reasons, a lender may initiate a foreclosure proceeding only to dismiss it before hearing or sale. For example, the borrower may reinstate the obligation secured by the deed of trust with the lender's consent or enter into a forbearance agreement. Or, during the foreclosure process, the lender may discover an environmental or title issue that requires resolution before the lender can safely foreclose. This can take considerable time, maybe even years. Prior to the Lifestore Bank case, lenders and their counsel generally assumed that a foreclosure special proceeding could 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 a civil action. In North Carolina, the Rules impose what is often called the "two-dismissal rule." The

two-dismissal rule bars a plaintiff who has twice filed and then dismissed a civil 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 Court of Appeals stated in Lifestore Bank that the two-dismissal rule would apply to invalidate a lender's foreclosure special proceeding where the lender has previously filed and dismissed two other foreclosure special proceedings based on same deed of trust. The Court determined that the Rules apply to all special proceedings unless made inapplicable by another statute.

The bad news for lenders is that Beasley re-affirms that the Rules apply to foreclosures. But the good news is that the two-dismissal rule will apply only if there is a "strict factual identity" between the two foreclosures. If the foreclosures involve separate defaults, the claims will be considered separate and distinct and the two-dismissal rule will not apply.

The takeaway from Beasley is that so long as the new foreclosure is based on a new default, such as the failure of the borrower to make a subsequent payment, the lender will not fall victim to the two-dismissal rule. Beasley also held that a lender does not have to re-file the foreclosure within one year after the dismissal—a corollary to the two-dismissal rule in civil actions.

Even after the Beasley decision, lenders should pay close attention to their foreclosure and workout strategies. Lenders should consider incorporating in any workout agreement with a borrower a waiver by the borrower of the "two-dismissal" rule —even though we cannot be certain that courts will enforce such a waiver. Lenders should also consider trying to put foreclosure proceedings on inactive status, rather than dismissing them outright. If a lender does dismiss and then re-file a foreclosure proceeding, the lender should prepare an affidavit for the hearing that clearly articulates the new default that is the basis for the new foreclosure.

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