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(2006-SC-000217-D)

Commonwealth of Kentucky

Court of Appeals

NO. 2004-CA-001351-MR

CITIZENS BANK OF NORTHERN KENTUCKY, INC. (F/K/A CITIZENS BANK OF CAMPBELL COUNTY, INC.) — APPELLANT

v.

APPEAL FROM BOONE CIRCUIT COURT
HONORABLE ANTHONY W. FROHLICH, JUDGE
ACTION NO. 02-CI-00661

PBNK, INC. (F/K/A PEOPLES BANK OF NORTHERN KENTUCKY, INC.) — APPELLEE

OPINION
AFFIRMING

** ** ** ** ** ** ** **

BEFORE: BARBER AND McANULTY, JUDGES; MILLER, SENIOR JUDGE.[1]

MILLER, SENIOR JUDGE: Citizens Bank of Northern Kentucky, Inc., (formerly known as Citizens Bank of Campbell County, Inc.) (Citizens Bank) brings this appeal from the Boone Circuit Court's determination that it does not have a valid legal and/or equitable mortgage superior to the mortgage of PBNK, Inc. (formerly known as Peoples Bank of Northern Kentucky, Inc.)

[1] Senior Judge John D. Miller sitting as Special Judge by assignment of the Chief Justice pursuant to Section 110(5)(b) of the Kentucky Constitution and Kentucky Revised Statute 21.580.

(PBNK) upon certain real property located in Boone County, Kentucky. Because the circuit court correctly determined that Citizens Bank does not have a valid legal or equitable mortgage on the subject property, we affirm.

FACTUAL AND PROCEDURAL BACKGROUND

In the fall of 1997 Anthony William Erpenbeck, Sr. (Tony) was the owner of an approximately 37-acre parcel of land located in Boone County. Tony's wife is Phyllis Erpenbeck.

Tony acquired the subject property in January 1997 for $1,579,610.00 from Mt. Zion Development Corp., a company owned by his son William Erpenbeck, Jr. (Bill), whose wife is named Marcia. Tony took the property subject to two mortgages: a 1995 mortgage in favor of nine attorneys with an unpaid balance of $404,234.95, and another 1995 mortgage in favor of Fifth Third Bank, Northern Kentucky, Inc. (Fifth Third Bank) in the amount of $750,000.00.

In 1997 Bill was the president and principal owner of The Erpenbeck Company, Inc., and Erpenbeck Development Company, Inc. The companies engaged in the construction and development business in the Northern Kentucky/Greater Cincinnati area.
In the fall of 1997 Bill and his companies obtained a loan in the amount of $500,000.00 from Citizens Bank. In the course of obtaining the loan, Bill misrepresented to Citizens Bank that he was the owner of the 37-acre tract previously conveyed to his

father, Tony. Bill wrongfully offered the tract as security for the loan.

During the loan evaluation process the bank conducted a title examination, but failed to discern that Tony, not Bill, was the owner of the land. The loan closed on December 8, 1997. Bill signed the loan documents representing that he was the owner of the property, and his wife, Marcia, signed the loan documents to mortgage her purported dower interest. The mortgage on the subject property was duly recorded in the office of the Boone County Clerk.

The proceeds of the loan were used to pay off the debt associated with the mortgage held by the nine attorneys and to pay down the Fifth Third Bank mortgage in the amount of $72,553.75. Bill pocketed $21,572.50.

In the spring of 2002, the Citizens Bank loan to Bill and his companies fell into default, and Citizens Bank initiated the present foreclosure action. Following the commencement of the foreclosure action, Citizens Bank first became aware that Tony, not Bill, was the owner of the property which secured Bill’s $500,000.00 loan.

After learning that Bill was not the owner of the property, on June 6, 2002, the Bank entered into an “Agreement to Sell and Purchase Note and Mortgage” with Tony. In the agreement, among other things, Tony represented that Bill had

signed the loan documents as his agent. It appears that this transaction was undertaken in Tony's attempt to retroactively ratify Bill's act of mortgaging his (Tony's) property and to ensure that Citizens Bank would have a valid lien upon same.

In the meantime, shortly after the Citizens Bank loan closed, PBNK made a mortgage loan to Tony secured by the subject property. The PBNK note, in the amount of $1,000,000.00, was signed by Tony, and the mortgage securing the note was properly signed by both Tony and his wife. The loan closed on December 18, 1997, and the mortgage associated with the PBNK loan was recorded subsequent to the Citizens Bank mortgage.[2]

At the time PBNK made its mortgage loan to Tony, PBNK was aware of the prior recorded mortgage in favor of Citizens Bank in connection with the $500,000.00 loan to Bill. There is no doubt as to PBNK's actual knowledge.

In Citizens Bank's foreclosure action, a dispute developed between Citizens Bank and PBNK regarding whether Citizens Bank held a valid prior mortgage upon the 37-acre parcel of land. The matter was referred to the Master Commissioner. On March 18, 2004, the Master Commissioner issued his Report wherein he determined that Citizens Bank did not have a valid legal and/or equitable mortgage on the subject property.

[2] Tony ultimately defaulted on the loan.

On June 8, 2004, the circuit court entered a "Judgment and Order of Sale" in which the Master Commissioner's report was adopted in full. Kentucky Rules of Civil Procedure (CR) 53.06(2). This appeal followed.

STANDARD OF REVIEW

We begin with a statement of our standard of review. CR 52.01 states, in pertinent part, for actions tried without a jury, "[f]indings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses. The findings of a commissioner, to the extent that the court adopts them, shall be considered as the findings of the court." As a result, when the trial court adopts the recommendations of the Commissioner, those recommendations fall under the same standard of review as applied to a trial court's findings. See Greater Cincinnati Marine Service, Inc. v. City of Ludlow, 602 S.W.2d 427, 429 (Ky. 1980) and Wells v. Sanor, 151 S.W.3d 819, 822 (Ky.App. 2004). A factual finding is not clearly erroneous if it is supported by substantial evidence. Substantial evidence is evidence, when taken alone or in light of all the evidence, which has sufficient probative value to induce conviction in the mind of a reasonable person. Janakakis-Kostun v. Janakakis, 6 S.W.3d 843 (Ky.App. 1999). An appellate court, however, reviews

legal issues de novo. Carroll v. Meredith, 59 S.W.3d 484, 489 (Ky.App. 2001).

ARGUMENTS OF CITIZENS BANK

On appeal, Citizens Bank contends that the circuit court erred by determining that it did not have a valid legal mortgage and/or a valid equitable mortgage on the subject property. Citizens Bank also makes an argument to the effect that it should prevail over PBNK because, otherwise, PBNK would be unjustly enriched. We consider each of these arguments in turn.

LEGAL MORTGAGE ISSUES

We believe it a general rule that where a mortgagor has previously disposed of property, his subsequent execution of a mortgage, the description of which included the land disposed of, does not create a lien upon it. Miller v. Williams, 144 Ky. 37, 137 S.W. 779 (1911). Moreover, we draw attention to KRS[3] 382.370 which provides, in relevant part, as follows:

> Powers of attorney to convey or release real or personal property, or any interest therein, may be acknowledged, proved and recorded in the proper office, in the manner prescribed for recording conveyances. If the conveyance made under a power, is required by law to be recorded or lodged for record, to make the same valid against creditors and purchasers, then the power must be lodged or recorded in like manner . . . . (Emphasis added.)

[3] Kentucky Revised Statutes.

Of course, in order to be valid as against purchasers and creditors, a mortgage must be recorded in the county clerk's office in which the property is located. KRS 382.270; KRS 382.110. In order for an agent to encumber or convey real property on behalf of a principal, the agent's authority must likewise be of record in the county clerk's office. KRS 382.370. See also State Bank of Stearns v. Stephens, 265 Ky. 615, 97 S.W.2d 553 (Ky. 1936) (Where a contract required to be in writing and recorded is made under a power of attorney, the power of attorney as to third parties must also be recorded); Graves v. Ward, 63 Ky. 301 (1865) (Deed executed by attorney-in-fact and recorded does not operate as constructive notice unless the power of attorney is also recorded or lodged for record); and Taylor v. McDonald's Heirs, 5 Ky. 420 (1811) (Power of attorney to convey land must be recorded in the county where the deed is required to be recorded).

In view of the foregoing, we must conclude that Bill had no power to mortgage property which he did not own. We further conclude that Bill could not act as Tony's agent in mortgaging the latter's property without having complied with the statutory requirements. The reasoning underlying these conclusions also prevents us from assigning merit to Tony's

attempted retroactive ratification of Bill's wrongful act so as to be effective against PBNK.

EQUITABLE MORTGAGE ISSUES

Citizens Bank also contends that an equitable mortgage was created because Tony accepted the benefits of the loan in that existing mortgages on the property were paid off with the proceeds of the Citizens Bank loan, thereby benefiting Tony by increasing his equity in the subject property.

> An equitable mortgage arises from a transaction, regardless of its form, which resolves into a security, or an offer or attempt to pledge land as security for a debt or liability. It is absolutely essential to its existence that there be a definite debt, obligation, or liability to be secured, due from the mortgagor to the mortgagee. . . . The true situation giving rise to an equitable mortgage is the extension of credit in reliance or an agreement that certain property is to be security for the loan. In such case the creditor is entitled to the security in equity, his remedy at law being inadequate as an unsecured creditor.

Keats, Pitt, and Oldham, Kentucky Practice, Vol. 3, § 18.5 (citing 59 C.J.S. *Mortgages* § 13).

Kentucky has few cases addressing the doctrine of equitable mortgages. We have, however, located a sister-state case which is, by analogy, applicable to the situation at hand.

In Lubin v. Klein, 193 A.2d 46 (Md. 1963) the Lubins held a third mortgage on the property of the defaulting parties, the Frohwirths, and the Kleins held an ostensibly inferior

judgment lien against the property. The Lubins' mortgage had been executed by an individual acting as attorney-in-fact for the Frohwirths pursuant to a general power of attorney. As it turns out, however, the power of attorney was not properly acknowledged as required by the Maryland statutory code.

The Lubins conceded that the power of attorney was defective at law because it lacked the required acknowledgment, but contended that their mortgage was nevertheless entitled to priority over the subsequent judgment lien of the Kleins on the theory that it was an equitable mortgage. The Court of Appeals of Maryland rejected this contention, stating as follows:

> It is well settled in this State, since Dyson v. Simmons, 48 Md. 207 (1878), that generally where an instrument intended to operate as a mortgage fails as a legal mortgage because of some defect or infirmity in its execution, an equitable mortgage may be recognized, with priority over judgments subsequently obtained. See also Jackson v. County Trust Co., 176 Md. 505, 6 A.2d 380 (1939); Western Nat. Bank of Baltimore v. National Union Bank, 91 Md. 613, 46 A. 960 (1900); cf. Berman v. Berman, 193 Md. 614, 69 A.2d 271 (1949). The theory underlying the equitable mortgage doctrine is that an instrument which is intended to charge certain lands, even though defectively executed, is nevertheless considered to be evidence of an agreement to convey, and a court of equity should enforce the obligation despite the technical defects in the instrument.
>
> The case before us is not one, however, where the defect complained of occurred in the mortgage itself. It occurred rather in

> the document which sought to invest the attorney-in-fact with power to execute the mortgage. The reasoning in Jackson v. County Trust Co., supra, recognizes power to convey or charge the land as a condition precedent to the invocation of the equitable mortgage doctrine. In that case, in which a mortgage executed without an affidavit of consideration was held to be an equitable mortgage and given priority over a subsequent judgment lien, the Court quoted from Dyson v. Simmons, supra (at p. 510 of 176 Md. at p. 382 of 6 A.2d):
>
> > '* * * At the time of the execution of this mortgage the *mortgagor had full and complete power of conveying or charging the land* * * * and the general principle is, that if a party has power to charge certain lands and agrees to charge them, in equity he has actually charged them; and a Court of equity will enforce the charge. * * *'
>
> This language, when considered in conjunction with the case of Citizens' Fire Insurance, etc. v. Doll, 35 Md. 89 (1872), leaves little doubt that the equitable mortgage doctrine must be limited to situations where the person who executed the mortgage had the legal power to do so, and cannot be extended to cure mortgages which have been executed by persons with no *legal* authority.

We conclude from the foregoing that while an equitable lien may be impressed upon property if there is a simple defect in the mortgage proposed to create the lien, an equitable lien will not be impressed upon the property if the person who sought to create the lien in the first instance had no legal authority to do so.

Analogous to the attorney-in-fact in Lubin, here, Bill did not have a properly recorded power of attorney to act as Tony's agent; thus, he was without legal authority to charge the property. We agree with the rule as stated in Lubin that the equitable mortgage doctrine cannot be extended to cure mortgages which have been executed by persons without legal authority. Application of the rule in the present case compels the result that Citizens Bank cannot claim an equitable mortgage in the subject property.

UNJUST ENRICHMENT ISSUES

Finally, we address Citizens Bank's contention that PBNK has been unjustly enriched. Citizens Bank thinks this is so because at the time PBNK made its loan, it well knew of the Citizens Bank loan and considered its loan subordinate. We know of no rule of law that dictates that a subordinate lienholder enhanced by the failure of a prior lien, or for that matter the cancellation or retirement of same, is to be considered unjustly enriched. A serendipity perhaps. But not an unjust gain to be condemned by the law.

The doctrine of unjust enrichment, an equitable one, is applicable as a basis of restitution to prevent one person from keeping money or benefits belonging to another. Haeberle v. St. Paul Fire and Marine Ins. Co., 769 S.W.2d 64 (Ky.App. 1989). Because Citizens Bank does not have a valid

legal or equitable mortgage on the subject property under which to assert a lien, it cannot claim that PBNK is depriving it of money or benefits. Citizens Bank's claim of unjust enrichment is thus without merit.

For the foregoing reasons, the judgment of the Boone Circuit Court is affirmed.

ALL CONCUR.

BRIEF FOR APPELLANT:

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BRIEF FOR APPELLEE:

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