

UNITED STATES BANKRUPTCY COURT  
WESTERN DISTRICT OF NORTH CAROLINA  
CHARLOTTE DIVISION



IN RE: )  
 ) Bankruptcy No. 98-30613  
CLAYTON J. BAILEY, )  
 ) (Chapter 7)  
 Debtor. )  
 ) JUDGEMENT ENTERED ON FEB 27 2002  
\_\_\_\_\_)  
LYNDELL D. THOMPSON AND LOIS Y. ) Adversary Proceeding  
THOMPSON, ) No. 00-3151  
 Plaintiffs, )  
v. )  
 )  
R. KEITH JOHNSON, TRUSTEE FOR )  
THE ESTATE OF CLAYTON J. BAILEY )  
 )  
 Defendant. )  
\_\_\_\_\_)

**ORDER GRANTING PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT**

This matter is before this Court upon the Plaintiffs' Motion for Summary Judgment. A hearing was held on October 11, 2001. A rehearing was held at the Court's initiative on January 31, 2001 to resolve points not apparent from the record. Based upon these hearings, and from the record presented, the undersigned believes that the Plaintiffs' Motion should be GRANTED.

**STATEMENT OF FACTS**

1. In February, 1997, the Thompsons sold eight duplexes located in Charlotte, North Carolina to Clayton Bailey (the "Charlotte duplexes"). The Thompsons financed Bailey's purchase, taking a "Balance Purchase Money Note" for \$1,041,000.

2. The Note was secured by a "Balance Purchase Money Deed of Trust" on the Charlotte duplexes. However, the parties also agreed

that \$70,000.00 of the debt would be secured by a mortgage on property which Bailey owned in Boca Raton, Florida (the "Florida property").

3. On March 16, 1998, some thirteen months later, Bailey filed a Chapter 13 case in this Court.

4. The Thompsons responded with a motion dated March 23, 1998, which sought relief from stay against the Charlotte duplexes, or, alternatively, adequate protection of their secured claim, dismissal, or conversion of Bailey's case (The "First Motion"). The First Motion asked for relief from stay against the Charlotte duplexes, but did not directly mention the Florida property.

5. Bailey converted his case to Chapter 11 on March 31, 1998, and then as a "debtor-in-possession," (11 USC 1107), he responded to the First Motion.

6. The First Motion was heard by Judge Hodges on April 15, 1998. This contested evidentiary hearing was broader in scope than the motion. While the first motion was directed to the Charlotte duplexes, evidence was taken, and arguments made, based upon the values and status of both it and the Florida property. This was without objection by Bailey.

7. Testimony was given on the structure of the debt (both the purchase money mortgage on the Charlotte duplexes and the second mortgage on the Florida property), the value of each property, and the status of insurance on each.

8. The primary issue at this hearing was whether the Thompsons' secured claim was adequately protected by the value of these two collateral properties. The enforceability of that secured claim, as against either piece of collateral was not questioned.

9. At the end of the hearing, Judge Hodges declined to give the Thompsons' relief from stay, but instead ordered Bailey to provide them with adequate protection via monthly payments and by maintaining insurance on them.

10. A written order was drafted and tendered by Thompsons' counsel. It was entered on April 23, 1998, without objection or modification.

11. The April 23 Order directs Bailey to provide adequate protection on the Thompsons' "allowed secured claim." It states that the Thompsons' debt is secured by the Charlotte duplexes and by a mortgage on the Florida property.

12. No appeal of, or request to modify this Order was made by Bailey.

13. On May 12, 1998, the Thompsons filed a second motion. Like the first, it sought relief from stay or adequate protection (the "Second Motion"). This motion was focused upon the Debtor's failure to comply with the April 23 Order and the adequate protection previously ordered.

14. Bailey, still a debtor-in-possession, responded to the Second Motion. Another hearing was held, this time on May 27, 1998 before Bankruptcy Judge Marvin R. Wooten.

15. This hearing was also focused on adequate protection. Enforceability of the Thompsons' secured claim as against either piece of collateral was not disputed.

16. After hearing the matter, Judge Wooten denied relief from stay, but again ordered Bailey to provide adequate protection to the Thompsons.

17. The written Order from this hearing was entered on June 11, 1998. It states, without elaboration, that the Thompsons hold an "oversecured claim." No appeal of, or request to reconsider, this order was ever made by the Debtor.

18. Bailey's case was converted to Chapter 7 on February 17, 1999. Johnson, the newly appointed Chapter 7 Trustee, began to market Bailey's various real estate holdings.

19. Eventually, the Trustee secured a purchaser for the Florida property. On July 16, 1999, he filed a motion for authority to sell the Florida property. However, the buyer reneged, and the sale fell through.

20. Not satisfied with these efforts, the Thompsons filed a third motion seeking relief from stay, etc. (the "Third Motion") on October 15, 1999.

22. The Third Motion alleges a failure of the adequate protection required by the April 23 and June 11 Orders. Since these issues had already been determined, it does not go into detail about the nature of the debt or the composition of the Thompsons' collateral. Rather, it cites the April 23 Order as finding the Thompsons to have a "properly perfected security interest in certain real property."

23. For some unexplained reason, the Trustee was not served with the Third Motion. However, he learned of the motion in time to file a "bare bones" objection, dated November 11, 1999.

24. This occasioned a third hearing on November 18, 1999. With Bailey in a Chapter 7 case, the undersigned heard that motion.

25. During this third hearing, Thompsons' counsel told the Court that the April 23, 1998 Order had established the Thompsons as having a secured claim on both the Charlotte and Florida property.

26. The Trustee disagreed, arguing there might be a legal problem with enforcing the Thompsons' purchase money debt against a nonpurchase money property like the Florida property. However, this question was not decided. During a break, the two sides reached agreement on a number of matters, including disposition of rents from the Charlotte duplexes, insurance proceeds, etc. They agreed to permit the Thompsons to foreclose on the Charlotte duplexes. The Trustee would try to sell the Florida property,

which was now in danger of foreclosure by the first mortgagee. An Order to this effect was drafted by Thompsons' counsel.

27. Thompsons' attorney drafted a written order, sent it to the Trustee for comments, and then tendered the same to the Court for entry. It was entered without objection on December 1, 1999. It has not been appealed from, nor has there been a request to reconsider this Order.

28. The December 1, 1999 Order states: As determined by the April 23 Order, the Thompsons hold an allowed secured claim, collateralized by both the North Carolina and Florida real estate.

29. Within a few weeks, the Trustee found a new purchaser for the Florida property and filed a Motion seeking sales approval on December 28, 1999. This Motion was the first pleading to contest the enforceability of the Florida mortgage.

30. In it, the Trustee agrees with the Thompsons that they are "secured" creditors (by virtue of the Charlotte property), but says their mortgage on the Florida property is unenforceable under NCGS 45-21.38, the North Carolina anti-deficiency statute.

31. As noted by the motion, the Thompsons had agreed that the Trustee sell this property, with their disputed lien to attach to the net sale proceeds. These were to be held pending the resolution of this question. An Order allowing the sale was entered the same day.<sup>1</sup>

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<sup>1</sup> The price for the second sale was higher than that in the earlier proposed sale. Since there had been no objections lodged

32. The Thompsons then foreclosed their deed of trust on the Charlotte duplexes. The foreclosure did not fully satisfy their debt. A deficiency remains of \$390,036.15.

33. In the meantime, the Trustee closed the Florida property sale, and netted (after closing costs and the first mortgage) \$76,596.22.

34. The Trustee then objected to the Thompsons' secured claim, citing the North Carolina anti-deficiency statute. However, because an adversary proceeding is required (FRBP 7001) to determine a lien, that claim objection was supplanted by this suit.

#### STATEMENT OF POSITIONS

The Thompsons seek validation of their secured claim against the Florida proceeds (to the extent of \$70,000, plus interest and costs), and an order directing the Trustee to turn over these funds. They contend that the validity of their secured claim as against the Florida property was established by the earlier relief from stay/adequate protection Orders. Under the doctrines of res judicata and collateral estoppel, and the Fourth Circuit's decision in *Spartan Mills v. Bank of America Illinois*, 112 F. 3d 1251 (4<sup>th</sup> Cir. 1997), the Thompsons say these orders cannot now be contested.

The Trustee disagrees. Substantively, he believes that, under NCGS 45-21.38, the Thompsons' purchase money note can only be

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to the earlier motion, and with an impending foreclosure by the first mortgage holder against this property, the Court did not require a new notice.

enforced against the purchase money property--the Charlotte duplexes--and therefore, the Florida mortgage is invalid.

Procedurally, he contends that enforceability of the Thompsons' claim against the Florida property has never been determined so as to be issue precluded. Alternatively, to the extent that enforceability was determined by the earlier orders, he thinks the ruling(s) should be reconsidered.

#### HOLDING

If writing on a clean slate, the undersigned would be inclined to agree with the Trustee. The case law interpreting NCGS 45-21.38 supports his view that a purchase money note cannot be enforced against nonpurchase money collateral.<sup>2</sup> Unfortunately, all participants to the April 15 hearing assumed the contrary. As such, and because this collateral was a part of the Thompsons' adequate protection, that assumption cannot now be undone. However, because the Thompsons consented to the Trustee selling their collateral, the Trustee should recover his costs and expenses of doing so under Section 506(c).

#### REASONING

This matter pits several legal principles and their underlying policies against one another.

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<sup>2</sup> See *In re Goforth*, 334 N.C. 369, 432 S.E. 855 (1993) (A purchase money creditor is limited strictly to the property conveyed, such that his debt is unenforceable against auxiliary collateral.).

On the one hand, there are the common law doctrines of res judicata and collateral estoppel. These related doctrines exist to prevent relitigation of issues previously decided, as well as to deter parties from taking inconsistent positions in different proceedings.

Generally speaking, res judicata dictates that when a judgment on the merits becomes final, further claims by parties or their privies based on the same causes of action are barred. *Montana v. United States*, 440 U.S. 147, 153(1979).

Collateral estoppel, or issue preclusion, is similar, but treats as final only those issues which were "actually and necessarily determined" in prior litigation. *Montana*, 440 U.S. at 153.

The applicability of these doctrines in a bankruptcy case cannot be doubted after the *Spartan Mills* decision, cited by the Thompsons in their brief. *Spartan Mills*, is a Fourth Circuit bankruptcy decision founded on the U.S. Supreme Court's holding in *Celotex v. Edwards*, 514 U.S. 300, 115 S.Ct. 1493, 131 L.Ed. 2d 403(1995). It eschews collateral attacks by parties to a bankruptcy case as to orders for which they were given notice, but failed to respond. *Spartan Mills* is an affirmation of the applicability of res judicata principles in bankruptcy. *Spartan Mills*, 112 F. 3d at 1256-7.

These doctrines suggest that the Thompsons should prevail in the current dispute. Clearly, the Trustee is in privity with the Chapter 11 debtor-in-possession who defended the first two motions. See *In re Bettis*, 97 B.R. 344 (Bankr. W.D. Tex. 1989); *In re Sherwood Ford, Inc.* 125 B.R. 957 (Bankr. D. Md. 1991), *aff'd* 1992 U.S. Distr. LEXIS 15516, 1992 WL 2951 (D. Md. 1992). He was a party to the third motion.

The nature and extent of the Thompsons' secured claim was an issue germane to the first relief from stay hearing,<sup>3</sup> and one that would have been relevant to the second and third hearings had the matter not been decided at the first hearing.

Evidence was taken at the first hearing about that secured claim, and arguments were made, but no one questioned the enforceability of the Florida mortgage. Just as with the Charlotte deed of trust, this was presumed. The decision was not appealed and is final. Thus, under traditional preclusion principles, that order would not be subject to review at this point.

However, a bankruptcy case was intended to be a quick moving, multiple-party, marshaling procedure.<sup>4</sup> This makes it difficult to

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<sup>3</sup> Technically, the First Motion did not seek relief from stay against the Florida property. However, it did ask for adequate protection of their secured claim, which included all of the Thompsons' collateral. Moreover, at hearing the parties tried the matter, without objection as both properties.

<sup>4</sup> Creditors, debtors and trustee's all have a stake, and can be parties in interest, in the same dispute

import the common law doctrines, at least without some modification.

One nuance of bankruptcy law that affects this case, not applicable to *Spartan Mills* or *Celotex*, is the fact that relief from stay and claims determinations orders do not always have a preclusive effect. Because relief from stay proceedings were designed to be summary proceedings, the Courts have limited or denied relief from stay orders a res judicata effect. *Grella v. Salem Five Cent Savings Bank*, 42 F.3d at 33(5th Cir.1994). ("The limited grounds set forth in the statutory language, read in the context of the overall scheme of Section 362, and combined with the preliminary, summary nature of the relief from stay proceedings, have led most courts to find that such hearings do not involve a full adjudication on the merits of claims, defenses, or counterclaims, but simply a determination as to whether a creditor has a colorable claim to property of the estate."); See also *Estate Construction Co. v. Miller & Smith Holding Co., Inc.*, 14 F.3d 213, 219 (4th Cir.1994) (hearings to lift the stay are summary in character, and counterclaims are not precluded later if not raised at this stage); *In re Vitreous Steel Prods. Co.*, 911 F.2d 1223 (7<sup>th</sup> Cir. 1990).

The conclusion that the Thompsons hold an allowed secured claim of course arose from litigation founded in part on a request

for relief from stay motion, which might in some measure, rob it of a preclusive effect.

A second nuance of bankruptcy law that alters common law preclusion doctrines is that Code Section 502(j) states that a claim may be reconsidered at any time, for cause shown. When cause is shown, the claim may be reconsidered according to the equities of the case. 11 U.S.C. 502(j).

Obviously, the monies now claimed by the Thompsons, if paid, must come out of estate property. Recognizing this mortgage claim on the Florida property means reducing the monies available to other creditors (who have enforceable claims, if not mortgages). Since it appears the Thompsons' mortgage claim would itself be unenforceable under North Carolina law, ordinarily, this Court would be inclined to reconsider the same.<sup>5</sup>

However, back in April of 1998, Judge Hodges found adequate protection, premised upon the equity in both the Charlotte duplexes and the Florida property. With this, he was able to continue the stay in effect and afford Bailey a chance to reorganize. That adequate protection ruling, cannot now be undone without harming the Thompsons.

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<sup>5</sup> Cause to reconsider might also exist due to the subtlety of the underlying legal question. Whether under the North Carolina anti-deficiency statute, a purchase money mortgage is enforceable against a nonpurchase money property in Florida is not a question easily answered.

Had it been known at the first hearing that the Thompsons' Florida mortgage was unenforceable, Bailey would likely have lost the motion. Take away \$70,000 of collateral, and the Thompsons' debt no longer appears oversecured. With relief from stay, the Thompsons would have foreclosed on the Charlotte duplexes.

Based upon this apparent equity, however, Bailey prevailed. He retained both properties and continued to enjoy the property rentals for a considerable period of time. The Thompsons, on the other hand, were restrained for over one and a half years from foreclosing or collecting the Charlotte rents. In the interim, interest continued to accrue on their secured debt, and they incurred substantial legal costs trying to compel Bailey to perform or to recover the property.

It is now known that the value of the Charlotte duplexes was not sufficient to fully secure the claim. The Thompsons will not be repaid in full.

Thus, Bailey has received the benefit of the error. The Thompsons got the burdens. It would be inappropriate to now reconsider that legal conclusion so as to reduce the Thompsons' collateral. This genie is out of the bottle and cannot be returned.

Looking at the matter from another perspective, if it had been necessary in order to afford the Thompsons' adequate protection, the Court had the ability at the April 15 hearing to grant the

Thompsons a lien on the Florida property. 11 USC 361(2). Although no one envisioned it at the time, that is, effectively, what this mistake did.

The Thompsons hold an allowed secured claim against these proceeds to the extent of \$70,000 plus interest. Their Motion for Summary Judgment should be granted, with one minor caveat.

The Thompsons consented to permitted the Trustee marketing and selling this property under Section 363. This was an advantage to them in that they avoided the need to buy out the first on the Florida property, whose pending foreclose would have cut off the Thompsons' lien. They also would have had to bring a foreclosure action in Florida.

Under Section 506, a Trustee may recover his reasonable, necessary costs and expenses of preserving and selling property. 11 USC 506(c).

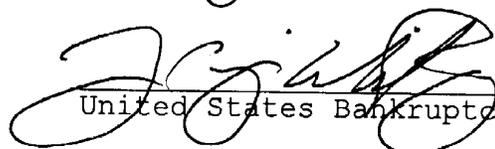
The sale of the Florida property netted \$76,596.22. The Thompsons' Note and Deed of Trust were capped at \$70,000. The sale benefitted both sides. The Court believes the Trustee's costs and expenses should be prorated.

To this end, the Trustee is instructed to file within fifteen days, an Affidavit setting out the monies he claims under this Section and his proposal to allocate the expenses. The Thompsons shall have fifteen days to respond. The Court will resolve any differences and enter a supplemental Order allowing this surcharge.

However, there is no point in holding any more funds than what is necessary to secure the amounts which the Trustee believes should go to the estate. Therefore, fifteen days after entry of this order, unless stayed, the Trustee shall turn over to the Thompsons the monies due them, which are not reserved.

**SO ORDERED.**

This the 26<sup>th</sup> day of February, 2002.

  
United States Bankruptcy Judge