UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NORTH CAROLINA

In Re: **ROBERT LEONARD and PENNY BURCHFIELD,** Debtors.	)	Case No. 92-31244 Chapter 13
ROBERT AND PENNY BURCHFIELD, Plaintiffs, vs. **ASSOCIATES FINANCIAL SERVICES, INC.,** Defendant.	)	Adversary Proceeding No. 95-3267

ORDER GRANTING SUMMARY JUDGMENT AND DIRECTING TURNOVER

This matter came before the Court upon the Debtors' Motion for Summary Judgment. Previously, this matter had been before U.S. Bankruptcy Judge Marvin R. Wooten on a proposed settlement of this adversary proceeding, approval of which was refused. This precipitated the present motion which was set for April 9, continued to April 23, 1996 and argued in Chambers before the undersigned at the parties' request.

The facts are not in dispute. Prior to bankruptcy, the Debtors borrowed $18,168.44 from Associates Financial Services, Inc. ("Associates"), evidenced by a Note and to be secured by a deed of trust on the Debtors' real property.

On June 26, 1992, the Debtors filed a Chapter 13 bankruptcy case in this Court. Believing it to be collateralized by the mortgage, the Debtors proposed to pay Associates' claim as a

secured debt, with the prepetition arrearage to be paid through the Plan and future payments to be made directly to Associates outside the Plan. Associates filed a secured proof of claim in this case on July 26, 1992 for $18,168.44. Neither the Debtors nor the Trustee objected to Associates' claim prior to confirmation of the Plan on July 31, 1992.

The Debtors proceeded to make payments under that Plan. From confirmation through December 21, 1995, the Debtors have paid Associates a total of $15,078.00, including both direct payments and Plan distributions on the prepetition arrearage. No payments have been made after that date. To this point in the Plan, unsecured creditors have been paid only 14% of their claims.

In October, 1995, the Debtors moved the Court to sell their residence. When a title search was made of their property preparatory to closing, the Debtors learned for the first time that Associates had never recorded its deed of trust in the Gaston County Register of Deeds' Office.

This being a summary judgment motion, no evidence was presented as to how Associates came to file a secured proof of claim in this case, and whether it was aware of its unperfected status at the time.

DISCUSSION

The Debtors seek reclassification of Associates' debt as an unsecured obligation and request turnover of the monies previously paid to Associates for the benefit of all unsecured creditors. The Chapter 13 Trustee joins the Debtors' position.

Associates objects, contending that confirmation of the Debtor's Chapter 13 Plan treating Associates debt as a secured claim precludes the Debtor or Trustee from asserting otherwise, under theories of res judicata and waiver.

Associates' position is untenable. Associates was legally entitled only to an unsecured claim in this proceeding. It must disgorge the monies previously paid to it during this Bankruptcy, at least to the extent that these monies exceed the amount it would have received heretofore as an unsecured claimant.

Section 1327, cited by Associates in support of its position, states:

> [T]he provisions of a confirmed plan bind the Debtor and each creditor, whether or not the claim of such creditor is provided for by the Plan, and whether or not such creditor is objected to, has accepted, or has rejected the Plan. 11 U.S.C. 1327(a).

A confirmed Chapter 13 Plan is a legally mandated contract which binds both the Debtor and its creditors. 5 Collier on Bankruptcy, 1327.01, at 1327[1], 59 S.Ct. 134, 137 (15th ed. 1996). It is also generally said that a confirmed Plan has a res judicata effect. Stoll v. Gottlieb, 305 U.S. 165, 170-71, (1938); In re Linkous, 990 F.2d 160, 162 (4th Cir. 1993). However, this general rule is fraught with exceptions.

For example, if the order in question was procured by fraud, the Courts will not afford it a preclusive effect. Russell, Bankruptcy Evidence Manual, 1995-96 Ed. Section 12, citing Heiser v. Woodruff, 327 U.S. 726, 736, 66 S.Ct. 853, 858, 90 L.Ed. 970

(1946), rehearing denied 328 U.S. 879, 66 S.Ct. 1335, 90 L.Ed 1647 (1946).

In like fashion, to the extent that an order violates the Due Process clause of the Fifth Amendment to the Constitution, no res judicata effect pertains. In re Linkous, 990 F.2d at 162.

Moreover, the res judicata doctrine and Section 1327 cannot be read to the exclusion of other Bankruptcy Code provisions. "The common law principal of res judicata...does not apply, 'when a statutory purpose to the contrary is evident'." Russell at § 317, p.38 quoting Astoria Federal Sav. and Loan Ass'n V. Solimino, 501 U.S. 104, 108, 111 S.Ct. 2166, 2170, 114 L.Ed. 2d 96 (1991). Thus, to the extent that it conflicts with the purposes of the Code, a confirmation order lacks a res judicata effect.

Finally, within this Circuit, issues which are required by Bankruptcy Rule 7001 to be raised by adversary proceeding are not affected by a confirmation order, even if that order specifically purports to do so. Cen-Pen Corp. v. Hanson, 58 F.3d 89 (4th Cir. 1995).

The controlling cases in this Circuit, as to the meaning of res judicata in the Chapter 13 context, are In re: Arnold, 869 F.2d 240 (4th Cir. 1989) and Cen-Pen Corp. v. Hanson, 58 F.3d 89 (4th Cir. 1995).

Arnold involved a creditor's postconfirmation request to modify a Chapter 13 Debtor's plan and to increase his plan payments to creditors. The Debtor in question had experienced a significant increase in his income after confirmation. In that case, the

Circuit Court ruled that notwithstanding Section 1327, res judicata bars post-petition modification of a debtor's Chapter 13 Plan only where there have been no "unanticipated substantial changes in the Debtor's financial situation" since confirmation. Arnold, 869 F.2d 240 at 243.

Arnold adopts an objective test of when "unanticipated substantial changes" have occurred, based upon whether the changes could have been reasonably anticipated at the time of confirmation by the party seeking modification. Id.

The Arnold decision, despite its reliance on statutory authority, is founded in equity. The Court's view, simply put, is that it would be grossly unfair for a Debtor, who had experienced improvement of his finances, to refuse to share some of that with his creditors, who otherwise would receive only a nominal payout on their claims.

The other controlling case is Cen-Pen Corp. v. Hanson, cited above. Cen-Pen redresses an attempt by Chapter 13 debtors to use their Plan to determine and void a creditor's lien on their real property. In Cen-Pen, the Plan specifically stated: (1) the creditor, Cen-Pen, would be treated as an unsecured creditor; (2) secured claimholders would be required to file proofs or their liens would be voided upon discharge; and (3) absent objection, the Plan would be confirmed.

The Hansen's Plan was served on Cen-Pen who, despite receiving the same, failed to object to confirmation or to file a proof of claim. Thereafter, when the creditor filed an action in Bankruptcy

Court to establish its lien, the debtors argued that Section 1327 and principles of res judicata barred it from doing so.

The Fourth Circuit again ruled that the Chapter 13 Plan did not have a res judicata effect that would preclude litigating this dispute. In short, Cen-Pen's holding is that a Chapter 13 Plan is res judicata only as to matters which can be determined by the less formal procedures applicable to contested matters, including Plans. "'If an issue must be raised through an adversary proceeding, it is not part of the confirmation process and, unless it is actually litigated, confirmation will not have a preclusive effect...'" Cen-Pen, 58 F.3d at 93, quoting In re Beard, 112 B.R. 951, 955-56 (Bankr. N.D. Ind. 1990). Since Bankruptcy Rule 7001 requires an adversary proceeding to determine the nature, extent and priority of a lien, the Circuit Court concluded confirmation had no effect on Cen-Pen's asserted lien and it was free to seek determination, and potentially to enforce this lien. Id.

Associates cites yet another Fourth Circuit opinion, In re Varat Enterprises, Inc., 81 F.3d 1310 (4th Cir. 1996), in support of its position. The holding in Varat Enterprises applies res judicata to preclude a creditor from contesting a Chapter 11 Plan's characterization of the validity and priority of the lien claim of another creditor.

Varat is admittedly difficult to reconcile with the Court's ruling in Cen-Pen, since both cases deal with the matter of the res judicata effects of confirmed plans and involve almost identical statutes. Apparently, the Cen-Pen decision was not argued by the

parties in the Varat appeal, so the Fourth Circuit may have been unaware of the tension between these decisions. However, Varat is, in point of fact, a Chapter 11 case, whereas, like the current dispute, Cen-Pen and Arnold are Chapter 13 cases. Therefore, the undersigned believes that, where these decisions conflict, Varat is inapplicable and Cen-Pen and Arnold are controlling.

In the present case, the Debtor's plan was confirmed with a provision calling for treatment of Associates as a secured creditor. It is clear, in retrospect that, Associates was not legally entitled to such treatment.

North Carolina law makes an unrecorded deed of trust void as against purchasers for value and as against lien creditors. Webster, Real Estate Law in North Carolina, 1995 Ed., Section 17-2(a), p.702; N.C.G.S. 47-18, 47-20. Under 11 U.S.C. § 544, the bankruptcy trustee has the rights of a bona fide purchaser for value with respect to real property. Thus, Associates' unrecorded mortgage did not make it secured and it should have been treated as an unsecured creditor in this bankruptcy case. Clearly, to treat it as secured on res judicata grounds would violate the Bankruptcy Code's statutory scheme, as it would impinge upon Section 502 (a claim is not allowable if unenforceable against the debtor or his property under applicable law), Section 506 (a creditor is secured only to the extent of the value in the collateral), and Section 1322(b)(3) (equal treatment must be given to claims within a particular class). As such, no res judicata effect can be given to the Plan's statement that the claim is secured.

Second, this characterization error could only have occurred by a mutual mistake of the parties or, alternatively, fraud. It is undisputed that the Debtor and the Trustee believed Associates held a secured claim at the time the Plan was confirmed. What Associates knew at the time is not known, although in its proof of claim, it asserted to this Court that it was secured. If Associates believed at the time it prepared its claim that it had recorded its deed of trust, then all parties were under a mistake of fact, and general common law principles, allow modification to correct the error.

If, on the other hand, when in preparing its claim, Associates was aware that the deed of trust had not been filed, it is guilty of fraud. As noted above in Judge Russell's treatise, such an action would preclude affording the Plan's treatment of Associates' claim a res judicata effect. Russell, Bankruptcy Evidence Manual, Section 12. In either eventuality, res judicata does not pertain.

Moreover, the Debtor's action seeks to determine the validity of Associates' secured claim. Under the Cen-Pen holding, an adversary is necessary to determine the validity of Associates' lien, and the Debtor's Plan could not determine this issue.

Finally, it appears that discovery of this misunderstanding would constitute an "unanticipated substantial change" under the Arnold definition, since arguably no party was aware, prior to confirmation, that the deed of trust had not been recorded.

An argument can be made that this information would have been available to the Debtor and Trustee had they performed a title

search prior to confirmation. However, what is reasonably foreseeable must be considered in context. It is not reasonable to expect either a debtor or a Chapter 13 Trustee to conduct a title search of each debtor's real property prior to confirmation. To do so would be all but impossible given the number of cases filed and the limited time available before confirmation. Financially, it would be impossible. [It would also effectively set an extremely short statute of limitation for a Debtor or Trustee to file actions, which is equally impractical, and which is not mandated in the Bankruptcy Code.] At best, all parties were surprised to learn the deed of trust had not been filed. Blame for not doing so cannot be shifted from the party which had the document, to other parties in this manner. The circumstance was reasonably unforeseeable.

For the reasons, stated above, the Court hereby grants SUMMARY JUDGMENT in favor of the Debtor and as against Associates. Associates is hereby ORDERED to turn over to the Trustee the monies previously paid to it during this Chapter 13 case totaling $15,078.00, less $2,110.92 (14% of the sum which it would have received heretofore from the trustee as an unsecured claimant), for a total of $12,9676.08.

IT IS FURTHER ORDERED that Associates' claim in this case shall be recharacterized as an allowed unsecured claim, and upon return of the aforementioned sum, Associates shall be entitled to share in subsequent distributions to unsecured creditors by the Trustee, on a pro rata basis, including on the returned amount.

This the 3rd day of June. 1996.

United States Bankruptcy Judge