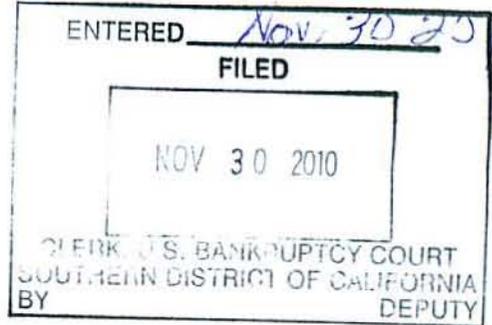


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WRITTEN DECISION – NOT FOR PUBLICATION



UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA

In re:) BK CASE NO. 10-05750-MM11
)
FANITA RANCH, L.P., a California Limited) CHAPTER: 11
Partnership,)
) **AMENDED:**
Debtor,)
) MEMORANDUM DECISION REGARDING
_____) APPROVAL OF SETTLEMENT, DISMISSAL
) OF COMPLAINT AND REMAND OF
GUARANTY BANK, as administrative agent) COUNTERCLAIMS
for Guaranty Bank and Wachovia Bank)
National Association,)
)
Plaintiff,)
) ADV. NO. 10-90204
)
v.)
)
FANITA RANCH, L.P.; WESTBROOK)
FANITA RANCH, L.P.; FIRST AMERICAN) DATE: November 5, 2010
TITLE INSURANCE COMPANY,) TIME: 10:00 a.m.
) CRTRM: 1
Defendants.)
) JUDGE: Margaret M. Mann
_____)
)
AND RELATED CROSS-ACTION.)
_____)
)

1 Fanita Ranch LP (the "Debtor"), Westbrook Fanita Ranch LP ("Westbrook") and Compass
2 Bank¹ ("Compass") each have a stake in 2,590 acres of undeveloped land located in the City of Santee
3 in eastern San Diego County known as the Fanita Ranch (the "Property"). The Debtor, and its
4 predecessor, Barratt American Incorporated ("Barratt"), pursued development of the Property that was
5 stalled by environmental litigation pending at the time of this bankruptcy.

6 Westbrook and Compass each have secured claims against the Property, the extent of which is
7 in dispute in this litigation.² While there is no dispute that Westbrook's deed of trust is senior in
8 priority to Compass' \$25 million deed of trust, Westbrook and Compass dispute the scope of the
9 secured obligations owed to Westbrook. The key point of contention is whether the \$15 million of
10 liquidated damages Westbrook claims against the Debtor are enforceable damages, and whether that
11 claim is secured by the Property. Given the proposed sale of the Property at one time in this Court at
12 \$36 million, which was not consummated, Compass will likely suffer a loss if the Westbrook secured
13 debt includes the \$15 million of liquidated damages.

14 The Debtor's alliances in the Westbrook/Compass dispute have shifted from time to time in this
15 action. When this litigation was pending in state court, the Debtor admitted in its pleadings that the
16 intent of the Westbrook loan was to include the liquidated damages as part of the secured obligations.
17 When the Debtor filed bankruptcy, the Debtor shifted its support to Compass, and claimed that
18 regardless of its contemporaneous intent regarding the Westbrook loan, the plain language of the
19 Westbrook documents supported Compass' view that the liquidated damages were unsecured. After
20 the Court denied summary judgment to Compass and the Debtor on their plain language argument,
21 finding ambiguities in the loan documents, the Debtor resumed supporting Westbrook and reached a
22 settlement. Since both Compass and Westbrook were beneficiaries at different times of the Debtor's
23 loyalties, the Court finds neither party has clean hands to complain about the issue.

26 ¹ Compass Bank is the successor in interest to Guaranty Bank and both are referred to
27 collectively as ("Compass").

28 ² This litigation was commended in state court and removed to this Court after the bankruptcy
was filed.

1 The Westbrook/Debtor settlement, in addition to resolving the Debtor's own challenges to
2 Westbrook's secured liquidated damages claim, also seeks to resolve Compass' separate but identical
3 challenge to this claim. The Court has carefully analyzed this issue in the context of previous tentative
4 rulings that it adopts here.³ The Court also held an evidentiary hearing to ascertain the relevant facts to
5 decide whether the settlement should be approved given that it is contingent upon the Court dismissing
6 Compass' claims in this action.

7 The Court finds that the Debtor's settlement with Westbrook is res judicata of Compass'
8 separate claims, which therefore may be dismissed on that basis. Specifically, the Court concludes that
9 Compass was on constructive notice of Westbrook's secured liquidated damages claim, which imposed
10 upon Compass a duty to investigate the claim. Since Compass failed to perform a reasonable
11 investigation of this claim, and because the reasonable investigation would have confirmed that
12 Westbrook's liquidated damages were secured and enforceable against the Debtor, Compass lacks
13 standing as a matter of state law to separately assert its claims. Because Compass no longer has
14 standing to assert its independent claims, Compass is in privity with the Debtor on these claims, which
15 are barred by res judicata, and may be dismissed. The Court will also approve the settlement and
16 remand Westbrook's counterclaims against Compass to state court, as they are no longer related to this
17 bankruptcy case. Compass will be relieved of the automatic stay to take whatever actions it chooses
18 regarding the Property that are not inconsistent with this decision.

19
20 **I. FACTUAL BACKGROUND**

21 **A. Westbrook Lien**

22 Westbrook's senior lien arises from its sale of the Property to Barratt on July 1, 2003, in a
23 complicated transaction that recognized that the Property was not yet fully developed. The transaction
24 involved: 1) a \$2 million cash down payment; 2) an \$8 million Purchase Price Promissory Note

25 ³ Tentative rulings and minute orders from the continued hearings were entered on the Court's
26 docket in the Adversary Proceeding 10-90204. As the Settlement Motion involves issues in both the
27 bankruptcy case as well as disposition of the Adversary Proceeding, the Court adopts all of the rulings
28 regarding the Settlement Motion entered in the Adversary Proceeding as though filed in the main
bankruptcy case as well.

1 Secured By Deed Of Trust ("Purchase Price Note") secured by a Purchase Price Deed of Trust,
2 Security Agreement and Fixture Filing ("Purchase Price TD"); 3) an Entitlement Payment Promissory
3 Note ("EP Note") secured by a first lien Entitlement Payment Deed of Trust ("EP TD") against the
4 Property; and 4) an unsecured Revenue Participation Promissory Note. The EP Note is the only
5 secured obligation outstanding against the Debtor as the Purchase Price Note has been satisfied, and
6 the Revenue Participation obligation never arose.

7 To ensure that Westbrook's remedies prior to tentative map approval were enforceable, the
8 Debtor and Westbrook negotiated a liquidated damages provision as part of the EP Note. The
9 liquidated damages provision was to be triggered by acceleration upon default, even if that occurred
10 before the entitlement payment became due.

11 **B. Compass Lien**

12 Compass lent \$25 million to the Debtor secured by a second position trust deed against the
13 Property in a loan transaction that closed December 20, 2005. Kent Newberry ("Newberry") was the
14 Compass loan officer with responsibility for the Barratt relationship overall and for the new loan.
15 Newberry testified the Debtor used the Compass loan proceeds to reimburse Barratt for transferring it
16 the Property. However, Barratt, who was a guarantor of the Compass loan, in turn intended to use the
17 proceeds to retire its mezzanine debt with Cerberus arising out of its management buyout. Initially, the
18 loan was underwritten as contemplating two advances: the first of \$25 million, and the second of
19 \$18.6 million to be payable when the EP Note became due and payable. By the time of funding,
20 however, the Compass Note was written only to reference the \$25 million advance, because Barratt
21 thought it could renegotiate the entitlement payment.

22

23 **C. Bankruptcy Proceedings**

24 **1. State Court Action**

25 The Debtor filed its petition for relief under Chapter 11 of the Bankruptcy Code on April 7,
26 2010. At this time, Compass' claims for declaratory relief that Westbrook's liquidated damages were

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1 not part of the secured obligations in the EP TD, and Westbrook's cross-claim were pending in state
2 court and close to trial.

3 Upon removal of this action from state court to this Court, this Court denied Westbrook's
4 motion seeking abstention and remand, since Compass' claims challenging the validity of Westbrook's
5 lien were core matters under 28 U.S.C. § 157(b)(2)(A) and (K).⁴ The Court also sua sponte raised the
6 issue of whether Compass continued to have standing to pursue its claims in the bankruptcy case,
7 because the Debtor intended to pursue the same claims. The Debtor then filed a cross-claim against
8 Westbrook, seeking: 1) lien avoidance under 11 U.S.C. § 544⁵, 2) disallowance of Westbrook's proof
9 of claim, and 3) declaratory relief that Westbrook's lien did not include the liquidated damages as part
10 of its secured claim.

11 2. Dispositive Motions

12 The parties next filed a series of dispositive motions. Westbrook filed a Motion to Dismiss the
13 Debtor's lien avoidance claim, and Compass and the Debtor both filed motions for summary judgment
14 on their declaratory relief claims. The parties also addressed Compass' standing, as previously raised
15 by the Court.

16 The Court issued tentative rulings on the motions on July 23, 2010, and on August 5, 2010
17 adopted the tentative rulings. The Court granted Westbrook's motion to dismiss the § 544 claim,
18 holding that the Debtor could not challenge the secured status of the liquidated damages, because a
19 hypothetical lien creditor or bona fide purchaser on the petition date would have had constructive
20 notice of Westbrook's assertion of this secured claim. The Court found that constructive notice was
21 provided through the EP TD references to the EP Note, as well as through the notice of default filed by
22 Westbrook and the lis pendens filed by Compass.

23 The Court also denied the motions for summary judgment brought by Compass and the Debtor,
24 finding that the documents are ambiguous as to whether the liquidated damages, as defined in the EP

25 ⁴ The Court noted, however, that the counter-claim brought by Westbrook was not core. The
26 Court's ruling was without prejudice, reserving the right to later remand the counter-claim to state court
if circumstances so warranted.

27 ⁵ All references to sections are to the Bankruptcy Code, Title 11, United States Code unless
28 otherwise referenced.

1 Note, constitute secured obligations under the EP TD. The Court found that the admission of parole
2 evidence would be necessary to determine the intent of the parties. The Court also found that there
3 were triable issues of fact as to whether the liquidated damages were enforceable.

4 The Court relied upon *In re Dominelli*, 820 F.2d 313, 317 (9th Cir. 1987) to find that Compass
5 appeared to have standing as a secured creditor to challenge Westbrook's secured claims. However,
6 the Court also noted that this finding could later change. Standing is a jurisdictional issue that must be
7 addressed whenever it arises through an evidentiary hearing if necessary. *In re Bennett Funding*
8 *Group, Inc.*, 336 F.3d 94, 102 (2nd Cir. 2003); *see also Duke Power Co. v. Carolina Env'tl. Study*
9 *Group, Inc.* 438 U.S. 59, 72 (1978).

10 Following the Court's rulings on these dispositive motions, the case was scheduled for trial.

11 3. Settlement Motion

12 By August 27, 2010, the Debtor had rejoined forces with Westbrook. It settled its claims
13 against Westbrook and filed a motion for approval of the settlement (the "Settlement Motion"). The
14 current terms of the settlement, including later modifications by the parties, are as follows:

- 15 - Westbrook to have a first priority secured claim as calculated in its proof of claim.
- 16 - The claims asserted by the Debtor and Compass against Westbrook to be dismissed with
17 prejudice.
- 18 - Westbrook's cross-claim against Compass to be remanded to the state court.
- 19 - Westbrook to be granted relief from stay to continue with non-judicial foreclosure
20 proceedings against the Property, but a sale could not occur before January 4, 2011.
- 21 - The automatic stay to be lifted as to the environmental litigation regarding the Property.
- 22 - Westbrook to re-convey the EP TD and cancel the EP Note if it received either \$14.5
23 million within 10 days of the effective date (defined as 15 days after the Court enters an
24 order approving the Settlement Motion), or \$17.5 million by December 15, 2010.
- 25 - If Westbrook purchased the Property at its non-judicial foreclosure sale, and then sold it
26 within 18 months of the foreclosure sale, Westbrook to distribute \$1 million pro-rata to all
27 unsecured creditors except Compass.
- 28 - Westbrook to distribute an additional \$1 million will be distributed to all unsecured
creditors except Compass if Westbrook made a profit from its sale of the Property.

25 The Settlement Motion was supported by the unsecured creditors and opposed by Compass.
26 Compass asserted the settlement was not "fair and equitable," that it violated the absolute priority by
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1 excluding Compass from the payments to unsecured creditors, and was not enforceable to the extent it
2 dismissed Compass' claims in this action.

3 In the Court's tentative ruling on the Settlement Motion made on October 18, 2010, the Court
4 rejected Westbrook's assertion that Compass' claims are property of the bankruptcy estate capable of
5 being brought, and settled, by the Debtor. *See In Re Real Marketing Services, LLC*, 309 B.R. 783, 788
6 (D. S.D. Ca 2004) (breach of contract claims against a defaulting purchaser could not be brought by
7 the debtor's managing partner). The Court also held that the factors identified in *Martin v. Kane (In re*
8 *A & C Props.)*, 784 F.2d 1377, 1381 (9th Cir.1986) had been met, so that the settlement could be
9 approved if the Court later determined it could dismiss Compass' claims on res judicata grounds.

10 With the exception of whether the Debtor and Compass were in privity, the Court found the elements
11 of res judicata would be satisfied if the settlement were approved. *Dominelli*, 820 F.2d at 317. The
12 elements of res judicata re: (1) the parties are identical or in privity; (2) the judgment in the prior
13 action was rendered by a court of competent jurisdiction; (3) there was a final judgment on the merits;
14 and (4) the same claim or cause of action was involved in both suits. *Rein v. Providian Fin. Corp.*, 252
15 F.3d 1095, 899 (9th Cir. 2001). The Court requested further briefing on the privity issue and
16 scheduled an evidentiary hearing to resolve the res judicata issues.

17 **II. ANALYSIS**

18 **A. Privity**

19 Whether a creditor is in privity with the debtor turns on whether the creditor has independent
20 standing to assert its claims under state law. Without independent standing, the creditor is in privity
21 with the debtor and the debtor can settle the creditor's claim. *Dominelli*, 820 F.2d at 317 (junior
22 lienholder's separate usury claims dismissed though trustee's bankruptcy settlement because the junior
23 lienholder lacked independent standing under California law to challenge the senior lienholder's
24 secured debt). Applying California law, Compass lacks standing since it had constructive notice of
25 Westbrook's secured liquidated damages claim. *Kaichen's Metal Mart, Inc. v. Ferro Cast Co.*, 33 Cal.
26 App. 4th 8, 16 (Cal. App. 2d Dist. 1995); *Pacific Trust Company TTEE v. Fidelity Fed. Sav. Loan*
27 *Assn.*, 184 Cal.App.3d 817 (1986).

1 In *Kaichen's*, 33 Cal. App. 4th at 16, a junior creditor was bound to the debtor's waiver of the
2 statute of limitation, and could not independently assert that the senior creditor's debt was time barred.
3 The court reasoned that the junior acquired its lien with full notice of the senior lien, and thereby "with
4 implied knowledge of [the senior's rights] including its limited right to extend [the debtor's] debt."
5 *Kaichen's, id.* Accordingly, the junior lienholder lacked standing to assert the statute of limitations
6 defense to invalidate the senior lien. Based upon *Kaichen's, id.*, Compass is bound by the Debtor's
7 settlement that Westbrook's liquidated damages are not an unenforceable penalty.

8 In *Pacific Trust*, a junior lienholder had constructive and inquiry notice of the pre-payment
9 terms of a promissory note, because the promissory note was referenced in the recorded deed of trust.
10 The junior lienholder thus lacked standing to challenge the pre-payment penalty after redeeming the
11 property. *Pacific Trust*, 184 Cal.App.3d at 825-26. Since Westbrook's liquidated damages were found
12 in the EP Note, which was in turn referenced in the EP TD, Compass was on constructive notice to
13 inquire about their enforceability and secured status.

14 **B. Constructive Notice**

15 Compass has asserted in the context of the Settlement Motion that the plain language of the EP
16 Note and EP TD are inconsistent with an interpretation that the liquidated damages were secured.
17 Therefore, Compass contends it could not have constructive notice of Westbrook's secured liquidated
18 damages claim. As in its previous tentative ruling, this Court continues to disagree, finding the plain
19 language EP TD and EP Note are ambiguous as to whether the liquidated damages are secured. These
20 very ambiguities, however, provide constructive notice to Compass to inquire into the secured status of
21 the liquidated damages. *Buehler v. Oregon-Washington Plywood Corp.*, 17 Cal. 3d 520, 529 (1976)
22 (ambiguities in an easement document give constructive notice); *Triple a Management Co. v. Frisone*,
23 69 Cal. App. 4th 520, 530-531 (Cal. App. 5th Dist. 1999) ("the subsequent encumbrancer . . . is not
24 entitled to interpret ambiguities in his own favor").

25 Compass next asserts that it could not have constructive notice of the liquidated damages since
26 they are not referenced in the EP TD, but in the EP Note, and only the EP TD is of public record.
27 However, as the Court ruled on Westbrook's motion to dismiss the Debtor's § 544 claim, the EP TD
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1 put Compass on notice that the liquidated damages might be considered part of the secured obligations
2 because the EP TD specifically refers to the EP Note. *Pacific Trust*, 184 Cal. App. 3d at 825-826
3 (constructive notice given of documents specifically referenced in the recorded document). The
4 remedies provided upon default are found in both the EP Note and the EP TD enhancing the
5 constructive notice provided to Compass. EP TD ¶ 2.7, EP Note ¶¶ 6 and 8. Another signal for
6 further inquiry by Compass contained in the EP TD was that the liquidated damages were payments
7 made "in lieu of" entitlement payments.⁶ Entitlement payments were clearly identified as a secured
8 obligation in the EP TD.

9 Compass also argues that it could not have received constructive notice of the secured status of
10 the liquidated damages because Barratt's outside counsel, Luce, Forward, Hamilton & Scripps did not
11 opine upon the enforceability of liquidated damages in its opinion letter. However, why that fact
12 should have absolved Compass of constructive notice is not clear since the attorney who drafted the
13 opinion letter for Barratt, Ronald Rouse, testified it was standard practice for counsel not to opine on
14 the enforceability of liquidated damages. Compass' waiver of its right to obtain an opinion letter from
15 the Debtor in connection with its \$25 million loan confirms that opinion letters were not greatly
16 significant to Compass.

17 **C. Reasonable Inquiry Obligation**

18 Due to this constructive notice, Compass had a duty to undertake a reasonable, if not
19 exhaustive, inquiry about the ambiguities in the EP Note and EP TD, and was bound by the facts it
20 would have discovered from that inquiry. *First Fidelity Thrift & Loan Ass'n v. Alliance Bank*, 60
21 Cal.App.4th 1433, 1445 (1998). California Civil Code § 19 imposes a duty of a prudent inquiry by one
22 with constructive notice. *In re Weisman*, 5 F.3d 417, 420 (9th Cir. 1993). Compass here is an
23 institutional lender that makes loans as one of its primary business activities and is charged with
24 making a reasonable investigation of the liquidated damages issues.

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27 ⁶ Compass judicially admitted that liquidated damages were to be "in lieu" of the entitlement
28 payments contained in paragraph 24 of its verified complaint.

1 Compass failed to make even a perfunctory inquiry into whether the liquidated damages were
2 secured before it made the loan. Despite Newberry's review of the documents,⁷ inquiries of the
3 Debtor, and outside counsel review,⁸ the only Compass representative to perceive any risk was Kara
4 Van Duzee, who reviewed the loan documents in 2008. Compass has admitted it asked no questions
5 about whether the parties to the transaction intended for the liquidated damages payable upon default
6 to be secured, and that it formed no view on whether the liquidated damages payment was secured
7 before its loan was made. Compass was aware of the importance of default remedies since its own
8 deed of trust contains 14 separate events of default.

9 Van Duzee's review of the documents enabled her to understand that the \$15 million liquidated
10 damages would be a senior secured obligation under the EP TD after default. She concluded, "[s]hould
11 the first lien holder decide to declare a default prior to the entitlement of the property, the EDOT
12 contains a clause that requires a \$15 MM payment (versus the \$18.6 MM entitlement payment)." In
13 calculating what Compass' loss could be, Van Duzee also deducted the liquidated damages from the
14 prospective sales proceeds before deducting Compass' own loan, signifying she knew the liquidated
15 damages were payable from the Property on a secured basis. Van Duzee also recognized that the
16 Compass loan itself and the transfer of the Property from Barratt to the Debtor violated the due on sale
17 provisions of the EP note and EP TD. Ex. 3.

18 Compass sought to exclude Van Duzee's testimony, arguing her review was untimely and void
19 as legal opinion. However, the Court admitted the testimony as relevant to what a Compass
20 businessperson could perceive from a review of the EP Note and EP TD. The Court also finds Van
21 Duzee, as a Compass officer charged with the important task of seeking approval from the loan
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24 ⁷ Newberry was aware that making a loan in second priority position was unusual and risky, but
25 did not have either training or experience to address these risks. His standard practice was to request a
26 subordination agreement from Westbrook, but he was persuaded by Barratt that Westbrook would not
27 provide one. Newberry's underwriting for the Compass loan focused on the risk of how the Debtor
28 would repay Compass the second \$18.6 advance when the entitlement payment became due.
However, this risk was never realized.

⁸ While outside counsel may have reviewed the loan documents, the record is devoid of evidence
that this review addressed the liquidated damages issues.

1 participant, was a reasonably prudent person. There was no evidence her review of the documents in
2 2008 involved anything different from Newberry's review in 2005 when the Compass loan was made.

3 Compass also claims to have relied on the representations and warranty of the Debtor that the
4 Compass loan did not create a default in any other transaction. Whether this representation or
5 warranty creates a claim against the Debtor is not before the Court. However, Compass cited no
6 authority that the representation or warranty protect Compass from undertaking its inquiry obligations
7 arising from its constructive notice.

8 Despite the Debtor's earlier challenge to the secured status of the liquidated damages based
9 upon the plain language of the documents, the Debtor⁹ has consistently stated the original intent of
10 Westbrook liquidated damages was that they were to be secured. Compass presented evidence at the
11 evidentiary hearing to attempt to challenge this intent. It sought to demonstrate that if the parties really
12 intended to include the liquidated damages as part of the secured obligations, they would have done so
13 specifically because Westbrook included the liquidated damages as part of the secured obligations in
14 its first draft of the Purchase Price TD. However, while the liquidated damages were later removed as
15 a secured obligation in the Purchase Price TD, this was for reasons¹⁰ that had nothing to do with the
16 secured status of the liquidated damages.

17 This case is markedly different from that in *First Fidelity*, 60 Cal.App.4th at 1445, where the
18 creditor did everything it could possibly do, short of contacting the senior lienholder, to determine
19 what liens were senior. Compass' efforts here were inadequate to satisfy its duty of investigation

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21 ⁹ The Court finds credible the testimony of J. Michael Armstrong's, Barratt's in house counsel
22 ("Armstrong") that the Debtor and Westbrook intended the liquidated damages would be secured
23 despite taking a contrary position based solely upon the language of the EP TD during his alliance with
24 Compass. Nothing in the record directly contradicts this statement of intent which was repeated more
25 than once in the state court litigation.

26 ¹⁰ Rouse testified his reason for removing the liquidated damages from the Purchase Price TD
27 was that the obligations under the Purchase Price Note were already liquidated. His handwritten notes
28 on the draft he returned to Westbrook regarding "liquidated damages" in any event not the liquidated
damages in the EP Note, but rather the liquidated damages in the Purchase Agreement, which were
payable "in the event that failure to close escrow is by reason of buyer's default." (Ex. 209, Section 4.1
at page 12.) Placed in proper context, Rouse's suggestion that this provision be stricken because a deed
of trust would only become effective upon the close of escrow was a valid point at the very early
stages of the negotiation of a different deed of trust.

1 because it failed to undertake the simple act of just asking Barratt: "Are the liquidated damages
2 secured?" Compass never asked that question because its representatives never thought of the issue.¹¹
3 Since Compass would have learned the liquidated damages were secured just by asking Armstrong,
4 any inquiry to Westbrook would have been superfluous. While *First Fidelity, id.*, did not impose any
5 obligation on a junior lienholder to ask the purported senior lienholder about a risk, it certainly does
6 not excuse Compass from asking the question of anyone.

7 **D. Carve Out Payment to Unsecured Creditors May Exclude Compass**

8 "Creditors are generally free to do whatever they wish with the bankruptcy dividends they
9 receive, including to share them with other creditors." *In re SPM Mfg. Corp.*, 984 F.2d 1305, 1313
10 (1st Cir. 1993). *Id.* Once estate property is distributed to creditors in a bankruptcy proceeding, those
11 creditors are free to pay "part of [the] monies to some or all of the general, unsecured creditors after
12 the bankruptcy proceedings [have] finished." *Id.* In *SPM Mfg.*, the First Circuit upheld an agreement
13 made by the secured creditor of a debtor in bankruptcy to transfer property to a group of unsecured
14 creditors after the distribution of estate property. *Id.* The court recognized that once the property was
15 properly distributed, it "became the property of" the secured creditor and the court had "no authority to
16 control how [the secured creditor] dispose[d] of the proceeds once it receive[d] them." *Id.* Similar
17 arrangements have been approved in various bankruptcy courts. *See In re Genesis Health Ventures*,
18 266 B.R. 591(Bankr. Del. 2001) ("creditors are generally free to do whatever they wish with the
19 bankruptcy dividends they receive, including to share them with other creditors, even if such sharing
20

21 ¹¹ The parties stipulated that representatives of Compass and the Debtor's predecessor, Barratt, do
22 not recall discussing or considering at the time of the loan by Compass to the Debtor whether: 1)
23 Westbrook's claim to liquidated damages was a secured obligation, or 2) the applicability of the due on
24 sale or encumbrance provisions of the EP TD. The evidence also established that if Newberry had
25 asked Reid whether liquidated damages were intended to be secured, Reid would have told Newberry
26 that he would have to speak with Armstrong. If Armstrong had asked Reid to relay any information to
27 Compass in response to such an inquiry, Reid would have done so. If Armstrong had been asked if the
28 parties had intended liquidated damages to be secured, Armstrong would have told him that the parties
intended that liquidated damages be secured. If Compass had asked Armstrong, he would have
testified that he believed the liquidated damages were secured by the EP TD. At no time prior to
closing its loan did Compass contact Armstrong to determine if he agreed with Compass's
interpretation of the Westbrook documents.

1 conflicts with the Bankruptcy Code's distribution and priority scheme"); *In re MCorp Financial, Inc.*,
2 160 B.R. 491 (S.D. Tex. 1993).

3 The Court is persuaded that the settlement agreement is consistent with bankruptcy law.
4 Similar to the agreement in *SPM Mfg. Corp.*, the distributions to some of the unsecured creditors will
5 not happen until after Westbrook conducts its foreclosure sale, purchases the Property at the sale and
6 then resells it within 18 months. At this time, Westbrook will not be distributing estate property, but
7 its own property. Westbrook would be free to enter into this arrangement with the unsecured creditors
8 after the completion of the bankruptcy case, so nothing should preclude Westbrook from entering into
9 this arrangement during the bankruptcy. *SPM Mfg. Corp.*, 984 F.2d at 1313 (rejecting an argument
10 that while the "secured creditor is free to share its proceeds with nonpriority creditors after bankruptcy
11 proceedings have concluded, it may not enter into a contract *during* bankruptcy in which it promises to
12 do the same thing.").

13 Compass attempts to distinguish the Settlement Agreement from the results in *In re DBSD*
14 *North America, Inc.*, 419 B.R. 179 (Bankr. S.D.N.Y. 2009), by arguing that in *DBSD* the gifting
15 creditor's claim or lien was undisputed, and that it was clear the creditor was distributing its own
16 property. See *In re DBSD*, 419 B.R. at 211. Since Westbrook is not obligated to make a distribution
17 until after the foreclosure sale, this is also the case here.

18 Compass' cannot rely on the absolute priority rules under 11 U.S.C. § 1129(b)(2)(B)(ii) to
19 defeat the settlement since these rules apply only in bankruptcy. Westbrook's conditional distribution
20 to unsecured creditors would be a transfer outside of bankruptcy. *SPM Mfg. Corp.*, 984 F.2d at 1313
21 ("Code provisions governing priorities of creditors apply only to distributions of property of the estate.
22 The Code does not govern the rights of creditors to transfer or receive nonestate property.").

23 **III. CONCLUSION**

24 For the reasons set forth in this Memorandum Decision, the Court finds that Compass is barred
25 by res judicata to separately assert that Westbrook's liquidated damages were unsecured. Accordingly,
26 Compass' claims in this action may be dismissed. The Court will also approve the Debtor's Settlement
27 Motion and will remand Westbrook's counterclaims against Compass back to state court as they are no
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1 longer related to this bankruptcy case. Compass will be relieved of the automatic stay to take whatever
2 actions it chooses regarding the Property that are not inconsistent with this Memorandum Decision.

3 This Memorandum Decision constitutes findings of fact and conclusions of law pursuant to
4 Bankruptcy Rule 7052. Counsel for the Debtors is directed to prepare an order in accordance with this
5 Memorandum Decision within ten (10) days of the date of entry.

6 IT IS SO ORDERED.

7 Dated: November 30, 2010

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9 MARGARET M. MANN, JUDGE
10 United States Bankruptcy Court
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