

UNITED STATES BANKRUPTCY COURT
For the Southern District of Iowa

In the Matter of	:	
	:	
COUNTRYSIDE INVESTMENT	:	Case No. 88-554-C H
COMPANY, a Partnership,	:	
	:	Chapter 7
Debtor.	:	
-----	:	
	:	
DONALD F. NEIMAN, CHAPTER 7	:	
TRUSTEE OF COUNTRYSIDE	:	
INVESTMENT COMPANY, a	:	Adversary No. 90-00061
Partnership,	:	
	:	
Plaintiff,	:	
	:	
v.	:	
	:	
HFC COMMERCIAL REALTY, INC.,	:	
	:	
Defendant.	:	

ORDER ON MOTION FOR SUMMARY JUDGMENT

On August 23, 1991 a telephonic hearing was held on a motion for summary judgment filed by defendant HFC Commercial Realty, Inc. (hereinafter HFC). Michael L. Molinaro and Charles D. Hunter appeared on behalf of HFC and Michael P. Mallaney spoke for the Plaintiff/Trustee. At the conclusion of the hearing, the Court took the matter under advisement and the Court considers the matter fully submitted. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2). The Court, upon review of the pleadings, arguments of counsel, and briefs submitted, now enters its findings and conclusions pursuant to Fed.R.Bankr.P. 7052.

FINDINGS OF FACT

The following findings are taken mainly from the statement of undisputed facts submitted by the parties July 15, 1991. Additional facts were found from the exhibits submitted by the parties.

1. Countryside Investment Company (hereinafter Debtor) executed and delivered to HFC a promissory note dated June 25, 1985 in the original principal amount of \$3,090,000 (hereinafter referred to as the Debtor's note or note).

2. The note was secured by a mortgage, assignment of rents, and security agreement dated June 25, 1985, executed and delivered by Debtor to HFC, encumbering certain real property and improvements described in the mortgage and commonly known as 6215 Fleur Drive, Des Moines, Iowa (hereinafter, the hotel property). The mortgage was perfected by its recording with the Recorder's Office of Polk County, Iowa on June 28, 1985.

3. To further secure the note, Debtor executed and delivered to HFC an assignment and security agreement dated June 25, 1985 (hereinafter assignment of Virginia note and deed of trust) granting to HFC a security interest in a certain promissory note (hereinafter the Virginia note) dated December 14, 1984 payable to the Debtor in the principal amount of \$1,424,000 and in a deed of trust (hereinafter Virginia deed of trust) dated December 14, 1984. The Virginia deed of trust was junior to two prior deeds of trust all of which encumbered certain real estate in Petersburg, Virginia

(hereinafter the Virginia property). The assignment and security agreement provides that it shall constitute a security agreement under and pursuant to the Uniform Commercial Code, as enacted in the state of Virginia.

4. Debtor assigned its right, title, and interest in the Virginia deed of trust to HFC pursuant to the collateral assignment of deed of trust dated June 25, 1985.

5. Venod and Surekha Vashi, the general partners of the Debtor, also guaranteed the Debtor's note by the execution of a guaranty dated June 25, 1985 (hereinafter, the guaranty).

6. As a result of Debtor's default under the note and other loan documents, HFC sent a letter dated September 11, 1987 to the maker of the Virginia note requesting that all future payments under the Virginia note be paid to HFC in accordance with the terms of the assignment of Virginia note and deed of trust. Paragraph 6 of the assignment & security agreement dated June 25 provides for HFC's rights in the event Countryside defaults under the U.C.C. including the right to collect on the note, sell or dispose of Countryside's interest in the note, and to bid at a sale of the note. The proceeds of the exercise of those rights "shall be applied by HFC...first to all costs and expenses of collection... and then to the repayment of the indebtedness...."

7. HFC and Debtor entered into an agreement dated October 27, 1987 (hereinafter letter agreement), which provided in part that beginning with the October 1987 payment, all payments due under the Virginia note would be paid

directly to HFC to be deposited in an escrow held by HFC for payment of real estate taxes on the property encumbered by the mortgage. The letter agreement further provided that upon default by Debtor under the note or letter agreement, HFC was entitled to apply the payments received from the Virginia note to the indebtedness owing under the note.

8. By letters dated January 6, 1988, February 4, 1988, and March 10, 1988, HFC notified Debtor of its default under the note and other loan documents and demanded payment of same.

9. On March 14, 1988, Debtor, Countryside Investment Company, filed a voluntary petition under Chapter 11 of the Bankruptcy Code.

10. HFC had received monthly payments from the maker of the Virginia note in the amount of \$10,846.83 from October 1987 to July 1989. In total, HFC collected \$244,032.70 from the Virginia note.

11. Pursuant to the Court's December 8, 1988 order, HFC spent \$103,474.83 to preserve the hotel property. HFC reduced the collections from the Virginia note by the above amount pursuant to the terms of the assignment of Virginia note and deed of trust, and the letter agreement. HFC has held the remainder of the collection from the Virginia note as a reduction to the balance of the debt owing by Debtor under the Debtor's note.

12. On December 19, 1988, the Court entered an order converting the Chapter 11 case to a case under Chapter 7 of

the Bankruptcy Code.

13. On January 4, 1989 the Court entered an order terminating the stay allowing HFC to foreclose the lien on its collateral pursuant to applicable state law.

14. HFC filed a petition for foreclosure including a waiver of its rights to a deficiency judgment. On April 13, 1989 the Iowa District Court for Polk County entered a Decree of Foreclosure with respect to the hotel property and a judgment in favor of HFC in the amount of \$3,019,208.58 plus interest, late charges, expenses, and costs. Because HFC waived its right to a deficiency judgment, the court reduced the period of redemption to ninety days pursuant to Iowa Code § 628.28.

15. On June 8, 1989 HFC bought the hotel property at sheriff's sale with the only bid of \$2,500,000.

16. After HFC foreclosed on the hotel property, it received two monthly payments on the Virginia note totalling \$21,693.66. One payment was made in June 1989 in the amount of \$10,846.83 and the other payment was in July 1989 in the amount of \$10,846.83. The maker of the Virginia note made no payments to HFC after July 1989. As of July 7, 1989, the balance remaining of the funds collected by HFC from the Virginia note was \$140,558.75.

17. On August 30, 1989 the United States District Court for the Northern District of Illinois Eastern Division entered an order granting summary judgment in favor of Vinod M. Vashi and Surekha V. Vashi dismissing HFC's complaint against them.

HFC had been seeking to enforce the terms of the guaranty executed by the Vashis and was seeking to recover the indebtedness due and owing under the note, which amounted to \$3,347,126.45 plus fees, costs, and per diem interest of \$1,090.27 accruing from and after September 13, 1988. The complaint had been filed September 15, 1988.

18. On November 20, 1989 W. M. Scaife, Jr., Trustee for the holder of the second deed of trust on the Virginia property sent HFC a letter, enclosing copies of the advertisement of the sale of the Virginia property.

19. The Virginia property was sold at a foreclosure sale on December 29, 1989 as a result of a default on the second deed of trust. Prior to the foreclosure sale of the Virginia property, HFC, which did not institute or participate in the foreclosure, did not advise the Debtor or Chapter 7 Trustee of the notice it received from W. M. Scaife, Jr. with regard to the Virginia property.

20. HFC as of this date still has possession of the Virginia note.

21. Trustee has filed a four count complaint naming HFC as defendant. The counts are as follows:

- a. Count I requests turnover of the Virginia note and monies collected thereon or judgment against HFC for the value of the same.
- b. Count II alleges HFC has willfully and maliciously converted the Virginia note and monies collected thereon to its own use so that in addition to actual damages, Trustee requests punitive exemplary damages.

- c. Count III alleges HFC breached an implied covenant of good faith and fair dealing.
- d. Count IV alleges a breach of contract in regards to HFC's duty of good faith.

DISCUSSION

Federal Rule of Bankruptcy Procedure 7056, which incorporates Federal Rule of Civil Procedure 56, sets forth the standard to be applied by the court in determining whether to grant a motion for summary judgment. Federal Rule of Bankruptcy Procedure 7056 provides in pertinent part:

- (c) The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.

Summary judgment should not be viewed as a disfavored procedural shortcut, but rather as an important method to be used to secure the just, speedy, and inexpensive determination of every action. Celotex Corp. v. Catrett, 477 U.S. 317, 330, 106 S. Ct. 2548, 2556 (1986); Sternco Inc. v. Associates Leasing, Inc. (In re Rose Way, Inc.), 113 B.R. 527, 528 (Bankr. S.D. Iowa 1990).

Defendant HFC has filed a motion for summary judgment. In opposition, Plaintiff argues that its statement of material facts and brief reflect there are material facts in dispute. Plaintiff does not, however, specify what facts are in dispute. While the parties certainly dispute the applicable

law and their respective rights and obligations, the Court is unable to find any dispute as to the material facts in this case. Trustee has, however, raised the issue of whether HFC's conduct in proceeding on the Virginia note was commercially reasonable--an issue for which the Court does not have facts sufficient for a grant of summary judgment dismissing the case. Therefore, as discussed below, the Court will grant HFC summary judgment as to all but the issue of commercial reasonableness as a matter of law.

Resolution of this dispute hinges on the rights of the parties with respect to the Virginia note and its proceeds. Trustee alleges HFC is barred from enforcing its security interest in or claim to the Virginia note or any monies collected therefrom, 1) by HFC's decision to forego a deficiency judgment in its foreclosure action; 2) by merger; and 3) by res judicata pursuant to the August 30, 1989 decree of the United States District Court for the Southern District of Illinois, which dismissed HFC's complaint seeking to enforce the personal guarantees of the Debtor's partners for the obligation owed to HFC. That is, Trustee argues the debt to HFC has been satisfied in full by the hotel property foreclosure action; thus HFC has no right to the Virginia note or funds collected thereon. In the alternative, Trustee argues that if the Debtor is found to have forfeited the Virginia note to HFC in 1987 or if HFC exercised its rights against the Virginia note in 1987, then the value of the Virginia note and collections made therefrom should be

properly credited against HFC's claim. In this vein, Debtor argues HFC did not apply or credit the Virginia note value against the Debtor's obligation as required by Iowa Code § 554.1203 (good faith requirement). This issue of good faith in HFC's collection on the Virginia note, claims the Trustee, is a factual issue precluding summary judgment. Thus, Trustee prays the Court find that the escrow account funds of \$244,032.70 representing funds collected on the Virginia note and the Virginia note be turned over to the Trustee as property of the estate.

Trustee also complains that HFC sought and received in its April 13, 1989 judgment for foreclosure amounts that had already been paid (or were later paid) by HFC's offset of escrow funds against the money HFC spent to preserve the hotel property, specifically \$10,283.48 (Jan. 1989 power bill plus Bell Bros. bill) and \$4,802.25 (real estate taxes). In addition, Trustee argues HFC breached a duty of good faith and fair dealing it owed to the Debtor and the estate by failing to advise of the foreclosure action against the Virginia note property. (Trustee's Brief at 22).

Effect of the U.S. District Court Decree

After buying the hotel property at sheriff's foreclosure sale for \$2,500,000.00, HFC sought to recover the remainder of their \$3,968,951.98 debt from the Vashis in the United States District Court for the Northern District of Illinois. The District Court denied HFC relief holding that HFC waived not

only its right to a deficiency judgment against the Debtor but also any right to recover a deficiency from the Vashis. HFC Comm. Realty, Inc. v. Vashi & Vashi, No. 88-C7926 Memorandum Opinion at 4 (N.D. Ill. Aug. 30, 1989). The Court further held that when HFC foreclosed, the Debtor fully satisfied any obligation it had to HFC. Id. (citing Decorah State Bank v. Zidlicky, 426 N.W.2d 388, 390 (Iowa 1988)). Zidlicky reiterated, in dicta, the general rule that payment of a debt by the principal obligor discharges the guarantor and terminates the obligation. Zidlicky, 426 N.W.2d at 390.

The District Court decree does not, under the doctrine of res judicata, affect HFC's rights in the Virginia note. First, the issue before the District Court was whether HFC could recover its debt by proceeding against the guarantees of the Vashis. Here, HFC is proceeding against additional collateral pledged under a separate security agreement. This latter issue was not litigated or even raised before the District Court. Nor would this issue have been material or relevant to the action on the Vashi guarantees. Furthermore, the District Court did not even address whether HFC may pursue this additional collateral to satisfy the debt owed to it. Thus, the doctrine of res judicata is not applicable in this action. See In re Neill, Case No. 90-2754-D op. at 5 (Bankr. S.D. Iowa Nov. 22, 1991) (#203) (citing Israel v. Farmers Mut. Ins. Ass'n, 339 N.W.2d 143, 146 (Iowa 1983) and Harrison v. State Bank, 440 N.W.2d 398, 401 (Iowa Ct. App. 1989)).

Effect of Foreclosure on HFC's Rights in the Virginia Note

The doctrine of merger does not bar HFC from retaining the Virginia note. The Debtor pledged the Virginia note to HFC as additional collateral in a security agreement separate from the mortgage. HFC foreclosed on the mortgage foregoing a deficiency judgment. Plaintiff has cited no case law that would indicate that under Iowa law a foreclosing creditor, which waives a deficiency judgment, loses its right to proceed against other additional collateral. Brenton State Bank v. Tiffany, 440 N.W.2d 583, 586 (Iowa 1989) supports HFC's contention that the principles of merger and res judicata do not preclude HFC from proceeding against additional personal property collateral--here, the Virginia note--evidenced by a separate security agreement. The debt remains unpaid and under Iowa law and the parties' agreements, HFC may proceed against each item of collateral the Debtor pledged until the debt is satisfied. See id. at 586.

Application of Virginia Note to the Debtor's Obligation

Trustee has an alternative argument, if the Court should find that HFC is entitled to retain the Virginia note and its payments. Trustee raises issues about whether HFC acted in good faith (Iowa Code § 554.1203) and in a commercially reasonable manner in its application of the Virginia note payments and the note itself against Debtor's obligation when it was allegedly forfeited to HFC. Trustee complains 1) that HFC had a duty to apply the payments and note against the

Debtor's note upon receipt instead of placing the payments into a non-interest paying account and allowing interest on the Debtor's note to accrue at more than \$1000/day; 2) that HFC in effect is collecting the debt twice because a) it included preservation expenses in its fully satisfied hotel foreclosure judgment and b) it already received reimbursement of those expenses out of the escrow account allegedly contrary to this Court's December 8, 1988 ruling that preservation funds advanced should be added to the principle amount of HFC's secured claim. (Trustee's Brief at 19). Finally, Trustee complains HFC violated a duty to give Debtor or the Bankruptcy Trustee notice of a pending foreclosure sale of the Virginia note property.

The Court rejects Trustee's argument that HFC is getting paid twice on the Debtor's note because the Debtor's note was fully satisfied by HFC's election to waive a deficiency judgment when it foreclosed on the hotel property. This argument was addressed above. Whether the preservation expenses were added to the principal amount of HFC's secured claim or were paid out of the escrow account of Virginia note payments appears to matter only if this Court decides that HFC's foreclosure fully satisfied the Debtor's note obligation. This Court has already decided the foreclosure judgment did not. Therefore, the Court need only consider the reasonableness of HFC's application of the Virginia note and its payments against Debtor's note and whether HFC owed a duty to Debtor or Trustee to give notice of the impending

foreclosure sale of the Virginia note property.

Trustee alleges HFC did not act in a commercially reasonable manner and therefore violated its duty of good faith under Iowa Code § 554.1203 by failing to apply the Virginia note and its collections properly against the Debtor's obligation. Essentially, Trustee asks the Court to decide to what extent HFC had a duty to apply the funds so as to minimize Debtor's obligation to HFC.

The Court finds that the issue of whether HFC proceeded in a commercially reasonable manner with regard to the Virginia note is an issue precluding summary judgment. Specifically, the issue of how the collections on the Virginia note and the Virginia note itself were or should have been properly applied against the Debtor's note is not capable of being resolved by summary judgment. In addition, the issue of whether the facts might indicate that HFC had a duty to notify the Debtor or Trustee of the foreclosure sale of the Virginia note property is not capable of being resolved by summary determination.

ORDER

IT IS HEREBY ORDERED that HFC's motion for summary judgment is partially granted and partially denied as follows:

- i. the Trustee's argument that HFC is precluded from proceeding against additional collateral, namely, the Virginia note, because of foreclosure without deficiency judgment against the hotel property is as

a matter of law without merit.

ii. the Trustee's argument that No. 88-C7926 (N.D. Ill. Aug. 30, 1989) bars HFC from proceeding against the Virginia note is also as a matter of law without merit.

iii. the issue of whether HFC acted in a commercially reasonable manner with regards to the Virginia note is an issue precluding summary judgment.

IT IS SO ORDERED.

Dated this 28th day of May, 1992.

RUSSELL J. HILL
U.S. Bankruptcy Judge