

**IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF KANSAS**

<b>In re:</b>	)	
	)	<b>Case No. 02-41255</b>
<b>Milton Richard McClung,</b>	)	<b>Chapter 7</b>
	)	
<b>Debtor.</b>	)	

**MEMORANDUM AND ORDER**

This matter is before the Court on Debtor’s Motion for Order Determining Amount of Secured Claim and Directing Payment of Proceeds of Sale of Real Property (Doc. No. 39). Both Debtor and Washington Mutual Bank, the holder of the mortgage and note at issue herein, have submitted briefs and are in agreement that the only remaining issue is one of law. The Court has jurisdiction to decide this matter under 28 U.S.C. § 1334, and it is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(O).

**I. FINDINGS OF FACT**

The facts of this case are not in dispute. On March 16, 2001, Debtor borrowed \$131,750 from Long Beach Mortgage Company to purchase a twenty-five acre tract of land, and gave Long Beach a mortgage on that land to secure the loan. Paragraph 5 of the note contained a prepayment penalty clause, which essentially provided that if Debtor prepaid the note within 3 years from the date of execution, Debtor would be obligated to pay a prepayment penalty. *See* Exhibit A to Debtor’s Memorandum of Law Concerning Dispute with Washington Mutual Bank. Washington Mutual Bank (WMB) has now succeeded to the interest of Long Beach.

A few months after his execution of the note, Debtor defaulted and Bankers Trust, trustee for Long Beach, filed a foreclosure action. On March 29, 2002, the District Court of Jefferson County, Kansas entered a Journal Entry Decree of Foreclosure, which was “Submitted and

Approved by Doering & Associates, P.C.,” the attorneys for WMB in that proceeding, and in this one. The Journal Entry granted judgment to the Bank against Debtor in the amount of \$131,660.42, plus interest at the contract rate, title search expense, and costs, including reasonable attorney’s fees of \$850.00, “together with all advances and expenditures properly chargeable under the terms of the Mortgage.”

Debtor filed his bankruptcy petition on May 16, 2002. In October 2002, Debtor, with this Court’s authorization and notice to creditors, sold ten unimproved acres of the twenty-five acre tract for \$20,000. WMB did not object to the sale. Pursuant to Court order, Debtor paid the net proceeds of the sale to WMB. In December 2002, Debtor entered into a contract to sell the remaining fifteen acres for \$165,000. On January 27, 2003 this Court authorized the sale, directing Debtor to pay the balance owed WMB and to retain any excess until further order of the Court. Again, WMB raised no objection to the sale.

At the closing, WMB notified the closing agent that it was owed in excess of \$170,608.94, making it impossible to close. Apparently \$5,915.69 of that claimed amount constituted a prepayment penalty that WMB sought to collect, since the land was being sold prior to the three year period provided in the note. Sometime thereafter, WMB was persuaded to appropriately apply the \$20,000 proceeds from the first sale to Debtor’s loan, which caused the amount claimed due by WMB to be less than the available loan proceeds on the remaining acreage, thus allowing the sale to close. Upon transfer of title to the buyer, Debtor paid some or all of the net proceeds to WMB, presumably satisfying Debtor’s obligation to WMB except as it relates to this prepayment penalty. The Court understands there is a sum of money being held by a closing agent, the distribution of which is dependent on this Court’s decision, and Debtor is required to account for any balance to the Trustee.

The parties also disputed whether \$3,611.03 was owed for real property taxes. The parties have advised the court that issue is settled, so the only issue for resolution is whether Debtor owes the \$5,915.69 prepayment penalty to WMB.

## **II. CONCLUSIONS OF LAW**

WMB contends that it is entitled to the prepayment penalty because Debtor sold the property and paid off the mortgage within the three year period after execution of the note. Debtor argues WMB is barred from collecting that penalty because WMB failed to seek or obtain that remedy in the state court foreclosure action. This Court agrees with Debtor.

WMB asserts two alternative arguments why it should be entitled to now receive the prepayment penalty. First, WMB claims that language in the foreclosure judgment does, in fact, include reference to the prepayment penalty. Second, WMB argues that the state court did not have the authority to refuse to award the prepayment penalty, and, thus, that this Court must therefore sua sponte alter the state court's foreclosure judgment to now allow it.

### **A. The State Court Judgment Did not Include the Prepayment Penalty.**

WMB points to language in the judgment, which appears to have been prepared by WMB's own counsel, that it contends allows it to collect a prepayment penalty. The language upon which WMB relies states that WMB is granted judgment, including "advances and expenditures properly chargeable under the terms of the Mortgage." WMB asserts that this catch-all provision encompasses prepayment penalties. This Court disagrees.

The common understanding of the words "advances" and "expenditures" encompasses funds that WMB has actually paid out that need to be recouped. Obviously, WMB has not paid out the prepayment penalty. In this Court's experience, such "advances" and "expenditures" often include amounts necessary to winterize a home, to replace or repair locks, to mow the land to avoid county

finer, and the like. The Court believes a reasonable person would not consider a prepayment penalty to be such an "expenditure," since WMB has not "spent" anything.

Black's Law Dictionary defines an "advance" as "[m]oneys paid before or in advance of the proper time of payment." 5<sup>th</sup> ed. 48 (1979). The Court cannot find that the term "advance" refers to penalties for advance payment by Debtor, either. Instead, that term is intended to reimburse WMB for payments made in furtherance of its collection efforts. Indeed, in paragraph 9 of the same judgment, "advance" is used in just such a context, stating "McClung should be required to pay for title search expense *advanced* by Plaintiff." (Emphasis added) Accordingly, it may not be reasonably inferred that this supposed catch-all provision was intended by the state court to include penalties such as the one claimed here.

As previously noted, this judgment was drafted by counsel for WMB's predecessor in interest. WMB thus stands in the shoes of its predecessor for purposes of exerting its rights under this contract. WMB should thus not be allowed to benefit, nor should Debtor and his other creditors be potentially harmed, by the failure of WMB and its predecessors to make clear the intent to preserve the right to collect the prepayment penalty. The Court does not find the terms of this document ambiguous on this point, but even if the terms were ambiguous, the Court would construe the terms against the drafter of the instrument. *Cf., Dumais v. American Golf Corp.*, 299 F.3d 1216, 1219 (10<sup>th</sup> Cir. 2002) (recognizing well-accepted rule that ambiguities in contracts are construed against the drafter).

In any event, this Court finds that the Journal Entry Decree of Foreclosure entered by the Jefferson County District Court was not intended to, and does not, in fact, give WMB the right to collect the prepayment penalty.

**B. WMB is Precluded From Relitigating the Amount Due.**

WMB alternatively argues that if this Court finds that the state court judgment excludes the prepayment penalty, that the state court judgment is erroneous and, apparently, this Court should now set it aside some twenty months after its entry. WMB did not appeal the state court's judgment to the Kansas Court of Appeals. An appeal would have been required within thirty days of the March 29, 2002 judgment, which time would have expired prior to the May 16, 2002 bankruptcy filing. *See* K.S.A. 60-2103(a). Accordingly, the state court judgment is final.

WMB argues that the state court did not have the authority to exclude the prepayment penalty because federal law not only allows prepayment penalty clauses, but also preempts this area of law. Debtor argues that the note upon which the claim for a prepayment penalty is based has merged into the judgment, and that WMB can no longer rely on the note's penalty clause to now assert and obtain the additional \$5,915.69.

The Court has reviewed 12 C.F.R. § 560.2(b)(5), upon which WMB relies to argue that federal law preempts the field of law dealing with "loan related fees, including ... prepayment penalties." That statute specifically includes judicial decisions in its definition of a "state law" that cannot preempt the federal statute. 12 C.F.R. § 560.2(a). Courts have validated this preemption under the supremacy clause of the Constitution. U.S. Const. art. 5, cl. 2. *See Meyers v. Beverly Hills Federal Savings & Loan Ass'n*, 499 F.2d 1145, 1146 (1974) (holding that California Law limiting prepayment provisions was inapplicable to federal lenders covered by the preemptive regulation).

Accordingly, had WMB, or its predecessor, raised this argument at the state court before entry of judgment, WMB may well be correct in arguing that the state court would have been required to allow a prepayment penalty as part of WMB's remedy, in the event the mortgagor sold

the property prior to the foreclosure sale or prior to the expiration of the redemption period. Had the state court refused, this might well have given WMB a basis for appeal of that decision. However, WMB has not claimed it raised this issue before the state court, and lost on the issue, nor has WMB claimed that it appealed the state court's decision, which is wholly silent on WMB's entitlement to a prepayment penalty.

The *Rooker-Feldman* doctrine, established by two Supreme Court decisions handed down 60 years apart, provides that "a party losing in state court is barred from seeking what in substance would be appellate review of the state judgment in a United States [trial] court." *Johnson v. De Grandy*, 512 U.S. 997, 1005-1006 (1994), *quoted in In re Abboud*, 237 B.R. 777 (10<sup>th</sup> Cir. B.A.P. 1999), citing to *Rooker v. Fidelity Trust Co.*, 263 U.S. 413 (1923); *District of Columbia Court of Appeals v. Feldman*, 460 U.S. 462 (1983). Section 1257 of Title 28 of the United States Code provides that the proper court in which to obtain such review is the United States Supreme Court. *Feldman*, 460 U.S. at 476.

The Tenth Circuit Bankruptcy Appellate Panel has recognized the applicability of the *Rooker-Feldman* doctrine to bankruptcy courts. *In re Abboud*, 237 B.R. at 780. *See also Goetzman v. Agribank, FCB (In re Goetzman)*, 91 F.3d 1173 (8th Cir. 1996) (holding that the bankruptcy court lacked subject matter jurisdiction to determine the amount of a debt that had been previously determined in state trial court) and *In re Beardslee*, 209 B.R. 1004 (Bankr. D. Kan. 1997).

Although it does not appear from anything in the record that WMB raised, before the state court, the issue it is now raising concerning the supremacy of the federal statute and regulations dealing with prepayment clauses, that failure is irrelevant to this Court's analysis, because WMB was, in fact, required to raise such claim in the foreclosure proceeding. The *Rooker-Feldman* doctrine bars consideration not only of issues actually presented to and decided by a state court, but

also bars consideration of claims that are "inextricably intertwined" with issues ruled upon by the state court. *In re Abboud*, 237 B.R. at 780 n.5. Clearly, the issue of its entitlement to a prepayment penalty in the event Debtor sold the property prior to the sale was inextricably intertwined with the issues ruled upon by the state court—specifically, how much was WMB entitled to receive from Debtor, or from the real estate, after the foreclosure judgment was entered.

Alternatively, rules of preclusion apply in bankruptcy actions. *Cf. Grogan v. Garner*, 498 U.S. 279, 284–85, n.11 (1991) (stating that collateral estoppel principles apply in discharge proceedings). As the Supreme Court noted in *Marrese v. American Academy of Orthopaedic Surgeons*, 470 U.S. 373, 380 (1985), the preclusive effect of a state court judgment in a subsequent federal lawsuit generally is determined by the full faith and credit statute, which provides that state judicial proceedings “shall have the same full faith and credit in every court within the United States ... as they have by law or usage in the courts of such State ... from which they are taken.” 28 U.S.C. § 1738. This statute directs a federal court to refer to the preclusion law of the State in which judgment was rendered.

The threshold constitutional question, whether WMB had a full and fair opportunity to be heard, is easily determined in the affirmative. Under the principles of claim preclusion, a final judgment on the merits of an action precludes the parties from relitigating not only the adjudicated claim, but also any theories or issues that were actually decided, or could have been decided, in that action. *See Grimmett v. S & W Auto Sales Co., Inc.*, 26 Kan. App. 2d 482, 487 (1999). If WMB wished to assert its right, under the note and mortgage that were the subject of the suit, to a prepayment penalty, it was required to raise the issue in the foreclosure proceeding it commenced in state court, or be forever barred.

The full faith and credit statute requires this Court to analyze state law to determine whether this judgment has preclusive effect. In *Indiana University Foundation v. Reed (In re Estate of Reed)*, 236 Kan. 514 (1985), the Court held:

The doctrine of res judicata is a bar to a second action upon the same claim, demand or cause of action. It is founded upon the principle that the party, or some other with whom he is in privity, has litigated, or had an opportunity to litigate, the same matter in a former action in a court of competent jurisdiction ... [R]es judicata forbids a suitor from twice litigating a claim for relief against the same party. The rule is binding, not only as to every question actually presented, considered and decided, but also to every question which might have been presented and decided. . . . [Res judicata] requires that all the grounds or theories upon which a cause of action or claim is founded be asserted in one action or they will be barred in any subsequent action. . . . This rule is one of public policy. It is to the interest of the state that there be an end to litigation and an end to the hardship on a party being vexed more than once for the same cause.

*Id.* at 519 (citations omitted and emphasis added). WMB was required to raise this issue, but did not.

Finally, Debtor argues that the prepayment penalty at issue is set forth in the note, which has merged in to the judgment. This is just another way of arguing what the Court has noted above, which is that WMB was required to litigate the issue before the entry of the final judgment, at which time the note no longer existed. The Court agrees that under state law, WMB's claim for a prepayment penalty arises under the very note that was plead in the case, and which then merged into the judgment. *See Exchange State Bank v. Central Trust Co.*, 127 Kan. 239, 243 (1929) (holding that mortgage lien is merged into a judgment foreclosing it, and that all causes of action under the instrument were thereby extinguished). Thus, under these facts, there is no note left to enforce, even if the *Rooker-Feldman* doctrine and claims preclusion bases did not apply.

### **III. CONCLUSION**

This Court finds that the issue of the amount of any judgment to which WMB was entitled under the applicable promissory note was previously decided by the Jefferson County District Court,

and this Court has no jurisdiction to overrule that decision. Further, that decision, which is final, is res judicata, and WMB's new claim for a prepayment penalty is precluded. The state court judgment does not provide WMB the right to collect a prepayment penalty as provided in the note, because such penalty is not an "advance[]" or "expenditure[]" properly chargeable under the terms of the Mortgage." Therefore, WMB is entitled to receive the balance due on its state court judgment, exclusive of any prepayment penalty now claimed and denied.

**IT IS, THEREFORE, BY THIS COURT ORDERED** that Washington Mutual Bank's claim for payment of a prepayment penalty is denied.

**IT IS FURTHER ORDERED** that Debtor must pay, out of the proceeds of the sale of the entire track of real estate encumbered by the mortgage, if not already paid, the balance due on the judgment WMB obtained in state court, inclusive of interest and the other categories of advances and expenses actually set forth in the judgment, but exclusive of the late-claimed prepayment penalty and minus, of course, all payments and distributions it has already received since the date of the judgment.

**IT IS SO ORDERED** this 11<sup>th</sup> day of December, 2003.

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JANICE MILLER KARLIN  
United States Bankruptcy Judge  
District of Kansas

## CERTIFICATE OF MAILING

The undersigned certified that copies of the Memorandum and Order was deposited in the United States mail, prepaid on this \_\_\_\_\_ day of December, 2003, to the following:

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