SO ORDERED.

SIGNED this 3 day of May, 2017.

Austin E. Carter
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF GEORGIA
MACON DIVISION

In re:	)	
	)	Case No. 16-51087-AEC
Shirley Monica Buafo and Charles Kingsford Buafo,	)	
	)	Chapter 11
Debtors.	)	
	)	
Shirley Monica Buafo and Charles Kingsford Buafo,	)	
	)	
Plaintiffs,	)	
	)	
v.	)	Adv. Proc. No. 16-5025-AEC
	)	
Nantahala Bank & Trust Company,	)	
	)	
Defendant.	)	

ORDER GRANTING MOTION TO DISMISS

Before the Court is the Motion to Dismiss of Defendant Nantahala Bank & Trust Company (the "Bank") (Dkt. 5). The Court held a hearing on the Motion, after which the parties submitted briefs on select issues as outlined by the Court at the hearing. After the hearing on this matter, the Debtors filed an Objection to the Bank's claim (Dkt. 16) based on the same substantive allegations as those in the Debtors' Complaint. The claim objection was consolidated into the instant

adversary proceeding by order of the Court pursuant to Federal Rule of Bankruptcy Procedure ("Bankruptcy Rule") 3007(b) and Bankruptcy Rule 7015 (Dkt. 16).

The Bank seeks dismissal of the Debtors' Complaint (Dkt. 1) and Debtors' Objection to Claim (Case No. 16-51087, Dkt. 128) under Federal Rule of Civil Procedure ("Rule") 12(b)(6) and Rule 8(a), made applicable to this adversary proceeding by Bankruptcy Rule 7008 and Bankruptcy Rule 7012. The Bank contends that claim and issue preclusion apply to bar the Debtors' claim of equitable subordination in this adversary proceeding, and based on the preclusive effect of a prior district court judgment, that the instant adversary proceeding Complaint fails to state a claim upon which relief can be granted. In response, the Debtors contend that their claim for equitable subordination is not precluded by the district court judgment because the claim could not have been brought in the prior action, and because the issue of equitable subordination is factually and legally distinct from the issues involved in the district court action.[1]

In reaching its decision, the Court has considered the parties' pleadings, the argument of respective counsel for the parties, and the remainder of the record. The Court has also taken judicial notice of the case *Diamond Falls Estates, LLC v. Nantahala Bank & Trust Co.*, No. 2:14-cv-00007-MR-DLH (W.D.N.C. removed to federal court Feb. 21, 2014) ("District Court Suit").[2]

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[1] The Debtors also contended that the district court judgment could not be given preclusive effect because the judgment was on appeal to the Fourth Circuit Court of Appeals and thus was not "final." As discussed in more detail below, this Court stayed this Adversary Proceeding pending the Fourth Circuit Court of Appeals ruling on that appeal. That court has since affirmed the district court judgment, making this issue moot (Dkt. 27).

[2] The Court may take judicial notice of the district court case because it is a public record that "can be accurately and readily determined from sources whose accuracy cannot reasonably be questioned." Fed. R. Evid. 201(b); *see also Horne v. Potter,* 392 Fed. Appx. 800, 802 (11th Cir. 2010) (per curiam) (citing *Universal Express, Inc. v. U.S. SEC*, 177 Fed. Appx. 52, 53 (11th Cir. 2006)).

BACKGROUND

I. Procedural Background.

In 2007, the Debtors, along with their daughter and a friend, formed an LLC to purchase residential real estate in Franklin, North Carolina for the purpose of developing a subdivision. When the Debtors became dissatisfied with the development effort, they formed a new LLC, Diamond Falls Estates, LLC, wholly owned by the two Debtors and their daughter, to refinance and continue the development efforts. Diamond Falls Estates entered into a loan agreement with the Bank, personally guaranteed by the Debtors, to finance the acquisition and development of the property. After experiencing hardship related to the development of the subdivision and the deterioration of their relationship with the Bank, Diamond Falls Estates and the Debtors filed suit against the Bank (and other parties) in the General Court of Justice, Superior Court Division, for Macon County, North Carolina in December 2013. *Diamond Falls Estates,* No. 2:14-cv-00007-MR-DLH, at Dkt. 1. In this suit, the Debtors and the other plaintiffs asserted lender liability claims against the Bank under the theories of breach of contract, breach of covenant of good faith and fair dealing, breach of fiduciary duty, negligent and fraudulent misrepresentation, unfair and deceptive trade practices, and constructive fraud. Shortly thereafter, the suit was removed to the District Court for the Western District of North Carolina. *Id.*

On September 7, 2015, the District Court issued an order granting the Bank's Motion for Summary Judgment on Plaintiffs' Third Amended Complaint ("District Court Order") thereby entering judgment against the Debtors on their claims against the Bank due to the absence of a genuine issue of material fact and ruling that the Bank was entitled to judgment on the Debtors' causes of action as a matter of law. *Diamond Falls Estates, LLC v. Nantahala Bank & Trust Co.*, No. 2:14-cv-

00007-MR-DLH at Dkt. 114, 2015 WL 5233010 (W.D.N.C. Sept. 8. 2015). The District Court Order also granted summary judgment in favor of the Bank's counterclaims against the Debtors, in the amount of $2,725,989.42, plus interest. This judgment forms the basis of the Bank's claim asserted in this bankruptcy case.

The Debtors filed a Chapter 11 petition in this Court on June 2, 2016. The Debtors initiated this adversary proceeding against the Bank on the same day. The Debtors' Complaint alleges that the Bank's claim should be equitably subordinated to the claims of the Debtors' other creditors because of the Bank's inequitable conduct in connection with the loan.[3] In general, the inequitable conduct alleged includes that (a) the Bank failed to disclose key relationships and engaged in self-dealing, (b) the Bank violated its loan agreement with the Debtors, and (c) the Bank tricked the Debtors into pledging their Florida property as additional collateral.

The Bank contends that the facts alleged in support of the Debtors' claim for equitable subordination are based on the same factual allegations made and decided against the Debtors in the District Court Suit and, on this basis, the Bank filed its Motion to Dismiss (Dkt. 5). Specifically, the Bank contends that both claim preclusion and issue preclusion should apply to prevent the parties from relitigating the same factual allegations that were litigated in the District Court Suit.

After the Fourth Circuit Court of Appeals scheduled oral arguments on the appeal of the District Court Order, the Debtors filed a *Motion to Stay Proceeding Pending Appeal* (Dkt. 18) on December 16, 2016. The Court granted the Debtors' Motion (Dkt. 23). The Fourth Circuit Court of Appeals issued a ruling in the Bank's favor on April 7, 2017, affirming the District Court Order. Pursuant to the Court's *Order Lifting Stay of Adversary Proceeding* (Dkt. 28), the stay has been lifted and this Court proceeds to rule on Bank's Motion to Dismiss.

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[3] The Debtors' Complaint also includes a count for a violation of the Equal Credit Opportunity Act based on racial discrimination, but the Debtors voluntarily dismissed that count (Dkt. 9).

II. Factual Background.

The operative facts alleged in this case were largely summarized by the District Court as follows:

> A. The Plaintiffs Acquire the Property
>
> The property at issue is a tract of real property consisting of 283.40 acres in Franklin, North Carolina (hereinafter the "Property"). In February 2007, the Plaintiffs Shirley M. Buafo ("Ms. Buafo") and Charles K. Buafo ("Dr. Buafo") (collectively, the "Buafos") formed a limited liability company called Pembroke Heights, LLC ("Pembroke") for the purpose of purchasing and developing the Property into a residential subdivision called Diamond Falls Estates. The Buafos funded Pembroke by making a $1.3 million cash capital contribution, each taking a 22.5% membership interest in the newly formed LLC. . . . The Buafos then acted through Pembroke to purchase the Property from West Ridge Land, LLC ("West Ridge") for $3.5 million, executing a $2.75 million promissory note to West Ridge and paying cash for the balance.
>
> After closing on the Property, the Buafos began their development efforts. . . . Ms. Buafo also became worried about the financing arrangement with West Ridge, believing that West Ridge was trying to trick her into a default situation so that it could get the Property back.
>
> To help her address these concerns, one of Ms. Buafo's advisers introduced her to James VanderWoude, a local real estate investor. VanderWoude was also one of the founders of the Bank, and has served since its formation as a director and Chairman of the Board.
>
> During his meeting with Ms. Buafo, VanderWoude told her: "if you get Steve Gravett to develop the land, I will finance it for you." Ms. Buafo testified that VanderWoude made this commitment despite the fact that she showed him no financial statements or other financial documentation. . . . VanderWoude referred the Buafos to Steve Gravett as a person he recommended if they wanted help with managing the Project.
>
> Gravett owned several businesses and provided consulting and land development services. He and VanderWoude had worked with each other in the past on various real estate projects. Additionally, Gravett's consulting business, Luxur, Inc., became a Bank

shareholder through its profit sharing plan in February 2007. Gravett is the trustee of the Luxur profit-sharing plan.

Ms. Buafo contacted Gravett by phone almost immediately after her meeting with VanderWoude. Ms. Buafo had several more telephone conversations with Gravett, which were followed by an in-person meeting. Within a short time thereafter, Gravett and the Buafos had entered into a Consulting Agreement.

B. The Original Note

Gravett immediately began addressing the issues that had arisen with the Buafos' earlier attempts to develop the Property. . . . [T]he Buafos organized Diamond Falls Estates, LLC ("DFE") on or about February 18, 2008. . . .

Next, Gravett and the Buafos worked on refinancing the West Ridge promissory note. Ms. Buafo testified that it was her idea to seek refinancing, because she felt uncomfortable with a seller-financed arrangement and wanted to deal instead with an independent lending institution. When the Buafos asked VanderWoude about a loan, he referred them to the Bank's Chief Credit Officer. Ultimately, this referral led to the initial loan from Bank ("the February 28, 2008 Loan"), the purpose of which was to refinance the West Ridge promissory note. The borrower under the February 28, 2008 Loan was the newly formed company, DFE. Upon closing, Ms. Buafo executed documents causing Pembroke (1) to transfer title to the Property from Pembroke to DFE in exchange for the funds DFE obtained from the Bank, and (2) to use those funds to satisfy the West Ridge note

Even before the February 28, 2008 Loan had closed, Gravett was in discussions with the Bank on behalf of DFE for a new loan package to include money not only to refinance the original acquisition of the Property but also to fund the development of Phase One of the Project ("the Development Loan"). . . .

On March 26, 2008, the Loan Committee approved the Development Loan. On March 28, 2008, Bank issued a Commitment Letter to DFE offering them a commitment to loan DFE a maximum of $4,780.935.00 for the purpose of refinancing the February 28, 2008 loan and for the purpose of developing the Property. The Commitment

Letter states that the "[m]aximum loan amount is to include a $240,000 interest reserve, $1,790,935 for development costs and $2,750,000 to refinance existing acquisition loan." The Commitment Letter further provides that: "A release provision of 95% of net sales proceeds with a minimum principal reduction of $35,000 per acre will apply for deed releases." (the "Release Provision"). The Commitment Letter also states, in pertinent part, that: "[t]he provisions of this commitment shall survive the closing of the loan and shall not be merged into any of the loan documents. if any terms herein are inconsistent with those of the loan documents, the term of the loan documents shall control." (the "Survival Provision").

In April 2008, at Gravett's instruction, the Buafos elected Gravett as a non-member manager of DFE, which gave him the rights as General Manager of DFE.

On May 28, 2008, DFE executed a promissory note (the "Original Note") in the principal amount of $4,780,935.00 in favor of the Bank. . . . As collateral for the loan, DFE pledged and the Bank obtained a Deed of Trust against the Property.

The Development Loan provided for an initial advance of $2,761,782.98 to pay off the February 28, 2008 Loan. Future draws were permitted to fund development expenses going forward, capped at a total outstanding loan balance of $4,780,935.00.

In January 2009, DFE sold the first lot in the development. In connection with that sale, the Bank accepted a lower than contractually required release amount and then modified the Release Provision going forward to reflect a different formula. This occurred as a result of the fact that the formula specified in the Release Provision relies on a "net" loan proceeds calculation (95% of net proceeds), requiring the loan officer to estimate prior to closing what the release fee will be. For the first closing, the loan officer's estimate turned out to be low, but approval was given to allow the transaction to close based on the pre-estimate amount, rather than to require that the closing be delayed. To avoid this problem going forward, the loan officer submitted a change request to the Loan Committee for an adjustment to the release fee formula to 85.5% of the *gross* proceeds. This adjustment was approved by the Loan Committee.

The Project began to experience financial difficulties in the early part of 2009 due to cost overages. These issues persisted through May 2009, when the Bank froze funding under the Development Loan due to expense overruns. As a result of the Bank's freeze on funding, the Buafos had to inject their own funds into the Project. The Project continued to experience financial difficulties through the fall of 2009, and by November 2009, the interest reserve funded at the closing of the Development Loan was depleted. The Buafos once again had to inject additional equity into DFE to fund the interest payments.

On January 28, 2010, DFE entered into a Debt Modification Agreement (the "First Modification") concerning the Original Note, which decreased the interest rate from 5.5 to 5.0 percent.

C. The Sales Event

In late spring and/or early summer of 2010, concerns with the Project shifted from cost overruns to lackluster lot sales. To address this problem, Gravett, on behalf of DFE, entered into a Marketing Agreement with a company called RPM Group LLC ("RPM"), which was to hold an "event sale" for Phase One of the Property ("the Sales Event"). The RPM Marketing Agreement originally provided that RPM was to receive 100% of the net sale proceeds up to $425,000.00 to reimburse it for its marketing fees, and after that, RPM was to receive up to a 29.75% commission if less than 50% of the lots sold and 33% if more than 50% of the lots sold.

. . .

The Sales Event was held on October 2, 2010, and Gravett considered it a huge success. The Buafos attended the Event, and, in fact, Ms. Buafo signed some of the lot sale contracts personally.

While the Sales Event was successful in terms of the number of lots sold, many of the lots had been sold below the minimum prices to which the Bank had agreed prior to the event (which prices themselves were lower than the original sale prices). This meant lower release fees for the Bank than it had anticipated, calling into question whether certain loan-to-value ratios required by banking regulatory guidelines would be met. . . . Additionally, the Bank accepted release fees far lower than the 95% of net sales proceeds contemplated by the 2008 Commitment Letter.

> . . .
> E. The Florida Mortgage
> In order to prevent a default on the Development Loan, the Bank requested additional collateral. On December 17, 2010, DFE entered into a second Debt Modification Agreement (the "Second Modification") concerning the Original Note. On December 17, 2010, the Buafos provided the Bank with a mortgage on property they owned in Florida (the "Florida Mortgage").

Diamond Falls Estates, LLC v. Nantahala Bank & Trust Co., No. 2:14-cv-00007-MR-DLH at Dkt. 114 (citations and footnotes omitted). These facts from the District Court Order were substantially alleged in the Debtors' Complaint. The Debtors' Complaint also alleges some related facts that were not specifically addressed in the District Court Order. Those facts are discussed in more detail below.

CONCLUSIONS OF LAW

I. Standard for 12(b)(6) Motion to Dismiss.

Pursuant to Rule 12(b)(6), made applicable to this adversary proceeding by Bankruptcy Rule 7012(b), a complaint should be dismissed if it fails to state a claim upon which relief can be granted. Fed. R. Civ. P. 12(b)(6); Fed. R. Bankr. P. 7012(b). Pursuant to Rule 8, made applicable to this adversary proceeding by Bankruptcy Rule 7008, the complaint must include "a short and plain statement of the claim showing that the pleader is entitled to relief." Fed. R. Civ. P. 8(a)(2); Fed. R. Bankr. P. 7008. "To survive a motion to dismiss, a complaint must 'state a claim to relief that is plausible on its face,' meaning that it must contain 'factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.'" *Bishop v. Ross Earle & Bonan, P.A.,* 817 F.3d 1268, 1270 (11th Cir. 2016) (quoting *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009)). The court must accept "the allegations in the complaint as true and construe them in the light most favorable to the plaintiff." *Hill v. White,* 321 F.3d 1334, 1335 (11th Cir. 2003)

(per curiam); *see also Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007). However, the court is not required to accept as true "[t]hreadbare recitals of the elements of a cause of action, supported by mere conclusory statements." *Iqbal,* 556 U.S. at 678 (citing *Twombly*, 550 U.S. at 555).

"The purpose of a motion authorized by Rule 12(b)(6) . . . is to evaluate the facial sufficiency of a pleading." *Bruner v. ARP Prod. Co., L.L.C.*, No. 6:14-CV-0618-SLB, 2014 WL 3970204, at *1 (N.D. Ala. Aug. 11, 2014). Thus, the court should only consider the allegations on the face of the pleadings and the documents attached thereto (or incorporated therein by reference). *See Harris v. Ivax Corp.*, 182 F.3d 799, 802 n.2 (11th Cir. 1999); *Brooks v. Blue Cross & Blue Shield of Fla., Inc.*, 116 F.3d 1364, 1368 (11th Cir. 1997); *Salvador v. Bank of America, N.A. (In re Salvador),* 456 B.R. 610, 614 (Bankr. M.D. Ga. 2011); see also Fed. R. Civ. P. 12(d). However, the Eleventh Circuit has recognized that a court may consider any document that is central to the plaintiff's claims and is undisputed, and may take judicial notice of public records when considering a motion to dismiss without converting it into a motion for summary judgment. *See Horne v. Potter,* 392 Fed. Appx. 800, 802 (11th Cir. 2010) (per curiam) (citing *Universal Express, Inc. v. U.S. SEC*, 177 Fed. Appx. 52, 53 (11th Cir. 2006) ("A district court may take judicial notice of certain facts without converting a motion to dismiss into a motion for summary judgment . . . The district court properly took judicial notice of the documents in Horne's first case." (citations omitted)); *Day v. Taylor,* 400 F.3d 1272, 1276 (11th Cir. 2005) (affirming district court's refusal to convert motion to dismiss when it considered documents central to plaintiff's complaint for purpose of ruling on motion).

II. Equitable Subordination.

The doctrine of equitable subordination allows the court to subordinate the claims and interests of creditors, who have acted in such a way that harmed the

position of other creditors, below the claims and interests of the other creditors in a bankruptcy case. The doctrine was judicially created, stemming from the equity powers afforded bankruptcy courts under the Bankruptcy Act. *See, e.g.*, *Benjamin v. Diamond (In re Mobile Steel Co.),* 563 F.2d 692, 698-99 (5th Cir. 1977). 11 U.S.C § 510(c) codifies the court's authority to equitably subordinate claims and interests but leaves the courts discretion to develop the scope of equitable subordination. 5 *Collier on Bankruptcy* ¶ 510.05 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed.). In so doing, the court in *In re Mobile Steel Co.* defined the elements of equitable subordination as follows: "(i) The claimant must have engaged in some type of inequitable conduct. (ii) The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant. (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy [Code]." 563 F.2d at 700 (citations omitted).[4] The court further instructed courts to consider three principles when determining whether or not to equitably subordinate claims: 1) "[I]nequitable conduct directed against the bankrupt or its creditors may be sufficient to warrant subordination . . . irrespective of whether it was related to the acquisition or assertion of that claim;" 2) "Claims should be subordinated only to the extent necessary to offset the harm with the bankrupt and its creditors suffered on account of the inequitable conduct;" and 3) "[T]he dealings of fiduciaries with their corporation are subjected to rigorous scrutiny." *Id.* at 700-01.

III. Claim & Issue Preclusion.

The Supreme Court has described the doctrines of claim and issue preclusion as follows:

> The preclusive effect of a judgment is defined by claim preclusion and issue preclusion, which are

[4] Decisions of the 5th Circuit issued before 1981 remain binding precedent in the 11th Circuit pursuant to *Bonner v. City of Prichard*, 661 F.2d 1206 (11th Cir. 1981).

> collectively referred to as "res judicata." Under the doctrine of claim preclusion, a final judgment forecloses "successive litigation of the very same claim, whether or not relitigation of the claim raises the same issues as the earlier suit." *New Hampshire v. Maine,* 532 U.S. 742, 748, 121 S.Ct. 1808, 149 L.Ed.2d 968 (2001). Issue preclusion, in contrast, bars "successive litigation of an issue of fact or law actually litigated and resolved in a valid court determination essential to the prior judgment," even if the issue recurs in the context of a different claim. *Id.,* at 748–749, 121 S.Ct. 1808. By "preclud[ing] parties from contesting matters that they have had a full and fair opportunity to litigate," these two doctrines protect against "the expense and vexation attending multiple lawsuits, conserv[e] judicial resources, and foste[r] reliance on judicial action by minimizing the possibility of inconsistent decisions." *Montana v. United States,* 440 U.S. 147, 153–154, 99 S. Ct. 970, 59 L.Ed.2d 210 (1979).

Taylor v. Sturgell, 553 U.S. 880, 892 (2008) (footnote omitted). "Federal courts must apply federal common law to determine the preclusive effect of a prior federal court judgment." *Baloco v. Drummond Co., Inc.,* 767 F.3d 1229, 1246 (11th Cir. 2014) (citing *Taylor v. Sturgell,* 553 U.S. at 891).

A. Claim Preclusion Does Not Preclude Debtors' Cause of Action

In the Eleventh Circuit, claim preclusion applies to bar a claim from being relitigated in a subsequent suit when "(1) there is a final judgment on the merits, (2) the decision was rendered by a court of competent jurisdiction; (3) the same cause of action is involved in both cases; and (4) the parties, or those in privity with them, are identical in both suits." *Baloco,* 767 F.3d at 1246 (citing *I.A. Durbin, Inc. v. Jefferson Nat'l Bank,* 793 F.2d 1541, 1549 (11th Cir. 1986)).

In this case, elements one, two, and four are all met. Under element one, the Debtors' claims in the District Court Suit were dispensed with in the District Court Order, an order granting the Bank's motion for summary judgment. The District

Court Order constitutes a final judgment on the merits.[5] An order granting summary judgment is conclusively considered a judgment "on the merits." *See Exhibitors Poster Exch., Inc. v. Nat'l Screen Serv. Corp.,* 421 F.2d 1313, 1319 (5th Cir. 1970) ("It would be strange indeed if a summary judgment could not have [preclusive] effect. That would reduce the utility of this modern device to zero. . . . Indeed, a more positive adjudication is hard to imagine."); 18 Charles Alan Wright et al., Fed. Prac. & Proc. Juris § 4427 (2d ed. 2016) ("Judgments entered by preemptive judicial action, through summary judgment or directed verdict, clearly constitute disposition on the merits."). Under element two, the decision was rendered by a court of competent jurisdiction. The case was removed from the state court to the district court, where the District Court for the Western District of North Carolina had jurisdiction to hear the claims. Under the fourth element, the parties involved in this adversary proceeding were all parties to the District Court Suit.

At issue in this case is element three: whether the same cause of action is involved in both cases. As argued by the Bank, under the "transactional approach," adopted by the Eleventh and several other circuits, a court answers this question by determining whether the case "'arises out of the same nucleus of operative facts, or is based upon the same factual predicate, as a former action.'" *Baloco,* 767 F.3d at 1247 (quoting *Griswold v. Cnty. Of Hillsborough,* 598 F.3d 1289, 1292 (11th Cir. 2010)); *see also N.A.A.C.P. v. Hunt,* 891 F.2d 1555, 1561 (11th Cir. 1990) ("Res judicata applies not only to the precise legal theory presented in the prior case, but

[5] Citing a case from the Bankruptcy Court for the District of Colorado, the Debtors argue that the fact that the District Court Order was on appeal prevented it from having preclusive effect. That argument has no weight now that the Fourth Circuit Court of Appeals has ruled in favor of the Bank. However, for clarification, "the federal rule is that the pendency of an appeal does not suspend the operation of an otherwise final judgment as res judicata." *Hunt v. Liberty Lobby, Inc.*, 707 F.2d 1492, 1498 (D.C. Cir. 1983). In the Eleventh Circuit, "[a] case pending appeal is res judicata and entitled to full faith and credit unless and until reversed on appeal." *Fidelity Standard Life Ins. Co. v. First National Bank & Trust Co.*, 510 F.2d 272, 273 (5th Cir.), *cert. denied*, 423 U.S. 864 (1975).

to all legal theories and claims arising out of the same nucleus of operative fact."). "However, res judicata bars only those claims that could have been raised in the prior litigation." *Griswold,* 598 F.3d at 1293 (citing *Ragsdale v. Rubbermaid, Inc.,* 193 F.3d 1235, 1238 (11th Cir. 1999)); *see also Hunt,* 819 F.2d at 1561 (stating that res judicata applies only to prevent claims "which could have been raised in the prior case").

In attempting to prove the that the Debtors' claim for equitable subordination is the same as the claims litigated in the District Court Suit, the Bank asserts that the Debtors' equitable subordination claim arises from the same nucleus of operative facts. The Bank argues that the facts supporting the Debtors' claim for equitable subordination are the same facts, merely "repackaged," that the Debtors used to support their claims in the District Court Suit. As such, the Bank contends that claim preclusion prevents the Debtors from relitigating their claims in bankruptcy court.

While the Court agrees that the facts alleged in the Debtors' Complaint are largely the same facts used to support the Debtors' claims in the District Court Suit, the third element of claim preclusion is not met in this case. As the case law establishes, a claim cannot be precluded if it could not have been brought in the prior action. Because equitable subordination is a claim that is unique to bankruptcy (arising from 11 U.S.C. § 510(c)), it could not have been brought by the Debtors prior to the filing of their bankruptcy petition on June 2, 2016. The purpose of equitable subordination is to "'prevent the consummation of a course of conduct by (a) claimant which . . . would be fraudulent or otherwise inequitable' by subordinating his claims to the ethically superior claims asserted by other creditors." *In re Mobile Steel Co.,* 563 F.2d at 698-99 (quoting *Heiser v. Woodruff,* 327 U.S. 726, 733 (1946)). This purpose cannot be accomplished in a state or federal court action, outside of bankruptcy, where the other creditors have no notice of or

interest in the proceedings. Thus, the Debtors' claim for equitable subordination in this case could not have been brought in and is not precluded by the District Court Suit based on claim preclusion.

B. Issue Preclusion Bars the Debtors' Equitable Subordination Claim

> The [Supreme Court] has long recognized that "the determination of a question directly involved in one action is conclusive as to that question in a second suit." The idea is straightforward: Once a court has decided an issue, it is "forever settled as between the parties," thereby "protecting" against "the expense and vexation attending multiple lawsuits, conserv[ing] judicial resources, and foster[ing] reliance on judicial action by minimizing the possibility of inconsistent verdicts." In short, "a losing litigant deserves no rematch after a defeat fairly suffered."

B & B Hardware, Inc. v. Hargis Indus., Inc., 135 S. Ct. 1293, 1302-03 (2015) (citations omitted). The Eleventh Circuit defines the elements of issue preclusion as follows:

> To claim the benefit of collateral estoppel the party relying on the doctrine must show that: (1) the issue at stake is identical to the one involved in the prior proceeding; (2) the issue was actually litigated in the prior proceeding; (3) the determination of the issue in the prior litigation must have been "a critical and necessary part" of the judgment in the first action; and (4) the party against whom collateral estoppel is asserted must have had a full and fair opportunity to litigate the issue in the prior proceeding.

Christo v. Padgett, 223 F.3d 1324, 1339 (11th Cir. 2000) (quoting *Pleming v. Universal-Rundle Corp.*, 142 F.3d 1354, 1359 (11th Cir. 1998); *see also Baloco,* 767 F.3d at 1251. An issue is considered actually litigated when the "issue is properly raised, by the pleadings or otherwise, and is submitted for determination, and is determined." Restatement (Second) of Judgments § 27, cmt. d (1982).

As an initial matter, though it is not listed as an element of the Eleventh Circuit test above, finality is a requirement for issue preclusion. *See Christo,* 223

F.3d at 1339. However, "[i]t is widely recognized that the finality requirement is less stringent for issue preclusion than for claim preclusion." *Id.* (citing *Miller Brewing Co. v. Jos. Schlitz Brewing Co.,* 605 F.2d 990, 996 (7th Cir. 1979); *Lummus Co. v. Commonwealth Oil Refining Co.,* 297 F.2d 80, 89 (2d Cir. 1961); Restatement (Second) Judgments § 13 (1980); 18 Charles Alan Wright et al., Federal Practice and Procedure § 4434 at 321 (1981 & Supp. 2000)). Having already determined that the District Court Order was sufficiently final to satisfy the requirements of claim preclusion above, this Court is satisfied that that District Court Order is sufficiently final for the purpose of determining issue preclusion.

Several courts have ruled on whether a claim for equitable subordination can be barred by issue preclusion when the same factual issues supporting equitable subordination were asserted and decided against the debtor in a prior action. The answer is generally "yes." *See, e.g., U.S. v. Stauffer Chem. Co.,* 464 U.S. 165, 171-72 (1984) (applying issue preclusion to prevent attempt "to litigate twice with the same party an issue arising in both cases from virtually identical facts."). "When an issue of fact or law is actually litigated and determined by a valid and final judgment, and the determination is essential to the judgment, the determination is conclusive in a subsequent action between the parties, whether on the same or a different claim. Restatement (Second) of Judgments § 27 (1982). "[T]he [first] inquiry is whether the facts of the second suit are 'separable' from the facts of the first suit." 18 Charles Alan Wright et al., Fed. Prac. & Proc. Juris § 4417 (3d ed. 2017).

In *In re Assante*, cited in the Bank's briefs, the court held that the plaintiff's claim for equitable subordination was barred by issue preclusion because the plaintiff based its new claim on "the same factual allegations set forth in the [state court] action and under the guise of new legal theories." *Assante v. Eastern Savings Bank (In re Assante)*, 470 B.R. 707, 713 (Bankr. S.D.N.Y. 2012). In applying issue preclusion, the *Assante* court explained that "Defendant's conduct in relation to the

entire loan transaction with Plaintiff was scrutinized by the Orange County Supreme Court and found to be valid. The state court found that Defendant did not engage in any fraudulent, immoral, or unconscionable conduct with respect to the transaction in question, nor did it influence the appraisal." *Id.* at 714. The court quoted an excerpt, in support of its holding, from the prior action in which the Supreme Court of New York expressly held that the bank demonstrated "that it did not engage in immoral and unconscionable conduct concerning the loan." *Id.* at 713-14. The *Assante* court is not alone in its holding; it relies on another New York bankruptcy court case that held issue preclusion could bar a claim for equitable subordination where the "underlying facts [in support of the claim for equitable subordination] were the same as in the state court action." *Id.* at 712 (citing *9281 Shore Road Owners Corp. v. Seminole Realty Co. (In re 9281 Shore Road Owners Corp.)*, 214 B.R. 676 (Bankr. E.D.N.Y. 1997). In *In re 9281 Shore Road Owners Corp.*, the court held that issue preclusion barred the debtor's claim for equitable subordination when the "identical factual allegations" had been raised and adjudicated in a prior foreclosure action. *In re 9281 Shore Road Owners Corp.*, 214 B.R. at 690; *see also GNK Enters., Inc. v. ConAgra, Inc. (In re GNK Enters., Inc.),* 197 B.R. 444, 449 (Bankr. S.D.N.Y. 1996) (denying objection to and request to equitably subordinate claim where "the operative facts on which the Debtor bases its claims for subordination and expungement . . . have already been determined against the Debtor by other courts.").

Based on the foregoing, this Court holds that issue preclusion bars the Debtors' claim of equitable subordination. After a careful review of the District Court Order, the Court has determined that the elements of issue preclusion are met as to the vast majority of the Debtors' allegations. The Bank is correct in its assertion that, like the plaintiffs in the *Assante* case, the Debtors have merely recast in this case the facts and allegations presented to the District Court. Indeed,

several of the allegations in the Debtors' Complaint were copied verbatim from the District Court Order. In the detailed, fifty-five page District Court Order, the court ruled against the Debtors on the same factual and legal issues that form the basis of the Debtors' equitable subordination request in this case. It is noteworthy that the District Court Order granted the Bank's motion for summary judgment as to the Debtors' claims because the Debtors were unable to present even a forecast of evidence to support their claims.

Giving preclusive effect to the issues decided by the District Court bars the Debtors' claim for equitable subordination under the standard for 12(b)(6) motions discussed above. Though the Debtors made some arguably new factual allegations or factual allegations not specifically addressed (not a "critical and necessary part" of the judgment) in the District Court Order, those facts (each of which existed prior to the filing of the District Court Suit) standing alone do not sufficiently state a claim for equitable subordination to satisfy the 12(b)(6) standard;[6] that is, after

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[6] The Court considers the following (non-exhaustive list of) allegations from the Debtors' Complaint new facts or facts not "a critical or necessary part" of the judgment because the District Court Order does not specifically address them:

1. ¶¶ 20-22: Alleging an actual business relationship ("Laurel Views, LLC") between Gravett & VanderWoude. The Court notes that the Debtors alleged a business relationship between Gravett and VanderWoude in their Third Amended Complaint in the District Court Suit. However, District Court Order does not specifically address these alleged facts.
2. ¶¶ 37-38: Alleging that VanderWoude considered the property as an investment for himself and alleging that West Ridge (the prior lender) is owned by a Bank shareholder and that the attorney for West Ridge is a director of the Bank
3. ¶¶ 42-45: Alleging specific monetary facts regarding the budget. The Court notes that the District Court Order addresses budget overages in holding that the Bank did not breach its duty of good faith and in granting summary judgment to the Bank.
4. ¶¶ 57-71: Alleging facts regarding the draw requests. The Court notes that the District Court Order addresses the draw requests and cost overages in holding that the Bank did not breach its duty of good faith and granting summary judgment to the Bank. However, the District Court Order did not address the alleged facts with any specificity.
5. ¶¶ 74-82: Alleging improper draws to the field accounts. The Court notes that the District Court Order addresses the field accounts in holding that the Bank did not breach its duty of good faith. However, the District Court Order did not address the alleged facts with any specificity.
6. ¶¶ 119-39: Alleging with factual specificity that the Bank "tricked" Debtors into "pledging their condominium as additional collateral." The Court notes that the District Court Order addresses similar allegations regarding the Florida condo in holding that the Bank did not

giving preclusive effect to the factual issues actually determined by the District Court, viewing these "new" facts in the light most favorable to the Debtors, the Debtors have not stated a claim for equitable subordination that is plausible on its face. *See* 18 Charles Alan Wright et al., Fed. Prac. & Proc. Juris § 4417 (3d ed. 2017) ("The possibility that new facts may surround continuation of the same basic conduct should not defeat preclusion unless it is shown that the new facts are relevant under the legal rules that control the outcome.").

Based on the foregoing, the Court HEREBY GRANTS the Bank's Motion to Dismiss and OVERRULES the Debtors' Objection to the Bank's Claim.

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violate its duty of good faith and that the Bank did not make fraudulent or negligent misrepresentations. However, the District Court Order did not address the alleged facts with any specificity.

Because the Court can give preclusive effect only to issues that are identical to, actually litigated in, and "a critical and necessary part" of the prior judgment, any facts or issues that do not meet these criteria are considered new allegations for the purpose of deciding a 12(b)(6) motion.