

What's So Special About a Foreclosure Special Proceeding?

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The North Carolina Supreme Court recently clarified that the North Carolina Rules of Civil Procedure and doctrines of *res judicata* and collateral estoppel do not apply to a non-judicial foreclosure special proceeding. This is welcome news for lenders because it removes the specter of discovery obligations during foreclosure proceedings and gives lenders multiple chances to overcome foreclosure defects.

Civil Actions and Special Proceedings

To understand the decision, it helps to know a little about court actions in North Carolina. They generally are civil actions or special proceedings. A civil action is a typical lawsuit before a trial judge. A plaintiff files a complaint against a defendant, the defendant answers, and off they go. The Rules of Civil Procedure govern a civil action and impose obligations that can be onerous. One of the biggest for lenders is complying with discovery—depositions, answers to written questions, and document production.

Special proceedings are not lawsuits. The clerk of court resolves special proceedings. When a lender forecloses under the power of sale provision in a deed of trust, it engages in a non-judicial foreclosure. Chapter 45 of the North Carolina General Statutes is the exclusive statutory framework governing non-judicial foreclosures. It establishes an efficient process to initiate, prosecute, and complete a foreclosure.

Non-Judicial Foreclosure

Chapter 45 requires the clerk to authorize a foreclosure sale if the lender establishes the existence of (1) a valid debt, (2) default, (3) the right to foreclose, (4) notice, (5) “home loan” classification and applicable pre-foreclosure notice, and (6) that the sale is not barred by the debtor’s military status. At a foreclosure hearing, a debtor can raise objections to these six findings. The evidentiary requirements are more relaxed than in a civil action.

If the clerk does not find evidence adequate to authorize the foreclosure sale, a lender has three options. One, the lender can appeal to the trial court for a *de novo* hearing—a do-over. Two, a lender can proceed with a judicial foreclosure—a civil action. Or three, the lender can proceed with a new non-judicial foreclosure on a different default by the debtor. A lender cannot proceed with a non-judicial foreclosure on the same default in which the clerk refused to authorize foreclosure.

The North Carolina Supreme Court’s Decision

In the case the North Carolina Supreme Court reviewed, In re Foreclosure of Lucks, the lender’s substitute

trustee paperwork was faulty. Chapter 45 has a threshold requirement that the lender appoint a substitute trustee with authority to conduct the foreclosure. As a result, the clerk dismissed the foreclosure. The lender commenced a second non-judicial foreclosure, but the clerk ruled it was barred by *res judicata*. The lender appealed to the trial court, but the court held the substitute trustee paperwork was faulty and dismissed the foreclosure “with prejudice.”

The Court determined the trial court could not dismiss the foreclosure “with prejudice.” A “dismissal with prejudice” arises from the Rules of Civil Procedure and bars future lawsuits on the same claims. In other words, no do-over. Since the Rules of Civil Procedure apply to civil actions, and since a non-judicial foreclosure is not a civil action, the “dismissal with prejudice” rule does not apply to a non-judicial foreclosure.

The Court also stated that traditional doctrines of *res judicata* and collateral estoppel related to lawsuits do not apply. Under the doctrine of *res judicata*, a final judgment on the merits in a prior action in a court of competent jurisdiction precludes a second suit involving the same claim between the same parties. A party does not get to re-try an issue already ruled on by the court. The Court explained that a non-judicial foreclosure arises from the contract between the lender and debtor. If a lender fails to obtain a foreclosure order from the clerk, it is not forever barred from foreclosing its collateral. Rather, the lender can proceed with a judicial foreclosure or with a non-judicial foreclosure on a different default by the debtor.

Conclusion

This decision is a victory for lenders. Lenders can use it to prevent attempts by debtors to conduct discovery during a foreclosure proceeding. Lenders also can rely on it if they are unsuccessful in a foreclosure proceeding and need to commence a second non-judicial foreclosure or a judicial foreclosure.

Ward and Smith's Creditors' Rights Practice Group is available to provide you with additional information and answer questions you have about Lucks and how it may affect you.

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