



SCHOOL OF LAW
TEXAS A&M UNIVERSITY

Texas A&M University School of Law
Texas A&M Law Scholarship

Faculty Scholarship

1985

Avoidance of Completed Real Estate Foreclosures in Bankruptcy

William H. Henning

Texas A&M University School of Law, bhenning@law.tamu.edu

Grant S. Nelson

Follow this and additional works at: <https://scholarship.law.tamu.edu/facscholar>



Part of the [Law Commons](#)

Recommended Citation

William H. Henning & Grant S. Nelson, *Avoidance of Completed Real Estate Foreclosures in Bankruptcy*, 41 J. Mo. B. 285 (1985).

Available at: <https://scholarship.law.tamu.edu/facscholar/453>

This Article is brought to you for free and open access by Texas A&M Law Scholarship. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Texas A&M Law Scholarship. For more information, please contact aretteen@law.tamu.edu.

AVOIDANCE OF COMPLETED REAL ESTATE FORECLOSURES IN BANKRUPTCY

The Eighth Circuit has ruled that in certain situations noncollusive real estate foreclosures can be set aside as fraudulent conveyances. This theory has generated considerable debate, but even if it is reversed legislatively, trustees may be able to obtain comparable results under a preference theory.

WHEN A MISSOURI DEED OF TRUST is foreclosed pursuant to a power of sale, there is only a limited statutory right of redemption.¹ This right will be triggered only if the debtor posts a redemption bond and the mortgagee is the successful foreclosure purchaser. Further, the prevailing judicial attitude is that the sale will not be set aside unless the price is so low that it "shocks the conscience" of the court and raises an inference of fraud or unfair dealing by the mortgagee or trustee.² As long as the proper procedures are followed, the debtor is not entitled to avoidance or monetary damages for mere inadequacy of price. As a result of these policies, it is not unusual for the debtor's equity to be sacrificed by foreclosure.³

In the last few years, courts interpreting the bankruptcy laws have fashioned a novel theory which creates, in effect, a *de facto* federal right of redemption. The theory views a foreclosure sale that brings less than 70 percent of the property's fair market value as a voidable fraudulent conveyance if the sale occurs while the debtor is insolvent and within one year prior to the commencement of bankruptcy proceedings. The theory originated with a decision of the United

States Court of Appeals for the Fifth Circuit, *Durrett v. Washington National Insurance Co.*,⁴ and it was approved last year by the Eighth Circuit in *In re Hulm*.⁵ Thus, the *Durrett* doctrine, as it has come to be called, is now the law in Missouri.

The doctrine has been highly controversial and has been opposed nationally by the real estate bar.⁶ Despite vigorous debate, it was not changed by the Bankruptcy Amend-

ABOUT THE AUTHORS. *Mr. Nelson is the Enoch H. Crowder Professor of Law at the University of Missouri-Columbia. He is a graduate of the University of Minnesota Law School and practiced in Minneapolis, Minnesota before joining UMC. He is a member of the Missouri and Minnesota Bars and is a Missouri commissioner to the National Conference of Commissioners on Uniform State Laws.*

Mr. Henning is a Professor of Law at the University of Missouri-Columbia. He received a J.D. degree from the University of Tennessee, and an LL.M. from the University of Illinois. He practiced law in Chattanooga, Tennessee before joining UMC and is currently a member of The Missouri Bar.

© 1985, William H. Henning and Grant S. Nelson.

ments and Federal Judgeship Act of 1984,⁷ but there is reason to believe that it may yet be overturned legislatively. If that occurs, however, it is possible that a similar result may be achieved by analyzing foreclosure sales as voidable preferences rather than fraudulent conveyances. There is some case authority for this proposition, but the preference theory has not yet been fully developed because of the ready availability of *Durrett*. The purpose of this article is to explain both theories to the Missouri Bar.

The *Durrett* doctrine is based on a literal reading of portions of section 548(a) of the Bankruptcy Reform Act (the "Code"). The relevant language states:

(a) The trustee may avoid any transfer of an interest of the debtor in property . . . that was made . . . within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily

* * * * *

(2)(A) received less than reasonably equivalent value in exchange for such transfer . . . ; and

(B)(i) was insolvent on the date that such transfer was made . . . or became insolvent as a result of such transfer. . . .⁸

There is a split among the circuits as to whether a foreclosure sale constitutes a transfer for purposes of section 548. The vast majority of lower courts have held that it does and have based their decisions on the statutory definition of transfer, which specifically includes involuntary dispositions of property.⁹ The Ninth Circuit, however, examined the history of fraudulent conveyances and held that a foreclosure sale that does not involve collusive conduct by the debtor does not constitute a transfer for purposes of section 548.¹⁰ This decision was probably legislatively overruled¹¹ in 1984 by amendments making "foreclosure of the debtor's equity of redemption" part of the definition of transfer and adding the phrase "voluntarily or involuntarily" to section 548(a). The Sixth Circuit has also rejected *Durrett*,

reasoning that the price received at a noncollusive foreclosure sale constitutes reasonably equivalent value as a matter of law.¹²

In *Hulm*, a case based on pre-1984 law, the Eighth Circuit held that a foreclosure sale is a transfer within the meaning of section 548.¹³ With that issue resolved, the other elements of an avoidance action under section 548 are (1) disposition within one year prior to commencement of bankruptcy, (2) of an interest of the debtor in property, (3) made while the debtor is insolvent, and (4) made for less than a reasonably equivalent value.

The foreclosure sale must occur within one year prior to bankruptcy

Under the first element, the foreclosure sale must occur within one year prior to bankruptcy, but the period of uncertainty for the purchaser at the sale may actually be much longer. An avoidance action under section 548 may be initiated until the earlier of two years after the appointment of a trustee or the time the case is closed or dismissed.¹⁴ Since a trustee may never be appointed in a Chapter 11 reorganization, a debtor in possession can bring an avoidance action at any time during the pendency of the bankruptcy proceedings.¹⁵ Even in a Chapter 7 liquidation the period of uncertainty may exceed three years.¹⁶

As to the second element, a foreclosure sale unquestionably disposes of an interest of the debtor in property. In *Hulm*, a case arising out of a judicial foreclosure sale in North Dakota, the Eighth Circuit noted that the sale divested *Hulm* of legal title, the right to possession, and his equity of redemption.¹⁷ This element would also be satis-

fied by any nonjudicial foreclosure sale in Missouri.¹⁸

The third element requires that the debtor be insolvent at the time of the foreclosure sale, and the test to be applied is based on the definition of insolvent at section 101(29) of the Code.¹⁹ In order to be insolvent, the sum of the debtor's liabilities must exceed the sum of his or her assets. In applying the test, the fair market value of the foreclosed property must be included as an asset with the value of any liens as a liability.

The final element requires that the property be sold for less than reasonably equivalent value, and this element has produced some controversy. In *Durrett*, the foreclosure sale brought roughly 58 percent of the property's fair market value and the Fifth Circuit suggested that a sale for less than 70 percent could be avoided.²⁰ Even though *Durrett* did not specifically establish 70 percent as the dividing line, that percentage has become a rule of thumb in the ensuing cases. The Eighth Circuit did not discuss percentages in *Hulm* and remanded the case for an evidentiary hearing to determine whether the foreclosure sale price was a reasonably equivalent value for the property.²¹ The Court did, however, expressly disapprove of the theory that absent fraud or collusion the price received at a foreclosure sale should be deemed a reasonably equivalent value as a matter of law.²² It seems likely that the 70 percent rule will become the norm in the Eighth Circuit.

The *Durrett* theory can be used in a Chapter 7 proceeding or in reorganization cases under Chapters 11 and 13.²³ Moreover, unlike under statutory redemption, where the redeeming debtor must pay the mortgage debt,²⁴ reliance on *Durrett* requires no such out of pocket expenditure. Once the trustee (or debtor exercising the rights of a trustee in a reorganization²⁵) proves the elements listed above, the property can be recovered from the immediate purchaser or from any subsequent purchaser

who gives less than fair market value.²⁶ The purchaser is then granted a lien on the property for any value given.²⁷ In a Chapter 7 proceeding, the trustee will then proceed to sell the property free of all liens and satisfy the purchaser's lien from the sale proceeds.²⁸ The equity becomes an asset of the estate. In a reorganization proceeding in which the property is to be retained by the debtor,

The final element requires the property be sold for less than reasonably equivalent value

the purchaser's lien will typically be satisfied by payments under the plan. The purchaser becomes, in effect, a forced lender.

While recovering the excess value of foreclosed property for distribution to unsecured creditors is consistent with basic bankruptcy policies, the *Durrett* doctrine does create some serious problems. First, the period of uncertainty following foreclosure is entirely too long. It exists for a minimum of one year, and if the debtor commences bankruptcy during that period the threat of avoidance can linger for three years or more. The long period of uncertainty may tend to chill bidding at foreclosure sales and prevent development of the land following the sale.²⁹

Second, avoidance can be inequitable when applied to purchasers other than the original lender. For example, suppose the lender buys residential realty at the foreclosure sale and then resells through a broker to a purchaser who intends to live in the home. While the purchaser has the right to prevent avoidance by paying the trustee the difference between the value of the purchaser's lien and the property's fair market value, the exercise of this right may

prove economically burdensome. In some instances, the purchaser may be forced to give up the home.

A third problem occurs in reorganization cases where the ultimate purchaser is a non-lender. Even if the purchaser is "adequately protected" in the sense that she will ultimately receive 100 percent of her investment through the plan, serious consequences can ensue from having funds tied up for a significant period of time. This is less of a problem where the purchaser is a lender whose ordinary business activities involve repayment of funds over time.

In addition to avoidance as a fraudulent conveyance, a pre-bankruptcy foreclosure sale that brings less than fair market value may also be attacked as a preference. Because of the pervasive impact of *Durrett*, the preference approach is still in its embryonic stage. However, if *Durrett* is legislatively overruled the preference theory is certain to be utilized more frequently. Consequently, it is important to understand the theory and how it differs from *Durrett*.

Under section 547(b)³⁰ of the Bankruptcy Code, the trustee may avoid a transaction if it was (1) a transfer of an interest of the debtor in property, (2) to or for the benefit of a creditor, (3) for or on account of an antecedent debt, (4) made while the debtor was insolvent, (5) made within 90 days before the commencement of bankruptcy (or between 90 days and one year in the case of insiders³¹), and (6) which enables the creditor to realize more than he would have received in a Chapter 7 liquidation.

The first element is identical with one of the elements in section 548(a) and is satisfied by the same analysis applicable in that context. The second, third and fifth elements are likewise non-controversial. If the mortgagee purchases at the foreclosure sale the transfer will be *to* a creditor; if a third party purchases, it will be *for the benefit of* a creditor. Since the foreclosure sale is a

separate transfer it will always be for an antecedent debt.

The fourth element requires, like section 548(a), that the debtor be insolvent on the date of the sale, but the trustee's proof will be easier than in the *Durrett* context. Under section 547(f), the debtor is presumed to have been insolvent during the 90 days preceding bankruptcy and the trustee will have to prove insolvency only in cases where the presumption is rebutted or the transfer was to an insider and occurred before the 90-day period commenced.

The sixth element is also present where the sale brings less than fair market value, but only if the mortgagee is the purchaser. If the transfer had not occurred, the mortgagee would have been treated as a creditor with a secured claim in a Chapter 7 proceeding and would have ultimately received the full value of the debt. By virtue of purchasing at the foreclosure sale, however, the mortgagee also obtains the debtor's equity, an asset that would have gone to unsecured creditors in a Chapter 7 proceeding. Thus, the mortgagee obtains more by way of foreclosure than it would have obtained in bankruptcy. This element will not be satisfied if a third party purchases at the foreclosure sale since the mortgagee will only be allowed to retain the amount of the debt.

It can be argued that this analysis is at odds with the purpose of section 547 because the concept of preference only applies to the extent that a creditor is paid up to the full amount of the debt. Any excess is not a preference but rather a fraudulent conveyance voidable under section 548.³² This argument is, however, unpersuasive. First, the language of section 547 applies literally to this situation and it is difficult to argue against a cause of action that is specifically defined in terms of elements when those elements clearly are satisfied. Moreover, this anti-preference reasoning reaches the ironic conclusion that section 547 may be used to deal with the lesser of two wrongs — namely, the

transfer that gives a creditor up to the full amount of her claim — but is unavailing to the extent the transfer gives her more than her due. Indeed, at least two cases have considered the issue and have concluded that section 547 can be used as a foreclosure-avoidance tool.³³ One of the cases, *Matter of Fountain*, was decided by the Bankruptcy Court for the Western District of Missouri.

In some respects, the preference approach is preferable to the *Durrett* doctrine. The pre-bankruptcy avoidance period is shortened to 90 days, although if bankruptcy is initiated during that period there may still be several years of uncertainty. In addition, since the theory only applies where the mortgagee is the purchaser the problem of inequitable treatment of third parties is resolved. Thus, third party bidding is less likely to be discouraged than in the *Durrett* setting. On the other hand, since the focus of the preference approach is on whether the mortgagee received more than it would have received in a Chapter 7 liquidation, unlike *Durrett* it may be used to recapture property where more than 70 percent of fair market value has been paid at the foreclosure sale.

CONCLUSION. *Durrett* and its preference theory counterpart are strong medicine. Any post-sale period of title defeasibility doubtless discourages foreclosure sale bidding. Indeed, because Missouri statutory redemption is unavailable if a third party purchases, such parties have heretofore been unconcerned about its consequences. As a result, *Durrett* may alter third party bidding practice to a greater degree in Missouri than in those states where such purchasers are not insulated from statutory redemption claims. We are admittedly troubled by this prospect. On the other hand, the benefits of *Durrett* and the preference alternative to unsecured creditors may outweigh the foregoing concern. As one of us has stressed in an earlier context, "there is no reason to

permit secured creditors to reap the benefit of assets that might have paid off unsecured creditors."³⁴ Moreover, both theories underscore in a powerful way the inadequacies of a foreclosure system that normally fails to produce an adequate price for foreclosed real estate.

Neither *Durrett* nor related theories are desirable as a permanent part of the foreclosure landscape. The long term solution to the problems they address lies in a major structural reform of state foreclosure practices. In an earlier article,³⁵ one of us described in detail a foreclosure system for Missouri that we believe will enhance the likelihood that fair market value will be obtained for foreclosed real estate. Under such a system, mortgaged real estate would be sold in a manner closely approximating how property is sold in an ordinary non-foreclosure context. While the proposed system provides for a substantial pre-foreclosure time period to cure default, there would be no post-sale redemption. Such a system, we believe, would enhance the likelihood of foreclosure surpluses and reduce the number of deficiency judgments, a result that would benefit unsecured creditors as well as mortgagors and junior lienors. Under such a system, *Durrett*, its preference counterpart and statutory redemption would be both unnecessary and self-defeating. □

FOOTNOTES

¹ §§443.410-.440, RSMo 1978. In order to exercise the right, the debtor or his successor must give written notice of intent to redeem at the sale or within ten days beforehand, must post a redemption bond within twenty days after the sale, and must tender the proper amount within one year following the sale. Statutory redemption is further limited in that it can be exercised only in cases where the mortgagee is the purchaser at the sale. See generally, Comment, *Statutory Redemption Following Power of Sale Foreclosure in Missouri*, 47 Mo. L. REV. 309 (1982).

² See, e.g., *Jackson v. Klein*, 320 S.W. 2d 553 (Mo. 1959); Nelson, *Deficiency Judgments After Real Estate Foreclosures in Missouri: Some Modest Proposals*, 47 Mo. L.

REV. 151, 157-158 (1982). See also G. Osborne, G. Nelson & D. Whitman, *Real Estate Finance Law* §7.21 (1979).

³ See Nelson, *supra* note 2, at 163.

⁴ 621 F.2d 201 (5th Cir. 1980). See generally Henning, *An Analysis of Durrett and Its Impact on Real and Personal Property Foreclosures: Some Proposed Modifications*, 63 N.C.L. REV. 257 (1985).

⁵ 738 F.2d 323 (8th Cir. 1984).

⁶ See *Summary of the Action of the House of Delegates*, 1983 A.B.A. Proc. 1, 31 (resolution endorsing amendment to state fraudulent conveyance law and to §548 of the Bankruptcy Reform Act of 1978).

⁷ Pub. L. No. 98-353, 98 Stat. 333 (amending 11 U.S.C. §§101-1113 and certain provisions of Title 28).

⁸ 11 U.S.C. §548(a) (1982), as amended. *Durrett* was decided under §67 of the Bankruptcy Act of 1898, but most of the ensuing cases, including *Hulm*, were decided under §548.

⁹ 11 U.S.C. §101(48) (1982), as amended.

¹⁰ *In re Madrid*, 725 F.2d 1197 (9th Cir. 1984).

¹¹ Interestingly, the overruling of *Madrid* was probably an accident. Opponents of *Durrett* had sought to change its result by amendments affirming that a foreclosure sale is a transfer but equating the price received at a noncollusive foreclosure sale with reasonably equivalent value as a matter of law. The effort to reverse *Durrett* failed and the provision on value was withdrawn, but the provisions supporting foreclosures as transfers were left in the Act. Thus, the opponents of *Durrett* inadvertently strengthened the theory by reversing the Ninth Circuit's conflicting opinion.

¹² *In re Winshall Settlor's Trust*, 758 F.2d 1136 (6th Cir. 1985).

¹³ 738 F.2d, at 326.

¹⁴ 11 U.S.C. §546(a) (1982).

¹⁵ 11 U.S.C. §1104 (1982) governs appointment of a trustee in a Chapter 11 proceeding.

¹⁶ 11 U.S.C. §702 (1982) governs appointment of a trustee in a Chapter 7 proceeding.

¹⁷ 738 F.2d, at 326.

¹⁸ There is no doubt but that the theory will also be applied to nonjudicial foreclosures. See Henning, *supra* note 4, at 266 note 55.

¹⁹ 11 U.S.C. §101(29) (1982).

²⁰ 621 F.2d, at 203.

²¹ 738 F.2d, at 327.

²² *Id.* The Court was referring to a ruling of the Ninth Circuit Bankruptcy Appellate Panel in *Madrid* which followed that theory. 21 Bankr. 424 (Bankr. 9th Cir. 1982). The

Ninth Circuit affirmed that decision but expressly declined to follow the Panel's reasoning. 725 F.2d, at 1199. The Sixth Circuit expressly approved the Panel's reasoning this year in *In re Winshall Settlor's Trust*, *supra* note 12.

²³ See Henning, *supra* note 4, at 266 notes 59-61 and accompanying text.

²⁴ See §443.410, RSMo 1978.

²⁵ A debtor in possession in a Chapter 11 proceeding is authorized to exercise the powers of a trustee. 11 U.S.C. §1107(a) (1982).

For a discussion of the debtor's right to initiate avoidance proceedings in a Chapter 13 proceeding, see Henning, *supra* note 4, at 283 note 154.

²⁶ 11 U.S.C. §§550(a), (b) (1982). §548 governs avoidance generally, while §550 governs the trustee's right to recover the property or its value after avoidance. Generally, an avoidance action and an action to recover the property for the estate should be joined procedurally. If they are not, §550(e) contains a separate statute of limitations for commencing a recovery action.

²⁷ The initial purchaser's lien is granted by 11 U.S.C. §548(c). Subsequent purchasers acquire the initial purchaser's lien. *Cf.* 11 U.S.C. §550(a).

Both the initial and any subsequent purchaser are also granted a lien to the extent of improvements which increase the property's value. 11 U.S.C. §550(d) (1982).

²⁸ The trustee's authority to sell is governed by 11 U.S.C. §363(f) (1982). The purchaser is entitled to "adequate protection" of his or her interest, and this means that the purchaser's lien will be satisfied from the resale proceeds. 11 U.S.C. §363(e) (1982).

²⁹ See Henning, *supra* note 4, at 276-77.

³⁰ 11 U.S.C. §547(b) (1982).

³¹ The term "insider" is defined in 11 U.S.C. §101(28) (1982), as amended.

³² If state law is the basis for avoidance, the trustee can use 11 U.S.C. §544(b) (1982). The trustee's power under this section is derivative in nature and requires that there be an actual creditor with an unsecured claim who could avoid part or all of the transfer under state law.

³³ *In re Wheeler*, 34 Bankr. 818 (Bankr. N.D. Ala. 1983); *Matter of Fountain*, 32 Bankr. 965 (Bankr. W.D. Mo. 1983). A third case, *In re Hill*, 39 Bankr. 894 (Bankr. D. Or. 1984), held that there was no separate transfer for bankruptcy purposes. Like *Madrid*, *supra* note 10, this reasoning has been legislatively overruled.

³⁴ See Henning, *supra* note 4, at 276.

³⁵ See Nelson, *supra* note 2, at 160-66.

THE CHANGING LAW OF LIMITED PARTNERSHIPS

State statutes governing limited partnerships have been undergoing many changes recently. Both new and existing limited partnerships have been affected. In 1984, five states—California, Alabama, Kansas, Wisconsin and Oklahoma—enacted major changes in their limited partnership laws. So far this year, Ohio and New Jersey have continued this trend. Additional changes are virtually assured in 1985.

You can be ready for them—and save time and avoid unnecessary filing delays—by calling your local C T office *before* you begin your next limited partnership assignment. We'll give you:

- Immediate, up-to-the-minute information on statutory costs, requirements, and procedures for any state and the District of Columbia.
- Expert assistance on your next limited partnership assignment. C T can check the name where required and, if permitted, reserve it for limited partnership use; compile forms for foreign registration in those states which permit such filings; obtain certified documents needed for registration of a foreign limited part-

nership; handle the details of the filing with state and/or county officials; arrange for publication where required; file amendments to a limited partnership charter; handle dissolution (cancellation) of the limited partnership; and provide the registered agent for service of process in the state.

For more information—and a copy of our “*Limited Partnerships*” compilation (it's free, for lawyers only)—just call your local C T branch office. Or mail this coupon.

C T: I'm a lawyer. I'd like more information on your limited partnership services. Send me a copy of your “*Limited Partnerships*” compilation, without charge or obligation.

Name _____

Firm _____

Address _____

City, State, Zip _____

385



C T CORPORATION SYSTEM

Serving lawyers since 1892

ELEGANCE THAT'S STRICTLY LEGAL.

Scarritt Place. An elegant alternative for Kansas City's legal and professional community.

- within two blocks of both the Jackson County and Federal courthouses*
 - complete law library on premises*
- dictation, wordprocessing, typing and stenography services available*
 - conference center and restaurant*

**'SCARRITT BUILDING'
& ARCADE'**

*For leasing information phone:
Hamill & Cardell 816/472-1984*



Ameritas, Inc., Restoring Kansas City's Architectural Heritage