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Grant S. Nelson

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The Impact of Mortgagor Bankruptcy on the Real Estate Mortgagee: Current Problems and Some Suggested Solutions*

GRANT S. NELSON**

I. INTRODUCTION

In theory, mortgagees should be unconcerned when insolvency forces mortgagors to file bankruptcy. Indeed, protection from such occurrences is the very reason for creation of mortgage security interests. In reality, however, mortgagees' rights, contractual and statutory, are often substantially affected by federal bankruptcy law, as many learn when they are forced into bank-

** Enoch H. Crowder Professor of Law, University of Missouri-Columbia.

ruptcy court to defend their security interests from the trustee's attack.[1] The purpose of this article is to provide a general overview of the impact of mortgagor bankruptcy on the real estate mortgagee, to explore in detail certain recent developments that are especially troublesome to such mortgagees and to propose certain changes in state foreclosure practices that would, it is hoped, obviate the problems that gave rise to those developments.

The Bankruptcy Code (the "Code") provides for three types of bankruptcy proceedings: Chapter 7[2] ("straight bankruptcy"), Chapter 11,[3] and Chapter 13.[4] Straight bankruptcy entails the liquidation of the debtor's nonexempt assets to satisfy his or her creditors according to the priority and amount of their claims. Such a proceeding ultimately discharges the debtor of most pre-bankruptcy debts. It is the most common type of bankruptcy proceeding. Relief may be sought by the debtor ("voluntary") or by creditors ("involuntary"). Chapter 11 proceedings, on the other hand, provide for the reorganization of corporate and other business debtors.[5] Rehabilitation, not liquidation, is the purpose of such proceedings. Reorganization plans can result in extension of debts and broad judicial control over both secured and unsecured creditors. Finally, Chapter 13 is to some extent a Chapter 11 equivalent for individuals. Such proceedings are aimed at the rehabilitation of the debtor by extension and reduction of both unsecured and certain secured claims. Such a proceeding may be used by an individual who owes less than $100,000 in unsecured debt and $350,000 in secured debt.[6]

The most immediate impact of debtor bankruptcy on the real estate mortgagee is the automatic stay. Under section 362(a) of the Code, all foreclosure proceedings, whether judicial or power of sale, are automatically stayed by the filing of any of the three types of bankruptcy proceedings.[7] The stay is applicable whether or not the foreclosure was initiated prior to the bankruptcy petition.[8] Moreover, in Chapter 13 proceedings the stay is also applicable to foreclosure and other proceedings against third persons who have guaranteed the bankrupt's consumer debt or put up property to secure it.[9] The only significant exception from the stay is for foreclosure "actions" brought by the Secretary of HUD on federally insured mortgages on property consisting of five or more

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1. *See infra* text accompanying notes 15-33.
2. *See* 11 U.S.C. §§ 701-66 (1982).
3. *See* 11 U.S.C. §§ 1101-74 (1982).
4. *See* 11 U.S.C. §§ 1301-30 (1982).
5. Individuals can use Chapter 11, although the typical case is a business case. *See* 11 U.S.C. § 109(d) (1982).
6. *See* 11 U.S.C. § 109(e) (1982).
7. *See* 11 U.S.C. § 362(a)(4) (1982). *See generally* Whelan, *Lenders' Rights in Bankruptcy Stays*, MORTGAGE BANKER, Oct. 1984, at 57; Nimmer, *Real Estate Creditors and the Automatic Stay: A Study in Behavioral Economics*, 1983 ARIZ. ST. L.J. 281; Nimmer, *Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness*, 68 MINN. L. REV. 1 (1983).
8. *See* 11 U.S.C. § 362(a) (1982).
9. *See* 11 U.S.C. § 1301 (1982).

living units.[10] The impact of the stay on the real estate mortgagee can be substantial. For example, a mortgagee can be in the middle of a complex judicial foreclosure in state court, and the filing of a bankruptcy petition can bring the action to an absolute halt. Not only will any foreclosure consummated in violation of the stay be ineffective, the mortgagee risks being punished for contempt as well.[11]

II. Straight Bankruptcy

As noted in the Introduction, the filing of a petition in straight bankruptcy, stays any pending or planned foreclosure proceeding. However, assuming the mortgage is valid, the trustee has a legitimate interest in the mortgaged real estate only if the mortgagor-debtor has "equity" in that real estate—the amount by which the value of the property exceeds the total amount of mortgage debt against it. If a mortgagee seeks relief from the stay, proves the non-existence of such equity, the trustee should abandon the real estate to the mortgagee who then can proceed to foreclose.[12] If equity is found to exist, the real estate will be sold by the bankruptcy court, either (1) subject to the existing mortgages and other liens, or (2) free and clear of them.[13] If the latter course is chosen, those liens will be transferred to the sale proceeds and satisfied in order of their priority.[14] Suppose, for example, that E-1 has a valid first mortgage on Blackacre with a $60,000 balance and that E-2 has a valid second mortgage on it with a $15,000 balance. If the trustee determines that Blackacre is worth less than $75,000, she will release it and either lienor will be free to foreclose under state law. If, however, Blackacre proves to be worth more than $75,000, she will either sell it subject to the foregoing mortgages or free and clear of them. If she chooses the latter course, the two mortgages will attach to the sale proceeds and be satisfied in order of their priority.

Because the trustee represents the interests of the bankrupt's unsecured creditors, her primary goal is to enlarge the asset pool available to satisfy their claims. Since each mortgage invalidated usually serves that purpose, she will be especially watchful for opportunities to attack vulnerable security interests. The Code affords her an impressive arsenal of weapons in this regard. Perhaps most basic is section 558, which gives the trustee "the benefit of any defense available to the debtor" against the mortgagee even if the debtor waives it after the commencement of bankruptcy.[15] Thus, for example, to the extent

10. *See* 11 U.S.C. § 362(b)(8) (1982).

11. *See* W. Collier, Collier on Bankruptcy § 362.11 (L. King 15th ed. 1984) [hereinafter cited as Collier].

12. *See* 11 U.S.C. §§ 554, 362(d) (1982); *In re* Thayer, 38 Bankr. 412, 422 (Bankr. D. Vt. 1984); *see also* Whelan, *supra* note 7, at 58; *In re* Victor Builders, Inc., 418 F.2d 880, 882 (9th Cir. 1969); *In re* Ira Haupt & Co., 398 F.2d 607, 612-14 (2d Cir. 1968); *In re* Polumbo, 271 F. Supp. 640, 643 (W.D. Va. 1967).

13. *See* 11 U.S.C. § 363(f) (1982); Collier, *supra* note 11, § 363.07.

14. Collier, *supra* note 11, § 363.07.

15. *See* 11 U.S.C. § 558 (1982); *In re* Hayes, 39 Bankr. 1 (Bankr. C.D. Ill.

that a debtor would be able to invalidate a mortgage based on fraud, usury, incapacity or other grounds, so too will the trustee. Also important is section 544(a)(3) which affords the trustee, irrespective of knowledge on her part, the status of a bona fide purchaser of real property from the debtor who has perfected under state law.[16] Such status can be utilized whether such a purchaser actually exists or not.[17] Consequently, the trustee will always be able to defeat any mortgage of the debtor that is unrecorded as of the commencement of bankruptcy. Because she is deemed to have perfected under state law, the type of state recording act (e.g., whether race-notice, notice, or pure race)[18] and its requirements become irrelevant.

While section 544(a)(3) permits the trustee to defeat any prior unrecorded mortgage, situations may arise where it is to her advantage to be able to assert its priority. Suppose, for example, that after a mortgage on Blackacre is executed, but never recorded, a second mortgage is recorded by another creditor who, under the applicable state recording act, qualifies as a bona fide purchaser as against that unrecorded mortgage. The debtor-mortgagor then files a bankruptcy petition. While section 544(a)(3), as noted earlier, allows the trustee to avoid the unrecorded mortgage, it does not prevent the second mortgage, which is admittedly valid, from being promoted in priority. However, section 551 of the Code then comes to the rescue. Under the latter provision, a trustee who avoids a senior lien becomes subrogated to the rights of the senior lienor up to the amount of the senior debt.[19] For example, suppose the unrecorded mortgage has a balance of $10,000 and the recorded second mortgage a balance of $20,000. If the real estate is sold by the bankruptcy court for $25,000, the trustee as subrogee will have a right to $10,000 and the second mortgagee will receive $15,000.

Certain mortgages may be vulnerable to a fraudulent conveyance attack.[20] Under section 548 of the Code, transfers made by the debtor within one year of bankruptcy may be set aside by the trustee if they were made with the intent to "hinder, delay or defraud" any creditor to which the debtor was or became indebted.[21] Thus, for example, suppose a debtor, in order to conceal his substantial equity in Blackacre, grants mortgagee a mortgage on it within a year of filing a bankruptcy petition. The trustee will be able to set aside the mortgage. Moreover, as is explored in detail later in this article,[22] the con-

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1983).

16. *See* 11 U.S.C. § 544(a)(3) (1982); *In re* Duffy-Irvine Assocs., 39 Bankr. 525 (Bankr. E.D. Penn. 1984); COLLIER, *supra* note 11, § 544.02; Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 732-42 (1984).

17. *See* 11 U.S.C. § 544(a)(3) (1982).

18. *See generally* R. CUNNINGHAM, W. STOEBUCK & D. WHITMAN, PROPERTY § 11.9 (1984).

19. *See* 11 U.S.C. § 551 (1982).

20. *See* 11 U.S.C. § 548 (1982).

21. *See* 11 U.S.C. § 548(a)(1) (1982); *see also* Jackson, *supra* note 16, at 777-86.

22. *See infra* text accompanying notes 162-219.

structive fraud provision of section 548 has increasingly become the basis for setting aside certain pre-bankruptcy foreclosure sales of the debtor's real estate that yield less than its "reasonably equivalent value." The trustee may have a further fraudulent conveyance weapon. To the extent that state fraudulent conveyance law confers on unsecured creditors broader powers to avoid debtor mortgages than are afforded by its section 548 counterpart, section 544(b) of the Code empowers the trustee to take advantage of that state law, a matter which is considered elsewhere in this article.[23] Finally, many mortgages given within ninety days of the mortgagor's bankruptcy will be voidable by the trustee as a preference under section 547 of the Act.[24] A significant policy embodied in the bankruptcy law is that similarly situated creditors be treated equally. However, once a debtor becomes financially unstable, creditors commonly violate that policy by seeking to gain advantage vis à vis their creditor brethren. Often this entails acquiring real estate mortgages from the debtor to secure pre-existing debt. To the extent that such mortgages are granted by an insolvent mortgagor within ninety days of bankruptcy and they would otherwise enable the creditor to realize more on its claim than it otherwise would in a straight bankruptcy liquidation, they constitute voidable preferences.[25] Moreover, there is a presumption of debtor insolvency during this ninety day period.[26] Moreover, if the creditor is an "insider,"[27] the preference period is one year rather than ninety days.[28]Another preference problem arises because of a bankruptcy policy against secret and unrecorded liens. Even though a mortgage is valid between the parties at the time of its execution, for bankruptcy purposes the transfer is deemed to occur on the date the mortgage is recorded if recordation occurs more than ten days after the mortgage is executed.[29] Since the transfer under such circumstances occurs as of the date of recording, it will be treated as a transfer for an antecedent debt even though present value was given when the mortgage became effective between the parties. For example, suppose that on January 15, mortgagor, who is insolvent, borrows $10,000 from creditor and the latter takes back a mortgage on Blackacre as security. On February 10 creditor records the mortgage. On March 15, mortgagor files a bankruptcy petition. Even though the $10,000 loan would otherwise represent new value,[30] because of the tardy recording, the transfer will be deemed to be for an antecedent debt within ninety days of bankruptcy.

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23. *See* 11 U.S.C. § 544(b) (1982); *see, e.g., In re* Penn Packing Co., 42 Bankr. 502 (Bankr. E.D. Pa. 1984); *see infra* text accompanying notes 214-16; *see generally* Note, *Good Faith and Fraudulent Conveyances*, 97 HARV. L. REV. 495 (1983).

24. *See* 11 U.S.C. § 547 (1982); Ross, *The Impact of Section 547 of the Bankruptcy Code upon Secured and Unsecured Creditors*, 69 MINN. L. REV. 39 (1984).

25. *Id.*

26. *See* 11 U.S.C. § 547(f) (1982).

27. *See* 11 U.S.C. § 101(25) (1982).

28. *See* 11 U.S.C. § 547(b)(4)(B) (1982).

29. *See* 11 U.S.C. §§ 547(e)(1)(A), 547(e)(2) (1982); *see also* COLLIER, *supra* note 11, § 547.44.

30. *See* 11 U.S.C. § 547(a)(2) (1982).

Accordingly, the mortgage can be set aside as a voidable preference.

While the foregoing trustee's powers are numerous and important, it would be a mistake to overemphasize their danger for the real estate mortgage. Most straight bankruptcy proceedings are consumated relatively rapidly, and normally the mortgage security and lien priority will be preserved. It is true that in some instances, a trustee may delay temporarily the disposition of income-producing real estate in an attempt to accumulate some of those rents for the benefit of unsecured creditors. This problem is examined in a later section.[31] By and large, however, the most significant impact of a straight bankruptcy on the mortgage will be the loss of part or all of its deficiency judgment and that should pose no problem to the prudent mortgagee who made sure initially that the debt was well-secured.

III. The Chapter 11 Reorganization

Because the purpose of a Chapter 11 proceeding is the rehabilitation rather than the liquidation of the debtor, the debtor typically continues to operate the estate as a "debtor-in-possession."[32] Parties in interest (usually creditors) may obtain the appointment of a trustee only for cause "including fraud, dishonesty, incompetence, or gross mismanagement" on the part of the debtor[33] or where appointment is otherwise in such parties' "best interests."[34] The appointment of a trustee is considered "an extraordinary remedy"[35] and there is thus a strong presumption in favor of the debtor remaining in possession, at least through the plan formulation period.[36] Moreover, the debtor-in-possession is entitled to exercise the avoidance powers of a Chapter 7 trustee.[37]

From the moment the mortgagor files a Chapter 11 petition, the mortgagee is stayed from foreclosing.[38] Usually the stay will remain in effect at least while a reorganization plan is being formulated and often during its execution. However, under section 362 of the Code, the bankruptcy court may

> terminat[e], annul, modify or condition such stay (1) for cause, including the lack of adequate protection of an interest in property of such [mortgagee]; or (2) with respect to a stay of an act against property, if —(A) the [mortgagor] does not have an equity in such property; and (B) such property is not necessary to an effective reorganization.[39]

The first ground for relief has provided some difficulty for the bankruptcy courts. Some courts, for example, suggest that "adequate protection" exists if

31. *See infra* § VII.
32. *See* Collier, *supra* note 11, § 1104.01; *see also* 11 U.S.C. § 1107 (1982).
33. *See* 11 U.S.C. § 1104(a)(1) (1982).
34. *See* 11 U.S.C. § 1104(a)(2) (1982); Collier, *supra* note 11, § 11.04.01(d).
35. Collier, *supra* note 11, § 1104.01(b).
36. *Id.*
37. *See* 11 U.S.C. § 1107 (1982).
38. *See* 11 U.S.C. § 362(a) (1982).
39. *See* 11 U.S.C. § 362(d) (1982).

there is an "equity cushion" in the mortgaged real estate.[40] Others stress that the foregoing language is designed to protect against post-filing decline in the value of the real estate.[41] In a few instances, mortgagor failure to pay real estate taxes or to keep the mortgaged premises insured have been deemed to cause a lack of adequate protection.[42] When such adequate protection is lacking, section 361 sets out three permissible ways to provide it.[43] As summarized by Professor Kennedy,

> [F]irst, the trustee may be required to make periodic cash payments to the [mortgagee] in an amount sufficient to compensate for the decrease in the value of the [mortgagee's] interest resulting from the stay. Second, the [mortgagee] may be provided with an alternative or additional lien equal in value to the decrease in the value of the [mortgagee's] interest resulting from the stay. Finally, any other relief may be granted that will give the [mortgagee] realization of the 'indubitable equivalent' of its interest in property.[44]

The latter alternative is a "catch-all" concept that awaits case by case development. Nevertheless, as one commentator has stressed, "[g]iving a creditor which holds security of the highest quality with an ample cushion alternative security of dubious value or of a value barely that of the debt would not meet 'indubitable equivalent' standard."[45]

The second ground for stay relief is more commonly relied upon by mortgagees. Under this approach two requirements must be satisfied. First, the mortgagor must lack equity in the mortgaged real estate and second, that real estate must not be necessary to an "effective reorganization."[46] The meaning of the term "equity" has proved especially troublesome for the bankruptcy courts. Under the predominate approach, "equity" refers to "the difference between the value of the property and all encumbrances against it."[47] A sizea-

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40. *See, e.g.*, Hagendorfer v. Marlette, 42 Bankr. 17 (S.D. Ala. 1984); *In re* Jamaica House, Inc., 31 Bankr. 192 (Bankr. D. Vt. 1983); *In re* Penn York Mfg., 14 Bankr. 51 (Bankr. M.D. Pa. 1981); *In re* Tucker, 5 Bankr. 180 (Bankr. S.D.N.Y. 1980).

41. *See, e.g.*, *In re* Development, Inc., 36 Bankr. 998 (Bankr. D. Hawaii 1984); *In re* Palmer River Realty, 26 Bankr. 138 (Bankr. D.R.I. 1983); La Jolla Mortgage Fund v. Rancho El Cajon Assocs., 18 Bankr. 283 (Bankr. S.D. Cal. 1982); *In re* BBT, 11 Bankr. 224 (Bankr. D. Nev. 1981); *In re* Gaim Dev. Corp., 9 Bankr. 17 (Bankr. S.D. Fla. 1981); *In re* Riviera Inn, 7 Bankr. 725 (Bankr. D. Conn. 1980).

42. *In re* Jenkins, 36 Bankr. 788 (Bankr. S.D. Fla. 1984); *In re* Ausherman, 34 Bankr. 393 (Bankr. N.D. Ill. 1983); *In re* Jamaica House, Inc., 31 Bankr. 192 (Bankr. D. Vt. 1983).

43. *See* 11 U.S.C. § 361 (1982).

44. Kennedy, *Automatic Stays Under the New Bankruptcy Law*, 12 U. MICH. J.L. REF. 343-44 (1979); *see In re* Development, Inc., 36 Bankr. 998 (Bankr. D. Hawaii 1984).

45. COLLIER, *supra* note 11, § 361.01[4].

46. *See* 11 U.S.C. § 362(d)(2) (1982).

47. *See, e.g.*, *In re* Development, Inc., 36 Bankr. 998 (Bankr. D. Hawaii 1984); *In re* Faires, 34 Bankr. 549 (Bankr. D. Wash. 1983); *In re* Trina-Dee, Inc., 26 Bankr. 152 (Bankr. E.D. Pa. 1983); *In re* Koopmans, 22 Bankr. 395 (Bankr. D. Utah 1982); *In re* Crescent Beach Inn, 22 Bankr. 161 (Bankr. D. Maine 1982); La Jolla Mortgage

ble majority of decisions, however, take the position that the term "means the difference between the value of the property and the lien which is the subject of [the request to stay relief], along with any liens senior thereto."[48] Under this view, it "makes no difference how many junior encumbrances are outstanding against the subject property so long as the [mortgagor] has a substantial and meaningful equity cushion over and above the senior encumbrances."[49] Because it enhances the likelihood that equity will exist and that relief from the stay will thus be denied, the minority view is especially appealing to junior lienholders. By keeping the stay in effect they postpone the day of reckoning when they must either satisfy the senior indebtedness or suffer foreclosure of their liens.[50]

If the court finds that equity exists, it must then determine whether the mortgaged real estate is "necessary to an effective reorganization."[51] As one court has stressed, it is "not enough for a debtor to argue that the automatic stay should continue because it needs the secured property in order to propose a reorganization. . . . The key word . . . is 'effective'."[52] The mere fact that the real estate is essential to the survival of the mortgagor's business is insufficient.[53] Rather, the mortgagor is required to demonstrate that there is "a reasonable likelihood of a successful reorganization within a reasonable period of time."[54]

Fund v. Rancho El Cajon Assocs., 18 Bankr. 283 (Bankr. S.D. Cal. 1982); *In re* Saint Peter's School, 16 Bankr. 404 (Bankr. S.D.N.Y. 1982); First Conn. Small Business Inv. Co. v. Ruark, 7 Bankr. 46 (Bankr. D. Conn. 1980); *In re* Dallasta, 7 Bankr. 883 (Bankr. E.D. Pa. 1980); Whelan, *supra* note 7, at 58; Note, *Automatic Stay Under the 1978 Bankruptcy Code: An Equitable Roadblock to Secured Creditor Relief*, 17 SAN DIEGO L. REV. 1113, 1123 (1980).

48. *In re* Faires, 34 Bankr. 549, 551 (Bankr. W.D. Wash. 1983). *But see, e.g., In re* Cote, 27 Bankr. 510, 512-13 (Bankr. D. Or. 1983); *In re* Palmer River Realty, Inc., 26 Bankr. 138, 140 (Bankr. D.R.I. 1983); *In re* Certified Mortgage Corp., 25 Bankr. 662, 663 (Bankr. M.D. Fla. 1982); *In re* Spring Garden Foliage, Inc., 15 Bankr. 140, 143 (Bankr. M.D. Fla. 1981); *In re* Wolford Enterprises, 11 Bankr. 571, 574 (Bankr. S.D. W. Va. 1981).

49. *In re* Spring Garden Foliage, Inc., 15 Bankr. 140, 143 (Bankr. M.D. Fla. 1981).

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> There may be many instances when the holder of a lien inferior to the lien of a plaintiff does not want relief from the stay afforded to the plaintiff. In a foreclosure a junior lienholder is faced with the possibility that unless it purchases the interests of those holders of superior liens it will lose any recovery upon its lien. The junior lienholder may prefer to negotiate with the debtor for different payment terms or a reduction in the amount due to it.

In re Cote, 27 Bankr. 510, 513 (Bankr. D. Or. 1983).

51. *See* 11 U.S.C. § 362(d)(2)(B) (1982).

52. *In re* Clark Technical Assocs., 9 Bankr. 738, 740 (Bankr. D. Conn. 1981).

53. *In re* Development, Inc., 36 Bankr. 998, 1005 (Bankr. D. Hawaii 1984); *In re* Mikole Developers, Inc., 14 Bankr. 524, 526 (Bankr. E.D. Pa. 1981).

54. *In re* Development, Inc., 36 Bankr. 998, 1005 (Bankr. D. Hawaii 1984); *In re* Sundale Assocs., 11 Bankr. 978, 980 (Bankr. S.D. Fla. 1981); *see also In re* Smith, 42 Bankr. 276, 277 (Bankr. E.D. Pa. 1984).

On the surface it would seem that a mortgagee should invariably prefer the "adequate protection" route to stay relief over the "no.equity—necessary to an effective reorganization" approach. For example, suppose the mortgagee can establish that an "equity cushion" no longer exists in the mortgaged real estate. If such a showing is enough to show inadequate protection, why should the mortgagee run the risk that mortgagor will be able to establish that the real estate is necessary to an effective reorganization? Perhaps the answer lies in the fact that if the court finds both a lack of equity and that the property is unnecessary to an effective reorganization, it will invariably dissolve the stay because, by definition, there is no reason for the court to retain control over it. On the other hand, a finding of inadequate protection alone may simply result in a decree ordering additional protection for the mortgagee or some modification, rather than dissolution, of the stay.[55]

A. *The Reorganization Plan*

Once the Chapter 11 petition is filed, the debtor has the exclusive right for 120 days to submit a reorganization plan.[56] That period may be extended for "cause."[57] If the debtor files a plan within the specified period, no other party can file a plan during the first 180 days of the case.[58] If he fails to file a plan, the other parties may file anytime after the expiration of the 120 day period.[59] Also, other parties can file at any time after a trustee has been appointed.[60] While the Code specifies in elaborate detail the contents of the plan,[61] two elements are especially important. First, the plan must classify creditor claims and, second, it must describe in detail its treatment of each creditor class. Claims generally are categorized as secured or unsecured.[62] Further distinctions are drawn based on the character or priority of the claims. For example, while two separate debts secured by one mortgage on Blackacre may be placed in one class, a junior mortgage on the same real estate arguably will not be included in it.[63] A detailed description of class treatment is required to place creditors on notice of the plan's prejudicial impact on them. For example, the plan will often restructure existing debt to provide for reduced payments over an extended period of time. Moreover, it may provide for

55. *See, e.g., In re* Jenkins, 36 Bankr. 788, 789 (Bankr. S.D. Fla. 1984); *In re* Jamaica House, Inc., 31 Bankr. 192, 195 (Bankr. D. Vt. 1983).

56. *See* 11 U.S.C. § 1121(b) (1982).

57. *See* 11 U.S.C. § 1121(d) (1982).

58. *See* 11 U.S.C. § 1121(c)(3) (1982).

59. *See* 11 U.S.C. § 1121(c)(2) (1982).

60. *See* 11 U.S.C. § 1121(c)(1) (1982).

61. *See* 11 U.S.C. § 1123 (1982).

62. *See* Comment, *Real Estate Reorganizations: The New Bankruptcy Code v. Chapter XII*, 1980 U. ILL. L.F. 251, 255.

63. *Id.* A plan can only put a claim into a particular class if it is "substantially similar" to other claims in the same class. *See* 11 U.S.C. § 1122(a) (1982).

an actual reduction in the amount of unsecured claims.[64]

After the plan is filed, a period for soliciting creditor acceptance begins.[65] Each creditor must receive a copy of the plan or a plan summary and a judicially approved disclosure statement.[66] Thereafter, the debtor solicits creditor approval for the plan. In general, each class must either accept the plan or not be "impaired" by it.[67] If a class is unimpaired, it is deemed to have accepted the plan.[68]

In general, in order for a class to qualify as "unimpaired," the plan may not alter the legal, equitable, or contractual rights of any claim in the class.[69] Importantly, under section 1124(2), a claim is not impaired even though the plan cures a "default . . . that occurred before . . . the commencement of the case . . . and reinstates the maturity of [the] claim . . . as such maturity existed before such default."[70] According to the legislative history of the foregoing section, a

> claim . . . is unimpaired by curing the effect of a default and reinstating the original term of an obligation when maturity was brought on or accelerated by the default. The intervention of bankruptcy and the defaults represent a temporary crisis which the plan of reorganization is intended to clear away. The holder of a claim . . . who under the plan is restored to his original position, when others receive less or get nothing at all, is fortunate indeed and has no cause to complain.[71]

While the foregoing section clearly authorized de-acceleration where a Chapter 11 petition is filed before the mortgagee invokes a state foreclosure procedure, courts disagree about the effect of a petition filed thereafter. Some hold that a foreclosure judgment cuts off the mortgagor's de-acceleration rights,[72] while others take the position that "it is the foreclosure sale rather than the entry of judgment which cuts off" those rights.[73] The latter approach is probably correct because in no event should de-acceleration be barred prior to the termination of the mortgagor's equity of redemption. Such an approach was utilized by the United States Court of Appeals for the Seventh Circuit[74] in a

64. Comment, *supra* note 62, at 256.
65. *Id.* at 255-56.
66. *Id.*
67. *See* 11 U.S.C. § 1129(a)(8) (1982).
68. *See* 11 U.S.C. § 1126(f) (1982).
69. *See* 11 U.S.C. § 1124 (1982).
70. *See* 11 U.S.C. § 1124(2) (1982).
71. S. REP. No. 989, 95th Cong., 2d Sess. 120, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5906.
72. *See, e.g., In re* Monroe Park, 18 Bankr. 790, 791 (Bankr. D. Del. 1982); *In re* St. Peter's School, 16 Bankr. 404, 409 (Bankr. S.D.N.Y. 1982); *In re* Garner, 13 Bankr. 799, 801 (Bankr. S.D.N.Y. 1981) (which involves Chapter 13 bankruptcy, not Chapter 11).
73. *In re* Orlando Tennis World Dev. Co., 34 Bankr. 558, 560 (Bankr. M.D. Fla. 1983); *see also In re* Hewitt, 16 Bankr. 973, 977 (Bankr. D. Alaska 1982).
74. *In re* Madison Hotel Assocs., 749 F.2d 410 (7th Cir. 1984).

Chapter 11 case where de-acceleration was sanctioned after the mortgagee had obtained a judicial order of foreclosure, but before that order had been reduced to judgment. The court emphasized that the result would have been the same even had the judgment been obtained, and quoted approvingly from a Seventh Circuit decision in an analogous Chapter 13 setting that pursuant to Wisconsin law

> a judgment of foreclosure does little more than determine that the mortgagor is in default, the amount of principal and interest due and unpaid, the amount due to the plaintiff mortgagee for taxes, etc. The judgment does not destroy the lien of the mortgage but rather judicially determines the amount thereof. . . . Accordingly, [the mortgagee's] failure to obtain a judgment of foreclosure on its accelerated loan is of no consequence [here].[75]

Indeed, de-acceleration will probably be permitted after the foreclosure sale in those states that afford the mortgagor statutory "post-sale" redemption rights.[76]

Suppose, however, it is determined that a class is impaired. It is deemed to accept the plan when a majority in number and two-thirds in total amount of the claims approve the plan.[77] Moreover, each member of an impaired class must, in any event, either accept the plan or "receive or retain . . . on account of [the plan] property of a value that is not less than the amount that such holder would so receive or retain if the debtor were liquidated" in straight bankruptcy.[78] In addition, at least one class of impaired claims must accept the plan.[79] Finally, the plan must satisfy a "feasibility test."[80] Under section 1129(a)(11) of the Code, the bankruptcy court must determine that confirmation "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor . . . under the plan, unless such liquidation or reorganization is proposed in the plan."[81] Under this standard, the court must examine "the adequacy of the capital structure; the business's earning power; economic conditions; management's ability; the probability of the present management's continuation; and any other factors related to the successful performance of the plan."[82] The court must satisfy itself that a rea-

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75. *Id.* at 422 (quoting from *In re* Clark, 738 F.2d 869, 871 (7th Cir. 1984)); *see infra* text accompanying notes 130-32.

76. *See In re* Hewitt, 16 Bankr. 973, 977-80 (Bankr. D. Alaska 1982). There is substantial authority in the Chapter 13 de-acceleration context. *See infra* notes 130-38 and accompanying text.

77. *See* 11 U.S.C. § 1126(c) (1982).

78. *See* 11 U.S.C. § 1129(a)(7)(A)(ii) (1982); Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441, 448 (1984).

79. *See* 11 U.S.C. § 1129(a)(10) (1982).

80. Broude, *supra* note 78, at 448.

81. *See* 11 U.S.C. § 1129(a)(11) (1982).

82. *In re* Polytherm Indus., 33 Bankr. 823, 831 (Bankr. W.D. Wis. 1983); *see In re* White, 41 Bankr. 227, 230 (Bankr. M.D. Tenn. 1984); *In re* Merrimack Valley Oil Co., 32 Bankr. 485, 488 (Bankr. D. Mass. 1983); *In re* Huckabee Auto Co., 33 Bankr. 141, 145 n.2 (Bankr. M.D. Ga. 1981).

sonable expectation of success exists.[83]

B. *The Cram-Down Concept*

Suppose that an impaired class fails to approve the plan. In that event, the debtor may invoke the "cram-down" power of the Act to gain confirmation of the plan over the objection of such a class.[84] However, "cram-down" is permitted only if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims that is impaired under, and has not accepted, the plan.[85] The unfair discrimination concept applies "only to the dissenting class and not to the plan in its entirety."[86] While there is little case law on this issue, there is authority that unfair discrimination exists when, for example, trade debt claims are treated separately from the unsecured claims of otherwise secured creditors.[87]

To be "fair and equitable" in the dissenting real estate mortgagee creditor context, section 1129(b)(2)(A) requires that one of three approaches be followed.[88] Under the first, the debtor can continue to operate the real estate subject to the mortgage, but the mortgagee must receive present or deferred cash payments equal to the amount of the mortgage debt and having a value that is not less than the value of the mortgaged real estate.[89] This approach "allows the [mortgagee] to recover the face amount of the debt, because he can elect to have his entire claim treated as secured even if in fact it is undersecured. Moreover, the debtor must pay for any deferment or debt extension at current interest rates . . . ."[90] Under the second alternative, the real estate will be sold, but the mortgage lien will transfer to the sale proceeds.[91] This option will be unappealing to a debtor whose major asset is a single piece of rental real estate.[92] The final approach allows a court to confirm a plan that provides for the mortgagee to realize the "indubitable equivalent" of its claim.[93] As one commentator has noted, "[m]ore has been written on indubitable equivalence with less effect than on almost any other area of bankruptcy

83. *See In re* White, 41 Bankr. 227, 230 (Bankr. M.D. Tenn. 1984); *In re* Huckabee Auto Co., 33 Bankr. 141, 145 n.2 (Bankr. M.D. Ga. 1981).
84. *See* Broude, *supra* note 78 at 450-51; Comment, *supra* note 62, at 256-58. *See generally* Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 CASE W. RES. L. REV. 301 (1982); Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C.L. REV. 925 (1980); Klee, *All You Ever Wanted to Know About Cram Down Under the Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979).
85. *See* 11 U.S.C. § 1129(b) (1982); Broude, *supra* note 78, at 450-51.
86. Broude, *supra* note 78, at 451.
87. *Id.*
88. *See* 11 U.S.C. § 1129(b)(2)(A) (1982).
89. *See* 11 U.S.C. § 1129(b)(2)(A)(i) (1982).
90. Comment, *supra* note 62, at 273.
91. *See* 11 U.S.C. § 1129(b)(2)(A)(ii) (1982).
92. Comment, *supra* note 62, at 273.
93. *See* 11 U.S.C. § 1129(b)(2)(A)(iii) (1982).

law."[94] Moreover, as one bankruptcy court noted, "there seems to be little controlling precedential definition of indubitable equivalent."[95] Legislative history suggests that the concept was intended to encompass abandonment of the security to the mortgagee or the granting of a lien on substitute security.[96]

IV. The Chapter 13 "Wage Earner" Plan

The Chapter 13 plan to some extent is to the salaried person or wage earner what Chapter 11 is to the corporate or other commercial entity. Such a proceeding may be utilized by an individual who has a regular income and owes secured debt not in excess of $350,000 and unsecured debt not exceeding $100,000.[97] The plan must be completed within three years of confirmation unless the bankruptcy court approves a longer period not to exceed five years.[98] The Chapter 13 trustee may exercise the same avoidance powers that are available to his or her straight bankruptcy counterpart.[99] However, the trustee usually is passive and the debtor typically remains in possession of the estate.[100] Even though the Act confers no general avoidance powers on the debtor, bankruptcy courts frequently authorize the debtor to exercise such powers.[101] The legislative history of Chapter 13 provides a valuable insight into its purpose and operation:

> The purpose of Chapter 13 is to enable an individual, under court supervision and protection, to develop and perform under a plan for the repayment of his debts over an extended period. In some cases, the plan will call for full repayment. In others, it may offer creditors a percentage of their claims in full settlement. During the repayment period, creditors may not harass the debtor or seek to collect their debts. They must receive payments only under the plan. This protection relieves the debtor from indirect and direct pressures from creditors, and enables him to support himself and his dependents while repaying his creditors at the same time.
>
> The benefit to the debtor of developing a plan of repayment under chapter 13, rather than opting for liquidation under chapter 7, is that it permits the debtor to protect his assets. In a liquidation case, the debtor must surrender his nonexempt assets for liquidation and sale by the trustee. Under chap-

94. Broude, *supra* note 78, at 452.
95. *In re* Gemini at Dadeland, Ltd., 36 Bankr. 129, 130 (Bankr. S.D. Fla. 1983).
96. Broude, *supra* note 78, at 452.
97. *See* 11 U.S.C. § 109(e) (1982).
98. *See* 11 U.S.C. § 1322(c) (1982).
99. *See* 11 U.S.C. § 1302(b) (1982).
100. *See* 11 U.S.C. § 1306(b) (1982); Henning, *An Analysis of* Durrett *and its Impact on Real and Personal Property Foreclosures: Some Proposed Modifications*, 63 N.C.L. Rev. 257, 283 n.154 (1984).
101. *See, e.g.*, *In re* Hall, 752 F.2d 582 (11th Cir. 1985); *In re* Cowart, 43 Bankr. 110 (Bankr. M.D. Fla. 1984); *In re* Dudley, 38 Bankr. 666 (Bankr. M.D. Pa. 1984); *In re* Wheeler, 34 Bankr. 818 (Bankr. N.D. Ala. 1983); *In re* Worcester, 28 Bankr. 910 (Bankr. C.D. Cal. 1983); Henning, *supra* note 100, at 283 n.154.

ter 13, the debtor may retain his property by agreeing to repay his creditors. Chapter 13 also protects a debtor's credit standing far better than a straight bankruptcy, because he is viewed by the credit industry as a better risk. In addition, it satisfies many debtors' desire to avoid the stigma attached to straight bankruptcy and to retain the pride attendant on being able to meet one's obligations. The benefit to creditors is self-evident: their losses will be significantly less than if their debtors opt for straight bankruptcy.[102]

When the debtor has completed the plan, all unsecured debts are discharged except alimony and child support obligations and those debts where the last payment is to be made after the expiration of the plan.[103] While the plan can regulate or sometimes modify the repayment of installments and arrearages on real estate mortgage debts (with the possible exception of mortgages on the debtor's principal residence) until the expiration of the plan, it cannot affect those mortgage payments coming due after its expiration date.[104] Thereafter, the debtor is required to make future payments as if no plan had existed.

Real estate mortgagees in a Chapter 13 proceeding are subject to the general stay provisions contained in section 362 of the Code.[105] In addition, there is a special stay provision protecting third parties who have guaranteed the bankrupt's debt or put up property to secure it.[106] Section 1301 provides that "a creditor may not act, or commence or continue any civil action, to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor or that secured such debt unless such individual became liable on or secured such debt in the ordinary course of such individual's business."[107] A "consumer debt" is one "incurred by an individual primarily for a personal, family or household purpose."[108] Thus, while the stay imposed by section 362 bars a mortgagee from foreclosing against the property of the mortgagor, section 1301 stays a mortgagee who holds "consumer debt" from foreclosing against the real estate of third parties that has been used as security for the mortgagor's non-business related debt.

A. *De-acceleration of Home Mortgage*

Often the only or, in any event, the most significant real estate mortgagee in a Chapter 13 proceeding is the holder of a mortgage on the debtor's home.[109] While section 1322(b)(2) provides that the plan may, under certain

102. H.R. REP. No. 595, 95th Cong., 2d Sess. 118, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6079.
103. *See* 11 U.S.C. § 1328 (1982); *see* Comment, *Home Foreclosures Under Chapter 13 of the Bankruptcy Reform Act*, 30 UCLA L. REV. 637, 643-46 (1983).
104. *See* 11 U.S.C. § 1328(a)(1) (1982).
105. *See* 11 U.S.C. § 362 (1982).
106. *See* 11 U.S.C. § 1301 (1982).
107. *See* 11 U.S.C. § 1301(a)(1) (1982).
108. *See* 11 U.S.C. § 101(7) (1982).
109. *See, e.g.*, Comment, *supra* note 103, at 646.

circumstances, "modify the rights of holders of secured claims,"[110] it prohibits such modification as to any holder of a "claim secured only by a security interest in real property that is the debtor's principal residence."[111] As one court has noted, this latter exception "was in response to perceptions, or to suggestions advanced in the legislative hearings . . . that home-mortgagor lenders, performing a valuable social service through their loans, needed special protection against modification."[112] Yet section 1322(b) also contains important cross-current provisions. Section 1322(b)(3) provides for the "curing or waiving of any default."[113] Moreover, section 1322(b)(5) specifies that "notwithstanding [section 1322(b)(2)]" the plan may "provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any . . . secured claim on which the last payment is due after the date on which the final payment under the plan is due."[114]

Attempts to reconcile the foregoing provisions have proved extremely difficult when debtors attempt to utilize the "cure" language to defeat a mortgage acceleration that has occurred prior to a Chapter 13 filing. Mortgagees argue that to permit "de-acceleration" under such circumstances would amount to an impermissible modification under section 1322(b)(2). Under this reasoning section 1322(b)(3) is read literally to be inapplicable to a home mortgage debt.[115] Consequently, a default on such a mortgage is curable, if at all, under section 1322(b)(5) and then only if "the last payment is due after the date on which the final payment under the plan is due."[116] As one federal Court of Appeals remarked,

> if so read,—and if the term 'on which the last payment is due' is given its state law meaning as to an accelerated debt that thereby becomes fully 'due' . . . it would thus bar—whenever the home mortgage debt had been accelerated prior to a debtor's petition—any Chapter 13 relief by which the debtor could save his home by paying past-due amounts on his home-mortgage through periodic payments under the term of his Chapter 13 plan.[117]

Indeed, several bankruptcy court decisions take such a restrictive approach to the right to cure.[118]

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110. *See* 11 U.S.C. § 1322(b)(2) (1982).

111. *Id.*

112. Grubbs v. Houston First Am. Sav. Assoc., 730 F.2d 236, 246 (5th Cir. 1984).

113. *See* 11 U.S.C. § 1322(b)(3) (1982).

114. *See* 11 U.S.C. § 1322(b)(5) (1982).

115. Grubbs v. Houston First Am. Sav. Assoc., 730 F.2d 236, 241 n.8 (5th Cir. 1984).

116. *Id.*

117. *Id.* at 241.

118. *See, e.g.*, *In re* Britton, 35 Bankr. 373 (Bankr. N.D. Ind. 1982); *In re* Williams, 11 Bankr. 504 (Bankr. S.D. Tex. 1981); *In re* LaPaglia, 8 Bankr. 937 (Bankr. E.D.N.Y. 1981); *In re* Soderlund, 18 Bankr. 12 (Bankr. S.D. Ohio 1981); *In re* Allen, 17 Bankr. 119 (Bankr. N.D. Ohio 1981), *rev'd*, 42 Bankr. 360 (N.D. Ohio 1984).

The foregoing approach was rejected in *In re Taddeo*,[119] a leading decision by the United States Court of Appeals for the Second Circuit. In that case, the debtors were permitted, pursuant to their Chapter 13 plan, to defeat a pre-petition mortgage acceleration by payment of arrearages and to reinstate the mortgage's original amortization schedule. Not only did the court hold that the "concept of 'cure' in section 1322(b)(5) contains the power to de-accelerate,"[120] but also that "the ban on 'modification' in section 1322(b)(2) does not limit the [debtors'] exercise of their curative powers under either section 1322(b)(3) or (b)(5)."[121] Consequently, the debtors were permitted to cure their default under (b)(3) and thereafter maintain their payments pursuant to (b)(5). In buttressing its conclusion, the Second Circuit not only rejected the argument that (b)(3) was inapplicable to home mortgages,[122] it emphasized:

> First, we think that the power to cure must comprehend the power to "de-accelerate." This follows from the concept of "curing a default." A default is an event in the debtor-creditor relationship which triggers certain consequences—here, acceleration. Curing a default commonly means taking care of the triggering event and returning to pre-default conditions. The consequences are thus nullified. This is the concept of "cure" used throughout the Bankruptcy Code . . . . Secondly, we believe that the power to "cure any default" granted in § 1322(b)(3) and (b)(5) is not limited by the ban against "modifying" home mortgages in § 1322(b)(2) because we do not read "curing defaults" under (b)(3) or "curing defaults and maintaining payments" under (b)(5) to be modifications of claims.[123]

Moreover, *Taddeo* rejected the contention that state law governs the effect of acceleration and the debtor's ability to cure a default.[124] Rather, it concluded that, by enacting section 1322(b), Congress intended to permit cure in bankruptcy proceedings. The court did "not believe that Congress labored for five years over this controversial question only to remit consumer debtors—intended to be primary beneficiaries of the new Code—to the harsher mercies of state law."[125]

Taddeo is supported by important policy considerations. As the *Taddeo* court itself stressed, "conditioning a debtor's right to cure on its having filed a Chapter 13 petition prior to acceleration would prompt unseemly and wasteful races to the courthouse. Worse, these would be races in which mortgagees possess an unwarranted and likely insurmountable advantage: wage earners seldom will possess the sophistication in bankruptcy matters that financial in-

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119. 685 F.2d 24 (2d Cir. 1982). For an excellent analysis of *Taddeo*, see Zaretsky, *Some Limits on Mortgagees' Rights in Chapter 13*, 50 BROOKLYN L. REV. 433 (1984).

120. *In re* Taddeo, 685 F.2d at 28.

121. *Id.*

122. *Id.* at 27.

123. *Id.* at 26-27.

124. *Id.* at 28.

125. *Id.* at 25.

stitutions do, and often will not have retained counsel in time for counsel to do much good."[126] Moreover, even assuming a relatively high level of debtor sophistication, an anti-*Taddeo* approach may well encourage premature bankruptcy petitions rather than debtor attempts to resolve their financial problems by negotiation, mediation, or other extrajudicial means.[127] In addition, a "refusal to permit de-acceleration . . . would probably . . . encourage mortgagees to declare defaults and accelerate earlier to avoid the necessity of dealing with a Chapter 13 debtor."[128] At a practical level, to the extent that a rejection of *Taddeo* results in foreclosure and forces the debtor to find other shelter, many Chapter 13 plans may well be jeopardized. More important, because the family residence is frequently the debtor's major asset and Chapter 13 is often utilized to protect it, an anti-*Taddeo* approach would substantially discourage Chapter 13 usage, a result which Congress, given its preference for debtor rehabilitation over liquidation, could hardly have intended.

Subsequent decisions by the federal courts of appeal and most bankruptcy courts have endorsed the *Taddeo* rationale.[129] So too has substantial scholarly commentary.[130] This does not mean, however, that *Taddeo* affords an open-ended right to de-accelerate all home mortgage loans in default irrespective of their terms. Suppose, for example, that the total principal balance of a home mortgage debt becomes due, not as the result of acceleration based on mortgagor failure to make timely installment payments, but rather because the terms of the loan called for a final "balloon" payment which mortgagor failed to pay. It is unlikely that such a mortgagor will be able to use *Taddeo* and its progeny to de-accelerate the balloon in order to pay it off on an installment

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126. *Id.* at 27.

127. Zaretsky, *supra*, note 119, at 443.

128. *Id.* at 443.

129. *See In re* Clark, 738 F.2d 869 (7th Cir. 1984); Grubbs v. Houston First Am. Sav. Assoc., 730 F.2d 236 (5th Cir. 1984); *In re* Parker, 46 Bankr. 106 (Bankr. N.D. Ga. 1985); *In re* Fisher, 35 Bankr. 678 (Bankr. N.D. Ohio 1983); *In re* Christian, 35 Bankr. 229 (Bankr. N.D. Ga. 1983); *In re* Frey, 34 Bankr. 607 (Bankr. M.D. Pa. 1983); *In re* Hardin, 16 Bankr. 810 (Bankr. N.D. Tex. 1982); *In re* Smith, 19 Bankr. 592, 593 (Bankr. N.D. Ga. 1982); *In re* Gooden, 21 Bankr. 456, 458 (Bankr. N.D. Ga. 1982); *In re* Kokkinis, 22 Bankr. 353 (Bankr. N.D. Ill. 1982); *In re* Young, 22 Bankr. 620 (Bankr. N.D. Ill. 1982); *In re* Evans, 22 Bankr. 980 (Bankr. S.D. Cal. 1982), *aff'd*, 30 Bankr. 530 (9th Cir. 1983); *In re* Briggs, 25 Bankr. 317 (D.N.D. 1982); *In re* Acevedo, 26 Bankr. 994 (E.D.N.Y. 1982); *In re* Rippe, 14 Bankr. 367 (Bankr. S.D. Fla. 1981; *In re* Davis, 15 Bankr. 22 (Bankr. D. Kan.), *aff'd*, 16 Bankr. 473 (D. Kan. 1981).

130. Zaretsky, *supra* note 119; Sable, *A Chapter 13 Debtor's Right to Cure Default Under Section 1322(b): A Problem of Interpretation*, 57 AM. BANKR. L.J. 127, 139-40 (1983); Comment, *supra* note 103, at 658-65; Comment, *Chapter 13 Bankruptcy: When May a Mortgage Debtor Cure the Accelerated Mortgage Debt Using Section 1322(b)(5)?*, 8 U. DAYTON L. REV. 109, 121-25 (1982); Note, *Bankruptcy—Mortgages—Despite Pre-Bankruptcy Acceleration of a Mortgage Under State Law, A Debtor Can Cure Default and Reinstate the Original Payment Schedule Under Chapter 13 of the Bankruptcy Code.*—In re Taddeo, 685 F.2d 24 (2d Cir. 1982), 52 U. CIN. L. REV. 196, 206-07 (1983).

basis. Indeed, the United States Court of Appeals for the Ninth Circuit held in this connection that to permit "de-acceleration" under such circumstances would constitute an impermissible "modification" under section 1322(b)(2).[131] According to the court,

> [w]hen a debt has been accelerated, 'cure' therefore results in the reinstatement of the original payment terms of the debt. But when a debt has already matured, . . . 'cure' . . . cannot aid the debtor, since reinstatement of the original terms of the debt will merely make the debt immediately due and payable.[132]

While the foregoing approach clearly burdens many homeowners who, because of "creative financing" techniques agree to balloon payments and find themselves unable to refinance them, it clearly is correct. It is one thing to de-accelerate a loan where the parties contemplated that it would be fully amortized by installment payments and quite another to do so where the balloon payment was an essential and bargained for element of the transaction.

Substantial differences remain as to when in the foreclosure process the *Taddeo* de-acceleration right should be cut off. Several cases suggest that de-acceleration should not be permitted after a foreclosure judgment has been entered.[133] Such decisions reflect a concern for protecting the finality of state court judgments and the avoidance of undue mortgage market uncertainty. Other cases, on the other hand, have permitted post-judgment de-acceleration.[134] The latter approach seems preferable. A foreclosure judgment only confirms that the entire debt is now due and owing and that the mortgagee may sell the property, although the debtor is still in possesion. Despite the mortgagee's efforts in obtaining the judgment, the debtor should be able to de-accelerate, especially since his residence is involved. In any event, the mortgage agreement will often allow the mortgagee to recover both the expenses of foreclosure and a subsequent judgment.[135]

To what extent should *Taddeo* de-acceleration be permitted after the foreclosure sale? The answer in large measure should depend on how "final" the foreclosure sale is under state law. For example, when the sale divests the mortgagor of all interest in the real estate, the debtor should not be allowed to

131. *In re* Seidel, 752 F.2d 1382 (9th Cir. 1985).

132. *Id.* at 1386.

133. *In re* White, 22 Bankr. 542 (Bankr. D. Del. 1982); *In re* Anderson, 16 Bankr. 697 (Bankr. S.D. Ohio 1982); *In re* Jenkins, 14 Bankr. 748 (Bankr. N.D. Ill. 1981); *In re* Land, 14 Bankr. 132 (Bankr. N.D. Ohio 1981); *In re* Davis, 15 Bankr. 22 (Bankr. D. Kan. 1981), *aff'd*, 16 Bankr. 473 (D. Kan. 1981); *In re* Wilson, 11 Bankr. 986 (Bankr. S.D.N.Y. 1981); *In re* Pearson, 10 Bankr. 189 (Bankr. E.D.N.Y. 1981).

134. *In re* Clark, 738 F.2d 869 (7th Cir. 1984); *In re* Tuchman, 29 Bankr. 39 (Bankr. S.D.N.Y. 1983); *In re* McCann, 27 Bankr. 678 (Bankr. S.D. Ohio 1982); *In re* McSorley, 24 Bankr. 795 (Bankr. D.N.J. 1982); *In re* Hubbard, 23 Bankr. 671 (Bankr. S.D. Ohio 1982); *In re* Acevedo, 26 Bankr. 994 (E.D.N.Y. 1982); *In re* Young, 22 Bankr. 620 (Bankr. N.D. Ill. 1982); *In re* Taylor, 21 Bankr. 179 (Bankr. W.D. Mo. 1982); *In re* Smith, 19 Bankr. 592 (Bankr. N.D. Ga. 1982).

135. Zaretsky, *supra* note 119, at 447.

restore the original payment schedule. A purchaser has no expectation of losing the property, and the debtor's interest should thus be permanently terminated.[136] On the other hand, about half the states have post-sale redemption statutes, under which the mortgagor and, in many cases, junior lienholders, have the right to redeem the foreclosed real estate for a specified period of time by paying the foreclosure sale purchaser the sale price.[137] Thus, the interest in finality is less compelling in a *Taddeo* sense because the foreclosure title is already defeasible. Indeed, several courts have applied the *Taddeo* concept in such situations.[138]

It may, however, be unwise to apply *Taddeo* in such contexts without drawing a further distinction between the mortgagee and a third party as foreclosure sale purchasers. When a mortgagor redeems under statutory redemption, as the foregoing indicates, she typically pays the foreclosure purchaser the foreclosure sale price in a lump sum. On the other hand, in post-sale de-acceleration, the goal of the mortgagor is simply to satisfy mortgage arrearages and to restore the original amortization schedule. If the mortgagee is the foreclosure sale purchaser, there should be no significant difference between a pre- and post-foreclosure de-acceleration. Any additional expenses incurred by the mortgagee will presumably be added to the mortgage balance.[139] Indeed, in many statutory redemption states the mortgagor retains the right to possession during the statutory period and, in those jurisdictions, de-acceleration will have no effect on possession.[140] On the other hand, when a third party purchases at the foreclosure sale, he relies on the fact that if the property is redeemed, he will receive a refund of the purchase price in a lump sum. Consequently, it seems especially inequitable to force him to accept redemption by installment under a Chapter 13 plan.[141]

Missouri mortgagors, however, will find only limited comfort in *Taddeo* as a post-foreclosure remedy. Unlike under most state statutory redemption systems, a Missouri mortgagor has no redemption rights unless the mortgagee is the foreclosure sale purchaser.[142] Consequently, if a third party purchases at an otherwise valid sale, the latter's title is non-defeasible and *Taddeo* thus should be inapplicable.

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136. *Id.* at 448; *accord In re* Smith, 43 Bankr. 313 (Bankr. N.D. Ill. 1984); *In re* Cretella, 42 Bankr. 526 (Bankr. E.D.N.Y. 1984); *In re* Nimai Kumar Ghosh, 38 Bankr. 600 (Bankr. E.D.N.Y. 1984); *In re* Wallace, 31 Bankr. 64 (Bankr. Md. 1983).

137. *See* G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW § 8.4 (2d Ed. 1985).

138. *See In re* Ivory, 32 Bankr. 788 (Bankr. D. Or. 1983); *In re* Chambers, 27 Bankr. 687 (Bankr. S.D. Fla. 1983); *In re* Kokkinis, 22 Bankr. 353 (Bankr. N.D. Ill. 1982); *In re* Gooden, 21 Bankr. 456 (Bankr. N.D. Ga. 1982); *In re* Thompson, 17 Bankr. 748 (Bankr. W.D. Mich. 1982).

139. Zaretsky, *supra* note 119, at 448.

140. *See* G. NELSON & D. WHITMAN, *supra* note 137, at §§ 8.4-8.6.

141. Zaretsky, *supra* note 119, at 450.

142. MO. REV. STAT. § 443.410 (1978); Comment, *Statutory Redemption Following Power of Sale Foreclosure in Missouri*, 47 MO. L. REV. 309, 314 (1982).

Even where the mortgagee is the sale purchaser, the mortgagor's redemption rights are not triggered unless at the sale or within ten days before it he gives the trustee written notice of an intent to redeem.[143] Moreover, he must also post a redemption bond within twenty days after the sale in an amount and in a form approved by the circuit court in the county where the land is located.[144] If the foregoing requirements are satisfied, the mortgagor has a one year period in which to redeem by payment to the mortgagee of an amount equal to the mortgage debt plus costs of sale and other additional sums.[145] Clearly, if the mortgagor fails to satisfy the pre-sale notification requirement, no statutory right survives the sale and, accordingly, neither should a *Taddeo* claim.[146] On the other hand, if the requisite notice is given and the bond is approved, the one year period is triggered and based on the reasoning of the earlier paragraphs in this subsection, a mortgagor who files a Chapter 13 proceeding during that period should be able to utilize a *Taddeo* de-acceleration to set aside the foreclosure sale. Moreover, even if the filing of the Chapter 13 proceeding occurs after the foreclosure sale but prior to the posting of the bond, since the mortgagor's statutory rights are still alive, an assertion of a *Taddeo* claim during that period may well be successful even though the bond is not ultimately approved.

B. *Relief from a Chapter 13 Stay*

As noted earlier, section 362(d) of the Act authorizes relief from the stay "(1) for cause, including the lack of adequate protection of an interest in property of [the mortgagor]; or (2) . . . if (A) the [mortgagor] does not have an equity in such property; and (B) such property is not necessary to an effective reorganization."[147] However, there has been substantial disagreement about whether (d)(2), as well as (d)(1), is applicable in Chapter 13 proceedings.[148] There is significant case law that it is and that a mortgagee is entitled to stay relief under either subsection.[149] Indeed, section 103 of the Act expressly states that Chapter 3, which includes section 362, is applicable to Chapter 13.[150] On the other hand, there is substantial case authority to the contrary[151]

143. Mo. Rev. Stat. § 443.410 (1978).

144. Mo. Rev. Stat. § 443.420 (1978).

145. *Id.*

146. *See In re* Taylor, Civ. Action No. 82-00559-CV-W (W.D. Mo. 1982), an unpublished federal district court opinion reversing 21 Bankr. 179 (Bankr. W.D. Mo. 1981). The latter opinion had utilized § 1322(b)(5) to set aside a foreclosure sale even though the mortgagor had failed to provide the notice required by Mo. Rev. Stat. § 443.410 (1978).

147. *See* 11 U.S.C. § 362(d) (1982); *see also* text accompanying notes 38-39, *supra.*

148. *See* Comment, *supra* note 103 at 646-47, 660-61.

149. *See, e.g., In re* Crouse, 9 Bankr. 400 (Bankr. S.D. Tex. 1981); First Conn. Small Business Inv. Co. v. Ruark, 7 Bankr. 46 (Bankr. D.C. Conn. 1980); *In re* Zellmer, 6 Bankr. 497 (Bankr. N.D. Ill. 1980).

150. *See* 11 U.S.C. § 103(a) (1982).

and a supporting textual argument as well. Since section 362(d)(2) refers to a "reorganization," it has been asserted that it is applicable only to Chapter 11, which is entitled "Reorganization," and not to Chapter 13 because the latter chapter is entitled "Adjustment of Debts of an Individual with Regular Income."[152] Moreover, a convincing policy argument may be made for the latter position.[153] According to one recent bankruptcy decision,

> If subsection (d)(2) applies, a debtor [who has] no equity in property which is not necessary to consumate a chapter 13 plan could, through lift-stay actions, be involuntarily dispossessed of such property; the purpose, however, of chapter 13 is to enable individual debtors with regular incomes to develop and perform a plan for the repayment of debts over an extended period of time. . . . The emphasis is on providing individuals with regular incomes an alternative to liquidation. . . . Hence, it is the ability of the individual debtors to furnish the creditor with the value of his interest [in the form of property or from current earnings], which is the key to the protection of the chapter 13 creditor. . . . Whether the [property] being retained by the debtor is necessary to the subsistence or rehabilitation of the debtor, or whether the debtor has any equity in [it] are not factors of concern [applicable or relevant] to Chapter 13 proceedings.[154]

In any event, stay relief after the confirmation of a Chapter 13 plan becomes much more problematical. However the foregoing section 362 question is ultimately resolved, once the plan becomes effective, bankruptcy courts will be reluctant to risk its failure by permitting foreclosure of the debtor's residence. Indeed, case law suggests that only significant debtor default under the plan will justify a dissolution of the stay.[155]

V. Setting Aside Pre-Bankruptcy Foreclosures

Traditionally, foreclosure sale purchasers have had relatively little to fear from subsequent mortgagor bankruptcy. Unless it could be established that the foreclosure violated state law or that the mortgage itself was avoidable, foreclosures were relatively secure from bankruptcy attack. To be sure, in jurisdictions that utilize statutory redemption,[156] a trustee in bankruptcy has the right to exercise the mortgagor-debtor's redemption rights.[157] However, the bankruptcy court probably does not have general equitable authority to stay

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151. *See, e.g., In re* Rhoades, 34 Bankr. 168 (Bankr. D. Vt. 1983); *In re* Feimster, 3 Bankr. 11 (Bankr. N.D. Ga. 1979); *see also In re* Sulzer, 2 Bankr. 630 (Bankr. S.D.N.Y. 1980); *In re* Youngs, 7 Bankr. 69 (Bankr. D.C. Mass. 1980).

152. Comment, *supra* note 103 at 648.

153. *See In re* Rhodes, 34 Bankr. 168, 171 (Bankr. D. Vt. 1983); Comment, *supra* note 103 at 661.

154. *In re* Rhodes, 34 Bankr. 168, 171 (Bankr. D. Vt. 1983).

155. *See, e.g, In re* Pizzullo, 33 Bankr. 740 (Bankr. E.D. Pa. 1983); *In re* Evans, 22 Bankr. 980 (Bankr. S.D. Cal. 1982).

156. *See* G. Nelson & D. Whitman, *supra* note 137, §§ 8.4-8.7.

157. *See supra* notes 150-52 and authorities cited therein.

the running of the redemption period.[158] Moreover, under the weight of authority, the automatic stay does not operate to toll the running of such periods.[159] The trustee may, however, pursuant to section 108(b) of the Bankruptcy Code redeem within the later of the expiration of the redemption period or sixty days after the filing of the bankruptcy petition.[160]

However troublesome the foregoing redemption rights may be for mortgagees and other foreclosure purchasers, they do not threaten the validity of pre-bankruptcy foreclosure sales. Recent developments, however, have eroded much of the traditional protection afforded such foreclosures. We have already explored in the preceding section how the *Taddeo* concept may be used in certain Chapter 13 contexts to de-accelerate previously foreclosed mortgage debts.[161] In addition, an increasing number of courts are utilizing the fraudulent conveyance provisions of the Bankruptcy Code to set aside pre-bankruptcy foreclosures. Moreover, to a much more limited extent, such foreclosures have been subjected to successful attack as voidable preferences. These latter two developments are explored in detail in this section.

A. *The Foreclosure Sale as a Fraudulent Conveyance*

1. The *Durrett* Problem

Under section 548(a) of the Bankruptcy Act not only may a trustee set aside a transfer by a debtor within a year of bankruptcy that was intended to defraud, hinder, or delay present or future creditors, she may also avoid such a transfer, irrespective of debtor intent, if the debtor "received less than a rea-

158. *See In re* Martinson, 731 F.2d 543 (8th Cir. 1984); Johnson v. First Nat'l Bank, 719 F.2d 270 (8th Cir. 1983); *In re* Lally, 38 Bankr. 622 (Bankr. D. Iowa); *In re* Martinson, 26 Bankr. 648 (D.C.N.D. 1983); *In re* Owens, 27 Bankr. 946 (Bankr. E.D. Mich. 1983).

159. *See* Johnson v. First Nat'l Bank, 719 F.2d 270 (8th Cir. 1983); Bank of Commonwealth v. Bevan, 13 Bankr. 989 (E.D. Mich. 1981); *In re* Owens, 27 Bankr. 946 (Bankr. E.D. Mich. 1983); *In re* Cucumber Creek Dev., 33 Bankr. 820 (D. Colo. 1983). *Contra In re* Smith, 43 Bankr. 313 (Bankr. N.D. Ill. 1984); *In re* Shea Realty, Inc., 21 Bankr. 790 (Bankr. Vt. 1982).

160. *See In re* Owens, 27 Bankr. 946 (Bankr. E.D. Mich. 1983); *In re* Cucumber Creek Dev., Inc., 33 Bankr. 820 (D. Colo. 1983). Section 108(b) provides as follows:

> (b) Except as provided in subsection (a) of this section, if applicable law, an order entered in a proceeding, or an agreement fixes a period within which the debtor or an individual protected under section 1301 of this title may file any pleading, demand, notice, or proof of claim or loss, cure a default, or perform any other similar act, and such period has not expired before the date of the filing of the petition, the trustee may only file, cure, or perform, as the case may be, before the later of—
>
> (1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; and
>
> (2) 60 days after the order for relief.

11 U.S.C. § 108(b) (1982).

161. *See supra* IV(A).

sonably equivalent value in exchange for such transfer . . . and was insolvent on the date that such transfer was made."[162] *Durrett v. Washington National Insurance Co.*,[163] a 1980 Fifth Circuit decision under the predecessor to section 548(a), marked the first time that a court used the fraudulent conveyance concept to invalidate a non-collusive foreclosure sale that was otherwise valid under state law.[164] In that case, a trustee under a Texas deed of trust sold the mortgaged real estate having a fair market value of $200,000 to a third party purchaser for $115,400. Nine days later Durrett, the mortgagor, filed a petition for reorganization under the predecessor to Chapter 11 and, in his capacity as debtor-in-possession, sought to set aside the foreclosure as a fraudulent conveyance. The district court held that the foreclosure sale constituted a transfer by the debtor, but denied Durrett's request on the ground that the sale produced "a fair equivalent" of the value of the real estate. The court of appeals agreed that a transfer had taken place, but reversed the district court on the consideration issue. The court acknowledged that two transfers had taken place—the first, when the deed of trust was executed eight years earlier and which was no longer vulnerable, and a second, when the foreclosure sale took place. The latter qualified as a transfer because, under Texas law, it passed to the purchaser the debtor-mortgagor's right to possession. Moreover, it clearly fell within the statutory period. As to the consideration issue, the court suggested that a foreclosure price of less than seventy percent of the property's fair market value failed to meet the "fair equivalency" test under the then existing statute.

Durrett has been followed in numerous section 548(a) cases, including *In re Hulm*,[165] a decision by the Eighth Circuit. It has been applied to judicial foreclosures,[166] strict foreclosures,[167] and a variety of power of sale and other non-judicial contexts.[168] The decisions involve reorganizations under Chapters

162. *See* 11 U.S.C. §§ 548(a)(2)(A), 548(a)(2)(B)(i) (1982). A debtor is "insolvent" if its debts are greater than its assets, at a fair valuation, exclusive of property exempted or transferred with actual fraudulent intent. *In re* Wheeler, 34 Bankr. 818, 822 (Bankr. N.D. Ala. 1983); *see* 11 U.S.C. § 101(29) (1982).

163. 621 F.2d 201 (5th Cir. 1980).

164. Several pre-*Durrett* cases concluded that a noncollusive foreclosure sale that yields less than fair market value was not a fraudulent conveyance. *See* Merriam v. Winpfheimer, 25 F. Supp. 405 (S.D.N.Y. 1938); Pierce v. Pierce, 16 Cal. App. 375, 117 P. 580 (1911).

165. 738 F.2d 323 (8th Cir. 1984); *see infra* notes 166-72 and cases cited therein. *But see In re* Winshall Settlor's Trust, 758 F.2d 1136 (6th Cir. 1985).

166. *See In re* Hulm, 738 F.2d 323 (8th Cir. 1984); *In re* Dudley, 38 Bankr. 666 (Bankr. M.D. Pa. 1984); *In re* Jones, 20 Bankr. 988 (Bankr. E.D. Pa. 1982).

167. *See In re* Carr, 34 Bankr. 653 (Bankr. D. Conn. 1983); *In re* Berge, 33 Bankr. 642 (W.D. Wis. 1983); *In re* Perdido Bay Country Club Estates, 23 Bankr. 36 (Bankr. S.D. Fla. 1982) (applying Vermont law).

168. *See In re* Wheeler, 34 Bankr. 818 (Bankr. N.D. Ala. 1983); *In re* Smith, 24 Bankr. 19 (Bankr. W.D.N.C. 1982); *In re* Richardson, 23 Bankr. 434 (Bankr. D. Utah 1982); *In re* Thompson, 18 Bankr. 67 (Bankr. E.D. Tenn. 1982); *In re* Marshall, 15 Bankr. 738 (Bankr. W.D.N.C. 1981).

11[169] and 13[170] as well as liquidations under Chapter 7.[171] Moreover, the "70% rule of thumb" is being increasingly institutionalized.[172]

2. Cases Rejecting *Durrett*

Two significant cases, each using a different rationale, reject the *Durrett* approach. The first, *In re Alsop*,[173] involved a power of sale foreclosure under a deed of trust that occurred two days prior to the filing of a Chapter 11 petition. The debtor-in-possession sought to avoid the foreclosure as a fraudulent transfer. The Bankruptcy Court for the District of Alaska rejected *Durrett* by applying a "relation back" analysis. While the *Alsop* court conceded that a transfer occurred at the time of the foreclosure sale, it stressed that section 548(d)(1) of the Act also needed to be considered.[174] Under this latter provision, a transfer is deemed to take place when "such transfer becomes so far perfected that a bona fide purchaser from the debtor against whom such transfer could have been perfected cannot acquire an interest in the property transferred that is superior to the interest in such property of the transferee."[175] In applying the foregoing section, the *Alsop* court concluded that

> [s]ince under Alaska law no purchaser from [mortgagors] subsequent to [mortgagors'] execution of the deed of trust and its recordation on November 8, 1978, could have acquired an interest superior to that of the transferee at the foreclosure sale, pursuant to the provisions of § 548(d)(1) the transfer was made as of November 8, 1978. Since this date is outside the one year period established by § 548(a), the foreclosure sale is not avoidable as a fraudulent transfer.[176]

Alsop seems to misinterpret section 548(d)(1). As noted earlier, a separate transfer occurs at the time of the execution of the deed of trust and, later, at the time of the foreclosure sale.[177] The purpose of section 548(d)(1) in each

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169. *See, e.g., In re* Frank, 39 Bankr. 166 (Bankr. E.D.N.Y. 1984); *In re* Berge, 33 Bankr. 642 (Bankr. W.D. Wis. 1983).

170. *See, e.g., In re* Dudley, 38 Bankr. 666 (Bankr. M.D. Pa. 1984); *In re* Wheeler, 34 Bankr. 818 (Bankr. N.D. Ala. 1983); *In re* Worcester, 28 Bankr. 910 (Bankr. C.D. Cal. 1983).

171. *See, e.g., In re* Richard, 26 Bankr. 560 (Bankr. D.R.I 1983); *In re* Smith, 24 Bankr. 19 (Bankr. W.D.N.C. 1982); *In re* Richardson, 23 Bankr. 434 (Bankr. D. Utah 1982).

172. *See supra* notes 10-16 and cases cited therein; *see also In re* Hulm, 45 Bankr. 523 (Bankr. D.N.D. 1984).

173. 14 Bankr. 982 (Bankr. D. Alaska 1981), *aff'd*, 22 Bankr. 1017 (D. Alaska 1982).

174. *See* 11 U.S.C. § 548(d)(1) (1982).

175. *Id.*

176. *In re* Alsop, 14 Bankr. 982, 986 (Bankr. D. Alaska 1981), *aff'd* 22 Bankr. 1017 (D. Alaska 1982).

177. *See infra* text accompanying note 156. For the view that foreclosure is not a separate transfer, see Coppel & Kahn, *Defanging* Durrett*: The Established Law of Transfer*, 100 BANKING L.J. 676 (1983).

context is to encourage prompt recording of the transfer instrument rather than to cause a separate and distinct transfer to relate back to an earlier one.[178] As Professor Henning has stressed:

> Foreclosure of the deed of trust involves an involuntary conveyance of the debtor's remaining interest in the property except for a statutory right of redemption in those states that grant such a right. This involuntary conveyance constitutes a separate transfer. The most important rights affected by this second transfer are the right to possession and the debtor's equity in the property, neither of which were conveyed under the deed of trust. When a purchaser buys at the foreclosure sale, the deed of trust ordinarily will be considered discharged; if the purchaser fails to record the trustee's deed, however, he will be protected against subsequent bona fide purchasers from the original debtor. Thus, recordation of the trustee's deed serves a different purpose than recordation of the original deed of trust because it protects a different set of rights. In this context, section 548(d)(1) refers to perfection of the interests acquired at the foreclosure sale, the second transfer, and not to perfection of the interests conveyed by the deed of trust, the first transfer. If the purchaser delays in perfecting his interest, the second transfer, like the first, can be brought forward into the avoidance period.[179]

According to Professor Henning, the "relation back" notion simply restates the principle that the purchaser takes free of any interests junior to the interest being foreclosed. Professor Henning argues however that this principle "does not provide a satisfactory basis for fusing the two transfers for purposes of section 548(d)(1). [The latter section] should be applied strictly as a mechanism for bringing a transfer . . . forward into the avoidance period."[180]

The second major anti-*Durrett* case is *In re Madrid*,[181] a decision of the Ninth Circuit. In that case, the bankruptcy court set aside a power of sale foreclosure in a Chapter 11 context that yielded 67% of the real estate's fair market value.[182] The Bankruptcy Appellate Panel, in reversing, did not deal with the transfer issue, but instead "constru[ed] the reasonably equivalent value requirement of § 548(a)(2) to mean the same as the consideration received at a non-collusive and regularly conducted foreclosure sale."[183] The court of appeals affirmed, but its reasoning differed from that used by the bankruptcy appellate panel and *Alsop* as well. The court of appeals eschewed the "relation back" approach even though the deed of trust had been recorded more than a year before the filing of the Chapter 11 petition. Rather, the court concluded that section 548(a)(2) was simply not intended to apply to

178. *See* Henning, *supra* note 100, at 267-68.
179. *Id.* at 268-69.
180. *Id.* at 269-70; *see also* Alden, Gross & Horowitz, *Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the* Durrett *Problem*, 38 Bus. Law 1605, 1609-11 (1983).
181. 725 F.2d 1197 (9th Cir. 1984), *cert. denied*, 105 S. Ct. 125 (1984); *see also In re* Winshall Settlor's Trust, 758 F.2d 1136 (6th Cir. 1985).
182. *In re* Madrid, 10 Bankr. 795 (Bankr. D. Nev. 1981).
183. *In re* Madrid, 21 Bankr. 424, 427 (9th Cir. 1982).

foreclosure sales under a valid lien. The latter section and its antecedents, according to the court, instead "provide authority for the proposition that conveyances are set aside when there is actual fraud or a situation indicative of fraud."[184]

The court of appeals' reasoning in *Madrid* has been called into question by a provision of the Bankruptcy Amendments and Federal Judgeship Act of 1984 which amended the Bankruptcy Act's general definition of transfer to include "foreclosure of the debtor's equity of redemption."[185] Post-enactment senatorial statements indicate that the amendment was "not intended to have any effect one way or the other on the . . . *Durrett* issue" or on *Madrid*.[186] On the other hand, Professor Henning has concluded that while "it is unclear whether [the amendment] signifies congressional approval of *Durrett*," it "probably overrules *Madrid*."[187] Whether one agrees with the latter assessment or not, the literal language of the amendment certainly emphasizes that a foreclosure sale can constitute a transfer and, at the very least, seriously undercuts the court of appeals' reasoning in *Madrid* that section 548(a) simply does not encompass foreclosure under valid liens.

3. Impact of *Durrett*

If *Durrett* ultimately prevails nationally, it in effect will create, de facto, in every state a one year statutory redemption system.[188] For those states that currently do not have a statutory redemption scheme, the impact of *Durrett* is dramatic.[189] However, its effect in most statutory redemption states will also be significant. This is because *Durrett* is broader in scope than most state redemption statutes. First, the one year period is longer than under some state statutes.[190] Second, while state legislation typically confers redemption rights on mortgagors and, in some instances, on junior lienholders,[191] rights conferred by *Durrett* benefit unsecured creditors as well. Third, a party who redeemed under statutory redemption usually must tender to the foreclosure purchaser the amount of the purchase price.[192] *Durrett*, on the other hand, imposes no such cost; rather, the purchaser ultimately will be reimbursed out of the proceeds of a bankruptcy resale.[193]

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184. 725 F.2d 1197, 1200 (9th Cir. 1984).

185. *See* 11 U.S.C. § 101(48) (1982) (adopted as the Bankruptcy Amendments and Federal Judgeship Act of 1984, § 421 (i), Pub. L. No. 98-353, 98 Stat. 333, 368).

186. 130 CONG. REC. S13771-13772 (daily ed. Oct. 5, 1984) (statements by Senators DeConcini and Dole).

187. Henning, *supra* note 100, at 271 n.79.

188. *Id.* at 265.

189. Almost half of the states have no statutory redemption. *See* G. NELSON & D. WHITMAN, *supra* note 137, § 8.4.

190. *Id.*

191. G. NELSON & D. WHITMAN, *supra* note 137, § 8.5.

192. G. NELSON & D. WHITMAN, *supra* note 137, § 8.4.

193. Henning, *supra* note 100, at 276.

Moreover, the impact of *Durrett* and *In re Hulm*,[194] its Eighth Circuit counterpart, will be more substantial in Missouri than in most other statutory redemption states. The Missouri redemption scheme[195] is much more limited than the systems utilized in other jurisdictions. As noted earlier in this article, the statutory right can be asserted only by the mortgagor and his successors in interest; it is unavailable to junior lienholders.[196] Moreover, it is triggered only if the mortgagor posts a redemption bond and the mortgagee is a successful foreclosure sale purchaser.[197] Consequently, while statutory redemption does not deter third party bidding in Missouri, *Durrett* almost surely will.

Under certain circumstances, *Durrett* can create uncertainty for more than a year. This can occur in those situations where a bankruptcy petition is, in fact, filed within a year of the foreclosure sale. Because a section 548 avoidance action "can be brought until the earlier of two years after the appointment of a trustee or the time the case is closed or dismissed, the period of uncertainty for the purchaser can exceed three years."[198] A Chapter 11 trustee, as noted earlier,[199] may never be appointed and, under such circumstances, the debtor-in-possession could in theory pursue a *Durrett* action at any time during the reorganization proceeding.[200] Moreover, even in a Chapter 7 liquidation, there can be considerable delay in the appointment of a trustee.[201]

What is the impact on a foreclosure sale purchaser of a successful avoidance under *Durrett*? Any good faith purchaser for value obtains a lien on the real estate to the extent of value given.[202] This lien will also include the value of post-purchase improvements to the real estate.[203] Moreover, interest is probably recoverable at either the mortgage rate or a market rate.[204] It should be remembered that a Chapter 7 trustee will be seeking to enhance the value of

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194. 738 F.2d 323 (8th Cir. 1984), *cert. denied*, 105 S. Ct. 398 (1984).

195. Mo. Rev. Stat. § 443.410 (1978),

196. *Id.*; *see supra* text accompanying notes 138-46. Comment, *Statutory Redemption Following Power of Sale Foreclosure in Missouri*, 47 Mo. L. Rev. 309, 316-20 (1982).

197. Mo. Rev. Stat. § 443.410 (1978); Comment, *supra* note 196, at 314-15.

198. Henning, *supra* note 100, at 265. On the other hand, the one year period probably runs from the foreclosure sale date, and not from the date that any statutory redemption period expires. *See In re* Kangas, 46 Bankr. 102 (Bankr. Minn. 1985).

199. *See supra* text accompanying notes 32-37.

200. Henning, *supra* note 100, at 265-66.

201. *Id.* at 266.

202. *See* 11 U.S.C. § 548(c) (1982); Henning, *supra* note 100, at 279. Value means "property, or satisfaction or securing of a present or antecedent debt of the debtor." 11 U.S.C. § 548(d)(2) (1982). It has been suggested that in a noncollusive regularly conducted foreclosure, good faith will not be a problem. *See* Henning, *supra* note 100, at 279 n.134. *But see* Note, *Nonjudicial Foreclosure under Deed of Trust May Be a Fraudulent Transfer of Bankrupt's Property*, 47 Mo. L. Rev. 345, 351 n.55 (1982).

203. *See* 11 U.S.C. § 550(d)(1) (1982); Henning, *supra* note 100, at 279 n.137.

204. Henning, *supra* note 100, at 280.

the debtor's estate by attempting to squeeze excess value out of the recaptured real estate. Thus, she will resell the property either subject to the purchaser's lien or free and clear of it.[205] If the latter approach is utilized, the purchaser's lien will attach to the sale proceeds.[206] In the event, however, the real estate cannot be sold for more than the lien, it should be abandoned to the purchaser.[207]

Proceedings under Chapters 11 and 13 pose special problems in the foregoing regard. While a Chapter 7 trustee will utilize *Durrett* to recover real estate for the purpose of prompt resale, recapture in the Chapter 11 or 13 context is typically sought to enhance the likelihood of a successful rehabilitation of the debtor. Consequently, in the latter setting the real estate could be tied up indefinitely as part of a reorganization plan. This probably does not impose an unfair burden on the mortgagee as a foreclosure purchaser. After all, so long as the reorganization plan affords him adequate protection, "he is no worse off than he would have been if bankruptcy proceedings had been commenced before foreclosure was complete."[208] This is not the case, however, where the purchaser is a third party. In effect, a *Durrett* recapture forces such a purchaser to become an involuntary lender. Even if he ultimately recoups his investment, he could be substantially prejudiced by having his funds tied up for a substantial period of time. Under such circumstances, the bankruptcy court should perhaps exercise its equitable discretion by compelling the trustee or debtor-in-possession to obtain new financing for the purpose of "cashing out" the purchaser. In any event, if *Durrett* ultimately prevails, the Bankruptcy Act probably should be amended to permit recovery of property in reorganization contexts only where an immediate resale or refinancing is likely.[209]

4. An Evaluation of *Durrett*

The reaction to *Durrett* from the real estate bar and other real estate interests has been uniformly hostile.[210] This hostility reflects a variety of concerns. It has been argued that the long period of uncertainty about foreclosure title created by *Durrett* will "naturally inhibit a purchaser other than the mortgagee from purchasing at foreclosure."[211] Consequently, it is asserted that

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205. *See supra* text accompanying notes 12-14.
206. Henning, *supra* note 100, at 279.
207. *Id.*
208. *Id.* at 283.
209. *Id.*
210. Groups that opposed *Durrett* include the American Land Title Association, the Mortgage Brokers Institute, the American Council of Life Insurance, the American College of Real Estate Lawyers, the California Bankers Association, and the California Bank Clearing House Association. *See* Alden, Gross & Horowitz, *supra* note 180 at 1607 n.8.
211. Abramson v. Lakewood Bank & Trust Co., 647 F.2d 547, 549 (5th Cir. 1981) (Clark, J., dissenting).

"by discouraging third-party buyers, [*Durrett*] may reduce sales prices and increase the likelihood of deficiency judgments. It will encourage secured creditors to foreclose on initial default in the hope that a quicker sale will lower the risk that the debtor will file for bankruptcy during the following year."[212]

Opposition to *Durrett* has been manifested in a variety of more tangible ways. Substantial effort has been devoted to seeking its repeal by Congress.[213] Indeed, concern about *Durrett* is reflected in the Uniform Fraudulent Transfer Act (UFTA), promulgated by the National Conference of Commissioners on Uniform State Laws in 1984.[214] Because of a fear that bankruptcy and state courts would interpret state law as incorporating *Durrett* principles,[215] the UFTA provides that "a person gives a reasonably equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale or execution of a power of sale . . . under a mortgage, deed of trust, or security agreement."[216] The foregoing language effectively insulates from a *Durrett*-type attack noncollusive foreclosures pursuant to any state procedure, judicial or otherwise, that entails a public sale.

While the merits of *Durrett* are debatable, on balance it was probably a desirable judicial development. To be sure, any post-sale period of title defeasibility discourages third party bidding and, for that reason, statutory redemption systems are of doubtful utility.[217] Moreover, to some extent *Durrett* compounds such problems. This especially may be true in those states that currently do not have statutory redemption. Even in those that do, *Durrett*, as we have seen, may extend state redemption periods and, in other significant ways, make foreclosure sales easier to avoid. On the other hand, *Durrett*'s benefits to unsecured creditors outweigh the foregoing concerns. As one commentator has stressed, "there is no reason to permit secured creditors to reap the benefit of assets that might have paid off unsecured creditors."[218] This reasoning is sound in reorganizations as well as liquidations. Moreover, while admit-

212. Note, *supra* note 202 at 351. For a comprehensive criticism of *Durrett*, see Zinman, Houle & Weiss, *Fraudulent Transfers According to Alden, Gross & Horowitz: A Tale of Two Circuits*, 39 BUS. LAW. 977 (1984).

213. *See* Summary of Action of the House of Delegates, 1983 A.B.A. Proc. 1, 31 (endorsing amendment to section 548); Gold, *Proposed Amendment to Clarify Status of Property Bought in Foreclosure*, N.Y.L.J., Nov. 17, 1982, at col. 1 (proposed amendment to section 548). An unsuccessful attempt was made in 1983 to amend section 548 to equate reasonably equivalent value with any amount paid at a good faith foreclosure. *See* S. 445, 98th Cong., 1st Sess. § 360, 129 Cong. Reg. 5972 (1983). A similar attempt in 1984 also failed.

214. *See* UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 161 (1978).

215. Section 544(b) permits the trustee to avoid any transfer that could be avoided by an unsecured creditor under state or federal non-bankruptcy law. *See* 11 U.S.C. § 544(b) (1982); *In re* Penn Packing Co., 42 Bankr. 502 (Bankr. E.D. Pa. 1984). Thus, the American Bar Association Section of Real Property, Probate and Trust Law urged the UFTA Drafting Committee to include anti-*Durrett* language.

216. UNIF. FRAUDULENT TRANSFER ACT § 3(b), 7A U.L.A. 161, 181 (1978).

217. G. NELSON & D. WHITMAN, *supra* note 137, § 8.8.

218. Henning, *supra* note 100, at 276.

tedly strong medicine, *Durrett* in a powerful way underscores the inadequacies of a foreclosure system that normally fails to produce an adequate price for foreclosed real estate.[219]

B. *The Foreclosure Sale as a Preference*

A pre-bankruptcy foreclosure may under certain circumstances be avoided as a preference, a theory that represents a potentially important alternative to *Durrett*. Under section 547 of the Code, the trustee may avoid a transaction if it was (1) a transfer of the debtor's property, (2) to or for the benefit of the creditor, (3) for or on account of an antecedent debt, (4) made while the debtor was insolvent, (5) within ninety days of bankruptcy (one year in the case of insiders), and (6) which enables the creditor to realize more than he would receive in a Chapter 7 liquidation.[220] At least two bankruptcy courts in Alabama and Missouri have used the foregoing section as a foreclosure-avoidance tool.[221] *In re Wheeler*,[222] the Alabama decision, is illustrative of this development. In that case, a mortgage executed eleven years earlier was foreclosed at a public sale at which the mortgagee purchased for $15,044, the amount of the debt and foreclosure expenses. Twenty-three days later, the mortgagor-debtor filed a Chapter 13 petition and sought to set aside the foreclosure sale under both *Durrett* and section 547. The bankruptcy court found that the foreclosure sale price represented only sixty-five percent of the fair market value of the mortgaged real estate, which the court had determined to be $24,000. Since the 70% *Durrett* standard was not satisfied, the court held that the foreclosure sale was a fraudulent transfer. Alternatively, however, the court held that the foreclosure sale constituted a voidable preference under section 547. According to the court, each of the six preference criteria was satisfied. The court reasoned that the foreclosure sale effected a transfer of the debtor-mortgagor's property on account of an antecedent debt. It also found the debtor to be insolvent at the time of the foreclosure sale and determined that the timing of the sale and the Chapter 13 filing complied with the ninety day requirement. Moreover, the court concluded that:

> It is clear that under a Chapter 7 liquidation, [the mortgagee], as a fully secured creditor, would be entitled to receive the full value of their $15,044 claim upon the disposition of the secured property. However, [mortgagee] would be entitled to no more than the amount of their claim. Yet, by reason of this foreclosure, [mortgagee] is receiving property with a market value several thousand dollars in excess of the amount of their claim. Thus, it becomes evident that the foreclosure sale did enable [mortgagee] to receive more than

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219. *See* G. NELSON & D. WHITMAN, *supra* note 137, § 8.8.

220. *See* 11 U.S.C. § 547(b) (1982); *see also* Collier, *supra* note 11, § 547.01; *In re* Wheeler, 34 Bankr. 818 (Bankr. N.D. Ala. 1983).

221. *See In re* Wheeler, 34 Bankr. 818 (Bankr. N.D. Ala. 1983); *In re* Fountain, 32 Bankr. 965 (Bankr. W.D. Mo. 1983).

222. 34 Bankr. 818 (Bankr. N.D. Ala. 1983).

they would in a Chapter 7 liquidation.[223]

While *Durrett* and the section 547 approach espoused by *Wheeler* both serve a policy of avoiding mortgagee windfalls and protecting mortgagors and unsecured creditors, they differed significantly in their impact on the foreclosure process. For example, while section 547 may be asserted only against mortgagee purchasers, *Durrett* is available against third party purchasers as well. Moreover, while the *Durrett* avoidance period is one year, for section 547 it is ninety days. On the other hand, since the focus under the preference approach is on whether the mortgagee-purchaser received "more" than it would have under a Chapter 7 liquidation, unlike *Durrett*, it might be used to recapture property where more than seventy percent of its fair market value was paid at the foreclosure sale.[224]

An argument can be made that the *Wheeler* analysis misreads the purpose of section 547.[225] This line of reasoning stresses that the latter section is applicable only to the extent that a creditor gets paid up to the full amount of her debt and not in those situations where she receives more than full payment. The excess, under this reasoning, is not a preference, but rather a fraudulent transfer voidable under either section 548 or, assuming state law is being utilized, section 544(b). In other words, if a creditor who is owed $1,000 would have received $300 in a Chapter 7 liquidation, and is paid $1,200 by the insolvent debtor within ninety days of bankruptcy, $700 is a preferential transfer while the $200 excess can only be a fraudulent transfer.

This argument is, however, unpersuasive. For one thing, it 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 she is due. The more blameworthy creditor conduct must be dealt with, under this reasoning, only as a fraudulent conveyance. However unsatisfying such a conclusion may seem intuitively, it could nevertheless be defended if the language of section 547 either compelled such a result or was at least ambiguous. After all, Congress certainly has the prerogative to treat the problems of full payment and overpayment separately. The problem with this reasoning, however, is that the language of section 547 literally applies to the *Wheeler*-type fact situation. Indeed, since *Wheeler*, the 1984 amendment to the Code's general definition of "transfer" to include "foreclosure of the debtor's equity of redemption" actually reinforces the application of section 547 in such foreclosure contexts.[226] Moreover, even though *Durrett* and *Wheeler* both serve similar policy objectives, the impact of *Wheeler* on state foreclosure practice is, as we have seen, less extreme than that of *Durrett*. Thus, if one attributes to

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223. *Id.* at 822.

224. *See* Henning, *supra* note 100, at 275 n.110.

225. For further criticism of the preference approach in the foreclosure context, see Zinman, Houle & Weiss, *supra* note 212, at 985.

226. *See supra* text accompanying note 185.

Congress an intent to deal with such problems in a manner less burdensome on state prerogatives, section 547 furthers that intent more than *Durrett.* In any event, it seems difficult to fault any court for refusing to read into the otherwise plain language of section 547 a meaning that would confer a windfall on a mortgagee at the expense of the debtor and his unsecured creditors.

So long as *Durrett* holds sway, the *Wheeler* preference approach will probably receive little attention. However, in those circuits where *Durrett* is not followed, the preference concept assumes greater importance. Indeed, this will especially be true if *Durrett* is either overruled or repealed by Congress.

C. *Reforming the Foreclosure Process*

Ultimately, the long-term solution to the problems dealt with by *Durrett* and the preference approach lies in a major structural reform of the foreclosure system. The foreclosure sale process, whether judicial or under a power of sale, is hardly designed to bring a fair price for mortgaged real estate. Frequently, the mortgagee is not only the foreclosure sale purchaser, but the only bidder attending the sale. There are several reasons for this phenomenon. First, because the mortgagee can bid up to the amount of the mortgage debt without putting up new cash, he has a distinct bidding advantage over a third party bidder, who will have out-of-pocket expense from the first dollar bid. Second, while foreclosure statutes require notice by publication to potential third party bidders, the notice, especially in urban areas, is published in legal newspapers of limited circulation. Moreover, because the publication is technical in nature, a potential third party purchaser has little idea what real estate is being sold. Third, many potential third party purchasers are reluctant to buy land at a foreclosure sale because of the difficulty of ascertaining if a purchaser will receive good and marketable title. Fourth, when a mortgagee forecloses on improved real estate, potential bidders often find it difficult to inspect the premises prior to sale. While it may be in the self-interest of the mortgagor to allow third party inspection of the premises, mortgagors who are about to lose their real estate through a foreclosure sale understandably are reluctant to cooperate.

Traditional legislative attempts to remedy the abuses of the foreclosure sale process have proved inadequate at best. For example, while anti-deficiency legislation limits the mortgagee/purchaser from using a deficiency to compound the mortgagor's plight, it does nothing to encourage bidding above the amount of the mortgage debt. Moreover, the advantages of statutory redemption may be more illusory than real. Because it uses the foreclosure sale price as the redemption amount and affords redemption rights to a wide variety of lien creditors as well as the mortgagor, it arguably encourages those who take part at the sale to bid higher as a means of protecting their prospective purchase from loss by redemption. However, it is equally likely that the defeasible nature of the purchaser's title coupled with the fact that the mortgagor often retains possession during the redemption period serve to suppress rather than enhance bidding and, hence, may depress the ultimate foreclosure price.[227]

A more fundamental reform of the foreclosure sale system is necessary. Not only should the goal be fewer deficiency judgments, but more frequent and large surpluses which benefit junior lienholders as well as mortgagors. Such a legislative approach should incorporate at least two components. First, the sale should be conducted by customary commercial methods used in the sale of real estate in a non-foreclosure setting, including the use of real estate brokers and normal commercial descriptive and pictorial advertising. Second, the person who conducts the sale should be a truly independent public official and should be given a strong incentive to achieve the highest possible foreclosure price. He should have substantial experience and expertise in real estate matters. While the title for this person is not particularly important, the one who now conducts foreclosure sales is often called a "trustee," and that title is probably as appropriate as any other.[228] To implement this latter concept, legislation should specify a reasonable time, e.g., ninety days, during which the trustee could sell the property by usual commercial means. The method of compensating the trustee should encourage him to obtain the highest possible sale price. For example, if the sale price does not exceed the mortgage debt, the trustee's fee should be relatively low, perhaps a fixed amount. If the foreclosure sale price exceeds the mortgage debt, the trustee should receive a percentage of the excess that increases as the excess increases.[229]

Under the scheme outlined above, a prospective purchaser would deal with the trustee in much the same way as he would deal with a seller of real estate in a normal sale context, using the customary earnest money contract and title examination procedures. If the trustee could not sell the property during the statutory time period, a regular public auction of the real estate would be conducted. On the other hand, if the trustee and a potential purchaser agree on sale terms, the trustee would be required to notify the mortgagor and junior lienholders of the proposed sale price. If neither the mortgagor nor any junior lienholders object within a short time (say, seven days), the transaction between the trustee and the purchaser would be consummated. If, however, the mortgagor or a junior lienor objects to the sale, the trustee would be required to hold a public auction. This procedure would estop the mortgagor or junior lienholders from subsequently attacking a sale between the trus-

227. G. NELSON & D. WHITMAN, *supra* note 137, § 8.4.

228. Colorado currently uses a public trustee system. *See* COLO. REV. STAT. §§ 38-37-101 to -139 (1973 & Cum. Supp. 1980). The governor appoints the trustee in first and second class counties. In smaller counties, the county treasurer is the public trustee. *Id.* § 38-37-102 (1973). Under the author's proposal, the local county court or the governor should appoint the public trustee to ensure adequate expertise and experience; he should not be elected.

229. For a detailed explanation of how one such compensation system would operate, see Nelson, *Deficiency Judgments After Real Estate Foreclosures in Missouri: Some Modest Proposals*, 47 MO. L. REV. 151, 164 n.67 (1982).

tee and a purchaser. If the real estate sells for less than the mortgage debt whether by negotiated sale or at auction, the mortgagee could seek a deficiency judgment. The amount of the deficiency would be the difference between the sale price and the mortgage debt and would not be subject to other anti-deficiency limitations.[230]

Such a system would have weaknesses. It would be more time-consuming and costly than current power of sale foreclosure practice. Mortgagors, notwithstanding their self-interest in obtaining the highest possible price for the mortgage real estate, may discourage physical inspection of improved real estate. Moreover, in economically depressed periods, the proposed system probably would not yield a higher price than would result under the current practice. Nevertheless, under most economic conditions, it should result in foreclosure sale prices that more closely approximate the fair market value of the foreclosed real estate. Such higher prices not only would compensate for the increased costs of the system but also might provide a surplus that would benefit the mortgagor and junior lienholders.[231] In addition, higher prices should reduce substantially the incidence of deficiency proceedings. Even in the worst case, the proposed system would not result in prices below those obtained under current practices. Under such a system, the *Durrett* doctrine, the preference approach as well as statutory redemption would be both unnecessary and self-defeating.

Several additional observations are appropriate. First, such a system would probably prove impractical in states with pervasive statutory redemption schemes because the prospect of receiving a defeasible title probably discourages third party interest and bidding.[232] Second, because the proposed system focuses on the mechanics of the sale rather than on the foreclosure proceeding itself, it can be utilized with judicial as well as power of sale foreclosure. As we emphasized earlier, however, because we believe that power of

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230. This proposal is similar in some respects to UNIF. LAND TRANSACTIONS ACT § 3-508, 13 U.L.A. 545, 702 (1980), which was promulgated by the National Conference of Commissioners on Uniform State Laws, but has not been adopted by any state. According to ULTA § 3-508(a), in power of sale foreclosures, the

> sale may be made at public sale or by private negotiation, by one or more contracts, as a unit or in parcels, at any time and place, and on any terms including sale on credit, but every aspect of the sale, including the method, advertising, time, place and terms, must be reasonable.

Unlike the author's proposal, however, the uniform act "does not require that the sale be conducted by a disinterested third party such as a trustee." *Id.* § 3-508, Comment 1. Thus, the mortgagee could conduct the sale under the uniform act. Commentators have criticized the uniform act's assumption that the mortgagee's interest is always to maximize the foreclosure price. *See* Kuklin, *The Uniform Land Transactions Act: Article 3*, 11 REAL PROP., PROB. & TR. J. 12 (1976); Washburn, *The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales*, 53 S. CAL. L. REV. 843, 938 (1980).

231. Normally, junior lienholders have priority over the mortgagor with respect to any foreclosure surplus. *See* G. NELSON & D. WHITMAN, *supra* note 137, § 7.31.

232. *See* G. NELSON & D. WHITMAN, *supra* note 137, § 8.4.

sale foreclosure can be constitutional as well as efficient,[233] a power of sale approach is probably preferable. Moreover, such a system need not be unfair to residential mortgagors and others thought to need special protection. The time period prior to the sale could, for example, be longer for such parties than for commercial mortgagors. Finally, perhaps such a system should come from Congress rather than the state legislatures.[234] Because the mortgage market is pervasively national in scope and its impact on the national economy increasingly significant, the traditional state-by-state approach to real estate foreclosure is a luxury of federalism we can ill continue to afford.

VI. Rents in Bankruptcy

Mortgagees commonly rely not only on real estate itself as security for the mortgage debt, but also on the rents and profits it produces.[235] Sometimes access to rents is gained through the appointment of a receiver. Such receiverships typically are created after mortgagor default and incident to foreclosure.[236] Mortgagees also frequently find comfort in mortgage clauses or separate agreements by which the mortgagor assigns the rents and profits as additional security for the debt. Such assignment agreements usually are not triggered until the mortgagee takes certain affirmative steps to activate them.[237] Typical of this approach is the Texas formulation that holds rent assignments ineffective "until the mortgagee obtains possession of the property, or impounds the rents, or secures the appointment of a receiver, or takes some other similar action."[238]

Once a mortgagor files a bankruptcy petition, an important question arises as between the trustee in bankruptcy, who represents the unsecured creditors, and the mortgagee as to whether the mortgagee has a valid security interest in rents collected from the mortgaged real estate during the pendency of the bankruptcy proceeding. This issue can be crucial for the mortgagee when the mortgage debt is not fully secured by the real estate. The ability to gain access to the rents under such circumstances could well determine the extent to which the mortgagee joins the ranks of the bankrupt's unsecured creditors.

Prior to 1979, the federal courts of appeal were divided as to what law governed entitlement to rents during this post-petition period. A majority of the circuits took the position that the mortgagee's rights should be governed by the state law which would have applied.[239] Thus, the mortgagee was re-

233. *Id.* at § 7.30.
234. *Id.*
235. G. Nelson & D. Whitman, *supra* note 137, § 4.35.
236. *Id.* at §§ 4.33-.34.
237. *Id.* at § 4.35.
238. Taylor v. Brennen, 621 S.W.2d 592, 594 (Tex. 1981). *See* G. Nelson & D. Whitman, *supra* note 137, § 4.35.
239. *See In re* American Fuel & Power Co., 151 F.2d 1242 (6th Cir. 1945);

quired to take those steps, either by leave of or through the bankruptcy court, as would have been necessary to activate its rights under state law. If, for example, a mortgagee was relying on a rents and profits clause, but state law required the appointment of a receiver for its activation, the majority of federal decisions required that the bankruptcy court apply the same standard. A minority of federal circuits, however, utilized a federal rule of equity that afforded the mortgagee a security interest in the rents even if state law failed to recognize such an interest.[240]

The foregoing conflict was resolved in *Butner v. United States*,[241] in which the Supreme Court endorsed the majority view and held that state law governed in determining whether the mortgagee had a valid security interest in rents collected during bankruptcy. According to the Supreme Court, the bankruptcy court "should take whatever steps are necessary to ensure that the mortgagee is afforded . . . the same protection he would have under state law if no bankruptcy had ensued."[242]

Because *Butner* was decided under the Bankruptcy Act of 1898 and not under the Bankruptcy Code, some doubt has been raised as to its current validity. Under section 552(b) of the Code,

> [e]xcept as provided in section 363 . . . if the [mortgagor] and a [mortgagee] enter into a security agreement before [the filing of a bankruptcy petition] and if the security interest created by such security agreement extends to property of the [mortgagor] acquired before the [the filing] and to proceeds, product, offspring, rents or profits of such property, then such security interest extends to such . . . rents or profits acquired by the estate after [the filing] to the extent provided by such security agreement and by applicable nonbankruptcy law, except to the extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.[243]

While the foregoing language "essentially codifies Congress' deference to state law in this area,"[244] the exceptions could be viewed as affording a bankruptcy court the discretion in certain situations to alter the *Butner* state law mandate.[245]

Tower Grove Bank & Trust Co. v. Weinstein, 119 F.2d 120 (8th Cir. 1941); *In re* Hotel St. James Co., 65 F.2d 82 (9th Cir. 1933); *In re* Brose, 254 F. 664 (2d Cir. 1918); *see also* Fidelity Bankers Life Ins. Co., v. Williams, 506 F.2d 1242 (4th Cir. 1974).

240. *See In re* Pittsburgh-Duquesne Dev. Co., 482 F.2d 243 (3d Cir. 1973); *In re* Wakey, 50 F.2d 869 (7th Cir. 1931); Bindseil v. Liberty Trust Co., 248 F. 112 (3d Cir. 1917).

241. 440 U.S. 48 (1979).

242. *Id.* at 56.

243. *See* 11 U.S.C. § 552(b) (1982).

244. Note, *Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor*, 31 HAST. L.J. 1433, 1440 (1980). For another excellent analysis of *Butner*, see Randolph, *The Mortgagee's Interest in Rents: Some Policy Considerations and Proposals*, 29 U. KAN. L. REV. 1 (1980).

245. Note, *supra* note 244, at 1440.

This argument was rejected by the United States Court of Appeals for the Fifth Circuit in *In re Village Properties*[246] Shortly after defaulting on a deed of trust containing an assignment of rents clause, the mortgagor filed a Chapter 11 petition. Three months thereafter, the bankruptcy court granted the mortgagee's request for relief from the automatic stay, and a day later the deed of trust was foreclosed. The mortgagee was the purchaser. Because the value of the real estate was apparently less than the mortgage debt, mortgagee filed a claim for the amount of the deficiency and sought to satisfy this claim by asserting a security interest in the rents collected from the mortgaged real estate between the date of mortgagor default and the foreclosure sale. The bankruptcy court, relying on Texas law, denied the mortgagee's request and the district court affirmed. The court of appeals agreed with the two lower courts and held (1) that the mortgagee's rights under the rents clause were governed by Texas law and (2) that those courts correctly interpreted and applied that law.

The court of appeals acknowledged that section 552(b) permits a bankruptcy court, "based on the equities of the case," to deviate from state law.[247] However, it noted that the bankruptcy judge in this case had found no equitable reason for such a deviation. Moreover, the court stressed, the legislative history regarding the "equities of the case" exception indicates its purpose was "to cover cases where an expenditure of the estate's funds increases the value of the collateral. . . . [It] gives as an example the situation where raw materials are converted into inventory at the expense of the estate (which would thus deplete the fund available for general unsecured creditors)."[248]

The mortgagee also sought to use the section 363 exception to escape the application of Texas law. That section protects parties with an interest in cash collateral and forbids the trustee or the debtor-in-possession from using, selling, or leasing such collateral unless each entity having an "interest" in it consents or the bankruptcy court so authorizes.[249] Under the definition then in effect, "cash collateral" meant "cash . . . or other cash equivalents in which the estate and an entity other than the estate have an interest." The mortgagee argued that rents are "cash collateral" and that its assignment created a lien or interest in them. Thus, the mortgagee asserted, its interest in the rents could be protected by the bankruptcy court irrespective of state law. The debtor, however, argued that bankruptcy courts "must turn to state law to determine whether and at what time a mortgagee has an interest in the rents because it is only at that time that it becomes 'cash collateral'."[250] The court of appeals agreed with this latter argument:

> We reject [mortgagee's] unsubstantiated reasoning that Congress in-

246. 723 F.2d 441 (5th Cir.), *cert. denied*, 104 S. Ct. 2350 (1984).
247. *Id.* at 444.
248. *Id.* (citations omitted).
249. *See* 11 U.S.C. § 363 (1982).
250. 723 F.2d at 444.

> tended for section 363 to preempt state law which traditionally determines the property rights at dispute in this case. "[S]tate-created property rights, in a bankruptcy context, will not be destroyed by implication." . . . Moreover, the [legislative history], on which [mortgagee] relies, provides that rents received "before or after the commencement of the case would be cash collateral to the extent that they are subject to a lien." This language mirrors the provision in section 552(b) which provides that a security interest will exist "to the extent provided by such security agreement and by applicable nonbankruptcy law . . . ." Thus, if [mortgagee's] claim fails under section 552(b), 363 is to no avail.[251]

Consequently, the court of appeals concluded that "the *Butner* decision remains unscathed by the new Bankruptcy Code."[252] The court found further comfort in the fact that numerous other decisions assumed the continued validity of *Butner*.[253]

Next, the court of appeals focused on whether the mortgagee had satisfied Texas requirements for perfection of an interest in the rents. It noted that the mortgagee had failed to petition the bankruptcy court for the "appointment of a receiver to collect rents for its benefit," for an "order of sequestration" or for any other order to impound rents.[254] At least, it concluded the "or takes some other similar action" requirement of Texas case law "encompasses perfection of a mortgagee's interest by petitioning for sequestration and the like."[255]

Shortly after *Village Properties* was decided, Congress, as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984, amended section 363(a) to provide that cash collateral "includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) . . . whether existing before or after the commencement of a [bankruptcy] case . . ."[256] Coming so close on the heels of *Village Properties*, it could be argued that Congress meant to make plain not only that rents can be cash collateral, but also that an assignment of such rents is enforceable by bankruptcy courts irrespective of state law. However, even assuming, as the *Village Properties* court was willing to do, that rents are "cash collateral," one is still confronted with the "have an interest" language of section 363(a), which was unaffected by the amendment. Nothing in the amendment suggests

251. *Id.* (citations omitted).

252. *Id.*

253. *In re* Jenkins, 13 Bankr. 721, 723 (Bankr. D. Col. 1981), *rev'd on other grounds*, 19 Bankr. 105, 107 (D.C. Col. 1982); *In re* Oak Glen R-Vee, 8 Bankr. 213, 216 n.3 (Bankr. C.D. Cal. 1981); *In re* Gaslight Village, Inc., 6 Bankr. 871, 874 (Bankr. D. Conn. 1980); *In re* Hellenschmidt, 5 Bankr. 758, 760 (Bankr. D. Col. 1980); *In re* Wheeler, 5 Bankr. 600, 603 (Bankr. N.D. Ga. 1980); *In re* Jeffers, 3 Bankr. 49, 56 (Bankr. N.D. Ind. 1980); *see also*, *In re* Southern Gardens, Inc., 39 Bankr. 671, 672 (Bankr. S.D. Ill. 1982); *In re* Kuhn Constr. Co., 11 Bankr. 746 (Bankr. S.D. W. Va. 1981).

254. *In re* Village Properties, 723 F.2d 441, 446 (5th Cir. 1984).

255. *Id.* at 446.

256. *See* 11 U.S.C.A. § 363(a) (West Supp. 1984).

that the latter language is no longer to be governed by state law. Thus, it seems unlikely that Congress intended to alter the *Butner* state law mandate. At least, such a preference for state law should not, to use language endorsed by *Village Properties*, be deemed "destroyed by implication."[257]

Assuming the continued vitality of *Butner* and *Village Properties*, certain practical observations are appropriate. First, to the extent that the mortgagee has gained access to the rents and profits prior to bankruptcy by taking lawful affirmative steps under state law, it will continue to be entitled to them during bankruptcy. Such pre-bankruptcy actions would include, for example, securing the appointment of a receiver or otherwise attaching or sequestering the rents and profits under state law.[258] Of course, if an assignment of rents clause is automatically effective under state law, such affirmative action would be unnecessary.[259] Second, where the mortgagee has not activated its security interest in the rents prior to bankruptcy, it may perfect its interest thereafter by taking those steps, either by leave of or through the bankruptcy court, as would have been necessary to trigger its rights under state law.[260] While sometimes this may require that the bankruptcy court actually appoint a receiver, there have been cases where bankruptcy courts, relying on state law, have found that the simple request for a receivership[261] or the mere demand on the trustee that rents be set aside will suffice.[262] Assuming the requisite steps are taken, the assignment clause will then become effective and subsequent rents should be applied to the satisfaction of the mortgage debt.

VII. CONCLUSION

The impact of mortgagor bankruptcy on the real estate mortgagee can be both substantial and frustrating. Not only will the mortgagee confront the initial obstacle of the automatic stay, it may also be forced to defend its mortgage from trustee or debtor avoidance in a forum whose natural bias favors enlargement of the bankrupt's estate for the benefit of unsecured creditors. Moreover, even where the mortgage itself is invulnerable to such attack, the debt it secures is subject to de-acceleration under *Taddeo* in Chapter 13 proceedings and under a similar theory in the Chapter 11 context. Finally, even consummated foreclosures are vulnerable to attacks under *Durrett* and its

257. *In re* Village Properties, 723 F.2d 441, 445 (5th Cir. 1984) (quoting *In re* Jeffers, 3 Bankr. 49, 56 (Bankr. N.D. Ind. 1980)).

258. *See* G. NELSON & D. WHITMAN, *supra* note 137, § 4.35.

259. *Id.*

260. *In re* Village Properties, 723 F.2d 441 (5th Cir. 1984); *In re* Southern Gardens, Inc., 39 Bankr. 671 (Bankr. S.D. Ill. 1982); *In re* Oak Glen R-Vee, 8 Bankr. 213, 216 (Bankr. C.D. Cal. 1981); *see also* Groves v. Fresno Guar. Sav. & Loan Ass'n, 373 F.2d 440, 442-43 (9th Cir. 1967); Pollack v. Sampsell, 174 F.2d 415, 418-19 (9th Cir. 1949).

261. *See, e.g.*, *In re* Flower City Nursing Home, 38 Bankr. 642 (Bankr. W.D.N.Y. 1984).

262. *In re* Southern Gardens, Inc., 39 Bankr. 671 (Bankr. S.D. Ill. 1982).

preference theory counterpart.

It would be a mistake, however, to overemphasize the significance of many of the foregoing concerns. Bankruptcy courts frequently lift stays expeditiously. Moreover, while delay is probably endemic to reorganization proceedings, Chapter 7 liquidations are consummated relatively rapidly. Normally mortgage security and priority are preserved irrespective of the bankruptcy proceeding. Even *Taddeo* and its Chapter 11 de-acceleration counterpart should not represent an overriding concern. Not only do state statutes frequently afford mortgagors the right to defeat acceleration prior to foreclosure by the tender of arrearages, so also do pervasively used mortgage forms.[263] For example, the Federal National Mortgage Association—Federal Home Loan Mortgage Corporation Uniform Mortgage and Deed of Trust Covenants—Single Family, widely used by lenders who desire to retain the option to sell their mortgages on the secondary market, specifically affords the mortgagor the right until five days prior to a foreclosure sale to reinstate the mortgage by payment of arrearages.[264]

The use of *Durrett* and related theories to invalidate previously consummated foreclosure sales is a matter of more serious concern. 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 protected from statutory redemption claims. This is admittedly a troubling prospect. In this respect, the impact of the preference theory is less profound because it cannot be used against third party purchasers and thus will not discourage bidding by such parties. The foregoing concerns notwithstanding, it is difficult both legally and morally to justify a system that too often allows a mortgagee purchaser to acquire property worth more than its debt at the expense of the mortgagor and his unsecured creditors. Moreover, whatever their merits, *Durrett* and its related theories force the legal and financial community to confront the inadequacies of the current foreclosure system.

The foregoing, however, should not be interpreted as a wholesale endorsement of *Durrett* or its related offshoots 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. Earlier in this article, a proposal for reform was examined. Such a system, it is hoped, 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,

263. *See* G. NELSON & D. WHITMAN, *supra* note 137, § 7.7.

264. FNMA/FHLMC Uniform Mortgage and Deed of Trust Covenants—Single Family, § 18.

Taddeo applied in the post-foreclosure stage, and statutory redemption would be unnecessary and self-defeating.