Nonjudicial Foreclosure under Deed of Trust May Be a Fraudulent Transfer of Bankrupt’s Property—Durrett v. Washington National Insurance Co.

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NONJUDICIAL FORECLOSURE UNDER DEED OF TRUST MAY BE A FRAUDULENT TRANSFER OF BANKRUPT’S PROPERTY

Durrett v. Washington National Insurance Co.¹

In 1969, Durrett executed a $180,000 note secured by a deed of trust on Texas land.² The deed of trust contained a power of sale clause.³ Seven years later, Durrett defaulted, and the trustee sold the property at a non-judicial public sale. Mitchell, the lone bidder, bought the property for the exact amount due on the note, $115,400.⁴

Nine days after the sale, Durrett filed a petition for arrangement⁵ under Chapter XI of the Bankruptcy Act of 1898 (1898 Act)⁶ in the United States District Court for the Northern District of Texas. As a debtor in possession,⁷ Durrett petitioned to set aside the trustee’s sale as a fraudulent transfer under section 67(d) of the 1898 Act.⁸ Under that section, transfers made by the debtor within the year preceding the filing for bankruptcy were voidable

1. 621 F.2d 201 (5th Cir. 1980).
3. About 25 states permit the power of sale foreclosure. The clause permits the sale of property after default without judicial supervision. Normally, the trustee under a deed of trust, the mortgagee, or a public official designated by statute conducts the sale. See G. Osborne, G. Nelson & D. Whitman, REAL ESTATE FINANCE LAW § 7.19 (1979).
4. 621 F.2d at 203.
5. Arrangement is an option for some business debtors when they become insolvent. The goal of the proceeding is not liquidation of assets, but rehabilitation of the debtor. See generally B. Weintrab & A. Resnick, BANKRUPTCY LAW MANUAL ¶¶ 8.01-.02 (1980).
7. Courts often allow a business debtor to keep control of his business during the bankruptcy proceedings. The debtor then is a “debtor in possession,” and he has most of the duties and powers of a bankruptcy trustee. See note 25 infra. The term does not refer to the party with physical possession of the property involved in the fraudulent transfer action. See B. Weintrab & A. Resnick, supra note 5, ¶ 8.08.
unless, among other things, the amount received in exchange was a "fair equivalent" of the transferred property's value. 9

The district court ruled that a trustee’s nonjudicial foreclosure under a power of sale was a transfer by the debtor for purposes of section 67(d), 10 but it denied the petition because the sale price, less than sixty percent of the fair market value, was a fair equivalent of the property’s value. 11 On appeal, the United States Court of Appeals for the Fifth Circuit agreed that the trustee’s sale was a transfer under section 67(d). The court reversed, however, on the ground that the consideration received was not a fair equivalent of the market value. 12 The trustee’s sale of the property was held void as a fraudulent transfer. 13

Durrett is the first case in which a bankruptcy court has held void, as a fraudulent transfer, an otherwise valid foreclosure sale of real property made under a deed of trust entered into more than a year prior to bankruptcy. 14 Two cases have followed it. 15 Although Durrett was decided under the 1898 Act, the decision remains significant. 16 The bankruptcy laws were rewritten extensively in the Bankruptcy Reform Act of 1978 (1978 Act), 17 but the

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9. Id. § 107(d)(2) provided:
   Every transfer made and every obligation incurred by a debtor within
   one year prior to the filing of a petition initiating a proceeding . . . by or
   against him is fraudulent . . . if made or incurred without fair considera-
   tion by a debtor who is or will be thereby rendered insolvent, without regard
   to his actual intent . . . .
    1978), rev'd, 621 F.2d 201 (5th Cir. 1980).
11. 460 F. Supp. at 54. The district court found that the fair market value
    of the property was $200,000. The sale price of $115,400 was 57.7% of
    the fair market value.
12. The court noted that no previous case had held payment of less than 70%
    of the fair market value to be a fair equivalent. 621 F.2d at 203.
13. Id. at 204.
14. See Abramson v. Lakewood Bank & Trust Co., 647 F.2d 547, 550 (5th
    Cir. 1981) (Clark, J., dissenting). In an earlier case, another court had declined
    to decide whether a judicial foreclosure sale was a transfer by the debtor for pur-
15. Abramson v. Lakewood Bank & Trust Co., 647 F.2d 547, 549 (5th Cir.
16. Durrett’s petition was filed prior to Oct. 1, 1979, the date the 1978 Act
    took effect. See Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, tit. IV, §
    101-151326 (Supp. IV 1980).
Durrett reasoning applies to section 548, 18 the successor to section 67(d).19 In re Madrid,20 a case decided under section 548 of the 1978 Act, relied on Durrett to reach the same result.21

In theory, the substantive rights of secured creditors such as mortgagees are affected much less by bankruptcy proceedings than those of unsecured creditors.22 In practice, however, bankruptcy proceedings have affected mortgagees.23 Filing a bankruptcy petition automatically stays pending foreclosures.24 Trustees in bankruptcy25 also can set aside foreclosures of certain liens obtained by unsecured creditors26 and certain mortgages and

18. Section 548(a) provides in part:
The trustee may avoid transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor—
(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer occurred or such obligation was incurred, indebted; or
(2) (A) received less than a reasonable equivalent value in exchange for such transfer or obligation . . .

19. For the text of § 67(d)(2), see note 9 supra.


21. Id. at 800.

22. Protection from losses caused by bankruptcy or insolvency of the debtor is one of the most desirable features of the secured transaction. G. Osborn, G. Nelson & D. Whitman, supra note 3, § 8.11, at 554.

23. See In re Jersey Island Packing Co., 138 F. 625, 627 (9th Cir. 1905) ("Everyone who takes a mortgage or deed of trust intended as a mortgage, takes it subject to the contingency that proceedings in bankruptcy against his mortgagor may deprive him of the specific remedy which is provided for in his contract.").

24. 11 U.S.C. § 362(a) (Supp. IV 1980). The stay applies to both judicial and nonjudicial proceedings. Stays should be dissolved unless reasonably necessary. In re Empire Steel Co., 228 F. Supp. 316, 319 (D. Utah 1964). They usually will be reasonable, however, when the debtor has a significant equity interest. Such stays can "freeze property for years." G. Osborn, G. Nelson & D. Whitman, supra note 3, § 8.11, at 554-55.

25. The bankruptcy trustee is an officer appointed by the court to manage the estate of the bankrupt. See 11 U.S.C. §§ 704, 1106 (Supp. IV 1980) (duties of trustee); B. Weintraub & A. Resnick, supra note 5, ¶¶ 7.01-.10.

26. Such lien foreclosures are not fraudulent transfers. Rather, they are "preferences" under the definition of 11 U.S.C. § 547(b) (Supp. IV 1980). To be voidable as a preference, a transaction must meet the following requirements: (1) there must have been a transfer of the debtor's property, (2) it must have been to or for the benefit of a creditor, (3) it must have been on account of an antecedent debt, (4) the debtor must have been insolvent when the transaction occurred, (5)
deeds of trust executed in the year preceding bankruptcy.27 The decision in Durrett adds yet another weapon to the bankruptcy trustee’s arsenal: the power to void nonjudicial foreclosure sales even though the sale is proper and final under state law.

The fifth circuit court of appeals’ decision in Durrett correctly followed the letter and spirit of the bankruptcy statutes. The primary goals of a bankruptcy proceeding are to rehabilitate the bankrupt and to distribute his assets among his creditors fairly.28 Section 67(d)29 did not require actual fraudulent intent.30 Courts construed section 67(d) liberally to maximize the estate of the bankrupt,31 and the same policy should apply to its successor, section 548.32 A “transfer” for purposes of section 548 means “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of dispos-

it must have been made within a fixed period of time (usually 90 days) before bankruptcy, and (6) it must have enabled the creditor to receive more than he otherwise would have from the bankruptcy court. 4 COLLIER ON BANKRUPTCY ¶547.01 (15th ed. 1981). A transfer that meets these guidelines is voidable whether voluntary or involuntary. Id. ¶547.10. Preferences are not the same as fraudulent transfers because reasonably equivalent consideration can include cancellation or reduction of an existing debt. 11 U.S.C. § 548(d)(2)(A) (Supp. IV 1980). In the usual preference, the amount paid to the creditor is matched by a reduction in indebtedness; therefore, the creditor gives reasonably equivalent value. Thus, the transaction is not voidable as a fraudulent transfer, and it must be attacked as a preference. See 11 U.S.C. § 547 (Supp. IV 1980); B. WEINTRAUB & A. RESNICK, supra note 5, ¶ 7.06[8].

27. If a debtor executes a mortgage or deed of trust within 90 days prior to bankruptcy, or within one year if the mortgagee is an insider with reasonable cause to believe the mortgagor or trustor is insolvent, it may be set aside as a preference. 4 COLLIER ON BANKRUPTCY ¶547.14 (15th ed. 1981). See note 26 supra. If a mortgage is void, any subsequent foreclosure and sale also is invalid. In re Turley, 92 F.2d 944, 946 (7th Cir. 1937).


32. 11 U.S.C. § 548 (Supp. IV 1980). Congress sought to make the definition of “transfer” as broad as possible to encourage liberal construction. See note 33 infra.
ing of or parting with property or with an interest in property, including retention of title as a security interest.” Even under prior definitions, a mere change of possession had constituted a transfer. The Durrett court apparently reasoned that because the foreclosure sale was accompanied by a change of possession, it fell within the definition of “transfer.” There is nothing in the statutes or prior decisions that compels a different result.

Durrett does not change the law. Rather, it extends well-settled law into a new area. In the past, courts have voided nonjudicial foreclosure sales by other means. Some, for example, have allowed a bankruptcy trustee to use state statutory redemption rights to redeem property after foreclosure sales. Others have voided mortgages that were executed without fair con-

33. 11 U.S.C. § 101(40) (Supp. IV 1980) (emphasis added). The definition of “transfer” under the 1898 Act provided:

“Transfer” shall include the sale and every other and different mode, direct or indirect, of disposing of or of parting with property or with an interest therein or with the possession thereof or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings, as a conveyance, sale, assignment, payment, pledge, mortgage, lien, encumbrance, gift, security, or otherwise . . . .


Under both the new and old definitions, involuntary transfers by levy and execution are transfers by the debtor. B. WEINTRAUB & A. RESNICK, supra note 5, ¶ 7.06[1]. The definition of “transfer” is broader than that used in most states or in the UNIFORM FRAUDULENT CONVEYANCES ACT § 1. Judicial liens are not necessarily included in the definition of “transfer” under state law or the U.F.C.A., but they are included under the bankruptcy statutes. Cook, Fraudulent Transfer Liability Under the Bankruptcy Code, 17 HOUS. L. REV. 263, 267 (1980).

34. 1 COLLIER ON BANKRUPTCY ¶ 1.30 (14th ed. 1974).

35. 621 F.2d at 204. The court noted that its decision was supported by “reliable and ample” authority, but it cited only 1 COLLIER ON BANKRUPTCY ¶ 1.30, at 130.28(2)(3) (14th ed. 1974), which states, “The present definition covers not only alienations of title but includes surrender of possession.”

36. About half of the states give defaulting debtors a statutory right to redeem property after it is sold at foreclosure. Unlike the traditional equity of redemption, these rights usually accrue only after foreclosure. G. OSBORNE, G. NELSON & D. WHITMAN, supra note 3, §§ 7.1, 8.4.

sideration in the year preceding bankruptcy.\footnote{38} Judicial liens and subsequent sales also have been voided as preferences\footnote{39} when the foreclosure involved a judgment lien obtained by an unsecured creditor within a specified period prior to bankruptcy.\footnote{40}

Although the \textit{Durrett} decision flows logically from the statutory definition of "transfer," it has not escaped criticism. In \textit{Abramson v. Lakewood Bank & Trust Co.},\footnote{41} the fifth circuit court of appeals followed its decision in \textit{Durrett}, but one judge dissented. The dissenting judge would have found that a foreclosure sale by a trustee is not a transfer by the debtor because it is not a "voluntary conveyance."\footnote{42} Since the power of sale was a valuable property right acquired by the trustee more than a year before bankruptcy, the dissent argued that the power had "vested absolutely" in the trustee. Under this view, the transfer by the debtor occurred when the parties executed the deed of trust and not when the trustee foreclosed.\footnote{43}

The \textit{Abramson} dissent is correct that the power of sale was transferred when the parties executed the deed of trust. Its analysis, however, fails to recognize the sweeping definition of "transfer" in the bankruptcy statutes.\footnote{44} The assertion that the sale was not a transfer because it was involuntary or not made by the debtor\footnote{45} ignores two well-settled propositions: transfers include dispositions of property, whether voluntary or involuntary,\footnote{46} and a mere change of possession may constitute a transfer.\footnote{47}

Although the \textit{Durrett} holding is correct, it creates potentially serious problems for mortgagees, secured creditors, and those defaulting debtors who do not file for bankruptcy. If a debtor files for bankruptcy during a one-year period following a nonjudicial foreclosure sale of his property,\footnote{48} \textit{Durrett} holds

\begin{itemize}
\item Osborne, G. Nelson & D. Whitman, \textit{supra} note 3, §8.11, at 555-56 ("Jurisdiction . . . normally does not extend to property in which the debtor's only interest is a statutory redemption right from a foreclosure sale held before the date of bankruptcy.").
\item 38. \textit{See}, e.g., \textit{In re Farm & Home Co.}, 84 F.2d 933, 935 (6th Cir. 1936); \textit{In re Turley}, 92 F.2d 944, 946 (7th Cir. 1937).
\item 39. \textit{See} note 26 \textit{supra}.
\item 40. E.g., Adler v. Greenfield, 83 F. 2d 955, 956-57 (2d Cir. 1936); \textit{In re Cofax Corp.}, 96 F. Supp. 420, 422 (S.D.N.Y. 1951). 11 U.S.C. § 547 (Supp. IV 1980) "is concerned primarily with judgments or judicial proceedings that create liens within the 90-day period to secure claims that previously had no preferential standing." 4 \textit{COLLIER ON BANKRUPTCY} ¶ 547.12[1], at 547-43 (15th ed. 1981).
\item 41. 647 F.2d 547 (5th Cir. 1981).
\item 42. \textit{Id.} at 549 (Clark, J., dissenting).
\item 43. \textit{Id.} at 550 (Clark, J., dissenting).
\item 44. \textit{See} note 33 and accompanying text \textit{supra}.
\item 45. 647 F.2d at 549 (Clark, J., dissenting).
\item 46. 11 U.S.C. § 101(40) (Supp. IV 1980).
\item 47. 1 \textit{COLLIER ON BANKRUPTCY} ¶ 1.30 (14th ed. 1974).
\item 48. Since fraudulent transfers that occur during the year prior to bankruptcy
\end{itemize}
that the sale may be set aside if the consideration was not reasonably equivalent.\textsuperscript{49} In effect, Durrett creates a one-year period of uncertainty. The Abramson dissent is correct in noting that Durrett casts a cloud on mortgages and trust deeds that will “naturally inhibit a purchaser other than the mortgagee from buying at foreclosure.”\textsuperscript{50} Durrett requires that buyers at foreclosure sales pay fair market value to protect against having the sale set aside.\textsuperscript{51} They are usually reluctant to do so.\textsuperscript{52} By discouraging third-party buyers, the decision may reduce sale prices and increase the likelihood of deficiency judgments.\textsuperscript{53} It will encourage secured creditors to foreclose on the initial default in the hope that a quicker sale will lower the risk that the debtor will file for bankruptcy during the following year. One commentator suggests that the net effect of Durrett will be to discourage third parties from bidding at foreclosures sales and to expose creditors who buy at foreclosure sales to liability for reselling the property.\textsuperscript{54}

The purchaser at the foreclosure sale generally will not forfeit the money he paid for the property if the sale is set aside. A good faith purchaser for value\textsuperscript{55} will have a lien on the property for the amount he paid.\textsuperscript{56} The pur-

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\textsuperscript{49} Are voidable, a bankruptcy court may hold a foreclosure sale void if the debtor files for bankruptcy within a year after the sale. 11 U.S.C. § 548(a) (Supp. IV 1980). The provision is analogous to a one-year statutory redemption period. See notes 36 & 37 and accompanying text supra.

\textsuperscript{50} 621 F.2d at 203-04.

\textsuperscript{51} 647 F.2d at 549 (Clark, J., dissenting).

\textsuperscript{52} In determining whether an amount paid at a foreclosure sale is reasonable, “[i]t is apparent that the Courts have established a firm 70% guideline because the greater the market value of a piece of property the more equity that can be cut off by the variation of a few percentage points.” In re Madrid, 10 B.R. 795, 800 (D. Nev. 1981) (64% of fair market value not reasonable).

\textsuperscript{53} 52. Lifton, Real Estate in Trouble: Lender’s Remedies Need an Overhaul, 31 BUS. LAW. 1927, 1937 (1976).

\textsuperscript{54} See 647 F.2d at 549 (Clark, J., dissenting).

\textsuperscript{55} Recent Real Property Decisions, 16 REAL PROP., PROB. & TR. J. 168, 228 (1981).

\textsuperscript{56} For purposes of the fraudulent transfers provisions, “‘value’ means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor . . . .” 11 U.S.C. § 548(d)(2)(A) (Supp. IV 1980). The value given by the transferee need not be reasonably equivalent, but good faith is required. See 4 COLLIER ON BANKRUPTCY ¶ 548.07[2] (15th ed. 1981). It is arguable that anyone buying at a foreclosure sale ought to be on notice that the financial condition of the debtor is questionable. But purchasers at such sales apparently will be protected. The court in Durrett gave the purchaser a lien on the property for the amount he paid. 621 F.2d at 204.

\textsuperscript{56} 11 U.S.C. § 548(c) (Supp. IV 1980). This section provides: [A] transferee or obligee . . . that takes for value and in good faith has a lien on any interest transferred, may retain any lien transferred, or may
chaser is entitled to get his money back if the trustee decides to have the transfer set aside, but he loses the benefit of his bargain and may have his money tied up during a lengthy bankruptcy proceeding.

Although the Durrett decision creates problems for lenders and purchasers, it benefits debtors who file for bankruptcy and their unsecured creditors. There are two broad types of bankruptcy proceedings: liquidation and reorganization. In a liquidation proceeding, the trustee sells the debtor’s assets to pay his creditors. In a reorganization proceeding, the debtor may work his way out of financial difficulty without liquidating his assets. The benefits of Durrett are most apparent in reorganization cases. If the debtor can regain substantial equity in property sold before he files for bankruptcy, his chances of working out a successful reorganization are increased. Even in a liquidation case, the debtor may want to set aside a prior foreclosure sale if he prefers to see his creditors paid rather than allow the foreclosure sale purchaser to keep a windfall profit. Similarly, the unsecured creditors will benefit when a foreclosure is set aside because of the increased pool of assets available to satisfy their claims.

Durrett does not resolve whether a judicial foreclosure could constitute a fraudulent transfer. Arguably, neither Durrett nor the bankruptcy statues

enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

57. B. WEINTRAUB & A. RESNICK, supra note 5, ¶ 7.06[7], provides an illustration:

For example, assume that an insolvent debtor sold property worth $50,000 to a bona fide purchaser for $40,000. Upon the debtor’s bankruptcy, the purchaser is given a lien on the property to secure repayment of $40,000. Accordingly, the trustee must return $40,000 in order to obtain the property worth $50,000.


60. Debtors seeking reorganization risk transformation of a reorganization proceeding into a liquidation proceeding on request of any party in interest. If, among other things, the court finds that the debtor is unable to effectuate a plan to pay his debts, it can order liquidation. Id. § 1112(b). The change must be made for cause, but Congress intended “cause” to include the lack of a “reasonable likelihood of rehabilitation.” S. REP. NO. 989, 95th Cong., 2d Sess. 117, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5787, 5903. The more money available to the estate, the greater the likelihood of rehabilitation.

61. In Cowen v. Guidry, 274 F. Supp. 22 (E.D. La. 1967), the issue of whether a judicial foreclosure sale could be a fraudulent transfer was raised. The court skirted
RECENT CASES

353

prevent a court from finding that a judicial sale is a transfer. 62 In other circumstances, bankruptcy courts have set aside judicial foreclosure sales 63 and other court-ordered dispositions of property. 64 It may be argued that there should be a presumption that amounts received in judicial sales are reasonably equivalent. 65 The temptation to extend Durrett to judicial sales will be strong, however, when the debtor’s equity is large and the sale price is low. 66

Since Durrett and the cases that have followed it have involved nonjudicial sales, the immediate impact will be strongest in jurisdictions when debtors have few statutory redemption rights following trustees’ sales and power of sale is the usual method of foreclosure. 67 In jurisdictions with statutory redemption rights, 68 purchasers know that foreclosure sales will be voided

the issue by finding that the fair market value of the property was equal to the sale price, although there was considerable evidence to the contrary. Id. at 24.

62. Indeed, the emphasis in Durrett was on the change of possession as constituting a transfer. 621 F.2d at 204. Possession changes whether the foreclosure is judicial or nonjudicial, thus the situations cannot be distinguished on that basis. The old definition of “transfer” specifically referred to changes of possession as sufficient to constitute transfers. 11 U.S.C. § 1(30) (1976) (repealed 1978). See note 33 supra.

63. E.g., Adler v. Greenfield, 83 F.2d 955, 956 (2d Cir. 1936) (judicial sale of drugstore fixtures after default judgment in favor of debtor’s brother held to be transfer by debtor and voidable); Wolf v. Aero Factors Corp., 126 F. Supp. 872, 878 (S.D.N.Y. 1954) (chattel mortgagee’s sale of mortgaged notes at judicial sale held to be voidable, preferential transfer).

64. E.g., Britt v. Damson, 334 F.2d 896, 902 (9th Cir. 1964) (court-ordered property settlement in divorce action was “transfer by the debtor” and could be set aside unless consideration was fair), cert. denied, 379 U.S. 966 (1965).

65. There is, however, little evidence of such a presumption in the bankruptcy cases. In Britt v. Damson, 334 F.2d 896, 902 (9th Cir. 1964), cert. denied, 379 U.S. 966 (1965), the court was willing to presume that there was fair consideration in a divorce settlement if the division of property was equal, but the court remanded the case to determine if the debtor received fair consideration for the amount his wife received in excess of half. 334 F.2d at 903-04.

66. The bankruptcy laws are to be construed broadly to maximize the estate of the bankrupt. See note 26 supra. This is an overriding concern of the fraudulent conveyances provisions, and when the amount to be regained for the estate is large, adherence to that spirit would require a finding that the judicial foreclosure sale is a transfer.


68. Equitable redemption rights need not be considered in this context because