

1985

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Recommended Citation

Benjamin Weintraub and Alan N. Resnick, *From the Bankruptcy Courts: Mortgage Foreclosure Sales as Fraudulent Conveyances-Does the 1984 Act Make a Difference?*, 17 UCC L.J. 376 (1985)

Available at: http://scholarlycommons.law.hofstra.edu/faculty_scholarship/878

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From the Bankruptcy Courts

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MORTGAGE FORECLOSURE SALES AS FRAUDULENT CONVEYANCES—DOES THE 1984 ACT MAKE A DIFFERENCE?

The comprehensive changes to the Bankruptcy Code resulting from the Bankruptcy Amendments and Federal Judgeship Act of 1984 (1984 Act)¹ touch almost every area of bankruptcy practice. In fact, it is difficult to ascertain the extent and impact of many of the amendments because of lingering uncertainties regarding their applicability. Needless to say, bankruptcy courts will be busy defining the reach of the new legislation.

One of the open questions relates to the avoidance of a pre-bankruptcy real estate mortgage foreclosure sale as a fraudulent conveyance when a noncollusive and regularly conducted sale produces a price that is less than the reasonably equivalent value of the property.

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Conflicting Decisions

In 1980, real estate practitioners were thrown into a state of shock when the Court of Appeals for the Fifth Circuit in *Durrett v. Washington National Insurance Co.*² held that a debtor in possession could avoid a transfer of real property made by means of a non-judicial foreclosure of a deed of trust within one year before bankruptcy. The property was sold for only 57.7 percent of its fair market value and, therefore, the court held that the price was not the reasonably equivalent value of the property within the meaning of Section 548(a)(2).³ It is easy to see how the *Durrett* decision causes

¹ Pub. L. No. 98-353 (July 10, 1984). Most of the substantive amendments to the Bankruptcy Code, including those discussed in this article, apply to cases commenced on or after October 8, 1984.

² 621 F.2d 201 (5th Cir. 1980). Other cases that have followed the reasoning in *Durrett* are, e.g., *Abramson v. Lakewood Bank & Trust*, 647 F.2d 547 (5th Cir. 1981), *cert. denied*, 454 U.S. 1164 (1982); *In re Richardson*, 23 Bankr. 434 (D. Utah 1982); *In re Perdido Bay Country Club Estates, Inc.*, 23 Bankr. 36 (S.D. Fla. 1982); see also *In re Hulm*, 738 F.2d 328 (8th Cir. 1984).

³ 11 U.S.C. § 548(a)(2). In essence, this section permits a trustee to avoid a transfer of the debtor's interest in property made while the debtor is insolvent and within one year prior to bankruptcy for "less than a reasonably equivalent value."

considerable uncertainty regarding the title obtained at a mortgage foreclosure sale for at least one year following the sale.⁴

The Ninth Circuit Appellate Panel, however, disagreed with *Durrett* and held in *In re Madrid*⁵ that a noncollusive and regularly conducted mortgage foreclosure sale, in and of itself, renders the price the fair equivalent of the value of the property. The court of appeals affirmed the *Madrid* decision, but reasoned that the transfer of property sold at a foreclosure sale actually dates back to the time the original deed of trust was perfected and, therefore, may be removed from the one-year fraudulent conveyance period under Section 548.⁶ In any event, as long as courts are in disagreement on the avoidability of such

foreclosure sales, the cloud over the title obtained at these sales will continue.

Did Congress in the 1984 Act address and resolve the uncertainty regarding the *Durrett* issue? Does the recent legislation either adopt or reject the reasoning of the court of appeals in *Madrid*? After the 1984 Act, can Section 548 be used to avoid a noncollusive and regularly conducted mortgage foreclosure sale because the price paid is less than the property's reasonably equivalent value? The only clear answer which could be given to these questions is maybe.

The 1984 Act

The 1984 Act contains two provisions which could, at first glance, lead to the conclusion that Congress intended to reject *Madrid* and codify the holding in *Durrett*. First, the introductory language of Section 548(a) was amended to clarify that the section applies to "voluntary or involuntary" transfers.⁷ Why would Congress add this clarification unless it wanted to emphasize that an involuntary taking of the debtor's property (i.e., a mortgage foreclosure) is subject to Section 548 on fraudulent conveyances? It is interesting to note that this amendment was entirely unnecessary in view of Section 101, which

⁴ Although § 548 applies to transfers made within one year prior to bankruptcy, the passage of one year does not necessarily remove the threat of avoidance. By virtue of § 544(b), the trustee or debtor in possession may use the rights of an actual unsecured creditor who, under state law, could have avoided the foreclosure sale as a fraudulent conveyance. In this regard, it is interesting to note that the National Conference of Commissioners on Uniform State Laws recently adopted the official text of the Uniform Fraudulent Transfer Act, which clearly rejects the *Durrett* holding. In states which adopt the new Transfer Act, the price received at a noncollusive and regularly conducted foreclosure sale will be deemed reasonably equivalent value regardless of the market value of the property.

⁵ 21 Bankr. 424 (9th Cir. A.P. 1982).

⁶ 725 F.2d 1197 (9th Cir. 1984); see also *In re Alsop*, 14 Bankr. 982 (Alaska 1981), *aff'd*, 22 Bankr. 1017 (Alaska 1982).

⁷ Pub. L. No. 98-353, § 463(a)(1).

already had defined "transfer" in the Code to include the voluntary and involuntary parting with property.

The second relevant amendment contained in the 1984 Act added the language "and foreclosure of the debtor's equity of redemption" to the definition of "transfer" in Section 101.⁸ On its face, this change appears to be a clear rejection of the Ninth Circuit Appellate Panel's holding in *Madrid* and a direction to bankruptcy courts to consider a foreclosure sale as a transfer that is separate and distinct from the original transfer of the mortgage lien which occurred when the deed of trust was perfected. When these two statutory amendments are examined, it appears that the 1984 Act supports the *Durrett* holding, at least to the extent of rendering mortgage foreclosure sales subject to the avoiding power of Section 548.

Nonetheless, there are two reasons why practitioners should not jump to the conclusion that *Durrett* is clearly applicable to all new cases by virtue of the 1984 Act. First, although the recent amendments state that "foreclosure of the debtor's equity of redemption" is a "transfer" and that Section 548 applies to both voluntary and involuntary transfers, the 1984 Act does not expressly address the question of whether the

price received at a noncollusive and regularly conducted foreclosure sale will, in and of itself, be deemed reasonably equivalent value as a matter of law. Therefore, Congress appears to have made prebankruptcy foreclosure sales subject to the strict scrutiny of bankruptcy courts (thus rejecting the court of appeals's decision in *Madrid*) without affecting the standards with which the avoidability of such foreclosure sales should be determined.

Senatorial Interpretations

Another reason for doubting those who are convinced that the 1984 Act codifies the *Durrett* holding is contained in the *Congressional Record*⁹ where a discussion between Senator DeConcini and Senator Dole was reported as follows:

Mr. DECONCINI. Apparently there may have been some misunderstanding regarding the effect of certain technical amendments made by the recently enacted bankruptcy legislation, Public Law 98-353, specifically section 421(i), which amended the definition of transfer in the Bankruptcy Code—11 U.S.C. section 101(48) in the new legislation—to add the phrase "and foreclosure of the debtor's equity of redemption,"; and section 467(a)(1), which amended section 548(a) of the Bankruptcy Code

⁸ Pub. L. No. 98-353, § 421(i).

⁹ 130 Cong. Rec. 13771-13772, 98th Cong., 2d Sess. (Oct. 5, 1984).

to add the phrase "voluntarily or involuntarily." A question has arisen whether these amendments somehow support the position taken by the U.S. Court of Appeals for the Fifth Circuit in *Durrett v. Washington National Insurance Co.*, 621 F.2d 201 (5th Cir. 1980), where the court held that a nonjudicial foreclosure sale could be set aside in bankruptcy if the sale price was not sufficiently high. My understanding is that these provisions were not intended to have any effect one way or the other on the so called Durrett issue. Is my understanding correct?

Mr. DOLE. The Senator's understanding is indeed correct. As the Senator knows, Senator THURMOND's amendment in the nature of a substitute to H.R. 5174, when introduced, contained language that would have overturned the position represented by the Durrett decision. Senator METZENBAUM, however, believed that no action should be taken on the Durrett issue until the Judiciary Committee had an opportunity to hold hearings on the issue and consider the matter thoroughly. In deference to Senator METZENBAUM's position, Senator THURMOND agreed to delete from his amendment all provisions dealing with the Durrett issue, and so stated on the floor on June 19—CONGRESSIONAL RECORD at page S7617. Consequently, no provision of the bankruptcy bill as passed by this body was intended to intimate any view one way or the other regarding the correctness of the position taken by the U.S. Court of Appeals for the Fifth Circuit in the Durrett case, or regard-

ing the correctness of the position taken by the U.S. Court of Appeals for the Ninth Circuit in *Lawyers Title Insurance Corp. v. Madrid*, 725 F.2d 1197 (9th Cir. 1984), which reached a contrary result.

The first provision, which amends the definition of "transfer" contained in section 101 of the Bankruptcy Code, appears to provide that certain foreclosures are included within the definition of "transfer." It does not purport to deal with whether such a transfer will fall within the scope of section 548(a)(2), which was the subject of the ninth circuit's decision, nor with the question of when a transfer occurs for purposes of section 548. Under section 548(d)(1), the transfer occurs on the date of the perfection of the mortgage or deed of trust, for after such date no bona fide purchaser from the mortgagor could take priority over the rights of a purchaser at the foreclosure sale. Those courts following Durrett have found and held that the former definition of "transfer" in section 101(41) was broad enough to include a foreclosure sale of the debtor's property while courts rejecting Durrett on the basis of the date of transfer, have done so under section 548(d)(1) and not section 101(41). Thus, the amendment should not be construed to in any way codify Durrett or throw a cloud over noncollusive foreclosure sales.

The second provision, which adds "voluntarily or involuntarily" to section 548(a) is consistent with the majority holding in *Madrid*. Finally, neither of the provisions purport to deal with the question of

whether a noncollusive, regularly conducted foreclosure sale should be deemed to be for a reasonably equivalent value.

Mr. DeCONCINI. Then I am correct in concluding that parties in bankruptcy proceedings who seek avoidance of prepetition foreclosure sales would find no support for their arguments in these amendments?

Mr. DOLE. The Senator's conclusion is correct.

Conclusion

It remains to be seen whether these remarks will be deemed conclusive when bankruptcy courts faced with the *Durrett* issue in the future must decide whether any weight should be given to the 1984 Act. These comments are not called "legislative history" because they were made more than three months *after* Congress passed the statute. Although both senators played a significant role

in the adoption of the 1984 Act, nonetheless they are unable to express the intention of the remaining members of Congress who never spoke on the issue. Moreover, while denying that *Madrid* is overruled by the 1984 Act, these remarks do not suggest any alternative rationale for adding "foreclosure of the debtor's equity of redemption" to the definition of "transfer" in Section 101. The senators' remarks leave the issues in limbo. It would be more consistent with state law and the practical problems in selling property at a foreclosure sale that the Bankruptcy Code follow the recently adopted official text of the Uniform Fraudulent Transfer Act, which clearly rejects the *Durrett* holding. After all, Section 548 was modeled upon the UFCA.¹⁰

¹⁰ See note 4 *supra*.