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Practitioner's Guide to Foreclosure on a Deed of Trust in the District of Columbia

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A PRACTITIONER'S GUIDE TO FORECLOSURE ON A DEED OF TRUST IN THE DISTRICT OF COLUMBIA

I. INTRODUCTION

Judicial sale is the traditional method of foreclosure on real estate in the United States today. For as long as anyone can remember, however, foreclosure practice in the District of Columbia has been accomplished extrajudicially through the power of sale provision in a deed of trust.

The statutory framework for real estate foreclosure is set forth in title 45, chapter 7 of the District of Columbia Code (D.C. Code).[1] A careful reading of these statutory provisions and the cases cited therein reveals that there exists no exclusive or even suggested statutory procedure for foreclosing on a deed of trust. On the contrary, the D.C. Code leaves the parties relatively free to privately contract foreclosure procedure.

The purpose of this guide is to set out and explain a foreclosure procedure commonly followed by title companies, auction houses and the real estate bar, as well as to discuss the nature of the deed of trust, the parties thereto, and various factors the practitioner should weigh when considering or conducting a foreclosure.

II. FORECLOSURE IN GENERAL AND THE DEED OF TRUST

A. *An Overview of Traditional Foreclosure Procedures*

American jurisprudence has developed numerous techniques for protecting the creditor when the debtor defaults on his obligations under a real estate purchase contract. These techniques, which are for the most part statutory, vary greatly among jurisdictions.

Judicial sale is still the most commonly used foreclosure procedure.[2] Although all jurisdictions allow foreclosure by this method, in some it is the sole remedy available to the creditor.[3] Judicial sale is typically initiated by

1. D.C. CODE ANN. §§ 45-701 to -720 (1981).

2. *See* 4 G. OSBORNE, AMERICAN LAW OF REAL PROPERTY, §§ 16.184-.195 (1952 & Supp. 1977), for a discussion of the development and current state of judicial foreclosure proceedings in the United States.

3. 4 G. OSBORNE, *supra* note 2, § 16.185, at 444. In the District of Columbia, foreclosure by judicial sale is governed by §§ 45-701 through 45-720 of the D.C. Code. Under §

filing a bill in equity setting forth the terms of the purchase agreement and the facts establishing the debtor's default. The court will then order the property sold and appoint a trustee to effect the sale. The chief complaints concerning this method of foreclosure are that, as with any court-supervised proceeding, it is expensive and time-consuming.[4]

Strict foreclosure, another traditional procedure, also involves court mediation. It differs from judicial sale, however, in that once the debtor is found to be in default and unable to cure the default, title to the property is conveyed to the creditor, and the debtor is forgiven his obligations under the purchase agreement.[5]

The third major traditional procedure is foreclosure by power of sale created by contract: the creditor retains a power of sale interest in the property that is triggered by the debtor's default. The creditor then has the right to sell the property and to apply the proceeds to the debtor's obligations.[6] Generally, loan contracts which include a power of sale are classified as such because two parties are involved: the creditor and the debtor. The deed of trust, on the other hand, involves three types of parties: the creditor, the debtor, and the trustee.

B. The Deed of Trust

1. General Considerations

The deed of trust is designed to create maximum flexibility in financing the purchase of real estate while preserving the interests and expectations of the parties. After the debtor executes a promissory note—termed a "deed of trust note"—for the purchase price, the creditor conveys the property to the debtor, who simultaneously deeds the property to a trust administered by a trustee. While the creditor is said to be the beneficiary of the trust, the debtor retains equitable title to the property and the normal incidents of ownership.[7] However, if the debtor defaults, for example, by failing to meet the monthly payment schedules, the creditor may direct the trustee to have the property sold.

45-706, if the creditor sues for the balance of the mortgage debt, and the debtor files an admission, the court may, without holding a hearing, order the property sold. If the debtor sets up a defense to the creditor's suit, the action proceeds according to equity practice. *See* D.C. CODE ANN. § 45-712 (1981).

4. 10 G. THOMPSON, COMMENTARIES ON THE MODERN LAW OF REAL PROPERTY, § 5175, at 205 (1957).

5. *See* 9 G. THOMPSON, *supra* note 4, § 4814, at 671.

6. *See* 10 G. THOMPSON, *supra* note 4, § 5183, at 251-53 (application of proceeds of sale pursuant to a power of sale clause). For a general discussion of the power of sale in a deed of trust, see *id.* §§ 5157-5185.

7. *See* 4 G. OSBORNE, *supra* note 2, § 16.17, at 36.

The chief advantage of the deed of trust is the simple and time-saving method by which the creditor may be made whole in the event of breach of the debtor breaches the underlying financial obligation. The apparent ease with which the creditor may reacquire possession of the property, to the inevitable consternation of the debtor, is defended on the theory that providing a swift mechanism for foreclosure benefits debtors as a class.[8] Lengthy judicial foreclosure proceedings drive up the creditor's financing costs, including attorneys' fees, court costs, lost interest payments, and lost profits from impaired principal. These monies might otherwise have been earning interest. Moreover, the creditor will pass these expenses on to other borrowers in the form of higher interest rates. Thus, power of sale foreclosure protects both the creditor and debtors as a class from delinquent borrowers.[9]

Within the District of Columbia, the power of sale provision has emerged unscathed from several constitutional challenges.[10] Debtors argue that the provision violates due process because their property is being seized and sold without resort to the courts.[11] Provided that the terms of the deed, especially with respect to the events triggering default, are not unconscionably unfavorable to the debtor, the courts treat the power of sale provision as a consensual agreement in which the debtor expressly agrees to allow foreclosure upon default.[12] Because the debtor consented to the provisions, foreclosure will be upheld in the absence of fraud or overreaching. The analysis is essentially identical to the judicial treatment afforded confessed judgment provisions in other forms of contracts.[13]

2. *The Parties*

Foreclosure on a deed of trust also is simplified by the legal relationship between the creditor and the debtor. Both parties assume the posture of

8. 10 G. THOMPSON, *supra* note 4, § 5175, at 204.

9. *Id.* at 204-05.

10. *See* Bryant v. Jefferson Fed. Sav. & Loan Ass'n, 509 F.2d 511 (D.C. Cir. 1974); Young v. Ridley, 309 F. Supp. 1308 (D.D.C. 1970).

11. *See Bryant*, 509 F.2d at 512-13; *Young*, 309 F. Supp. at 1311.

12. *See Bryant*, 509 F.2d at 513-14; *Young*, 309 F. Supp. at 1311-12. An alternative defense to the claim accepted by the courts, that the execution of a power of sale violates the fifth and fourteenth amendments, is that such execution does not involve state action, and therefore does not violate due process guarantees. *Bryant*, 509 F.2d at 513-14 (citing Moose Lodge No. 107 v. Irvis, 407 U.S. 163 (1972) and Shelley v. Kraemer, 334 U.S. 1 (1948)).

13. *See Young*, 309 F. Supp. at 1313 n.13; *see also* Note, *Confessions of Judgment*, 102 U. PA. L. REV. 524 (1954) (constitutionality of confessed judgment provisions in contracts); Bower v. Casanave, 44 F. Supp. 501, 507 (S.D.N.Y. 1941) (constitutionality of confessed judgment provisions in contracts).

parties to an ordinary contract.[14] As such, there is no particular duty imposed on the creditor to be deferential in the relationship with the debtor. This relationship contrasts with that present in the power of sale mortgage wherein the creditor's conduct will be strictly scrutinized to ensure that the creditor has not engaged in self-dealing or other conduct demonstrating bad faith in the execution of the power of sale.[15]

Under a deed of trust, judicial scrutiny is targeted instead at the trustee. The District of Columbia considers the trustee to be a true fiduciary, owing duties of fairness and full disclosure to the debtor as well as the creditor.[16] This fiduciary relationship serves two purposes. First, it protects the debtor by making the trustee, who is often a bank or other financial institution, liable for any misconduct. Because the trustee is a fiduciary, it is held to a higher standard of commercial integrity than would be the creditor, who has bargained with the debtor from an "arm's length" position in a commercial setting. Second, it relieves the creditor from the burden of considering both the debtor's interests and its own. The creditor may, without claims of self-dealing or conflict of interest, conduct its affairs with respect to the debtor in any commercially reasonable manner. Thus, for example, the creditor is allowed to bid for and purchase the property when auctioned by the trustee.[17] This freedom generally is not permitted the creditor who holds a power of sale mortgage.[18]

3. Events Triggering Default

The deed of trust note does not differ significantly from other debt contracts with regard to events triggering default. The parties are free to establish criteria which will allow the creditor to direct the trustee to exercise the power of sale. Along with a failure to make payments clause, the agreement will often define default as including bankruptcy of the debtor, the filing of a tax lien against the debtor, or any other event that may impair the creditor's ability to protect the loan.

One typical provision that is of special significance to the holder of a second deed of trust note is the "due on sale" clause. This provision de-

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14. *Cf. Bryant*, 509 F.2d at 515 (power of sale provisions in deeds of trust possess the normal incidents of private contracts) (citing D.H. Overmeyer Co. v. Frick Co., 405 U.S. 174 (1972)).

15. 10 G. THOMPSON, *supra* note 4, at 205-06.

16. *See* Brown v. Oriental Univ., 44 App. D.C. 414 (1916); Johnson v. Inter-City Mortgage Corp., 366 A.2d 435 (D.C. 1976); Canelacos v. Hollway, 123 F.2d 934 (D.C. Cir. 1941); 10 G. THOMPSON, *supra* note 4, § 5176, at 215; *see also* 4 G. OSBORNE, *supra* note 2, § 16.17, at 36 (both the debtor and the creditor are, technically, the *cestuis que trust*).

17. 10 G. THOMPSON, *supra* note 4, § 5184, at 253-57.

18. *Id.* at 253.

fines default as including sale of the property, whether voluntarily, by judicial proceedings, or by execution of power of sale held for the benefit of a junior lienholder. On sale of the property, the senior creditor can call the note due and demand satisfaction of the debt from the proceeds of sale. The junior creditor therefore should carefully examine all senior liens on the property to determine if a "due on sale" provision is present. If so, the creditor should determine if the expected proceeds of sale of the property will satisfy the senior creditor's claims, the junior creditor's claims, and all expenses incidental to the sale. If the junior creditor's claim proves to be undercollateralized, its interests may be better served by refinancing the debt.

III. Foreclosure on the Deed of Trust

A. Preliminary Observations

The decision to foreclose on a deed of trust involves more a weighing of practical considerations than a searching legal analysis. As with any plan for collecting on a debt, the paramount concern is how best to recover the majority of the creditor's loan. The dispositive facts in this analysis are the debtor's financial status, the creditor's priority position with regard to the property, and the degree of collateralization of the debt.

1. Priority of the Lien

As discussed earlier, in the case of a junior lien and an undercollateralized debt, the creditor's most advantageous alternative, at least in the instance of a solvent debtor, is to refinance the loan. If, however, the debtor is insolvent and has filed a bankruptcy petition or is otherwise immune from the effects of a deficiency judgment, the creditor may negotiate a voluntary assignment of the property from the debtor in exchange for absolution of the debt. Such an agreement costs the creditor nothing, since it saves him the additional attorneys fees, auctioneer fees, publication fees and other expenses incidental to execution of the power of sale. Furthermore, a deficiency judgment, in any event, would be worthless.

As this discussion indicates, it is essential for the junior lienholder to acquire and carefully analyze a title report on the property involved so as to ascertain the rights of all other secured parties and the manner in which such rights impact on the creditor's ability to recover the loan.

2. Auction House Policy

A procedural factor to consider when conducting a foreclosure is that auction companies in the District of Columbia establish their own in-house rules of procedure for participation in the execution of a power of sale. The most important rule provides that the debtor must be in arrears in payments for at least sixty days. While there is no particular legal basis for this grace period, this policy is enforced by most of the well established auction companies. The creditor is well advised to use this time to analyze carefully the debtor's financial health and perhaps come to some agreement with the debtor with respect to the loan.

B. The Foreclosure Process

1. Instruction to the Trustee

The first step in the foreclosure process is for the creditor to notify the trustee that the debtor is in default. Because of the potential liabilities arising from the trustee's fiduciary responsibilities, the trustee should demand to be apprised of the specific circumstances giving rise to the default. The trustee should then write the debtor, explaining that the creditor has requested foreclosure and the grounds for the asserted default, and request that the latter inform the trustee of any refutation or defense to the creditor's claim of default. Ideally, an agreement can be reached between the debtor and the creditor with respect to curing the default.

2. Acceleration

An important event triggered by the creditor's declaration of default is acceleration of the loan payments. Section 45-705 of the D.C. Code provides that once the creditor has declared the debtor to be in default, the debtor can cure by tendering in full the outstanding principal and all interest due together with all costs incurred in the foreclosure process.[19] The debtor, however, cannot cure the default by bringing current the arrearages.

This acceleration provision can be altered by contract, and often must be waived if the loan is insured by many of the federal mortgage insurance institutions. For example, no residential real estate loan will be insured by the Veterans Administration or the Federal Home Administration, nor made through the Federal National Mortgage Association or the Federal Home Loan Mortgage Association, unless the lender waives its right to accelerate the loan on default.

3. Statutory Notice

Section 45-715 of the D.C. Code provides that no foreclosure sale, au-

19. *See* D.C. CODE ANN. § 45-705 (1981).

thorized pursuant to a power of sale provision in a deed of trust, may take place unless the debtor is given thirty days notice of the impending sale.[20] A notice pursuant to standard Recorder of Deeds Form No. FS-1[21] sets forth such facts as the names and addresses of the creditor and the debtor, the legal description of the property, the balance due on the note, and similar matters.[22]

The statute, however, does not require that the debtor actually receive the notice, but only that notice be sent to the debtor's last known address.[23] Notification, therefore, would be valid even if the debtor were out of state or otherwise absent from his home address for a prolonged period of time.

The thirty day statutory notice period prior to the sale of the property is deemed to commence when the notice is received by the mayor's office.[24] The mayor's office, upon receipt of the notice, will mail an acknowledgment of receipt to the creditor stating the date on which the notice was received.[25]

4. Advertising

After notice has been sent to the debtor and the mayor's office, the trustee typically will engage an auctioneer to effect the sale. The first step of the sale process is advertisement.

Unlike most jurisdictions that permit foreclosure by deed of trust power of sale, the District of Columbia has no statutory requirements for advertising the foreclosure sale. Nonetheless, adequate advertising is in the creditor's best interests for a number of reasons. First, the property is more likely to command fair market value if the sale is well attended. The creditor is therefore more likely to recover the balance of its loan in full. Second, the trustee may require a full advertising schedule so as not to be charged with breach of duty by reason of a surreptitious sale. Third, title insurance companies may decline to insure the title or may charge a higher premium if the advertising is deemed inadequate for fear of having the sale later set aside by a court decree.

Common practice in the District of Columbia is to run an advertisement on alternate days at least five times, commencing after the thirty day statutory notice period has expired. Auction houses require that the advertise-

20. *Id.* § 45-715(b).
21. This form may be procured at the Recorder of Deeds Office.
22. *See* D.C. CODE ANN. § 45-715(b) (1981).
23. *Id.* Notice must be sent to the debtor by certified mail, return receipt requested. *Id.*
24. *Id.*
25. *Id.*

ment appear in a newspaper of general circulation such as the *Washington Post.*

5. The Sale

On the day fixed by the advertisement, the auctioneer will sell the property to the highest bidder. If the bids are considered to be too low, the auctioneer, on the instruction of the trustee, may decline to accept the bids, readvertise, and proceed with the sale at a later date. Obviously, this action will increase the ultimate cost of foreclosure, and thus such costs should be weighed against the expected increase in the property's sale price.

Because the security interest of junior lienholders will be extinguished by sale of the property, all such creditors are well-advised to be represented at the sale, and to "bid-in" if the high bid would be insufficient to satisfy both their claim and the balance of the debts owed to all senior creditors. Purchase of the property may seem unsatisfactory to junior creditors seeking a more liquid recoupment of the loan, but it is essential in instances in which the debtor is insolvent and execution on a deficiency judgment, were it possible, would be a lengthy and expensive process.

Junior lienholders, however, are not entitled to notice of the sale other than through the advertisement required by statute. Therefore, diligent reading of the foreclosure advertisements or an agreement with senior creditors for individual notice is necessary if the junior creditor is to protect his interests by attending the sale.

It is often advantageous for the first deed of trust creditor to "bid-in" at the auction in order to ensure that the property is sold for at least the amount of the balance due on the loan. Commonly, the creditor will enter a bid with the auctioneer at the start of the sale for the amount of the balance due on the loan, the expenses of the sale to date, and any unpaid real estate taxes or similar fees and expenses.

The debtor has no right to redeem the loan and buy back the property once the sale has taken place at auction at the time and place specified by the advertisement.[26]

6. Post-Sale Events

Settlement on the sale will take place within the time specified by the advertisement, typically thirty days after the sale. At settlement, the

26. *See* Parker v. Dacres, 130 U.S. 43 (1889) (common law has never recognized a mortgagor's right to redeem the loan after sale of the property has occurred). There is no District of Columbia statute modifying this general rule.

trustee will deliver a trustee's deed to the buyer in exchange for the purchase price. The trustee will then disburse to the creditor the amount of the outstanding debt plus expenses. If there are lienholders senior to the creditor conducting the sale, their claims must be satisfied first. The debtor will then receive the surplus, if any, of the proceeds. If there are insufficient proceeds to extinguish the debt, the debtor will remain liable for the deficiency.

IV. The Debtor's Options

A. Acquiescence

In most cases, the debtor's receipt of the statutory notice of foreclosure is not the first communication the debtor has received warning that his property is in jeopardy of being sold. By this point, negotiations generally have been held between the debtor and the creditor in an effort to stave off foreclosure. Consequently, receipt of the notice informs the debtor of the creditor's pessimism about the parties' ability to reach a suitable settlement and the creditor's intention to recover the amount due under the loan by execution of the power of sale.

A careful analysis of the factual circumstances, including the solvency of the debtor, the latter's acquired equity in the property, and current real estate market conditions, is necessary to determine the most favorable course of action. In the absence of an available defense to foreclosure, the debtor's most prudent recourse is to deed the property to the creditor, thereby sparing himself the expenses of a public sale. If, for example, the debtor is insolvent, with little or no equity in the property and, further, assuming that fair market value would be received upon the sale, the debtor might be able to convince the creditor to forgive the debt in exchange for a deed to the property. Similarly, if the debtor has acquired a substantial amount of equity in the property, the creditor may be willing to "buy-out" that equity on conveyance of the property.

B. Defenses to Foreclosure

Where the debtor intends to assert a defense against foreclosure, his first act should be to petition an appropriate court for a temporary restraining order (TRO). Defenses are generally based on contractual, equitable or statutory grounds.

1. Defenses on the Contract

The debtor may assert any breach of the promissory note or the deed of trust as grounds for a TRO. The most common claim concerns procedural irregularities in executing the power of sale, based either on express provisions in the note or deed or implied conditions referenced from the provisions of the District of Columbia Code.[27]

The debtor might also assert that there has been no default on his part, and that in the absence thereof execution of the power of sale is a breach of contract by the creditor and a breach of trust by the trustee.

2. *Equitable Defenses*

The debtor has a large arsenal of equitable claims that may be asserted to restrain sale of the property, including fraud in the inducement of the promissory note, breach of fiduciary duty by the trustee, lack of capacity of the debtor to execute the agreement, and mistake.[28] More tenuous equitable defenses, such as temporary job loss or uncontrollable fluctuations in income, may provide a sympathetic court of equity sufficient reason to issue a TRO. Obviously, the less compelling the rationale for granting a TRO, the more severe the harm to the efficient market theory which is the basis for the deed of trust mechanism.

3. *Federal and District of Columbia Statutory Defenses*

Defenses to foreclosure are commonly based upon violations of various applicable lending statutes, such as the federal Truth in Lending Act,[29] the District of Columbia Loan Shark Act,[30] and the Usary Act[31]. The creditor should carefully review these statutes prior to setting the terms of the deed of trust note so as to avoid complications when attempting to foreclose.[32]

Similarly, noncompliance with the rules and regulations of the Veterans Administration, the Federal National Mortgage Association and similar institutions may be grounds for a TRO if the loan is insured or made through one of these entities.[33] The creditor, therefore, must take care to waive acceleration rights, make good faith efforts to refinance payment schedules, and otherwise comply with applicable provisions.

27. *See* D.C. CODE ANN. § 45-715(b) (1981) (thirty day notice requirement).

28. *See* 10 G. THOMPSON, *supra* note 4, § 5179, at 230.

29. *See* 15 U.S.C. §§ 1601-1693 (1982).

30. *See* D.C. CODE ANN. §§ 4-147 to -150 (1981).

31. *Id.* §§ 28-3301 to -3309.

32. The practitioner should note that none of these statutory provisions are retroactive.

33. *See, e.g.*, Perry v. Virginia Mortgage and Inv. Co., 412 A.2d 1194 (D.C. 1980) (noncompliance with mortgage insurer's regulations may be grounds for temporary restraining order).

V. Conclusion

The practice of foreclosure on a deed of trust in the District of Columbia is a potpourri of tradition and policy without statutory basis, influenced more by institutional lenders and auction houses than by legislative enactment. The result, interestingly, is a financial market mechanism which has proved successful and beneficial to both lender and borrower. Although foreclosure on a deed of trust is no doubt mysterious to newcomers to the field because of the lack of legislative direction, other areas of commercial practice could prosper from the assimilation of this time and money saving, self-executing device.

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