

ARTICLES

Can a Pre-Petition State Tax Lien Foreclosure Be Avoided as a Fraudulent Transfer?

By Lynn J. Hinson

Section 548(a)(1)(B) of the United States Bankruptcy Code provides that a bankruptcy trustee has the power to avoid any pre-petition transfer of an interest of the debtor in property that was made on or within 2 years before the date of the filing of the bankruptcy petition if the debtor was insolvent at the time the transfer was made *and* voluntarily or involuntarily received less than reasonably equivalent value in exchange for the transfer. As provided by § 1107(a), a debtor in possession has the same power to avoid a fraudulent transfer.

Real Estate Mortgage Foreclosure Sales

Twenty years ago, the United States Supreme Court rendered its decision in *BFP v. Resolution Trust Corporation*, 511 U.S. 531 (1994). The question presented was whether the consideration received from a non-collusive real estate mortgage foreclosure sale conducted in conformance with applicable state law conclusively satisfied the requirement that transfers of property by insolvent debtors prior to the filing of a bankruptcy petition is an exchange for reasonably equivalent value.

The Supreme Court held that the consideration received from a non-collusive real estate mortgage foreclosure sale conducted in accordance with applicable state law conclusively establishes that the consideration received was for reasonably equivalent value. Accordingly, neither a bankruptcy trustee nor a debtor can avoid a mortgage foreclosure sale conducted in conformity with applicable state law.

However, the Court emphasized that its holding does not render § 548(a)(1)(B)(i) superfluous since the “reasonably equivalent value” criterion will continue to have independent meaning outside a real estate foreclosure context. The Court also stated that reasonably equivalent value generally has a meaning similar to fair market value. The Court also specifically reserved on extending its holding to other foreclosures or forced sale proceedings, such a tax foreclosure proceedings.

***In Rem* Real Estate Tax Foreclosure Sales**

Recently, several courts have addressed the question of whether state real property tax foreclosures are governed by the Supreme Court’s ruling in *BFP*. The courts reached different conclusions.

In *County of Clinton v. Warehouse at Van Buren Street, Inc.*, 2013 WL 2145056 (N.D. N.Y. May 15, 2013), the United States District Court for the Northern District of New York affirmed a

Bankruptcy and Insolvency Litigation Committee

bankruptcy court order requiring the County to reconvey to the Chapter 11 debtor title to a parcel of real property following an *in rem* real estate tax foreclosure sale.

The pre-petition tax lien foreclosure proceeding in *Van Buren Street* was filed by the County following the debtor's failure to pay approximately \$7,200.00 in real property taxes. The debtor did not defend against the proceeding, and a tax foreclosure judgment was entered on March 10, 2010. As provided by New York Real Property Tax Law § 1136(3), title passed to the County.

The property, which was then owned by the County, was sold for \$120,000.00 at a public auction several months later. The debtor filed a Chapter 11 petition the same day, and listed the property as an asset of the estate. Following the filing of the petition, the debtor commenced an adversary proceeding seeking to avoid the pre-petition transfer pursuant to the provisions of § 548. The debtor argued that the transfer of title to the County should be avoided because it was for less than reasonably equivalent value.

The Bankruptcy Judge found that the transfer was for less than reasonably equivalent value. The County was therefore ordered to reconvey title to the property to the debtor. The County appealed to the United States District Court for the Northern District of New York.

The County made several arguments on appeal. The primary argument was that Congress could not have intended for a tax foreclosure sale to fall within the scope of §548. The District Court rejected the County's argument, and stated that the amount of a tax lien is no evidence whatsoever of the value of the property.

The Court in *Van Buren Street* relied, in part, on the holding of the United States Bankruptcy Court for the Northern District of New York in *In re Herkimer Forest Products Corp.*, 2005 WL 6237559 (Bankr. N.D. N.Y. 2005). In that case, the Bankruptcy Court recognized that the *in rem* tax foreclosure process under New York law is substantially different than the process in mortgage foreclosures. The main distinction was that the tax foreclosure process did not require a public sale and competitive bidding.

The District Court, citing *In re Herkimer Forest Products*, concluded that there can be no presumption that the consideration received in a tax foreclosure sale is for reasonably equivalent value. The Court held that the factual question regarding reasonably equivalent value in a tax sale is always an issue for the bankruptcy court to decide. The bankruptcy court's factual determination that the value of the property was far in excess of the amount of the real estate taxes that were due was upheld. Accordingly, the Court affirmed the Bankruptcy Court's order requiring the County to reconvey the property to the debtor.

In a more recent ruling, the United States District Court for the Northern District of New York again considered and rejected a county's argument that tax lien sales should be shielded from claims under Section 548 and affirmed the bankruptcy court's ruling that the property tax foreclosure sale could (and would) be avoided pursuant to Section 548(a)(1)(B). The Court refused to extend the ruling in *BFP* based on the differences between New York mortgage foreclosures and *in rem* tax foreclosures. *Clinton County Treasurer v. Wolinsky*, 2014 WL

2139269 (N.D. N.Y. May 2014). The Court also stated that the County's policy based arguments in favor of the protection of tax lien sales from the reach of Section 548(a)(1)(B) were not persuasive and, in any event, "more appropriately made before Congress."

In contrast, the Bankruptcy Appellate Panel of the Ninth Circuit recently reached the opposite conclusion in *Tracht Gut, LLC v. Cnty. of L.A. Treasurer & Tax Collector, et. al, (In re Tracht Gut, LLC)*, 503 B.R. 804 (9th Cir. BAP 2014). In *Tracht*, the debtor sought to avoid the County's pre-petition tax sales of real property. The attempt to avoid the sale was based on the debtor's contention that the sales were not made for reasonably equivalent value. The bankruptcy court dismissed the complaint with prejudice after concluding that an amendment would be futile. The debtor appealed the dismissal to the United States Bankruptcy Appellate Panel of the Ninth Circuit.

The BAP affirmed the bankruptcy court's ruling based on the holding in *BFP*. In support of its ruling that *BFP* should be applied to regularly conducted sales of tax-defaulted real property in California, the BAP cited the following requirements of California law:

1. Substantial lead time before the commencement of foreclosure proceedings;
2. Publication of a notice of the sale once a week for three consecutive weeks prior to the sale; and
3. Strict adherence to prescribed competitive bidding rules and auction procedures required by California law.

Here, the BAP found that "there was appropriate lead time before the commencement of foreclosure proceedings," "notice was properly given to the defaulting parties," "there was publication of a notice of sale" and "competitive bidding" in compliance with California law. Accordingly, the BAP concluded that based on compliance with the procedural requirements of California law, the tax foreclosure sale presumptively was for reasonably equivalent value.

Conclusion

In 1994, the Supreme Court held that the consideration received from a non-collusive real estate mortgage foreclosure sale conducted in conformance with applicable state law conclusively satisfies the requirement that transfers of property by insolvent debtors prior to the filing of a bankruptcy petition is an exchange for reasonably equivalent value. The Court did not decide whether state tax lien foreclosure sales are in exchange for reasonably equivalent value.

New York and California courts disagree on whether state tax lien foreclosure sales are for reasonably equivalent value. However, the rulings can be reconciled. The decisions in New York are based on the significant differences between the procedural requirements of mortgage foreclosures and tax lien foreclosures.

The decisions in California are based on the similarities of the procedures for mortgage foreclosures and tax lien foreclosures. Tax lien foreclosures in California require substantial lead

Bankruptcy and Insolvency Litigation Committee

time before commencement, publication of notice of the foreclosure sale and competitive bidding.

It appears likely that courts will hold that tax lien foreclosure sales are for reasonably equivalent value as long as the procedural requirements are the same as those in state mortgage foreclosures and are strictly complied with.

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The views expressed in this submission are those of the author.