

# Chapman Client Alert

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Current Issues Relevant to Our Clients

## Seventh Circuit Holds Illinois Tax Sales May Be Set Aside as Fraudulent Transfers

Generally, a sale or other transfer of an insolvent debtor's property may be set aside as a fraudulent transfer if the transfer was for less than "reasonably equivalent value." 11 U.S.C. §548(a)(1)(B).

The United States Supreme Court has held that sales such as mortgage foreclosure sales that comply with state law are deemed to be for "reasonably equivalent value" as a matter of law. *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994).

On January 20, 2016, the Seventh Circuit held in *In re Smith*, No. 15-1166, 2016 WL 231769 (7th Cir. Jan. 20, 2016) that Illinois real property tax sales cannot be deemed to be for "reasonably equivalent value" as a matter of law. Applying the general rule of §548(a)(1)(B), the Court noted that tax sales do not involve competitive bidding and the bid amount bears no relationship to the value of the underlying real estate.<sup>1</sup>

The debtors' home was liened for unpaid taxes in 2000. In 2001, the county, under state law, auctioned the tax lien, which was ultimately purchased for slightly over \$5,000.00 by a tax lien purchaser. The tax lien purchaser was awarded a Certificate of Purchase that entitled it to, among other things, title to the property if the debtors did not pay the tax lien purchaser the tax obligations, plus accruing interest, and redeem the tax obligations.

The debtors failed to redeem the tax obligations and the tax purchaser applied for, obtained and recorded its tax deed with the county in April 2005. Shortly thereafter, the tax purchaser sold the property to a third party investor for \$50,000.00.

In April of 2007, the debtors filed their Chapter 13 bankruptcy petition and simultaneously filed an adversary action against the tax lien purchaser and the third party purchaser to avoid the tax sale of her property as a fraudulent transfer. After a trial, the Bankruptcy Court held that the *BFP* decision did not apply to Illinois tax sales. On cross-appeals, the District Court disagreed, holding that because the tax sale had complied with state law it could not be set aside as a fraudulent transfer.

Balancing state law and the interest in collecting delinquent real estate taxes with longstanding fraudulent transfer principles, the Seventh Circuit agreed with the Bankruptcy Court and held that *BFP's* holding does not extend to Illinois tax sales. While other Circuits have extended *BFP's* rationale

to tax sales, the Seventh Circuit noted that the *BFP* decision was based on the practical concerns of allowing federal bankruptcy law to work with state mortgage foreclosure law and not "textual clues" in §548. The Seventh Circuit also observed that *BFP's* holding was limited in scope to mortgage foreclosure sales, and the Supreme Court had specifically identified other forced sales as requiring different considerations.<sup>2</sup>

Because Illinois' tax sale method<sup>3</sup> is not designed to produce bids that could be deemed "reasonably equivalent value" (there being no correlation between the bid and the value of the property), the Seventh Circuit declined to extend the holding in *BFP* to Illinois tax sales. The debtors received a value of slightly more than \$5,000.00 from the tax lien purchaser, but had to surrender their home worth somewhere between \$50,000.00 (what the third party purchaser paid), and \$110,000.00 as appraised — or only 4% to 9% of the value of the property. Citing the broader principles of the Bankruptcy Code's fraudulent transfer provision, the Seventh Circuit considered this a windfall to one creditor at the expense of others that did not allow for a "fresh start" for the debtors.<sup>4</sup>

Addressing the argument that its decision would bring Illinois tax sales under "a federally created cloud" while creating instability in the tax lien purchase market and dampening the ability of the State to collect delinquent real estate taxes, the Seventh Circuit focused on the fact that delinquent taxpayers already had 2 years to redeem the sold taxes and the probability of a tax buyer obtaining title to the real estate was minimal.<sup>5</sup>

Will this decision chill tax sale bidding and "wreak havoc" with Illinois' collection of delinquent real estate taxes? Of course, it is hard to know given that the decision was just rendered. But the Seventh Circuit was keen to point out that tax buyers still

have plenty of incentive to bid at tax lien sales including, as alluded to above, that most delinquent taxpayers redeem the sold taxes before the tax purchaser can take title to the property, and that good faith third party property purchasers are shielded from liability under 11 U.S.C. §550(b)(a). If anything, tax lien purchasers may be more inclined to bid higher than the 0% penalty interest rate floor to lessen the chances of a fee-simple windfall and ultimately recover more from the delinquent taxpayer (should redemption occur as it does in the majority of instances).

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### For More Information

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1 *Id.* at 2.

2 *Id.* at 6-7.

3 In Illinois tax sale bidders are purchasing the tax lien and not the real property. Bids are not formulated on the real estate's value, but rather as decreasing interest percentages or what the tax buyer may demand in penalty interest rates from the delinquent taxpayer to redeem the property (from a ceiling of 18% down to a floor of 0%). The lowest bidder wins and is granted the tax lien and a certificate of purchase — allowing the tax lien purchaser to obtain title to the property if the delinquent taxes and other charges are not paid within 2 years.

4 *Id.* at 10-11.

5 *Id.* at 11-12.

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