



Insights

Tax Sales and Fraudulent Transfers: Two Approaches

Article

September 27, 2016 | *Law360*

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 U.S. Supreme Court has held, however, that property sales such as mortgage foreclosure sales that comply with state law are deemed to be for "reasonably equivalent value" as a matter of law and cannot be challenged as fraudulent transfers. *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994).

Despite the Supreme Court cautioning that the "reasonably equivalent value" principle would in most cases remain similar to a market-value definition, and refusing to force its holding on other forced-sale proceedings, on Sept. 8, 2016, the Ninth Circuit became the third federal appeals court to extend BFP's holding to real estate tax sales.

In *Tracht Gut LLC v. Los Angeles County Treasurer and Tax Collector*, (9th Cir. Sept. 8, 2016), the Ninth Circuit held that California real estate tax sales are for reasonably equivalent value and cannot be set aside as fraudulent transfers under 11 U.S.C. 548(a)(1)(B). Previously, the Fifth and Tenth Circuits applied BFP to state tax sales. In *re T.F. Stone Co.*, 72 F.3d 466, 472 (5th Cir. 1995) (tax sale complying with state law satisfied "present fair equivalent value" requirement consistent with "reasonably equivalent value" requirement of 548); In *re Grandote Country Club Ltd.*, 252 F.3d 1146, 1152 (10th Cir. 2001) (BFP applies to tax sales challenged under state fraudulent transfer law when state law requires competitive bidding procedures).

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Earlier this year, however, the Seventh Circuit in *In re Smith*, No., 811 F.3d 228 (7th Cir. 2016), refused to extend BFP to Illinois tax sales. The Seventh Circuit held that without a process that invites competitive bidding and thus bid amounts that correlate to value of the underlying real estate, Illinois tax sales are not designed to produce bids that could be deemed “reasonably equivalent value.”

The debtors in *Smith* received a value of slightly more than \$5,000 from the tax lien purchaser, but had to surrender their home — worth somewhere between \$50,000 (what the third-party purchaser paid), and \$110,000 (as appraised) — for only 4 percent to 9 percent of the value of the property. Citing the broader principles of the Bankruptcy Code’s fraudulent transfer provisions, 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.¹

While the debtor in *Tracht Gut* argued the exact same thing, and there was evidence that the tax sale purchase price was far less than the market value of the real estate, the Ninth Circuit, relying on “the rationale and policy considerations” of the BFP holding, largely ignored the debtor’s arguments. The Ninth Circuit applied BFP’s holding to California tax sales, noting that like mortgage foreclosure sales, tax sales in California require such procedural safeguards, such as notice to the defaulting land owner, substantial lead time before the foreclosure sale, and strict adherence to prescribed bidding and auction procedures. With its deference to state law on matters concerning real estate, the Ninth Circuit further reinforced BFP’s mantra that “market value has no applicability in the forced sale context.” *Id.*

It may be that the Ninth Circuit did not want to bring California state tax sales under a cloud in federal bankruptcy cases, preferring to avoid instability in the tax sale market that could dampen the state’s ability to collect delinquent real estate taxes.

The Seventh Circuit was obviously not bothered by such concerns, noting that the Supreme Court in BFP expressly limited its decision to mortgage foreclosure cases, based on the practical concerns of allowing federal bankruptcy law to work with state mortgage foreclosure law.² The Seventh Circuit determined that its holding would not “wreak havoc” on Illinois’ system for collecting delinquent property taxes.³ In the Seventh Circuit, at least for now, forced sales other than mortgage foreclosure sales are assailable on fraudulent conveyance grounds.

So is it really just a matter of having a competitive tax sale bidding procedure or one that operates more like a mortgage foreclosure sale? It is, of course, difficult to say.

In Illinois, the tax sale procedures provide only for a tax lien. The debtor retains title to the real estate until the tax purchaser obtains a tax deed, which can occur no earlier than two years after the tax sale. This is in contrast to the procedure in California, where the tax sale purchaser obtains title to the underlying real estate upon the tax sale purchase. These differences in the sale process may explain the disparity between the Seventh and Ninth Circuit on this issue. The different approaches may also reflect the Ninth Circuit being more deferential to state laws and procedures, and the Seventh Circuit being more literal in interpreting the scope of the BFP decision.

1. Id. at 238.
2. Id. at 236.
3. Id. at 239.

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