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News at 11

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Tax Lien Foreclosures Could Be Unraveled in Bankruptcy

Debtors often lose real property pre-petition for failure to pay property taxes to their local taxing authority. If a debtor is delinquent on property tax payments, the local taxing authority will place a lien on the property. If the debtor fails to pay the delinquent property taxes after given an opportunity to remove the lien through payment, the taxing authority will seek to recover the delinquent taxes and satisfy the debt owed to it through a foreclosure and sale of the property. Many real estate investors specialize in acquiring property at tax lien foreclosure sales, which often allows investors to obtain property at a price below market value. However, the investment transaction is not risk-free.

One risk that investors and county taxing authorities may overlook is the possibility that the debtor may file for bankruptcy protection shortly after the foreclosure sale and prior to closure of the sale transaction. In such an instance, the debtor or trustee may seek to unravel the sale transaction and recover the property or its value so that the value may be available for distribution to all creditors of the bankruptcy estate. The debtor can accomplish the transfer avoidance and recovery by commencing a fraudulent transfer avoidance action under § 548(a)(1) of the Bankruptcy Code. This article discusses (1) recent cases in which tax lien foreclosure sales were unraveled in bankruptcy because the court found that reasonably equivalent value was not received; (2) how tax lien foreclosures are distinct from mortgage foreclosures with respect to the reasonably equivalent value analysis; and (3) the key takeaways of the case law regarding avoidance of tax lien foreclosures.

Recovering Debtor's Property Through Fraudulent-Transfer Actions

If a property transfer through foreclosure of a tax lien was made or incurred on or within two years before the bankruptcy filing, the foreclosure transaction may be avoided and the property may be transferred to the debtor's bankruptcy estate if the property was transferred through actual fraud or constructive fraud. A tax lien foreclosure transaction will most often be challenged on a constructive-fraud basis: The debtor or trustee will seek to establish that "less than reasonably equivalent value" was received in exchange for the transfer of the foreclosed real property and that the debtor

(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or

(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.²

If the tax lien foreclosure transaction is successfully avoided, the debtor may recover for the bankruptcy estate "the property transferred, or, if the court so orders, the value of such property."³



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¹ This article represents the views of the author, and such views should not necessarily be imputed to Norton Rose Fulbright, Fulbright & Jaworski LLP or their respective affiliates and clients.

² 11 U.S.C. § 548(a)(1).

³ 11 U.S.C. § 550(a).

Recent Cases

In *Clinton County Treasurer v. Wolinsky*,⁴ the debtor failed to pay pre-petition property taxes on his real property owned in Clinton County, N.Y. The county treasurer, on behalf of Clinton County, consequently commenced an *in rem* tax foreclosure proceeding seeking payment of the delinquent tax debt.⁵ The debtor failed to pay the tax debt owed, and the title to the debtor's property was then transferred to the county.⁶ The assessed value of the property at the time of transfer was \$42,000.⁷ More than two months later, the county sold the property to a bona fide purchaser at a public auction for \$25,500.⁸ A quitclaim deed was recorded in the county records.⁹

Six months after the sale to the bona fide purchaser, the debtor filed for chapter 7 protection.¹⁰ Post-petition, the chapter 7 trustee commenced an adversary proceeding to avoid the sale on constructive fraudulent grounds.¹¹ The court found that reasonably equivalent value was not received and therefore allowed avoidance of the sale. The court also required that the county pay the estate the \$25,500 amount that was realized at the auction, less the tax debt that was owed and any expenses incurred.¹²

In an earlier bankruptcy case, the county foreclosed on the debtor's real property for approximately \$7,200 in delinquent property taxes.¹³ A judgment of foreclosure was entered, and the title was transferred to the county under New York state real property tax law.¹⁴ Four months later, the property was sold to a third party at a public auction for \$120,000.¹⁵ At the time of the sale, approximately \$29,000 in taxes were owed to the county.¹⁶ On the same day that the property was sold at auction, the debtor commenced a chapter 11 proceeding.¹⁷ The sale transaction did not close due to the bankruptcy filing and related litigation.¹⁸

During the bankruptcy case, the debtor sought to have the foreclosure avoided and the property reconveyed to the debtor's bankruptcy estate.¹⁹ The court ruled in the debtor's favor, finding that it is not presumed that reasonably equivalent value is received in a tax-foreclosure proceeding.²⁰ Further, "[a]voidance under section 548 brings the property into the bankruptcy estate and makes it available for the benefit of all creditors, as opposed to permitting a taxing district ... to be enriched to the detriment of other creditors following the sale of a foreclosed upon property."²¹

Tax Lien Foreclosures Distinct from Mortgage Foreclosures

Although tax lien foreclosures may be unraveled in bankruptcy, properly conducted mortgage foreclosure sales may not.

In *BFP v. Resolution Trust Corp.*,²² the U.S. Supreme Court set forth the general rule that mortgage foreclosure sales properly conducted under applicable state law cannot be unraveled in bankruptcy because it is presumptively established that reasonably equivalent value was received for the transferred property.

In the *BFP* case, the debtor obtained a loan from the mortgage lender, Imperial Savings Association, to purchase a home,²³ which secured payment for the loan.²⁴ The debtor eventually defaulted on the loan, prompting the mortgage lender to enter a notice of default and schedule a properly noticed foreclosure sale.²⁵ While the foreclosure sale was pending, an involuntary bankruptcy petition was filed on behalf of the debtor.²⁶ The filing of the involuntary petition temporarily halted the foreclosure,²⁷ but the involuntary petition was later dismissed.²⁸ Following dismissal of the involuntary petition, the foreclosure proceeding was completed, which resulted in the transfer of the home to a third-party purchaser.²⁹

A few months after the foreclosure sale was completed, the debtor filed a voluntary petition for chapter 11 relief.³⁰ The debtor commenced a post-petition fraudulent-transfer action seeking to set aside the conveyance of the home to the third-party purchaser.³¹ The debtor alleged that the actual worth of the home at the time of the sale was approximately \$300,000 more than the price for which it sold at the pre-petition foreclosure sale.³² Therefore, the property was not transferred for reasonably equivalent value.³³ The Supreme Court and lower courts concluded that "a noncollusive and regularly conducted nonjudicial foreclosure sale ... cannot be challenged as a fraudulent conveyance because the consideration [it] received in such a sale establishe[d] 'reasonably equivalent value' as a matter of law."³⁴

The Supreme Court rejected the notion that "reasonably equivalent value" within the meaning of § 548 means "fair market value" or "fair foreclosure price"³⁵ because "property that *must* be sold within [the strictures of state-prescribed foreclosure] is simply *worth less*" than market value.³⁶ Further, "no one would pay as much to own such property as he would pay as much to own real estate that could be sold at leisure and pursuant to normal marketing techniques."

In addition, mortgage foreclosure sales are presumptively valid given the added protections under state foreclosure law. The court emphasized that state "[f]oreclosure laws typically require notice to the defaulting borrower, a substantial lead time before [the] commencement of foreclosure proceedings, publication of a notice of sale, and strict adherence to prescribed bidding rules and auction procedures."³⁷ A number of states also require government officials to conduct sale auctions, and some will not allow "property to be sold for less than a specified fraction of a mandatory presale fair-market value appraisal."³⁸ The court limited its holding to only mort-

4 No. 8:13-CV-1142, 2014 WL 2139269, at *1 (N.D.N.Y. May 23, 2014).

5 *Id.*

6 *Id.*

7 *Id.*

8 *Id.*

9 *Id.*

10 *Id.*

11 *Id.*

12 *Id.* at *4-5.

13 *County of Clinton v. Warehouse at Van Buren Street Inc.*, No. 8:12-cv-1636, Dkt. No. 12, (GLS) (N.D.N.Y. Nov. 11, 2012).

14 *Id.*

15 *Id.*

16 *Id.*

17 *Id.*

18 *Id.*

19 *County of Clinton v. Warehouse at Van Buren Street Inc.*, 496 B.R. 278 (N.D.N.Y. 2013).

20 *Id.* at 282-83.

21 *Id.* at 283, n.5.

22 511 U.S. 531 (1994).

23 *Id.* at 533.

24 *Id.*

25 *Id.*

26 *Id.*

27 *Id.*

28 *Id.*

29 *Id.* at 534.

30 *Id.*

31 *Id.*

32 *Id.*

33 *Id.*

34 *Id.* (internal quotation marks and citation omitted).

35 *Id.* at 538-39, 545.

36 *Id.* at 539 (emphasis in original).

37 *Id.* at 542.

38 *Id.* (citations omitted).

gage foreclosures of real estate, noting that “considerations bearing upon other foreclosures and forced sales (to satisfy tax liens, for example) may be different.”³⁹

A number of courts have noted that tax lien foreclosure sales under some states laws do not provide debtors with the protections afforded to state mortgage foreclosure sales. For instance, the tax sale statutes in Wyoming do not permit a sale through a public auction, which allows for competitive bidding.⁴⁰ In *Balaber-Strauss v. Town of Harrison (In re Murphy)*,⁴¹ the court concluded that in those cases, such as tax forfeitures, “[w]here property is seized without a sale or competitive bidding, there cannot be a presumption as a matter of law that reasonably equivalent value was received because market forces were completely absent.” Other courts have found that reasonably equivalent value was received in cases where the tax lien foreclosure procedures provided protections that were similar to those provided for in state mortgage foreclosures, such as notice to the debtor/owner and a competitive bidding process.⁴²

Key Takeaways

County taxing authorities and real estate investors and other third-party purchasers should be aware that tax lien foreclosure transactions are not bankruptcy-proof. The debtor may voluntarily seek bankruptcy relief, or the debtor’s creditors may even force an involuntary bankruptcy to recover more money for distribution to all of the debtor’s creditors.

To assess the risk that a tax lien foreclosure transaction may be unraveled in a bankruptcy proceeding filed shortly after the sale transaction, the taxing authority and potential third-party purchaser of the property should conduct a legal analysis of the applicable state’s law governing mortgage foreclosures and tax lien foreclosures in effect at the time of the proposed transaction. The analysis should also include a comparison of the state’s mortgage foreclosure procedures and tax lien foreclosure procedures to determine whether the tax lien foreclosure procedures provide similar protections to those provided under state mortgage foreclosure law. Most importantly, the taxing authority and prospective purchaser should assess whether the tax lien foreclosure procedures allow for sufficient notice to the owner and a competitive bidding process. If the tax lien foreclosure procedures do not allow for competitive bidding and other key protections, there is a risk that the taxing authority and/or third-party purchaser may lose the property or the value of the property in the event of a bankruptcy filing of the debtor/owner before the closing of the sale transaction. **abi**

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³⁹ *Id.* at 537, n.3.

⁴⁰ See *Sherman v. Rose*, 223 B.R. 555, 559 (B.A.P. 10th Cir. 1998).

⁴¹ 331 B.R. 107, 119-20 (Bankr. S.D.N.Y. 2005).

⁴² See, e.g., *Russell-Polk v. Bradley (In re Russell-Polk)*, 200 B.R. 218, 221 (Bankr. E.D. Mo. 1996) (finding that “same protections are afforded by both mortgage foreclosure and tax foreclosure procedures in Missouri,” therefore, it is presumed that reasonably equivalent value was received in tax foreclosure sale); *Golden v. Mercer Cty. Tax Claim Bureau (In re Golden)*, 190 B.R. 52, 58 (Bankr. W.D. Pa. 1995) (“[T]he protections, rights and remedies afforded [to] a delinquent taxpayer under the [Pennsylvania] Tax Law are no less than those [that are] afforded a mortgagor under Pennsylvania’s mortgage foreclosure law.”) (citations omitted).