

Alert

Sixth Circuit Holds State Court Tax Foreclosure Subject to Fraudulent Transfer Attack

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A “federal [fraudulent transfer claim under Bankruptcy Code § 548] is independent of [a] state-court [foreclosure] judgment,” held the U.S. Court of Appeals for the Sixth Circuit on Dec. 27, 2021. *In re Lowry*, 2021 WL 6112972, *1 (6th Cir. Dec. 27, 2021). Reversing the lower courts’ approval of a Michigan tax foreclosure sale, the Sixth Circuit reasoned that “the amount paid on foreclosure bore no relation at all to the value of the property, thus precluding the ... argument that the sale was for ‘a reasonably equivalent value’ under the rule of *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 544-45 (1994) [(reasonably equivalent value is the price actually received for the property at a foreclosure sale, so long as that sale satisfied all the requirements of state foreclosure law)]. Accordingly, the court remanded the case for “consideration of further arguments not fully developed below.”

Relevance

Courts have been split on whether the *BFP* rule applies to local tax foreclosures — i.e., whether a tax foreclosure can be avoided as a fraudulent transfer. See, e.g., *In re Grandote Country Club Co., Ltd.*, 252 F.3d 1146, 1152 (10th Cir. 2001) (tax sale upheld) (“Although *BFP* did not address a tax sale ... *BFP* has been extended to the tax sale context[T]he decisive factor in determining whether a transfer pursuant to a tax sale constitutes ‘reasonably equivalent value’ is a state’s procedure for tax sales, in particular, statutes requiring that tax sales take place publicly under a competitive bidding procedure.”); *In re Lindsay*, 59 F.3d 942, 949 (9th Cir. 1995) (tax sale “complied with Texas law, ... was noncollusive, and notice was proper... foreclosure stands”); *contra*, *In re Smith*, 811 F.3d 228, 234 (7th Cir. 2016) (“... the reasoning of *BFP* does not extend to Illinois tax sales”); *In re GGI Props., LLC*, 568 B.R. 231 (Bankr. D.N.J. 2017) (pre-bankruptcy tax foreclosure sale conducted in accordance with New Jersey law which did not provide for advertising or competitive bidding, and which allowed taxing authority to acquire tax sale certificates at conclusion of auction when no bids were received, did not conclusively establish reasonably equivalent value; transfer of property to municipality pursuant to tax sale and foreclosure, when there was no competitive bidding, can constitute fraudulent transfer); *but see Gunsalus v. Ontario County, NY*, 576 B.R. 302 (Bankr. W.D. N.Y. 2017) (“Reasonably equivalent value” conclusively presumed at regular non-collusive tax foreclosure sale). State taxing authorities need revenue and want finality in their foreclosure sales. On the other hand, though, neither creditors nor the taxing authorities should want a property sold for a fraction of its value, as was the case in *Lowry*.

Facts

The debtor in *Lowry* owned a home in Michigan and failed to pay his property taxes for years. The county foreclosed on the home and a city bought the property for the amount of outstanding taxes due, without a public auction, with the statutory “minimum bid” of \$14,486. But the debtor claimed that the

property had “a fair market value of \$152,000 at the time of the foreclosure.” *Lowry*, 2021 WL 6112972, at *2.

The bankruptcy court dismissed the fraudulent transfer complaint filed by the debtor and the subsequent buyer of the property who had paid “one dollar” for it. *Id.* According to the bankruptcy court, the debtor was merely attempting to relitigate the foreclosure proceedings in the state court and the *BFP* rule “should extend to tax foreclosures in Michigan.” *Id.* Affirming the bankruptcy court, the district court held that the *Rooker-Feldman* doctrine¹ “barred review [because the debtor’s] appeal would require the court to revisit a fully-litigated state court decision,” characterizing the debtor’s arguments as “nothing more than an attempt to gain a review of the state court’s ruling.” *Id.* at *3.

Sixth Circuit Analysis

Rooker-Feldman did not apply, held the Sixth Circuit, because the “alleged injury ... is not the state court foreclosure judgment, but instead is the fact that the debtor could not use [Code] § 548 to avoid the foreclosure as a fraudulent transfer. Although the § 548 [fraudulent transfer] issue is closely related to the state foreclosure judgement, that by itself does not mean that *Rooker-Feldman* applies.” *Id.*

More important, the Sixth Circuit held that “*BFP* does not apply to the facts of this case.” *Id.* at *4. In *BFP*, the Supreme Court reasoned that “if state law is followed in a mortgage foreclosure sale, the debtor cannot use § 548 to avoid the foreclosure as a fraudulent transfer.” *Id.* In contrast, however, “this case involves a tax foreclosure, not a mortgage foreclosure, and in *BFP* the Court explicitly declined to decide whether the rule applied to tax foreclosures, limiting its opinion to cover ‘only mortgage foreclosures of real estate.’” 511 U.S. at 537 n.3. In fact, the Supreme Court noted that the “considerations bearing upon other foreclosures and forced sales (to satisfy tax liens, for examples) may be different.” *Id.*

The tax foreclosure process in *Lowry* was “significantly different from the mortgage foreclosure system in *BFP*. The debtor’s home in *BFP* was sold for \$433,000 in a foreclosure sale that provided sufficient procedural protections under state law.” *Lowry*, 2021 WL 6112972, at *4, citing 511 U.S. at 534, 541-42, 545-46. In *Lowry*, though, “the Michigan foreclosure law ... permitted the local government to purchase the property, without a public auction, for the ‘minimum bid.’” *Id.* The city’s purchase of the property was for a “an amount that had no apparent relation to the value of the property and was only about ten percent of the alleged fair-market value.” *Id.* The “Michigan law also permitted the foreclosing government authority to retain the ‘surplus proceeds’ from a foreclosure sale,” making it “thus distinguishable from the mortgage foreclosure process ... in *BFP*.” *Id.*

In sum, the Michigan tax foreclosure sale turned “on the value of the taxes owed rather than the value of the property.” *Id.* Accord, *In re Smith*, 891 F.3d 228, 234 (7th Cir. 2016) (*BFP* did not extend to Illinois state court tax foreclosure because the “lowest bid wins, and the bid amounts bear no relationship to the value of the underlying real estate;” no competitive bidding; “bidders bid how little money they are willing to accept in return for payment of the owner’s delinquent taxes.”) (emphasis in original).

The Sixth Circuit remanded the issue in *Lowry* to the district court because of an insufficient record on appeal. First, the lower courts never decided the “threshold issue of whether [the debtor] satisfies the

¹ *Rooker v. Fidelity Trust Co.*, 263 U.S. 413 (1923), and *D.C. Court of Appeals v. Feldman*, 460 U.S. 462 (1983) (federal courts should not review state court decisions unless authorized by Congress to do so).

insolvency requirement of [Code] § 548[(a)(1)(B)(ii)],” an essential element of a constructive fraudulent transfer claim. Nor did the parties develop other unrelated issues in the lower courts.

Comment

The Sixth Circuit in *Lowry*, like the Seventh in *Smith*, focused on the particular state tax foreclosure procedure. Did it did permit a public auction? Competitive bidding? Broad notice? Concern for the property’s value? And if the debtor in *Lowry* is found to have been solvent, the fraudulent transfer issue is moot.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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