ALERTS

Ninth Circuit Insulates California Tax Sale from Fraudulent Transfer Attack

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"[T]he price received at a California tax sale" properly held under state law "conclusively establishes 'reasonably equivalent value' for purposes of" the Bankruptcy Code's ("Code") fraudulent transfer section (§ 548(a)(1)), held the U.S. Court of Appeals for the Ninth Circuit on Sept. 8, 2016. *In re Tracht Gut LLC*, 2016 WL4698300, at *1 (9th Cir. Sept. 8, 2016). Affirming the lower courts, the Ninth Circuit reasoned that "California tax sales have the same procedural safeguards as the California mortgage foreclosure sale" approved by the U.S. Supreme Court in *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 533, 545 (1994) (*held*, price received at mortgage foreclosure sale "conclusively satisfies" Code's requirement that transfer of insolvent debtor's property be in exchange for "reasonably equivalent value" so long as mortgagee complied with relevant foreclosure laws of state in question, i.e., California).

Relevance

A transfer by an insolvent or inadequately capitalized debtor is constructively fraudulent under Code § 548(a)(1)(B) if made for "less than a reasonably equivalent value" *and* within two years of bankruptcy. Because the debtor in *Tracht Gut* was apparently insolvent, the "central" question was whether the proceeds of the tax sale constituted "reasonably equivalent value" under Code § 548(a). 2016 WL4698300, at *1. Prior to the Supreme Court's 1994 *BFP* ruling, appellate courts had been split on whether the proceeds of the foreclosure sale could ever constitute "reasonably equivalent value." See, e.g., *Durrett v. Wash. Nat'l Ins. Co.*, 621 F.2d 201 (5th Cir. 1980) (rigid mathematical approach requiring that at

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least 70 percent of fair-market value be realized); *In re Bundles*, 856 F.2d 815, 824 (7th Cir. 1988) (facts considered include fair appraisal of property, range of advertisements and competitiveness of bids). Although *BFP* resolved the value issue with respect to real estate mortgage foreclosure sales, the Supreme Court limited its holding to that context because the "considerations bearing upon other foreclosures and forced sales (to satisfy tax liens, for example) may be different." *BFP*, 511 U.S. at 537 n.3. As shown below, courts have also applied the reasoning of *BFP* even when a bankruptcy trustee seeks to undo a pre-bankruptcy matrimonial decree.

Facts

The debtor purchased two parcels of real estate in 2012 for $60,000, "subject to three deeds of trust" and four years of unpaid real property taxes. 2016 WL4698300, at *1-*2. Because both parcels were "tax defaulted," the County Treasurer ("County") later conducted tax sales of the properties under California law. After a public auction, two buyers bought each parcel, one for $300,000, and the other for $100,000.

The debtor filed its Chapter 11 petition a month after the tax sales. It promptly sued the County and the two buyers of the properties, asserting, among other things, that "the sales were fraudulent transfers" under Code § 548 because "the sales price [for each parcel] was too low." *Id.* at *6. The bankruptcy court dismissed the complaint for failure to state a claim for relief, and the Bankruptcy Appellate Panel ("BAP") affirmed, relying on the Supreme Court's *BFP* opinion, and reasoning that it should also apply "to tax sales under California law." *Id.* at *2.

Analysis

The Ninth Circuit agreed with the BAP, stating that "the rationale and policy considerations behind … *BFP* are just as relevant in the California tax sale context." *Id.* at *4. It conceded that the Supreme Court had "expressly limited [its] holding to mortgage foreclosures of real estate." Agreeing with the BAP, though, the court explained why *BFP* "should also apply to tax sales in California."

Market Value Not Relevant

The court rejected the debtor's argument that the foreclosure sales price "was too low when compared to market value." *Id.* at *5. As the Supreme

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Court explained, "market value, as it is commonly understood, has no applicability in the forced-sale context," because market value "is the very *antithesis* of forced-sale value." *BFP*, 511 U.S. at 537. Indeed, "state law allows the forced sales of real estate," meaning that "property sold at such sales is 'simply *worth less*' than property 'sold at leisure and pursuant to normal marketing techniques.'" 2016 WL 4698300, at *5, citing *BFP*, 511 U.S. at 539. In other words, "the lower price obtained at a foreclosure sale, when compared to a fair-market valuation, is a result of the mechanism of forced sales .... " *Id.* Thus, "if debtors were able to avoid mortgage foreclosures under federal bankruptcy laws simply because the property was sold below market value at the foreclosure sale, the state regulatory regime in which creditors can conduct forced sales on foreclosed property would be frustrated." *Id.*, citing *BFP*, at 537-39.

State Law Key

The Ninth Circuit stressed that "tax foreclosure sales conducted by state and local governments are governed by state law." For that reason, the "same procedural safeguards under California law that led the Supreme Court [in *BFP*] to conclude that mortgage foreclosures would yield reasonably equivalent value are also required in California for tax sales." *Id.* The California tax sale procedure required "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." *Id.*, quoting *BFP*, 511 U.S. at 542. Finally, California law "requires that all tax sales shall be at public auction to the highest bidder." *Id.*

Other Contexts

The Ninth Circuit had previously extended the *BFP* analysis "beyond the context of mortgage foreclosures." See, e.g., *Batlan v. Bledsoe* (*In re Bledsoe*), 569 F.3d 1106, 1112 (9th Cir. 2009) (Chapter 11 debtor spouse's bankruptcy trustee sued non-debtor spouse, seeking to avoid purportedly "inequitable" property transfer required by marital dissolution judgment; relying on *BFP*, held, "a state court's dissolution judgment, following a regularly conducted contested proceeding, conclusively established 'reasonably equivalent value' for purpose of § 548, in the absence of actual fraud"; "state's traditional interest in the regulation of marriage and divorce is at least as powerful as its traditional interest in regulating sales of real property"; "[a]voiding transfers made pursuant to a state-court dissolution judgment would seriously impinge on that traditional state

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interest."). Accord, *In re Erlewine*, 349 F.3d 205, 212-213 (5th Cir. 2003) (same; divorce "fully litigated"; despite unequal division of property, debtor received reasonably equivalent value).

Other Circuits

The Fifth and Tenth Circuits also have applied *BFP* to tax sales. *In re T.F. Stone Co.*, 72 F.3d 466, 472 (5th Cir. 1995) (*held*, 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) (*held*, *BFP* applies to tax sales challenged under state fraudulent transfer law when state law requires competitive bidding procedures).

The debtor only argued that the "sales price was too low," but failed to "allege any procedural defects with ... the tax sales .... " 2016 WL 4698300, at *6. In short, the court properly presumed "that the price received at the tax sale was for reasonably equivalent value absent procedural irregularity" under applicable state law. *Id.*

Authored by Michael L. Cook.

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

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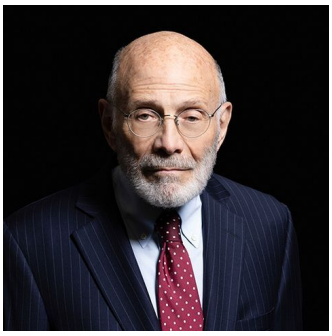

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