

1995

BFP v. Resolution Trust Corporation: Critiquing the Supreme Court's Method of Determining "Reasonably Equivalent Value" Within the Context of Bankruptcy Foreclosures

David P. Schwartz

Follow this and additional works at: <https://scholarlycommons.law.cwsl.edu/cwlr>

Recommended Citation

Schwartz, David P. (1995) "BFP v. Resolution Trust Corporation: Critiquing the Supreme Court's Method of Determining "Reasonably Equivalent Value" Within the Context of Bankruptcy Foreclosures," *California Western Law Review*. Vol. 31 : No. 2 , Article 6.

Available at: <https://scholarlycommons.law.cwsl.edu/cwlr/vol31/iss2/6>

This Comment is brought to you for free and open access by CWSL Scholarly Commons. It has been accepted for inclusion in California Western Law Review by an authorized editor of CWSL Scholarly Commons. For more information, please contact alm@cwsl.edu.

~~NOTE, BEP v. RESOLUTION TRUST CORPORATION~~
Criticizing the Supreme Court
CRITIQUING THE SUPREME COURT'S METHOD OF DETERMINING "REASONABLY EQUIVALENT VALUE" WITHIN THE CONTEXT OF BANKRUPTCY FORECLOSURES

INTRODUCTION

In the early 1990s, the national economy was generally depressed, and the result for property owners was devastating. During these years, the poor economy and stagnant real estate market forced lenders to foreclose upon the property of delinquent debtors, leaving debtors with little or no recourse. As a result, many debtors have been forced to seek relief under the bankruptcy laws in order to avoid complete financial obliteration.¹

The United States Supreme Court did not help matters. On May 23, 1994, the Supreme Court ended a conflict that had existed among the federal courts for years by redefining the meaning of "reasonably equivalent value" within the U.S. Bankruptcy Code fraudulent transfer provision, section 548(a)(2).² Under section 548(a)(2)(A), the bankruptcy trustee may avoid³

1. Michael L. Welcott, *Avoidance of Foreclosure Sales as Fraudulent Transfers Under Section 548(a) of the Bankruptcy Code: An Impetus To Changing State Foreclosure Proceedings*, 66 NEB. L. REV. 383, 383 (1987).

2. 11 U.S.C. § 548(a)(2) (1984). Section 548 provides in part:

(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition if the debtor voluntarily or involuntarily

(1) made such transfer or incurred such obligation with actual intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(B)(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; or

(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; or

(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. . . .

11 U.S.C. § 548 (1988) (emphasis added). The conflict in defining "reasonably equivalent value" had existed among three circuits. In *Durrett v. Washington Nat'l Ins. Co.*, the Fifth Circuit, interpreting a provision of the old Bankruptcy Act analogous to § 548(a)(2), held that a foreclosure sale that yielded at least 70% of the property's fair market value could be considered "reasonably equivalent value." 621 F.2d 201, 203 (5th Cir. 1980). The court also indicated in dicta that any such sale for less than 70% of fair market value should be invalidated. *Id.* In *Lawyer's Title Insurance Corp. v. Madrid*, the Ninth Circuit applied the *Durrett* rule, and held that a determination of "reasonable equivalence" depends on whether there was compliance with state foreclosure procedures. 21 B.R. 424, 427 (Bankr. 9th Cir. 1982), *aff'd* 725 F.2d 1197 (9th Cir. 1984), *cert. denied* 469 U.S. 833 (1984). In *In re Bundles*, the court considered the totality of circumstances in determining "reasonable equivalency." 856 F.2d 815 (7th Cir. 1988). See *infra* section II.

a property transfer by the debtor if the debtor received less than a "reasonably equivalent value" in exchange for the transfer.⁴

The Court in *BFP v. Resolution Trust Corporation*⁵ held that "reasonably equivalent value" is not to be equated either with fair market value⁶ or with fair foreclosure price.⁷ Rather, the Court held that "reasonably equivalent value" is any price received at the foreclosure sale, provided all of the requirements of the state's foreclosure laws have been met.⁸ The majority reasoned that the price received at the foreclosure sale conclusively establishes "reasonably equivalent value."⁹ In effect, the Court held that, "by the terms of the Bankruptcy Code, Congress intended a peppercorn paid at a noncollusive and procedurally regular foreclosure sale to be treated as 'reasonably equivalent' to the value of a California beachfront estate."¹⁰

The implications of the Court's decision are potentially devastating, both to mortgagors¹¹ and their creditors. As the dissent in *BFP* accurately points out, a central premise of bankruptcy law is that a property transfer may be

3. In certain instances, the trustee in bankruptcy is given broad powers to avoid transfers of property of the debtor. In addition to § 548, the Bankruptcy Code provides avoidance powers in five other sections. Section 544(a)(1) allows the trustee to avoid any transfer of property of the debtor if a creditor extends credit to the debtor at the time of the commencement of the bankruptcy petition. 11 U.S.C. § 544(a)(1) (1988). Section 545(1) allows the trustee to avoid the fixing of a statutory lien on property of the debtor if the lien becomes effective against the debtor upon commencement of the bankruptcy petition. 11 U.S.C. § 545(1)(A) (1988). Section 547(b)(4)(A) allows the trustee to avoid a transfer of an interest in property made on or within ninety days of filing the petition. 11 U.S.C. § 547(b)(4)(A) (1988). Section 549(a)(1) allows the trustee to avoid a transfer of property of the debtor's estate that occurs after the commencement of the bankruptcy petition. 11 U.S.C. § 549(a)(1) (1988). Section 724(a) allows a trustee to avoid a lien that secures a claim of a kind specified in § 726(a)(4) of this title 11. 11 U.S.C. § 724(a) (1988). Section 726(a)(4) makes reference to claims for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such a claim.

4. 11 U.S.C.A. § 548(a)(2)(A) (West Supp. 1993).

5. 114 S. Ct. 1757 (1994).

6. "Fair market value" is defined as the amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. BLACK'S LAW DICTIONARY 597 (6th ed. 1990).

7. *BFP*, 114 S. Ct. at 1757.

8. *Id.*

9. *Id.* (Scalia, J., delivered the opinion of the Court, in which Rehnquist, C.J., and O'Connor, Kennedy, and Thomas, JJ. joined).

10. *Id.* at 1767 (Souter, J., dissenting) (citations omitted). In 1984, Congress actually considered, but did not enact, an amendment that said precisely what the Court in *BFP* held, that the power to avoid or nullify the foreclosure sale is confined to foreclosures involving collusion or procedural irregularity. S. 445, 98th Cong., 1st Sess., § 360 (1983). The majority relied on a purposely omitted amendment. Also, the phrase "fair market value" appears in only two Bankruptcy Code provisions. Thus, the term of choice in the bankruptcy setting seems to be "value," which has been read to mean "fair market value." *Id.* at 1768 n.1.

11. A mortgagor is defined as one who, having all or some part of title to property, by written instrument, pledges that property for some particular purpose such as security for a debt. BLACK'S LAW DICTIONARY 1012 (6th ed. 1990).

set aside because of its impact on other creditor or on the debtor's chances for a fresh start.¹² However, in light of the *BFP* holding, "reasonably equivalent value" does not necessarily mean that a fair value is required before the property may be transferred. Thus, upon foreclosure, the debtor and creditor must each hope that the trustee sale will yield a fair price. If the trustee sale fails to bring a price higher than the outstanding mortgage, the creditors will lose all or a portion of their interest in the proceeds of the sale. The result for the debtor is equally troublesome. Because the creditor will be paid first from the proceeds of the trustee sale, a low price received at the foreclosure sale will cause the debtor to lose any equity in the foreclosed property.

Several commentators have suggested ways to obtain a fair price at a foreclosure sale, and thus protect the debtor and his or her creditors.¹³ However, no commentator has provided a method guaranteed to achieve optimal prices at the foreclosure sale.

This Note suggests ways to establish such a guarantee, by providing a statutory scheme that would protect both the creditors and the debtor. Under this proposed scheme, the bankruptcy court would require a percentage of the foreclosed property's fair market value to be obtained as a prerequisite to a transfer of title. As will be discussed, such a practical approach is neither an abuse of the power of the bankruptcy court¹⁴ nor an overextension of bankruptcy law beyond the traditional field of fraudulent transfers.¹⁵

Section I of this Note presents an overview of the impact of bankruptcy on real estate transactions in the United States. Specifically, this section addresses the fraudulent transfer provisions of the Bankruptcy Code and focuses on a central premise of the bankruptcy avoidance powers: what state law plainly allows as acceptable or "fair" as between a debtor and a creditor may be set aside because of its impact on other creditors or on the debtor's chances for a fresh start.¹⁶ Section II focuses on three predecessor cases leading up to the decision in *BFP: Durrett v. Washington National Insurance Company*,¹⁷ *Lawyer's Title Insurance Corporation v. Madrid*,¹⁸ and *Bundles v. Baker*.¹⁹ These three cases illustrate the divergent conclusions courts have

12. *BFP*, 114 S. Ct. at 1774-75 (Souter, J., dissenting). ("When the prospect of such avoidance is absent, indeed, the economic interests of a foreclosing mortgagee stand in stark opposition to those of the debtor . . . and of his other creditors."). *Id.* at 1775.

13. See *infra* section V.

14. For a discussion of bankruptcy courts as the most qualified entity to give "reasonably equivalent value" sensible content in evaluating particular transfers upon foreclosure, see *infra* section V.B.

15. For a discussion of fraudulent transfers with collusion, see *infra* Section I.A. For a discussion of fraudulent transfers without collusion, see *infra* section I.B.

16. *BFP*, 114 S. Ct. at 1774-75 (Souter, J., dissenting).

17. 621 F.2d 201 (5th Cir. 1980).

18. 21 B.R. 424 (Bankr. 9th Cir. 1982), *aff'd* 725 F.2d 1197 (9th Cir. 1984), *cert. denied*, 469 U.S. 833 (1984).

19. 856 F.2d 815 (7th Cir. 1988).

reached regarding the appropriate standard for defining “reasonably equivalent value.” Section III examines *BFP v. Resolution Trust Corporation*,²⁰ where the Court held that judicial invalidation of a foreclosure sale is permissible only where there is irregularity in the conduct of the sale under applicable state law, regardless of the price received at the sale.²¹ Section IV addresses the implications of the Supreme Court’s decision, focusing on the Court’s failure to adequately respond to the policy behind the Bankruptcy Code. This Note argues that by not requiring fair market value at a bankruptcy foreclosure sale, the Court neglected to recognize the purpose of the Bankruptcy Code: to maximize distribution of the debtor’s estate for the benefit of the creditors.²² Section V provides a solution to the problems caused by the decision, by requiring a transfer to be set aside when the amount received at the foreclosure sale is not at least seventy percent of the property’s appraised value. Section VI provides a proposed amendment to the Bankruptcy Code that protects the interest of creditors by equating “reasonably equivalent value” with “fair market value.” This Note concludes that the *BFP* Court failed to adequately address the requirements of the Bankruptcy Code, and that future court decisions must focus on the impact a transfer of title will have on the creditor.

I. HOW BANKRUPTCY AFFECTS REAL ESTATE TRANSACTIONS

In Biblical times, all debtors were allowed a new start.²³ Each seventh, or sabbatical, year was a year of release from debts, where “every creditor shall release that which he hath lent unto his neighbor.”²⁴ As civilization has progressed, society has taken a dimmer view of those who file for bankruptcy.²⁵ For obvious reasons, creditors of those who file bankruptcy are the most concerned group, because they potentially have as much to lose as the bankrupt party.

Generally, there are three types of foreclosure proceedings: strict, judicial, and power of sale.²⁶ Strict foreclosure occurs when the mortgagee is declared the owner of property following default without any sale of the

20. 114 S. Ct. 1757 (1994).

21. *BFP*, 114 S. Ct. at 1765.

22. *Martin v. Phillips*, 58 B.R. 128, 130 (Bankr. E.D. Tenn. 1986) (stating that the purpose is to “preserve the assets of the bankruptcy estate”).

23. MICHAEL T. MADISON & ROBERT M. ZINMAN, *MODERN REAL ESTATE FINANCING: A TRANSACTIONAL APPROACH* 1065, 1065 n.1 (1991). “Even the land was given a new start: every seventh year it would not be cultivated but would lie fallow, a process that helped considerably to prevent exhaustion of the land and to enhance its fertility in the other years.”

24. *Id.* See also *Exodus* 23:10 and *Leviticus* 25:4.

25. MADISON & ZINMAN, *supra* note 23, at 1065.

26. GRANT S. NELSON & DALE A. WHITMAN, *REAL ESTATE FINANCE LAW* § 7.11 (2nd ed. 1985).

premises.²⁷ Judicial foreclosure refers to a foreclosure accomplished by resort to the judicial process.²⁸ Under this proceeding, the court is intimately involved in the foreclosure process and acts as a neutral third party, helping to some degree to achieve the maximum amount for the property at the foreclosure sale.²⁹ The judicial involvement, coupled with other beneficial procedural guarantees such as notice, due process, and adjudication of issues, might lead to the conclusion that judicial foreclosure is the preferable method of foreclosing property. However, the costs associated with judicial foreclosure cause most mortgagees to avoid its use where legally permissible.³⁰ In addition, the mortgagor is generally allowed a statutory redemption right,³¹ which allows the mortgagor to redeem property that has been forfeited due to default on mortgage payments.³² Thus, judicial foreclosures provide the potential for a "reentry" by the mortgagor on property legitimately purchased by a third party.

The power of sale has been used historically as the most prevalent and efficient method of foreclosure.³³ "Under this procedure, the mortgagee conducts the sale under statutory guidelines intended to diminish the costs of foreclosure and maximize the competitive bidding for the property."³⁴ "The power-of-sale foreclosure encourages higher bids by assuring the purchaser at the sale that the bid is acceptable without the need for further judicial action."³⁵ The primary difference between the judicial foreclosure and the foreclosure by power of sale is that the court supervises the judicial foreclosure, but not the power-of-sale foreclosure.³⁶ Also, the right of redemption generally does not exist in the power-of-sale foreclosure.³⁷

27. Strict foreclosure is used in only two states: Connecticut and Vermont. *Id.* at §§ 7.9-7.10. Generally, strict foreclosure is accomplished by judicial action. *Id.*

28. *Id.* § 7.11.

29. *Id.*

30. *Id.* at §§ 7.11, 7.19.

31. Equity of redemption, also called a right of redemption, is defined as the right of the mortgagor of property to redeem the property. BLACK'S LAW DICTIONARY 541 (6th ed. 1990). Redemption rights are accorded to the judgment debtor or his successor. *See, e.g.,* CAL. CIV. PROC. CODE § 729.010 (West 1994). *See infra* note 173 for allowable redemption periods.

32. *See, e.g.,* CAL. CIV. PROC. CODE § 729.010 (West 1994).

33. *See* NELSON & WHITMAN, *supra* note 26, at §§ 7.9-7.10.

34. Scott B. Ehrlich, *Avoidance of Foreclosure Sales as Fraudulent Conveyances: Accommodating State and Federal Objectives*, 71 VA. L. REV. 933, 976 (1985). "Moreover, from the mortgagee's standpoint, the power-of-sale foreclosure is far less expensive and much less time-consuming; it also provides greater certainty." *Id.*

35. *Id.* The assumption here is that the procedures for foreclosure are properly tailored to produce an adequate price for the property. *Id.*

36. NELSON & WHITMAN, *supra* note 26, at §§ 7.11-7.19.

37. *Id.* "Many legislatures, including Alaska's, do not grant the debtor a right of redemption from a non-judicial foreclosure sale in order to enhance the reliability of the title acquired at the sale and thereby encourage participation in the bidding." Alden et al., *Real Property Foreclosure as a Fraudulent Conveyance: Proposals For Solving the Durrett Problem*, 38 BUS. LAW 1605, 1613 (1983).

Aside from the disruption and delay, the basic interests of real estate mortgagees should otherwise be generally unaffected by a foreclosure sale.³⁸ If the property has equity, that is, if it is worth more than the liens attached to it, the property can be sold by the bankruptcy court to realize on the equity.³⁹ After the sale, the mortgagee is paid the outstanding debt from the proceeds of the sale. If there are creditors junior⁴⁰ to the mortgagee, they will receive what is owed them if any proceeds remain after the debt to the mortgagee or senior lienholder is paid. Finally, the debtor is entitled to any proceeds remaining after each secured creditor⁴¹ receives the obligation owed. However, the mortgagee is not paid the outstanding debt where the property is sold at the foreclosure sale for a price less than or equal to the amount of indebtedness on the property.⁴²

The situation where a mortgagee receives less than the amount of the indebtedness can result from three major causes. First, a sharp downturn in market value of real estate will cause the property to sell for a price less than the balance of the outstanding mortgage. Second, collusion between the debtor and the purchasing party potentially results in a price far below the property's market value. Third, a lower than fair market price received from a foreclosure sale will also lower the amount of recovery for the mortgagee.⁴³

A. Mortgage Foreclosures as Fraudulent Transfers

The primary goal of the Bankruptcy Code's fraudulent transfer⁴⁴

38. MADISON & ZINMAN, *supra* note 23, at 1066. Because court supervision is not required, the nonjudicial foreclosure is more efficient, although the mortgagor or another interested party may initiate a review of the proceedings. Ehrlich, *supra* note 34, at 976.

39. MADISON & ZINMAN, *supra* note 23, at 1066.

40. A junior interest is a legal right which is subordinate to another's legal right as applied to property. BLACK'S LAW DICTIONARY 851 (6th ed. 1990). A junior creditor is one whose claim or demand accrued at a date later than that of a claim or demand held by another creditor, or whose claim ranks below other creditors in rights to the debtor's property. *Id.* at 257.

41. A secured creditor is a creditor who holds some special pecuniary assurance of payment of his debt, such as a mortgage, collateral, or lien. *Id.* at 1354.

42. See NELSON & WHITMAN, *supra* note 26, §§ 7.11-7.19.

43. See *Durrett v. Washington Nat'l Ins. Co.*, 421 F.2d 201 (5th Cir. 1980), discussed *infra* at section II.A. The *Durrett* court held that a foreclosure sale that yielded 57% of the property's fair market value could be set aside as a fraudulent transfer, because it did not yield a "reasonably equivalent value." *Id.* at 203.

44. The Bankruptcy Code's fraudulent transfer provisions regard as a constructive fraud any transfers made while the transferor is insolvent within a year before bankruptcy for a consideration not "reasonably equivalent" to what the property being transferred is worth. 11 U.S.C. § 548 (1988). Fraudulent conveyance laws were designed to protect creditors from a debtor's intentional action in placing his property beyond a creditor's reach. Alden, *supra* note 37, at 1605. "However, it has been argued (not always successfully) that a public foreclosure sale is designed to provide a state-sanctioned method for determining value and that the price obtained at a noncollusive foreclosure sale should, therefore, be deemed to be reasonably equivalent . . . to the value of the property." MADISON & ZINMAN, *supra* note 23, at 978. Still, three circuits have held that noncollusive, regularly conducted foreclosure sales may be set aside as fraudulent transfers where the price paid was less than "reasonably equivalent" to the

provision is to protect the debtor's estate for the benefit of unsecured creditors.⁴⁵ Traditionally, the objective behind the fraudulent transfer laws was to prevent a debtor from transferring the estate's assets either to other creditors as preferential treatment or to "friendly hands" for safekeeping.⁴⁶ To protect against such a transfer, "section 548(a)(2) of the Bankruptcy Code allows a trustee to avoid a transfer by a debtor to any person if, for example, the debtor did not receive 'reasonably equivalent value' for the property."⁴⁷

Consider the following hypothetical: a developer owns a parcel of property and has suffered financial losses. Concerned that creditors may obtain judgments and a levy on his property, the developer executes a mortgage in favor of his brother-in-law that is recorded against the property. When the creditors start closing in, the developer deliberately defaults under the mortgage. His brother-in-law forecloses, buys the property at the foreclosure sale for the mortgage balance, and transfers the property to a corporation of which the developer is president.⁴⁸ The developer will be unsuccessful in attempting to put his property out of the reach of his creditors.⁴⁹ A debtor who voluntarily transfers an interest in real property, with the actual intent to deprive his creditors of the full value of that interest, has committed a fraudulent conveyance.⁵⁰

Section 548(a) consists of two subsections. Section 548(a)(1)⁵¹ authorizes the bankruptcy trustee to avoid a transfer of the debtor's property where actual fraudulent intent is proven. Section 548(a)(2)⁵² provides for avoidance regardless of whether intent to defraud exists. Although it is possible for a debtor and a secured creditor to conspire in a foreclosure proceeding to intentionally defraud other creditors, most foreclosures do not

value of the property. *Durrett v. Wash. Nat'l Ins. Co.*, 621 F.2d 201 (5th Cir. 1980); *Abramson v. Lakewood Bank & Trust Co.*, 647 F.2d 547 (5th Cir. 1981); *In re Bundles*, 856 F.2d 815 (7th Cir. 1988); *In re Hulm*, 738 F.2d 323 (8th Cir. 1984).

45. BAXTER DUNAWAY, *THE LAW OF DISTRESSED REAL ESTATE*, § 25.03[1] (1991).

46. *Id.*

47. Martha Sewell, *Avoidance of Foreclosure Sales Under Section 548 of the Bankruptcy Code: A Balancing of Interests*, 27 WAKE FOREST L. REV. 1011 (1992). In addition to "reasonably equivalent value," the trustee also must show that (1) a transfer of a debtor's interest occurred; (2) the transfer was made on or within one year of the filing of the petition; and (3) the debtor was insolvent on the transfer date or became insolvent as a result of the transfer. 11 U.S.C. § 548(a) (1988).

48. MADISON & ZINMAN, *supra* note 23, at 1043.

49. *See Lefkowitz v. Finkelstein Trading Corp.*, 14 F. Supp. 898 (S.D.N.Y. 1936) (The transfer of property of an insolvent corporation effected by means of purchase of such property at a fraction of its fair value and immediate resale to family of former owner held fraudulent and void as to creditors and trustee in bankruptcy for whom no assets had been left).

50. *See Ehrlich, supra* note 34, at 936. *See also* ACLI Gov't Sec., Inc. v. Rhoades, 653 F. Supp. 1388 (S.D.N.Y. 1988). In *Rhoades*, an attorney conveyed a large tract of land to his law partner, who was also his sister, the day before a large judgment was entered against him. The transfer was set aside as a fraudulent conveyance. *Id.*

51. 11 U.S.C.A. § 548(a)(1) (West Supp. 1993).

52. 11 U.S.C.A. § 548(a)(2) (West Supp. 1993).

involve actual intent to defraud.⁵³ "In most cases, foreclosing creditors are merely enforcing their security rights against a defaulting debtor."⁵⁴

In the hypothetical case discussed above, the developer clearly attempted to fraudulently convey his property to his brother-in-law in order to avoid a trustee sale. But, would the result be different if the transfer involved no collusion, and the property still did not fetch its fair market value? Whether fraudulent transfers may occur without collusion has been a fundamental consideration in construing the requirement of "reasonably equivalent value" in section 548(a)(2).⁵⁵

B. Section 548(a): Fraudulent Transfer Without Collusion?

The purpose of section 548 is to preserve bankrupt debtors' estates for fair distribution to all creditors.⁵⁶ With that in mind, suppose that a debtor owned a property with a fair market value of \$500,000 and a mortgage balance of \$300,000. When the debtor defaulted on her payments and filed bankruptcy, the bankruptcy trustee sold the property to a bidder who bid \$100,000. Can the bankruptcy trustee have the transfer set aside on the theory that the property was fraudulently transferred under section 548(a)(2), even though there was no collusion in the sale?

The answer should be a resounding "yes." The primary goal of federal fraudulent transfer law is to protect the bankruptcy estate for the benefit of unsecured creditors from a transfer of estate property to any person for less than "reasonably equivalent value."⁵⁷ However, as will be discussed in

53. Vic S. Lam, *Avoidability of Foreclosure Sales Under Section 548(a)(2) of the Bankruptcy Code: Revisiting the Transfer Issue and Standardizing Reasonable Equivalency*, 68 WASH. L. REV. 673, 674 (1993). This is true even though forced-sale prices are generally lower than market prices. See *infra* note 168 and accompanying text.

54. *Id.* (citing THOMAS D. CRANDALL ET. AL., *THE LAW OF DEBTORS AND CREDITORS*, § 16.05, at 16-71 n.6 (rev. ed. 1991)). The preference provision of the Bankruptcy Code (11 U.S.C. § 547(b) (1983)) permits a trustee to avoid pre-petition transfers that have the effect of preferring one creditor over others by giving the favored creditor more than its respective share of the debtor's assets under the bankruptcy law. *Id.*

55. Some critics have taken the position that the requirement of fair market value is properly sensitive to the policy underlying § 548 of the Bankruptcy Code. See, e.g., Alden et al. *supra* note 37, at 1610.

56. See *Grissom v. Johnson* (11th Cir. 1992), 955 F.2d 1440, 1446-47 (stating that the purpose of § 548 is to prevent depletion of bankruptcy estates); *Barrett v. Commonwealth Fed. Sav. & Loan Assn.*, 939 F.2d 20, 23-24 (3d Cir. 1991); *Bundles v. Baker* (7th Cir. 1988), 856 F.2d 815, 824 (stating that the purpose is to "preserve the assets of the [bankruptcy] estate"); *Henry-Luqueer Properties, Inc. v. Mayo* (Bankr. E.D.N.Y. 1992), 145 B.R. 771, 775 (stating that the purpose is to "foster an equitable distribution of the debtor's property"); *Ruebeck v. Attleboro Sav. Bank* (Bankr. D. Mass. 1985), 55 B.R. 163, 168 (stating that the purpose is to "foster an equitable distribution of the debtor's property").

57. See Sewell, *supra* note 47, at 1011.

Section III, *infra*, the creditors will share the \$100,000.⁵⁸ The debtor will

58. *See infra* Section III. Under the Bankruptcy Code, certain creditors are entitled to more favorable distribution of the debtor's assets. For example, tax liens will always have priority over any creditor upon distribution. Creditors who have a perfected security interest under Article 9 of the U.C.C. are entitled to the repayment of the full value of their collateral. However, employees of the debtor are entitled to payment of their wage claims before most other creditors receive any distribution. Distribution to creditors, however, is subject to any statutory exemption rights the debtor may have. Under § 507 of the Bankruptcy Code:

- (a) The following expenses and claims have priority in the following order:
- (1) First, administrative expenses allowed under section 503(b) of this title, and any fees and charges assessed against the estate under chapter 123 of title 28.
 - (2) Second, unsecured claims allowed under section 502(f) of this title.
 - (3) Third, allowed unsecured claims, but only to the extent of \$4,000 for each individual or corporation, as the case may be, earned within 90 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first, for-
 - (A) wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by an individual; or
 - (B) sales commissions earned by an individual or by a corporation with only 1 employee, acting as an independent contractor in the sale of goods or services for the debtor in the ordinary course of the debtor's business if, and only if, during the 12 months preceding that date, at least 75 percent of the amount that the individual or corporation earned by acting as an independent contractor in the sale of goods or services was earned from the debtor;
 - (4) Fourth, allowed unsecured claims for contributions to an employee benefit plan-
 - (A) arising from services rendered within 180 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first; but only
 - (B) for each such plan, to the extent of-
 - (i) the number of employees covered by each such plan multiplied by \$4,000; less
 - (ii) the aggregate amount paid to such employees under paragraph (3) of this subsection, plus the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan.
 - (5) Fifth, allowed unsecured claims of persons-
 - (A) engaged in the production or raising of grain...
 - (6) Sixth, allowed unsecured claims of individuals, to the extent of \$1,800 for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family or household use of such individuals, that were not delivered or provided.
 - (7) Seventh, allowed claims for debts to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit, or property settlement agreement, but not to the extent that such debt-

not realize any of the equity she has placed into the house, with the exception of any statutory homestead exemption.⁵⁹ Applying the *BFP* decision, if \$100,000 was the highest bid at the sale, that amount is presumed to be “reasonably equivalent value” for a property with a fair market value of \$500,000, provided there was no irregularity in the sale.

1. The Legislative History of Section 548(a)

Section 548(a) of the Bankruptcy Act of 1978 replaced and simplified section 67(d) of the Bankruptcy Act of 1878.⁶⁰ The Commission on the

(A) is assigned to another entity, voluntarily, by operation of law, or otherwise; or
(B) includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance or support.

(8) Eighth, allowed unsecured claims of governmental units; only to the extent that such claims are for-

(A) a tax on or measured by income or gross receipts-
(i) for a taxable year ending on or before the date of the filing of the petition for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition. . .

(9) Ninth, allowed unsecured claims based upon any commitment by the debtor to a Federal depository institutions regulatory agency (or predecessor to such agency) to maintain the capital of an insured depository institution. . .

11 U.S.C. § 507 (1988). *See infra* note 59.

59. The “homestead exemption” is one of the most common state exemptions, where individuals are allowed to exempt their “homestead” from creditor attachment. In California,

The amount of the homestead exemption is one of the following: (1) Fifty thousand dollars unless the judgment debtor or spouse of the judgment debtor who resides in the homestead is a person described in paragraph (2) or (3). (2) Seventy-five thousand dollars if the judgment debtor or spouse of the judgment debtor who resides in the homestead is at the time of the attempted sale of the homestead a member of a family unit, and there is at least one member of the family unit who owns no interest in the homestead or whose only interest in the homestead is a community property interest with the judgment debtor. (3) Seventy-five thousand dollars if the judgment debtor or spouse of the judgment debtor who resides in the homestead is at the time of the attempted sale of the homestead any one of the following: (A) A person 65 years of age or older (B) A person physically or mentally disabled and as a result of that disability is unable to engage in substantial gainful employment, . . . (C) A person 55 years of age or older with a gross annual income of not more than fifteen thousand dollars or, if the judgment debtor is married, a gross annual income, including the gross annual income of the judgment debtor's spouse, of not more than twenty thousand dollars and the sale is an involuntary sale.

CAL. CIV. PROC. CODE § 704.730(a) (West Supp. 1995). It should be noted, however, that the debtor will not be entitled to the full homestead exemption if the debtor's equity in the property is less than the statutory homestead exemption. In such a case, the debtor will be entitled to exempt from property of the estate only the amount of equity in the property. *Id.*

60. 11 U.S.C. § 548(a)(2) (Supp. II 1978). The introduction to the Act provided: “This section is derived in large part from the section 67(d) of the Bankruptcy Act [section 107(d) of former Title 11]. It permits the trustee to avoid transfers by the debtor in fraud of his creditors. Its history dates from the statute of 13 Eliz. ch. 5 (1570).” S. REP. NO. 989, 95th Cong., 2d

Bankruptcy Laws of the United States, created by Congress to recommend changes in the bankruptcy laws, explained in its report: "Section 67(d) is modeled upon the Uniform Fraudulent Conveyance Act. The Commission believes that it has worked satisfactorily and it does not recommend any substantial changes therein, except a simplification of its extremely complex language."⁶¹

Accordingly, although some subsequent changes were made, the current law is largely a simplification of the old statute.⁶² However, substitution of the term "transfer" for "conveyance" sparked considerable debate by courts⁶³ and commentators.⁶⁴ The most important change was the replacement of the phrase "fair consideration" with "reasonably equivalent value."⁶⁵ The Bankruptcy Code does not define "reasonably equivalent value," and the debate over the definition, beginning with the *Durrett* decision, triggered a long-standing split among the circuits.⁶⁶

The legislative history of both section 548 and its predecessor, section 67, sheds little light on how "reasonably equivalent value" should be defined.⁶⁷ Neither of the sections contain reference to its meaning. However, read in its literal terms, section 548 potentially has the power to

Sess. (1978).

61. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93rd Cong., 1st Sess. 20 (1973).

62. See W. COLLIER, 4 COLLIER ON BANKRUPTCY § 548.01[1], at 548-8 (15th ed. 1994). The Bankruptcy Code makes few substantive changes in prior law. However, the first sentence of former § 67(e) provided the trustee with an arsenal of its own. *Id.* at 548-5. "This sentence, in condemning 'conveyances . . . with the intent . . . to hinder, delay, or defraud his creditors,' utilized common law terms, which were to have uniform application in bankruptcy courts throughout the land." *Id.* (citations omitted)

63. See, e.g., *Madrid v. Lawyers Title Ins. Corp.* (*In re Madrid*), 21 B.R. 424 (Bankr. 9th Cir. 1982), *cert. denied*, 469 U.S. 833 (1984) ("transfer" relevant to § 548 occurs at perfection of the deed of trust); *Alsop v. Alaska* (*In re Alsop*), 22 B.R. 1017 (Bankr. D. Alaska 1982) ("transfer" in the context of § 548 occurs at execution and recordation of the deed of trust).

64. David B. Simpson, *Real Property Foreclosures: The Fallacy of Durrett*, 19 REAL PROP. PROB. & TR. J. 73, 78-79 (1984) (arguing that while a transfer of a property interest takes place at foreclosure, it is an interest inferior to that transferred to the mortgagee of the mortgage).

65. See Sewell, *supra* note 47, at 1017. Mention has been made of the fact that former § 67(2)(a) declared a transfer during or resulting in insolvency of the transferor for less than a fair consideration to be fraudulent only as to creditors existing at the time of such transfer. No such limitation exists under § 548(a)(2). See, e.g., COLLIER, *supra* note 62, at 548-53. "Section 548(a)(2) does not refer either to creditors existing at the time of the transfer or obligation or to future creditors." *Id.* at 548-50.

66. See *infra* section II. The Fifth Circuit, in *Durrett v. Washington Nat'l Ins. Co.*, interpreted a provision of the old Bankruptcy Act analogous to § 548(a)(2) and held that a foreclosure sale that yielded 57% of the property's fair market value could be set aside. 621 F.2d 201, 203 (5th Cir. 1980). The court indicated in dicta that any such sale for less than 70% of fair market value should be invalidated. The Ninth Circuit, in *Lawyer's Title Ins. Corp. v. Madrid*, applied the "Durrett rule," and held that a determination of "reasonable equivalence" depends on whether there was compliance with state foreclosure procedures. 21 B.R. 424 (Bankr. 9th Cir. 1982). The Seventh Circuit, in *In re Bundles*, considered the totality of circumstances in determining reasonable equivalency. 856 F.2d 815 (7th Cir. 1988).

67. Sewell, *supra* note 47, at 1018.

set aside a foreclosure sale if the price received is so inadequate that it is deemed to be less than "reasonably equivalent value."⁶⁸

Still, without a definition provided in the Code itself, and with nothing conclusive in the legislative history to guide them, the courts have been free to follow their own reasoning in determining the proper method for defining "reasonably equivalent value." The respective positions taken have favored two conflicting objectives: (1) protecting the mortgagor's equity, a purpose served by federal bankruptcy law;⁶⁹ and (2) ensuring the certainty and finality of real estate foreclosures, a purpose traditionally served by state law.⁷⁰

In reviewing these competing policy considerations, the ultimate resolution of this issue should be based upon the underlying principle of both bankruptcy and foreclosure law: protecting equity for the benefit of unsecured or undersecured creditors.

2. The Equity-Protecting Purpose of Section 548(a)(2)

As noted earlier, the purpose of section 548 is to preserve bankruptcy estates for fair distribution to all creditors.⁷¹ To further this purpose, section 548 seeks to preserve the debtor's equity in foreclosed properties.⁷² Such protection is needed because the typical foreclosure sale yields far less than the fair market value of the property being sold,⁷³ which results in a windfall to the purchaser at the trustee sale at the expense of the mortgagor's unsecured or undersecured creditors.⁷⁴ "It might be acceptable to approve as final a foreclosure sale at far less than market value when the only party to suffer is the debtor."⁷⁵ This is especially true when the debtor has "allowed a valuable property interest to be sold at a public sale, despite

68. *Id.* at 1012.

69. *Id.* at 1020 ("Section 548 is intended to ensure a 'fair return on the debtor's assets for the benefit of all [unsecured] creditors.'" (quoting *Lindsay v. Beneficial Reinsurance Co.* (*In re Lindsay*), 98 B.R. 983, 989 (Bankr. S.D. Cal. 1989))).

70. *Id.* at 1013-14. Mortgage foreclosure law compensates the mortgagee for the value of its investment, the effect of which is to disregard the debtor's unsecured creditors. DUNAWAY, *supra* note 45, at § 25.03[1].

71. See *supra* note 56 and accompanying text.

72. *BFP v. Resolution Trust Corp.*, 114 S. Ct. 1757, 1771 n.10 (1994) (Souter, J., dissenting) ("bankruptcy law affords mortgagees distinct and presumably adequate protections for their interest . . . along with the general promise that the debtors estate will, effectively, be maximized in the interest of creditors.").

73. Most commentators and practitioners would agree that the foreclosure sale price is not the fair market value of the property because the nature of the sale discourages third parties from participating. See, e.g., Gary Goff, *Fair Market Value: A Primer For Texas Legal Practice*, 15 TEX. TECH L. REV. 637 (1984).

74. See James B. Davis & Steven A. Standiford, *Foreclosure Sale as Fraudulent Transfer Under the Bankruptcy Code: A Reasonable Approach to Reasonably Equivalent Value*, 13 REAL ESTATE L.J. 201, 212 (1984).

75. Ehrlich, *supra* note 34, at 960.

ample opportunity to redeem the property or reinstate the loan.”⁷⁶ However, it is unacceptable “to allow an entity purchasing the property at a foreclosure sale to walk away with a windfall, while unsecured creditors are forced to bear the cost of the disproportionate exchange.”⁷⁷ A prudent unsecured creditor who has examined his debtor’s financial statements prior to extending credit has no control over the debtor subsequently mortgaging his property.⁷⁸ However, such prudence will not protect the unsecured creditor from loss. “The policies embodied in section 548(a)(2) are designed to prevent this inequitable result.”⁷⁹

Applying section 548 to foreclosure sales can preserve equity for the debtor and his creditors where the debtor subsequently files bankruptcy. By avoiding a foreclosure sale, the bankruptcy trustee gains an opportunity to resell the property at a price which presumably will more closely reflect a value “reasonably equivalent” to the property’s true market value. This allows the trustee to recoup at least some of the debtor’s equity for the benefit of other creditors.⁸⁰

Despite the consensus on, and the frequent reference to, the purpose of section 548(a)(2), courts have strongly disagreed on what the statutory language of “reasonably equivalent value” ought to mean to serve the statutory purpose.⁸¹

II. JUDICIAL INTERPRETATIONS OF “REASONABLY EQUIVALENT VALUE” PRIOR TO *BFP*

Prior to the *BFP* decision, there were three major approaches to determining what constitutes “reasonably equivalent value.” The first approach measured the foreclosure sale price against a benchmark percentage

76. *Id.*

77. *Id.*

78. *But see* Davis & Standiford, *supra* note 74, at 232. Mr. Davis and Mr. Standiford suggest that

requiring an unsecured creditor to assume that a debtor might subsequently mortgage his property is not inconsistent with the purpose of the fraudulent transfer laws. Unsecured creditors need not assume the risk that their debtor will make an improvident transfer while insolvent; they need to assume only that the debtor might obtain a bona fide mortgage loan in which the mortgage given is reasonably equivalent to the money borrowed. Such a loan causes no harm to an unsecured creditor because it does not deplete the value of the debtor’s estate.

Id. (citations omitted).

79. Ehrlich, *supra* note 34, at 960.

80. Most debtors facing foreclosure will have at least some “equity” in the property. Equity in this context is “the amount or value of a property above the total liens or charges . . . thus, an equity of \$5,000 may come about by having fair market value property of \$20,000 with debt of \$15,000.” BLACK’S LAW DICTIONARY 584 (5th ed. 1979). *See* COLLIER, *supra* note 62, § 548.

81. *See infra* section II.

of the fair market value established by the appraised value of a foreclosed property.⁸² The second approach focused on compliance with state foreclosure procedures.⁸³ The third approach examined all relevant factors surrounding the sale in view of some equitable or commercially reasonable standard.⁸⁴

A. The Durrett Rule: Requiring a Seventy Percent "Benchmark" to Protect the Debtor and Creditor

Durrett v. Washington National Insurance Company was the first example of a court exercising its ability to set aside a foreclosure sale as a fraudulent transfer because of a lack of fair consideration.⁸⁵ Although *Durrett* was decided under the predecessor to the current Bankruptcy Code, the case has had a lasting impact on the issue of the meaning of "reasonably equivalent value."⁸⁶

The circumstances of the *Durrett* case arose from the debtor's default on a note executed by the debtor in the amount of \$180,000, and secured through a deed of trust on his property.⁸⁷ Upon default on the note and subsequent foreclosure sale, the property was sold for \$115,400.⁸⁸ This amount represented 57.7% of the fair market value of the property, and the debtor/trustee effectively suffered a loss on the property of more than \$84,000.⁸⁹

In reversing the district court, the Fifth Circuit in *Durrett* concluded that a foreclosure sale price of \$115,400 was not fair consideration for property with an estimated fair market value of \$200,000.⁹⁰ The court concluded

82. See, e.g., *Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201 (5th Cir. 1980). See also Lam, *supra* note 53, at 678.

83. See, e.g., *Lawyer's Title Ins. Co. v. Madrid*, 21 B.R. 424 (Bankr. 9th Cir. 1982). See also Lam, *supra* note 53, at 678.

84. *Bundles v. Baker (In re Bundles)*, 856 F.2d 815 (7th Cir. 1988). See also Lam, *supra* note 53, at 678.

85. See Simpson, *supra* note 64, at 73.

Prior to the decision of the United States Court of Appeals in *Durrett*, bankruptcy courts had not invoked their statutory authority to avoid fraudulent conveyances to set aside, on grounds of inadequacy of consideration, a foreclosure sale completed prior to a debtor's bankruptcy so long as the underlying mortgage had itself been given in a transaction immune from attack as a fraudulent transfer.

Id. (citation omitted).

86. William A. Walsh, *In Re Bundles: Finding A New Basis For Determining "Reasonable Equivalent Value" Under Section 548 of the Bankruptcy Code*, 40 DEPAUL L. REV. 175, 182 (1990).

87. *Durrett*, 621 F.2d at 202-03.

88. *Id.* at 203. The property was purchased by the only party to appear at the sale.

89. *Id.*

90. *Id.* at 204.

that the debtor had not received “fair equivalent” value for the property.⁹¹ In dictum, the court noted that it could not locate a single federal case upholding a transaction under section 67(d) where a trustee/debtor received less than seventy percent of the fair market value in consideration.⁹² As a result of this dictum, *Durrett* has been said to embody the proposition that a foreclosure sale for less than seventy percent of the fair market value is not a sale for “reasonably equivalent value” under Section 548(a)(2).⁹³

Support for the “*Durrett* rule” was far from unanimous. Many courts and commentators reasoned that a rule requiring a percentage of fair market value as a prerequisite to transfer would chill foreclosure sale bidding.⁹⁴ Still, the decision arguably encourages reform of the entire state foreclosure process.

B. The Madrid Approach: Requirement of Compliance With State Procedure as the Determinative Factor for “Reasonably Equivalent Value”

Under the *Madrid*⁹⁵ approach, the court held that the foreclosure price is not to be considered within the context of section 548(a)(2).⁹⁶ Instead, the court focused on whether the foreclosure sale complied with the applicable state foreclosure procedures.⁹⁷ Under this approach, a court will conclusively presume that a noncollusive, regularly conducted foreclosure sale yields a “reasonably equivalent value.”⁹⁸

91. As predecessor to § 548, § 67(d) required a “fair equivalent” value. This has been construed as having the same meaning as “reasonably equivalent value.” See Sewell, *supra* note 47, at 1017.

92. *Durrett*, 621 F.2d at 203.

93. *Lindsay v. Beneficial Reinsurance Co. (In re Lindsay)*, 98 B.R. 983, 986 (Bankr. S.D. Cal. 1989) (“Most courts have interpreted *Durrett* as standing for the proposition that ‘reasonably equivalent value’ . . . is present if the sale achieves at least 70 percent of the fair market value. . . .”) *Id.* See also *Barrett v. Commonwealth Fed. Sav. & Loan Ass’n (In re Barrett)*, 939 F.2d 20 (3d Cir. 1991), where the court allowed a foreclosure sale for 69.5% of the market value.

94. See, e.g., Lawrence D. Coppel & Lewis A. Kahn, *Defanging Durrett: The Established Law of “Transfer,”* 100 BANKING L.J. 676, 677 (1983) (theorizing that *Durrett* made it impossible to “convey clear and marketable title at foreclosure sales. . . .”); Simpson, *supra* note 62, at 73 (“The rule of *Durrett* must have sent shock waves throughout the secured lending community. . . . [T]he effect of *Durrett* has been to jeopardize the security of all titles acquired through foreclosure sales.”); *Alsop v. Alaska (In re Alsop)*, 22 B.R. 1017, 1018 (Bankr. D. Alaska 1982) (stating that *Durrett* is inconsistent with the rationale of the Ninth Circuit’s decision in *Evans v. Valley West Shopping Center*, 567 F.2d 358 (9th Cir. 1978)). *But see Gillman v. Preston Family Inv. Co. (In re Richardson)*, 23 B.R. 434, 448 (Bankr. D. Utah 1982) (“while *Durrett*’s application of bankruptcy fraudulent conveyance law to a foreclosure sale may have been unprecedented, there is nothing novel in avoiding transfers under bankruptcy law which are valid under state law.”).

95. *Lawyer’s Title Ins. Corp. v. Madrid (In re Madrid)*, 21 B.R. 424 (Bankr. 9th Cir. 1982).

96. *Id.* at 427.

97. *Id.*

98. *Id.*

The facts of *Madrid* are fairly comparable to those of *Durrett*. The debtor in *Madrid* had purchased a parcel of property by borrowing the entire purchase price and executing both a first and second deed of trust as security for the loans.⁹⁹ When the debtor defaulted, the trustee under the second trust deed sold the property at a foreclosure sale, where the property was purchased for sixty-four percent to sixty-seven percent of the property's fair market value.¹⁰⁰ Seven days after the foreclosure sale, the debtor filed bankruptcy and sought to avoid the transfer under section 548(a).¹⁰¹

The Bankruptcy Appellate Panel in *Madrid* held that "the consideration received at a non-collusive, regularly-conducted public sale satisfies the 'reasonably equivalent value' requirement of 11 U.S.C. § 548(a)(2)" ¹⁰² Relying on prior state law decisions, the court concluded that inadequacy of price alone was insufficient grounds for avoiding a foreclosure sale.¹⁰³ The court added that "there must be in addition proof of some element of fraud, unfairness, or oppression as accounts for and brings about the inadequacy of price."¹⁰⁴

Commentators and courts note several arguments favoring the *Madrid* approach. For example, the *Madrid* approach narrowly construes section 548, which prevents preemption in an area of law traditionally controlled by the states, thus preserving the integrity of state real estate law.¹⁰⁵ Also, since the Code does not define "reasonably equivalent value," this construction arguably complies with the Code.¹⁰⁶

99. *Id.* at 425.

100. *Id.* The property was purchased by the only bidder at the sale, who purchased the property subject to the first deed of trust and an amount necessary to liquidate the indebtedness secured by the second trust deed. *Id.*

101. *Id.*

102. *Id.*

103. *Id.* at 427 (citing *Golden v. Tomiyasu*, 387 P.2d 989 (Nev. 1963)) ("If we consider the question of price adequacy in the context of foreclosure law we find, not surprisingly, that mere inadequacy will not upset a foreclosure sale."). *Id.*

104. *Id.* (quoting *Oller v. Sonoma County Land Title Co.*, 290 P.2d 880, 882 (Cal. Ct. App. 1963)). By requiring "some element of fraud," the *Madrid* court reintroduced the good faith requirement that the drafters had abandoned in § 548 of the Bankruptcy Code. The court gave a regularly conducted non-collusive foreclosure a presumption of innocence. *Id.* According to the *Madrid* court, a debtor's demonstration of some indication of fraud or "bad faith" is the only way to overcome this presumption and set aside the transfer. *Id.*

105. *Bennett v. Genoa AG Ctr., Inc. (In re Bennett)*, 154 B.R. 140, 146 (Bankr. N.D.N.Y. 1992). The court in *Bennett* held that the federal standard of reasonable equivalence, at least as applied to regularly conducted, noncollusive foreclosure sales, should be consonant with applicable state foreclosure law. See also *Zajac v. Federal Land Bank*, 909 F.2d 1181, 1183 (8th Cir. 1990) (illustrating that a broad interpretation of "reasonably equivalent value" allows for § 548(a)(2) to encroach into state substantive foreclosure law).

106. Mark E. Budnitz, *The Duties Imposed by Bankruptcy Courts Upon Mortgagees at Foreclosure Sales: How to Avoid Avoidance Under Section 548*, 46 BUS. LAW. 1183, 1185 (1991). Budnitz also notes that, to the extent bankruptcy courts are content with state procedures and do not impose additional costly requirements, the holding in *Madrid* allows mortgagees to operate more efficiently and provide more and cheaper credit to homeowners. *Id.*

Absent collusion, intentional fraud, or violation of state foreclosure procedures, the *Madrid* court held that a foreclosure sale will stand. This is true even if the price realized falls substantially below the fair market value of the property foreclosed.¹⁰⁷

C. The Bundles Analysis: A Case-By-Case Determination Considering the Totality of the Circumstances

Dissatisfaction with both the *Durrett* seventy percent rule and the *Madrid* state-procedural approach became evident when the Eighth Circuit refused to adopt either standard and instead required a case-by-case evidentiary determination of reasonably equivalent value.¹⁰⁸ Also dissatisfied with the approaches of *Durrett* and *Madrid*, the Seventh Circuit, in 1988, formulated a third alternative which takes a middle-of-the-road approach to interpreting “reasonably equivalent value.”¹⁰⁹ In *Bundles v. Baker*, the Seventh Circuit advised that courts should be aware of the purpose of section 548, which is to preserve the assets of the estate, while also giving respect to state foreclosure proceedings.¹¹⁰

In *Bundles*, the debtor was unable to meet his mortgage payments due to various financial and health problems. At the foreclosure sale, the debtor’s property was purchased for \$5,066.80.¹¹¹ The value of the property at the time of sale was \$15,500.¹¹² The Seventh Circuit noted that while fair market value marks an appropriate starting point for analysis, the determination of “reasonably equivalent value” cannot be limited to a simple comparison of sale price to fair market value.¹¹³ Instead, the court concluded ultimate focus must be on the fair market value as affected by the foreclosure sale.¹¹⁴ Consequently, the *Bundles* court found that there is a rebuttable presumption that the foreclosure price is the property’s “reasonably equivalent value.”¹¹⁵ The presumption can be rebutted by examining the entire transaction to determine whether the “procedures employed were calculated not only to secure for the mortgagee the value of its interest, but also to return to the debtor-mortgagor his equity in the property.”¹¹⁶

107. *Id.*

108. *First Fed. Sav. & Loan Ass’n of Bismarck v. Hulm (In re Hulm)*, 738 F.2d 323, 327 (8th Cir. 1984), *cert. denied*, 469 U.S. 990 (1984). The *Hulm* court rejected the state procedural approach of *Madrid* and conspicuously ignored *Durrett*.

109. *Bundles v. Baker (In re Bundles)*, 856 F.2d 815, 824 (7th Cir. 1988).

110. *Id.*

111. *Id.* at 817

112. *Id.*

113. *Id.* at 824.

114. *Id.* at 825.

115. *Id.*

116. *Id.* at 824.

When reviewing the transaction as a whole, the *Bundles* court suggested evaluating factors such as: (1) whether there was a fair appraisal of the property; (2) whether the property was advertised widely; and (3) whether competitive bidding was encouraged.¹¹⁷ Since 1988, three circuit courts of appeals have adopted the totality of circumstances test advocated in *Bundles*.¹¹⁸

III. *BFP v. RESOLUTION TRUST CORPORATION*: PRESUMPTION OF "REASONABLY EQUIVALENT VALUE" WHERE SALE IS CONDUCTED IN COMPLIANCE WITH STATE LAW

The U.S. Supreme Court in *BFP* parted from the positions taken by both the fifth circuit in *Durrett* and the Seventh Circuit in *Bundles*. The Court held that both *Durrett* and *Bundles* wrongly refer to fair market value as the benchmark against which determination of "reasonably equivalent value" is to be measured.¹¹⁹ Such reference, according to the Court, is not consistent with the text of the Bankruptcy Code,¹²⁰ because "fair market value" does not appear in section 548 of the Bankruptcy Code.¹²¹

In *BFP*, the petitioners took title to a California home subject to a deed of trust in favor of Imperial Savings Association.¹²² After the petitioners were unable to continue payments and the loan was in default, the home was purchased for \$433,000 at a properly conducted foreclosure sale.¹²³ *BFP* soon petitioned for bankruptcy and filed a complaint to set aside the sale as a fraudulent transfer.¹²⁴ *BFP* claimed that the home was worth over

117. *Id.* See also *National Envtl. Sys. Corp. v. Long Pond Realty Trust (In re National Envtl. Sys. Corp.)*, 111 B.R. 4 (Bankr. D. N.H. 1989) (examining the extent of competitive bidding and effect of giving notice to local brokers).

118. See *Grissom v. Johnson (In re Grissom)*, 955 F.2d 1440 (11th Cir. 1992) (clarifying its earlier decision in *Walker v. Littleton (In re Littleton)*, 888 F.2d 90 (11th Cir. 1989)); *Barrett v. Commonwealth Fed. Sav. & Loan Ass'n*, 939 F.2d 20 (3d Cir. 1991); *Cooper v. Ashley Communications, Inc. (In re Morris Communications N.C.)*, 914 F.2d 458 (4th Cir. 1990).

119. *BFP v. Resolution Trust Corp.*, 114 S. Ct. 1757, 1761 (1994).

120. *Id.*

121. *Id.* In contrast, Justice Scalia noted that § 522 of the Bankruptcy Code, 11 U.S.C. § 522(a)(2) (1988), dealing with debtors' exemptions, "specifically provides that, for purposes of that section, 'value' means 'fair market value' as of the date of the filing of the petition." *Id.*

122. *Id.* at 1759.

123. *Id.*

Respondent Resolution Trust Corporation (RTC) [acted] in this case as receiver of Imperial Federal Savings Association (Imperial Federal), which was organized pursuant to a June 22, 1990, order of the Director of the Office of Thrift Supervision, and into which RTC transferred certain assets and liabilities of Imperial. The Director previously had appointed RTC as receiver of Imperial.

Id. at 1759 n.1.

124. *Id.* at 1759.

\$725,000 when sold and, thus, was not exchanged for a “reasonably equivalent value” under section 548(a)(2) of the Bankruptcy Code.¹²⁵ The bankruptcy court granted summary judgment to the purchaser.¹²⁶ The bankruptcy appellate panel affirmed the dismissal,¹²⁷ holding that consideration received in a non-collusive and regularly conducted, nonjudicial foreclosure sale¹²⁸ establishes “reasonably equivalent value” as a matter of law.¹²⁹ The court of appeals affirmed,¹³⁰ and the Supreme Court held that “reasonably equivalent value” is the price received at the foreclosure sale, so long as all of the requirements of the state’s foreclosure laws have been complied with.¹³¹

In reaching its conclusion, the majority, under Justice Scalia,¹³² focused on two identifying factors. First, the Court looked at the words “reasonably equivalent value,” and determined that no textual guidance existed that would equate “reasonably equivalent value” to “fair market value.”¹³³ In addition, the Court noted that until the value of a foreclosed property is determined, one cannot establish whether the value received in exchange for the foreclosed property is “reasonably equivalent value.”¹³⁴ Second, even if such guidance existed, “reasonable equivalence” cannot mean “fair market value” where there is a forced sale.¹³⁵ This is because “fair market value” presumes market conditions that, by definition, do not exist in the context of a forced sale.¹³⁶

125. *Id.*

126. *Id.*

127. 132 B.R. 748 (Bankr. 9th Cir. 1991).

128. *See supra* notes 7-10.

129. 132 B.R. 748 (1991).

130. *In re BFP*, 974 F.2d 1144 (9th Cir. 1992).

131. *BFP*, 114 S. Ct. at 1765.

132. *Id.* at 1759.

133. *Id.* at 1761.

134. *Id.* at 1766. The majority noted that three possible measures exist as to how to value a foreclosed property: fair market value, reasonable-forced sale price, and the foreclosure price itself. *Id.*

135. *Id.* at 1761.

136. *Id.* *See also* Washburn, *The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales*, 53 S. CAL. L. REV. 843, 848 (1980). “Foreclosure sale prices are often greatly below actual fair market values because they reflect the fact that the sale is a forced sale rather than an arm’s length, free market sale between a willing buyer and a willing seller.” *Id.* (citing *Girard Trust Bank v. Castle Apts., Inc.*, 379 A.2d 1144, 1146 (Del. Super. Ct. 1977); *Maule Indus. v. Seminole Rock & Sand Co.*, 91 So. 2d 307, 311 (Fla. 1956); *Aaron v. Life Ins. Co.*, 226 S.E.2d 96, 98 (Ga. App. 1976) (Clark, J., concurring); *Levy v. Broadway-Carmen Bldg. Corp.*, 8 N.E.2d 671, 677 (Ill. 1937); *Gilbert v. Lusk*, 106 N.E.2d 404, 413 (Ind. App. 1952); *Fox v. Jackson*, 64 N.E.2d 799, 801 (Ind. App. 1946); *Commercial Bank v. Madsen*, 236 P.2d 343, 345 (Utah 1951).

*A. The Majority's Reasoning: No Textual Guidance Equating
"Reasonably Equivalent Value" To "Fair Market Value"*

In reaching its definition of "reasonably equivalent value," the Court found that no textual guidance existed which would allow "reasonably equivalent value" to equate to "fair market value." In fact, the Court noted that section 548 seemingly goes out of its way to avoid the standard term, "fair market value."¹³⁷

The Court reasoned that because the phrase "fair market value" appears in other sections of the Bankruptcy Code, Congress did not intend a foreclosure sale upon bankruptcy to require fair market value.¹³⁸

Also, because it is generally presumed that Congress acts intentionally and purposefully when it includes particular language in a statute, it may be presumed that Congress did not intend fair market value to be the benchmark upon which "reasonably equivalent value" is to be determined.¹³⁹ Even if the definition could be stretched to mean "as close to equivalent as can reasonably be expected," the Court noted that such "word-gaming" would deprive the criterion of all meaning.¹⁴⁰ Thus, without clearer textual guidance than the phrase "reasonably equivalent value," the Court refused to presume such a radical departure to "fair market value."¹⁴¹

*B. The Court's Presumption that "Fair Market Value" Does Not Exist
Within the Context of a Forced Sale*

The Court in *BFP* followed the presumption that fair market value does not exist where there is a forced sale.¹⁴² In reaching this conclusion, the Court reasoned that fair market value presumes market conditions that do not exist in the forced-sale context.¹⁴³ This is because property sold within the

137. *BFP*, 114 S. Ct. at 1761. *Id.* The Court added that the Code "might readily have said 'received less than fair market value in exchange for such transfer or obligation,' or 'less than reasonably equivalent or fair market value.' Instead, it used . . . the entirely novel phrase 'reasonably equivalent value.'" *Id.*

138. *Id.* Section 522 of the Bankruptcy Code, dealing with debtor's exemptions, specifically provides that, for purposes of that section, "value" means fair market value as of the date of the filing of the petition. 11 U.S.C. § 522(a)(2). "Fair market value" also appears in the Code provision that defines the extent to which indebtedness with respect to an equity security is not forgiven for the purpose of determining whether the debtor's estate has realized taxable income. *Id.* 11 U.S.C. § 346(j)(7)(B) (Supp. II 1984).

139. *Id.* at 1762.

140. *Id.*

141. *Id.* at 1764 (citing *United Sav. Ass'n. of Texas v. Timbers of Inwood Forest Assoc., Ltd.*, 484 U.S. 365, 380 (1988); *Midlantic Nat'l. Bank v. New Jersey Dept. of Envtl. Protection*, 474 U.S. 494, 501 (1986); *United States v. Texas*, 113 S. Ct. 1631 (1993) (statutes that invade common law must be read with presumption favoring retention of long-established principles absent evident statutory purpose to the contrary)).

142. *Id.* at 1758.

143. *Id.*

time and manner strictures of a state-prescribed foreclosure is simply worth less than property sold without such restrictions.¹⁴⁴

The Court also looked at the language of section 548(a)(2) (“received less than a reasonably equivalent value in exchange”) as requiring judicial inquiry into whether the foreclosed property was sold for a price that approximated its worth at the time of sale.¹⁴⁵ “An appraiser’s reconstruction of ‘fair market value’ could show what similar property would be worth if it did not have to be sold within the time and manner strictures of a state-prescribed foreclosure.”¹⁴⁶ However, the Court reasoned that property sold within these strictures is simply worth less.¹⁴⁷ As a consequence, no buyer would pay as much to own such property as the buyer would to own real estate that could be sold pursuant to normal marketing techniques.¹⁴⁸

IV. THE HARSH IMPLICATIONS OF THE SUPREME COURT’S DECISION: FAILURE TO RECOGNIZE THE POLICY BEHIND THE BANKRUPTCY CODE

The Supreme Court in *BFP* dictated that the price received at a mortgage foreclosure sale, *any* price received, conclusively establishes a “reasonably equivalent value” without the requirement of a fair market value. There are three fundamental problems with the Court’s decision. First, the Court failed to recognize the purpose of section 548, which is to preserve bankrupt debtors’ estates for fair distribution to all creditors.¹⁴⁹ This purpose reflects the “concept of avoidance based on the federal policy favoring maximum distribution to the unsecured creditors of a bankrupt debtor, *not on the blameworthiness of the parties.*”¹⁵⁰ It is inherently unfair to creditors and debtors alike that a significant portion of the value of the single largest investment which most individuals will ever make is lost during a

144. *Id.* at 1762. Justice Scalia suggests that specifying a federal minimum sale price beyond what state foreclosure law requires would extend bankruptcy law well beyond the traditional field of fraudulent transfers, thus upsetting the coexistence that fraudulent transfer law and foreclosure law have enjoyed for over 400 years. *Id.* at 1764.

145. *Id.* at 1762.

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. Ehrlich, *supra* note 34, at 972 (emphasis added). Professor Ehrlich focuses on both the creditor who has an interest in the proceeds of the sale and the bona fide purchaser at the foreclosure sale as parties without blame.

To allow the trustee both to recover the property and to retain the consideration given by the transferee would result in a windfall to the trustee and a punitive action against the foreclosure purchaser. Where the transfer is presumptively, not actually, fraudulent, it is illogical and inequitable to shift the entire burden of avoidance to a transferee who has merely exercised his state law right to purchase the property at a state-mandated foreclosure sale.

Id.

foreclosure sale.¹⁵¹ However, the Court did not accommodate the purpose of section 548, which is to focus on the creditor and debtor as protected parties.¹⁵² Instead, the Court focused on the bidding party at the foreclosure sale as the protected party.¹⁵³ The majority noted that security of title to real estate provides an essential state interest, and that the power to ensure that security “inheres in the very nature of [state] government.”¹⁵⁴

The second problem with the *BFP* decision is more fundamental. At “a typical foreclosure sale, a mortgagee has no incentive to bid any more than the amount of the indebtedness, since any ‘surplus’ would be turned over to the debtor (or junior lienholders). . . .”¹⁵⁵ Several commentators have suggested that if state procedures are properly designed to obtain a maximum price under the circumstances of a forced sale, the courts should presume that the price received is a realistic reflection of value.¹⁵⁶ However, even if this is true, without the requirement of a fair market price the mortgagee is not motivated to seek the highest possible price for the foreclosed property.¹⁵⁷

The *BFP* decision allows a mortgagee to bid at the foreclosure sale for the amount of the debt and in turn to realize a profit selling the property. This is especially true where the property is obviously worth more than the amount of the indebtedness, because the lender is more likely to take the property by bidding the amount of the indebtedness.¹⁵⁸ The result is a two-fold loss: (1) the creditors lose their interest in the proceeds of the sale, and (2) the debtor loses any equity in the foreclosed property.

Unfortunately, the Supreme Court’s decision in *BFP* follows the presumption that a foreclosed property must obtain a less-than-fair market

151. Steven Wechsler, *Through the Looking Glass: Foreclosure By Sale as De Facto Strict Foreclosure- An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850, 875 (1985).

152. Davis & Standiford, *supra* note 74, at 232. Still, Davis and Standiford note that while relief of debtors is a primary purpose of the Bankruptcy Code, any analysis of the fraudulent transfer provisions must be based on the purpose of fraudulent transfer laws, which is to remedy a wrong that a debtor had committed against his creditors. *Id.*

153. *BFP*, 114 S. Ct. at 1764-65.

154. *Id.*

155. *Id.* at 1775 (Souter, J., dissenting). See *supra* note 40 for a definition of “junior creditor.”

156. Ehrlich, *supra* note 34, at 979. Professor Ehrlich takes this position on the assumption that state foreclosure procedures are structured to produce an optimal sale price, while respecting the lender’s need for a low cost realization of the collateral. *Id.* See also Alan S. Glover & Glenn D. West, *The Texas Nonjudicial Foreclosure Process—A Proposal To Reconcile the Procedures Mandated By State Law With the Fraudulent Conveyance Principles of the Bankruptcy Code*, 43 Sw. L.J. 1061 (1990).

157. See Ehrlich, *supra* note 34, at 959. Professor Ehrlich suggests that “[t]he lender’s aim is completely inconsistent with the goal of maximizing value.” *Id.* “The lender’s only interest is selling the property at a price equal to the amount of its outstanding debt.” *Id.* This is because any “surplus” would be turned over to the debtor (or junior lienholder). *Id.* at 958. In some cases, it can even be advantageous for the creditor to bid less and seek a deficiency judgment. See Washburn, *supra* note 137, at 847-51.

158. *BFP*, 114 S. Ct. at 1775 (Souter, J., dissenting).

value.¹⁵⁹ The majority reasoned that because properties sold at a foreclosure sale are “simply worth less,” they must have been “worth” whatever price was paid.¹⁶⁰ This pessimistic view effectively leaves the debtor, as well as the creditor, essentially unprotected when a foreclosure occurs. By not referring to fair market value as the benchmark against which determination of “reasonably equivalent value” is to be measured, the *BFP* Court failed to take the pragmatic approach that the court in *Durrett* took. The cornerstone of bankruptcy law has always been achieving equitable results for creditors.¹⁶¹ Still, the majority in *BFP* chose to rely on the false presumption that foreclosure sales cannot be expected to yield fair market value.¹⁶² By relying on this presumption, the Court allowed the price received at the foreclosure sale, though significantly less than the property’s fair market value, to stand. The Court effectively dismissed the mandate requiring maximum distribution of the bankrupt debtor’s estate for the benefit of unsecured and secured creditors, leaving the creditor and debtor unprotected.¹⁶³

A third problem with the *BFP* decision is one of the proper construction of the term “reasonably equivalent value” as it appears in the Bankruptcy Code,¹⁶⁴ the majority failed to address. If a property’s “value” is conclusively presumed to be whatever the highest bid is, as the *BFP* holding suggests, the issue of whether the property sold for less than “reasonably equivalent value” would never be worth addressing. Thus, the bankruptcy

159. *Id.* at 1761.

160. *Id.* at 1768 (Souter, J., dissenting).

161. *Shell Oil Co. v. Waldron (In re Waldron)*, 785 F.2d 936, 941 (11th Cir. 1986), *cert. dismissed*, 478 U.S. 1028 (1986).

162. *BFP*, 114 S. Ct. at 1758.

163. Justice Souter, speaking for the dissent, stated his position as follows:

[T]he assessed value of a parcel of real estate at the time of foreclosure sale is not to be ignored. On the contrary, that figure plainly is relevant to the Bankruptcy Code determination, both because it provides a proper measure of the rights received by the transferee and because it is indicative of the extent of the debtor’s equity in the property, an asset which, but for the pre-bankruptcy transfer under review, would have been available to the bankruptcy estate. *It is also somewhat misleading*, similarly, to suggest that ‘no one would pay as much’ . . . for a foreclosed property as he would for the same real estate purchased under leisurely, market conditions. Buyers no doubt hope for bargains at foreclosure sales, but an investor with a million dollars cash in his pocket might be readily to pay ‘as much’ for a desired parcel of property on a forced sale, at least if a rival, equally determined millionaire were to appear at the same auction.

Id. at 1768 n.2 (emphasis added) (citations omitted). Justice Souter also noted that the principal reason foreclosure sales yield low prices is not so much that the properties are momentarily “worth less.” Rather, Justice Souter opined that such free-spending millionaires are in short supply, and those who do exist are unlikely to read the fine print which fills the “legal notice” columns of their morning newspaper. *Id.* at 1769.

164. 11 U.S.C. § 548(a)(2)(A) (“the trustee may avoid any transfer . . . if the debtor . . . received less than a *reasonably equivalent value* in exchange for such transfer or obligation. . . .”) (emphasis added).

avoidance power would apparently be a "dead letter" in reviewing real estate foreclosures.¹⁶⁵ This is incredulous, because if "reasonably equivalent value" is presumed to be whatever the property sold for, Congress would not have placed the phrase "reasonably equivalent value" in the Bankruptcy Code. Instead, Congress would have used the term "value" instead of "reasonably equivalent value," and defined "value" as whatever the property sold for.¹⁶⁶

V. POLICY REASONS OF *DURRETT*: THE ONLY PLAUSIBLE APPROACH TO PROTECT THE CREDITOR AND DEBTOR

Several commentators have suggested ways to achieve higher prices at the foreclosure sale. One suggestion is to improve the foreclosure sale by generating more active participation by third-party buyers.¹⁶⁷ This would ideally result in more spirited and competitive bidding.¹⁶⁸ Other suggestions include changing the requirement of cash payment at the foreclosure sale, lessening the chaos of the transaction by changing the forum of the sale, and improving the brokerage listing services.¹⁶⁹

These suggestions are not without merit, because they are factors that might allow for higher prices. However, they do not guarantee an optimal price will be received for the property. Ultimately, the forced-sale aspect of the foreclosure proceeding implies that the property will be sold for a

165. *Id.* at 1770 (Souter, J., dissenting).

166. However, two commentators have suggested that "reasonably equivalent value," in the context of a foreclosure sale, should mean the "value that should reasonably be received at a properly conducted public sale. This approach would mean that most foreclosure sales would not be avoidable as fraudulent transfers." See Davis & Standiford, *supra* note 74, at 230.

167. See Wechsler, *supra* note 151, at 891. Wechsler suggests that lack of notice about foreclosure sales may effectively exclude some third parties from bidding, because the notice required by the typical foreclosure statute do not attract the attention of the general public. *Id.*

168. Nevertheless, the basic structure of state foreclosure sale procedures favors the lender and discourages truly competitive bidding. Robert A. Glaves, *The Controversy Over Section 548 of the Bankruptcy Code in the Mortgage Arena: Making the Case For a Federal Statute Reforming the Foreclosure Process*, 23 J. MARSHALL L. REV. 683, 692 (1990). Although the forced nature of a foreclosure sale causes prices to be lower than they might be for a sale of real property in the open market, the lack of competitive bidding at foreclosure sales is a principal reason that prices tend to be well below the market value of the properties being sold. *Id.* State legislatures inexplicably have resisted structural reform of the foreclosure sale process. The Uniform Land Transactions Act, adopted in 1975 by the National Conference of Commissioners on State Laws, contains numerous provisions that would reform the structure of foreclosure sales. See UNIFORM LAND TRANSACTIONS ACT §§ 3-508 - 3-509, 13 U.L.T.A. 614-17 (1985) [hereinafter U.L.T.A.]. However, the U.L.T.A. has not been adopted in any state, although the New Hampshire Supreme Court has endorsed the concept for nonjudicial power of sale foreclosures in that state. For a general discussion of the U.L.T.A., see *Summary of the Uniform Land Transactions Act*, 13 REAL PROP. PROB. & TR. J. 672 (1978). Thus, although the forced nature of a foreclosure sale causes prices to be lower than they might be for a sale of real property in the open market, the lack of competitive bidding at foreclosure sales is a principal reason that prices tend to be well below the market value of the properties being sold. See Washburn, *supra* note 136, at 844-55.

169. Ehrlich, *supra* note 34, at 961-62.

bargain.¹⁷⁰ Also, the purchaser at the foreclosure sale often buys the property subject to several encumbrances, and is unwilling to pay the fair market price for a property where there might be a cloud on title.¹⁷¹ Thus, all the advertisements and broker listings in the world will not necessarily achieve fair market prices.¹⁷² This is especially true where there is a statutory right of redemption¹⁷³ for the defaulting party, which will necessarily lessen the value.¹⁷⁴

The only plausible approach to achieving a fair market value is the approach taken by the court in *Durrett*, and rejected by the Court in *BFP*. Under the *Durrett* rule, a purchaser at a foreclosure sale is required to bid at least seventy percent of the property's fair market value.¹⁷⁵ The most obvious attribute of the *Durrett* rule is that it attempts to address the purpose of section 548 and serve the main purpose of bankruptcy law: the preservation of the debtor's assets for the distribution to unsecured creditors. By overriding state law and imposing a "minimum bid" of seventy percent of the property's fair market value, the creditors secured by the property can be guaranteed the foreclosure will generate money for the debtor's estate. Thus,

170. *BFP*, 114 S. Ct. at 1762.

171. Telephone Interview with Barbara J. Schwartz, Real Estate Broker, Fred Sands Realtors (Nov. 20, 1994). A cloud on title is

[a]n outstanding claim or encumbrance which, if valid, would affect or impair the title of the owner of a particular estate, and on its face has that effect, but can be shown by extrinsic proof to be invalid or inapplicable to the estate in question. A conveyance, mortgage, judgment, tax-levy, etc., may all, in proper cases, constitute a cloud on title.

BLACK'S LAW DICTIONARY 255 (6th ed. 1990).

172. *BFP*, 114 S. Ct. at 1762. "No one would pay as much to own such property as he would pay to own real estate that could be sold at leisure and pursuant to normal marketing techniques." *Id.*

173. *See supra* text accompanying note 31. Foreclosure sales subject to redemption transfer a defeasible estate. Exercise of the redemption right terminates the sale and restores the property to the person who redeemed. The statutory right to redeem is part of the estate if the person entitled to redeem files a petition under Chapter 7, 11, or 13 of the Bankruptcy Code during the redemption period. In such event the trustee or debtor-in-possession may exercise the right of redemption within the period specified in 11 U.S.C. § 108(b). *See also* CAL. CIV. PROC. CODE § 729.030 (West 1995):

The redemption period during which property may be redeemed from a foreclosure sale under this chapter ends:

- (a) Three months after the date of sale if the proceeds of the sale are sufficient to satisfy the secured indebtedness with interest and costs of action and of sale.
- (b) One year after the date of sale if the proceeds of the sale are not sufficient to satisfy the secured indebtedness with interest and costs of action and of sale.

174. *Id.* A post-sale right of redemption has an adverse affect on the price received at a foreclosure sale. Bidders are unlikely to bid for property if they cannot rely on keeping it, or selling it on the fair market. Put another way, a person would not likely pay \$100,000 for a house that the debtor could reclaim at any time by paying \$80,000.

175. *Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201, 203 (5th Cir. 1980).

the seventy percent rule of *Durrett* facilitates the rehabilitation of debtors and increases the chances of payment to unsecured creditors.

In addition, the seventy percent rule may provide bidders at a foreclosure sale more certainty regarding whether a potential bid is likely to be upset in later proceedings.¹⁷⁶ “The seventy percent benchmark gives the buyer notice that he must pay at least a minimum amount or take the risk that a bankruptcy trustee may be able to avoid the sale.”¹⁷⁷ Such notice provides an advantage that the case-by-case approach of *Bundles* does not provide. Accordingly, the purchaser at a foreclosure sale can be more certain of the risks of buying property at a price below the seventy percent benchmark than he would be if the transaction at that price were subject to a case by case determination of “reasonable equivalence.”¹⁷⁸

In addition, providing an easily identifiable guideline, as *Durrett* does, “lend[s] more uniformity to case decisions than if the determination were left merely to judicial fiat.”¹⁷⁹ As observed by the court in *Jackson v. Security Federal Savings & Loan Association*,¹⁸⁰ even if appraisals differ, the seventy percent rule provides a thirty percent cushion that gives the purchaser at a foreclosure sale some discount for the risks of making a purchase at such a sale, in addition to eliminating minor differences of opinion as to fair market value.¹⁸¹

Because *Durrett* effectively achieves the purpose of bankruptcy law and provides certainty among the bidding parties, the most recent congressional enactment dealing with the fraudulent transfer provisions of the Bankruptcy Code, the Bankruptcy Amendments and Federal Judgeship Act of 1984,¹⁸² favored the *Durrett* decision.¹⁸³

A. *The Bankruptcy Amendments and Federal Judgeship Act of 1984: Codification of the Durrett Rule?*

The Bankruptcy Amendments and Federal Judgeship Act of 1984 (Bankruptcy Act of 1984)¹⁸⁴ was enacted subsequent to the *Madrid* and *Durrett* decisions in order to address the *Madrid / Durrett* problem. More specifically, the purpose of the Act was to determine whether fair market

176. Welcott, *supra* note 1, at 406.

177. Robert Buford, *Can Mortgage Foreclosure Sales Really Be Fraudulent Conveyances Under Section 548(a)(2) of the Bankruptcy Code?*, 22 HOUS. L. REV. 1221, 1243-44 (1985).

178. *Id.* at 1244.

179. Welcott, *supra* note 1, at 406.

180. 76 B.R. 597 (Bankr. N.D. Tex. 1987).

181. *Id.* at 599.

182. Pub. L. No. 98-353, §§ 401(1), 463(a), 98 Stat. 368, 370 (codified as amended at 11 U.S.C. §§ 101(54), 548(a) (1988)).

183. *Id.*

184. *Id.*

value or procedural regularity is to be the benchmark upon which “reasonably equivalent value”¹⁸⁵ is to be determined.

In the course of amending the Bankruptcy Code, Congress considered, but did not enact, an amendment that said precisely what the majority in *BFP* now says the current provision means; that the power to avoid a foreclosure sale is confined to foreclosures involving collusion or procedural irregularity.¹⁸⁶ The proposed amendment read:

A secured party or third party purchaser who obtains title to an interest of the debtor in property pursuant to a good faith prepetition foreclosure, power of sale, or other proceeding or provision of nonbankruptcy law permitting or providing for the realization of security upon default of the borrower under a mortgage, deed of trust, or other security agreement takes for reasonably equivalent value within the meaning of this section.¹⁸⁷

Had this proposed amendment been accepted, Congress would have granted an irrebuttable presumption of “reasonably equivalent value” to any mortgagee or third-party purchaser who purchases mortgaged property at a regularly conducted foreclosure sale. This would have given the *BFP* Court a basis for its decision.

However, in the debate on the floor of the Senate, Senator Metzenbaum objected to resolving the *Madrid / Durrett* issue in the bill because this issue had not been considered in committee.¹⁸⁸ As a consequence, the bill was amended to *delete* this proposed amendment.¹⁸⁹ Still, the two other amendments to the Bankruptcy Code, which adopted the *Durrett* analysis of the “transfer” issue, were left in the bill.¹⁹⁰ These changes consisted of: (a) amending the definition of “transfer” in the Bankruptcy Code to specify that it encompasses the “foreclosure of the debtor’s equity of redemption”, and (b) amending section 548 to emphasize its applicability to transfers where the debtor “voluntarily or involuntarily” receives less than reasonably equivalent value.¹⁹¹ While it might be wise not to attach too much significance to a legislative “nonoccurrence,” “it surely cautions against undue reliance on a different, entirely speculative congressional ‘omission.’”¹⁹²

185. 11 U.S.C. § 548(A)(2).

186. *BFP v. Resolution Trust Corp.*, 114 S. Ct. 1757, 1768 n.1 (1994) (Souter, J., dissenting).

187. S. 445, 98th Cong., 1st Sess. § 360 (1983).

188. *Id.*

189. *Id.*

190. *Id.*

191. *Id.*

192. *BFP v. Resolution Trust Corp.*, 114 S. Ct. 1757, 1768 n.1 (1994) (Souter, J., dissenting). In this case, such caution would be rewarded.” *Id.*

While the assertedly ‘standard phrase’ ‘fair market value’ appears in more than 150 distinct provisions of the Tax Code, it figures in

Ultimately then, the *BFP* Court was compelled to choose between two possible statutory provisions, one omitted from the Amendments and one included. The included statute authorizes the trustee to avoid involuntary transfers for less than a “reasonably equivalent value.”¹⁹³ The omitted proposal precludes such avoidance when “a secured party or third party purchaser . . . obtains title to an interest of the debtor in property pursuant to a good faith prepetition foreclosure . . . proceeding . . . permitting . . . the realization of security upon default of the borrower.”¹⁹⁴ Congress made its choice in 1984, by enacting the former alternative into law and not the latter.¹⁹⁵ The *BFP* Court made *its* decision ten years later by giving weight to an omitted statute.

In fact, the court in *Verna v. Dorman (In re Verna)*¹⁹⁶ was persuaded that the Bankruptcy Amendments of 1984 did in fact change the law on setting aside fraudulent conveyances.¹⁹⁷ The court held that when Congress added the “foreclosure of the debtor’s equity of redemption” to the Bankruptcy Code, the result was to validate the *Durrett* analysis.¹⁹⁸ The court also reasoned that by making the foregoing statutory changes, Congress overruled the Ninth Circuit decision in *Madrid*, and validated the analysis of the *Durrett* decision.¹⁹⁹ Still, rather than follow legislative mandate, the majority in *BFP* relied on a *purposefully-omitted* statute.

B. Durrett Rule: A Proper Role For the Courts

At least one commentator has suggested that the approach proposed by *Durrett* and its progeny suggests an improper role for the courts.²⁰⁰ The concern is that the courts are not the appropriate entity to determine “reason-

only two Bankruptcy Code provisions, one of which is entitled, suggestively, ‘Special Tax Provisions.’ The term of choice in the bankruptcy setting seems to be ‘value,’ unadorned and undefined, which appears in more than 30 sections of the Bankruptcy Code, but which is, with respect to many of them, read to mean ‘fair market value.’

Id. (citation omitted).

193. 11 U.S.C. § 548(a)(2)(A) (1988).

194. *See* S. 445, 98th Cong., 1st Sess. § 360 (1983).

195. The bill was enacted on July 10, 1984 and all the relevant portions became effective on October 8, 1984. 11 U.S.C. § 548 (1988).

196. 58 B.R. 246 (Bankr. C.D. Cal. 1986).

197. *Id.* at 250-51.

198. *Id.* at 251.

199. *Id.*

200. Ehrlich, *supra* note 34, at 963.

able equivalence.”²⁰¹ This author disagrees. As the dissent in *BFP* notes, bankruptcy courts regularly make comparably difficult determinations about the “reasonably equivalent value” of assets transferred through means other than foreclosure sales.²⁰² Because the bankruptcy courts are familiar with foreclosure sales and local real estate market conditions, they are the most qualified entity to give the term “reasonably equivalent value” sensible content in evaluating particular transfers on foreclosure.²⁰³ A trustee seeking avoidance of a transfer under section 548(a)(2) must persuade the bankruptcy court that the price obtained upon transfer of the property was unreasonably low.²⁰⁴ As in other cases under section 548(a)(2), the gravamen of such a claim will be that the challenged transfer significantly and needlessly diminished the bankruptcy estate (i.e., that it extinguished a substantial equity interest of the debtor and the foreclosing mortgagee failed to take measures which would have augmented the price realized).²⁰⁵ Thus, in judging the reasonableness of an apparently low price, it is necessary for the bankruptcy court to determine whether a mortgagee had done everything expected to achieve a fair price at the original sale, especially where the mortgagee promptly resells the property at a large profit.²⁰⁶

This determination by the bankruptcy court is made more viable by the implementation of the *Durrett* rule. By allowing a transfer only upon a showing that the property achieved at least seventy percent of its fair market value, the decision by the bankruptcy court becomes less discretionary. Instead, the decision allows for an objective appraisal of what the property is worth. This can be accomplished, for example, by taking into account the value of comparable properties in the locality, or by deferring to the testimony of expert real estate appraisers. The assessed value of a parcel of real

201. *Id.* Professor Ehrlich suggests that “the prospect that trial courts will determine reasonable equivalence on a case-by-case basis is untenable from both federal and state perspectives.” *Id.* According to Professor Ehrlich, “[f]rom a state viewpoint, an ad hoc approach produces intolerable uncertainty regarding the finality of any purchase at a foreclosure sale.” *Id.* “From a federal perspective, this uncertainty undermines the price-maximizing objectives of section 548(a)(2) because potential buyers will discount their assessment of the true market value of the property to reflect this uncertainty.” *Id.* at 963-64.

202. *BFP*, 114 S. Ct. at 1772 (Souter, J., dissenting). The dissent cited *Covey v. Commercial Nat’l Bank*, 960 F.2d 657, 661-62 (7th Cir. 1992) as an example of the regularity by which bankruptcy courts determine “reasonably equivalent value.” *Id.* The majority in *BFP* conceded that bankruptcy courts regularly make determinations about “reasonably equivalent value” of assets transferred through means other than foreclosure sales. *Id.* at 1766. However, Justice Scalia notes that the vast majority of cases in which the bankruptcy courts determine “reasonably equivalent value” are non-foreclosure sales. *Id.* In those cases, the majority reasoned, the bankruptcy courts can refer to the traditional common-law notion of fair market value as the benchmark. *Id.* Still, Justice Souter reasoned that, pursuant to the majority’s argument, the bankruptcy courts would still be required to speculate “as to the price ‘that would have been received if the foreclosure sale had proceeded according to state law.’” *Id.* at 1773 n.12. (citation omitted).

203. *Id.* at 1773.

204. *Id.*

205. *Id.*

206. *Id.* at 1773 n.13.

estate provides a proper measure of the rights received by the transferee, as well as the extent of the debtor's equity in the property.²⁰⁷

The *Durrett* rule claims only to be a description of what foreclosure prices have, in practice, been found "reasonable."²⁰⁸ As such, it is consistent with the textual directive that when one value is compared to another, the transfer may be set aside when one value is unreasonably "less than" another.²⁰⁹ Moreover, to the extent that *Durrett* is said to have announced a "rule," it could be just as easily understood as "recognizing a 'safe harbor' or affirmative defense for bidding mortgagees who paid seventy percent or more of a property's appraised value at the time of sale."²¹⁰ Such mortgagees, upon paying seventy percent of the property's fair market value at the foreclosure sale, will be assured that the sale will not be deemed fraudulent.²¹¹

VI. PROPOSED AMENDMENT TO SECTION 548(D)(2) OF THE BANKRUPTCY CODE

When a bankruptcy foreclosure sale occurs, three separate interests are formed: (1) the secured lender strives to recover as much of its loan as possible; (2) the third-party purchaser seeks to pay the lowest possible price to gain clear title to the property; and (3) the debtor and trustee wish to get the best possible price for the property in order to offset all outstanding debts and rehabilitate the debtor.²¹² To gain continuity within bankruptcy court decisions and protect the interest of the creditors by maximizing the estate of the debtor, Congress should amend section 548 of the Bankruptcy Code to implement a policy requiring creditor protection. The proposed amendment to section 548(d)(2) would equate "reasonably equivalent value" with fair market value.

Congress should adopt the following proposed language to amend section 548(d)(2) of the Bankruptcy Code:

207. See *supra* note 164.

208. *BFP*, 114 S. Ct. at 1773 n.13 (Souter, J., dissenting).

209. *Id.*

210. *Id.*

211. Section 550(a) of the Bankruptcy Code provides that where a transfer is held to be fraudulent the trustee may recover the property or the value of the property (i.e. the court-determined value of the property less the amount bid at the foreclosure sale) from the purchaser at the foreclosure sale but has no recovery against a "good-faith" purchaser at the foreclosure sale. 11 U.S.C. § 550(a) (1988). If the court chooses to recover the property from the purchaser at the foreclosure sale, and the purchaser has acted in good faith, § 548(c) provides that the purchaser obtains a lien on the property recovered by the trustee equal to the sale price. 11 U.S.C. § 548(c) (1988). In addition, § 550(d) provides that the good-faith purchaser at the foreclosure sale is entitled to a lien for the lesser of either the increase in value resulting from improvements made by the transferee before reconveyance or the costs of those improvements. 11 U.S.C. § 550(d) (1988).

212. Walsh, *supra* note 86, at 199.

(2) In this section—

(E) “reasonably equivalent value” shall be defined as follows for all nonjudicial foreclosures, judicial foreclosures, and strict foreclosures;

(i) “reasonably equivalent value,” within the meaning of subsection (a)(2)(A) of this section, shall be given when the amount given equals or exceeds seventy percent of the property’s “fair market value;”

(ii) “fair market value” shall be determined by the average of four independent appraisals of the value of four comparable properties, as determined by industry standards. A comparable property, under this section, is not a property owned by a party who has filed a voluntary petition, or a property owned by a party against which an involuntary petition has been filed, that is still pending.

The proposed definition of “fair market value” within the Bankruptcy Code specifically rejects any regard for value of property already the subject of a pending bankruptcy. If “fair market value” is defined with respect to comparable properties also the subject of bankruptcy proceedings, the proposed amendment would simply codify the Court’s holding in *BFP*. Such an amendment would fail of the essential purpose of maximizing the debtor’s estate, because the value of the foreclosed property would be “reasonably equivalent” to the value of another foreclosed property. Equity, by its very definition, would require a result that is fair to the third party purchaser, the debtor, and the creditor. By paying at least seventy percent of the property’s fair market value, the debtor is guaranteed a price “reasonably equivalent” to the fair market value of a comparable property, while the purchaser is guaranteed a fair purchase price for the property. The seventy percent benchmark gives the buyer notice that he must pay at least a minimum amount or take the risk that a bankruptcy trustee may be able to avoid the sale.

The proposed amendment also provides a thirty percent cushion that gives the purchaser at a foreclosure sale a potential discount for making a purchase at such a sale. Despite the potential bargain the purchaser is gaining, equity would also require the debtor to waive his statutory right of redemption. A purchaser should only be required to pay seventy percent of the property’s fair market value if the purchaser can be assured the property will not be redeemed by the debtor in the next year at a lower price.²¹³ Thus, Congress should also adopt the following addition to section 548(d) of the Bankruptcy Code:

213. See *supra* note 174.

(3) For purposes of this section, any transfer of an interest of the debtor in property in exchange for reasonably equivalent value, shall remove from the debtor any statutory redemption privilege.

Without the guarantee of clear title to the property, even a thirty percent discount will not likely be enough incentive to bid at the foreclosure sale. Such a discount is of no consequence if the purchaser does not gain immediate clear title to the property. Without the addition of section 548(d)(3) to the Bankruptcy Code, the debtor will have a right to redeem the property any time in the next year.²¹⁴

CONCLUSION: A FORCED SALE CAN BRING
"REASONABLY EQUIVALENT VALUE"

Upon foreclosure, the broad aim of federal bankruptcy proceedings is to preserve the estates of the insolvent so that there may be an equitable distribution of assets for the benefit of the creditors.²¹⁵ The state's aim with respect to foreclosures, on the other hand, is much less complex—protecting the purchaser's title to property.²¹⁶

Despite the simplicity of the state's goal, existing state foreclosure law protects neither the creditor nor the debtor. The only bidder at most foreclosure sales is the mortgagee,²¹⁷ and the price paid is seldom equivalent to market value.²¹⁸ As a response, state legislatures have utilized methods such as statutory redemption periods to protect the debtor and creditor. However, such methods have not resulted in increased foreclosure sale prices.²¹⁹

The proposed amendment to the Bankruptcy Code favors federal bankruptcy law at the expense of state foreclosure laws. Such favoritism might be frowned upon by the respective state seeking finality to the sale. However, where there is a bankruptcy, such favoritism is acceptable. In the Bankruptcy Code, the policy of encouraging stability and finality of title has a secondary position to the policy favoring protection of equity for the creditor. The proposed amendment provides an incumbency upon the courts to rely upon the equitable principle involved in bankruptcy law: the preservation of bankrupt debtors' estates for fair distribution to all creditors. Within this principle is the requirement to avoid asset-depleting, windfall

214. *See supra* note 173.

215. *See, e.g.*, *Simonson v. Granquist*, 369 U.S. 38, 40 (1962).

216. Ehrlich, *supra* note 34, at 979.

217. R. KRAVOTIL & R. WERNER, *MODERN MORTGAGE LAW AND PRACTICE* § 41.02 (2d ed. 1981).

218. *See, e.g.*, *Gelfert v. National City Bank*, 313 U.S. 221, 233 (1941); *In re Richardson*, 23 B.R. 434, 446 n.18 (Bankr. D. Utah) (citing evidence of the poor prices paid at foreclosure sales).

219. *See Washburn, supra* note 136, at 938-42.

transfers.²²⁰ The interests of federal bankruptcy law should be favored over state foreclosure law where the value received at a foreclosure sale does not adequately protect the interests of the debtor or creditor, and where such windfalls are allowed to occur.

Unfortunately, the majority in *BFP* failed to appreciate the fact that the *BFP* case arose under the Bankruptcy Code, where the policy of creditor protection is distinct from the policies of state debtor-creditor law, and should be favored over the state's interest in finality. This policy should be reflected in how courts define "reasonably equivalent value."

The controversy which surrounds avoiding mortgage foreclosures as fraudulent transfers is not one that is easily dispelled. Ultimately, the justification for avoiding a transfer under section 548(a) would be the unfair impact the transfer would have on the creditor. Given the inadequate protection provided by state foreclosure law, a statutory requirement of a fair market value is the only guarantee of protection for the creditor and debtor.

*David P. Schwartz**

220. Ehrlich, *supra* note 34, at 980.

* Thanks to my parents for their love and support.

