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Avoiding the Avoid: Re-securing the Mortgage Lender Post-BFP

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AVOIDING THE AVOID: RE-SECURING THE MORTGAGE LENDER POST-*BFP*

ABSTRACT

The Supreme Court's decision in BFP v. Resolution Trust Corp. *was intended to end the debate over what constitutes "reasonably equivalent value" pursuant to 11 U.S.C. § 548(a) with respect to foreclosure sales. In* BFP*, the Court held that the consideration received at a foreclosure sale is, in itself, reasonably equivalent value and rejected a minimum threshold amount. In its attempt to clarify the law, the Court left open the option for a bankruptcy trustee to avoid a foreclosure sale based on a lack of state law compliance. As shown in this Comment, state foreclosure laws vary drastically, and relying on state law compliance undermines the uniform application of the Bankruptcy Code.*

First, this Comment compares the decision in BFP *and its predecessors with the legislative intent behind the various fraudulent transfer acts and § 548 of the Bankruptcy Code. Second, this Comment further proposes amending the Bankruptcy Code to require a trustee seeking avoidance of a real estate transfer to show a lack of substantial compliance with state real estate foreclosure laws and to expressly exempt foreclosure sales from § 548's reasonably equivalent value requirement. Finally, this Comment proposes needed definitions in § 101 of the Bankruptcy Code including definitions for "reasonably equivalent value" and "real estate foreclosure sale." This solution would not only codify the decision in* BFP*, but would also clear up the numerous inconsistencies in the trustee avoidance powers based on the drastically different state foreclosure laws and promote uniform application of the Bankruptcy Code.*

INTRODUCTION

The current practice of allowing a trustee to avoid a prepetition foreclosure sale based on lack of state law compliance and the lack of an expressly defined federal standard for "reasonably equivalent value" under the constructive fraud provision of § 548 of the Bankruptcy Code[1] (the "Code") lead to enormous inconsistencies in the avoidance powers of the bankruptcy trustee. These inconsistencies stand in direct contradiction with Congress's intentions in drafting these provisions of the Code. Congress, in its 1984 and 2005 amendments, gave additional protection to creditors and attempted to prevent debtor abuse.[2] This intended creditor protection, coupled with other Code provisions,[3] proves Congress's intent not to hinder a secured creditor's ability to secure its collateral. The United States Supreme Court's decision in *BFP v. Resolution Trust Corp.* reflects this same intent to give protection to lenders for noncollusive foreclosure sales in determining constructive fraud under § 548.[4]

As the Seventh Circuit Court of Appeals held in *Bundles v. Baker* (*In re Bundles*),[5] Congress's intentional use of a federal standard made clear that it did not believe relying on state foreclosure law to avoid a transfer would protect federal interests.[6] The later decision in *BFP* provided a federal standard for determining reasonably equivalent value in foreclosure sales, but left outstanding the frequently occurring and inconsistent practice of avoiding

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1 11 U.S.C. § 548(a)(1) (2012). The Code describes the trustee's power to avoid a transfer in property, stating,

> 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 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily . . . (B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation . . . .

Id.

2 *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23; 130 CONG. REC. H7497 (daily ed. June 29, 1984) (statement of Rep. Brooks) (praising the 1984 Amendments for "eliminating the use of the bankruptcy system by debtors who are not suffering economic hardship"). The 1984 Amendments were intended to "stop[] consumer abuse of the Code. Critics of the 1978 Code believed that debtors abused the Code's liberal provisions to discharge payable debts." Anne McLaughlin, Note, *Tithing in a Chapter 13 Plan: The Requirement of Reasonableness Under the Religious Liberty and Charitable Donation Protection Act*, 47 B.C. L. REV 375, 379 (2006).

3 *See* 11 U.S.C. § 1322(b)(2) (preventing modification of the rights of secured creditors with a security interest in real property that is the debtor's principal residence); *id.* § 1325 (providing the "cramdown" exemption, which protects the secured creditor's right to payment).

4 *See* 511 U.S. 531 (1994).

5 856 F.2d 815 (7th Cir. 1988).

6 *See id.* at 824 ("Congress's conscious use of a federal standard suggests that it did not believe that the expedient of relying entirely on state foreclosure law would protect adequately federal interests.").

foreclosure sales based on state law deficiencies in the sale.[7] In complying with the Supreme Court's ruling in *BFP*, Congress should expressly exempt real estate foreclosure sales from avoidance powers in the "constructive fraud" provision of § 548(a)(1)(B).

With the current issues in the national housing market and state foreclosure processes, the Code should not, and as § 541(c) proves, is not required to, defer to state law in determining avoidance powers.[8] Section 541(c) allows an interest of the debtor to become property of the estate "notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law."[9] Avoidance based on state law compliance should require "substantial compliance" rather than complete compliance with state law.

This Comment argues that having a federal foreclosure standard and exempting foreclosure sales from "constructively fraudulent" avoidance would resolve the inconsistencies with state law requirements. This solution aligns the bankruptcy trustee's avoidance powers with the intent of Congress, the purpose of the Code, and current case law. Homeowners have state law remedies under wrongful foreclosure statutes to protect their interests.[10] Therefore, mortgagees, as secured creditors, should not be subjected to additional hurdles to secure their collateral under the avoidance powers if the sale is absent actual fraud, as stated in § 548(a)(1)(A), or is otherwise noncollusive.

The beginning of this Comment will map out the current avoidance powers under the Code and the rise of the Uniform Fraudulent Conveyance Act ("UFCA") and Uniform Fraudulent Transfer Act ("UFTA"). It will then discuss the split of authority in determining the meaning of the reasonably equivalent value requirement of § 548(a) before and after the Supreme Court's decision in *BFP*.

Part II.A of this Comment will propose needed amendments to the Code, including the need for a state law substantial-compliance standard in accordance with the decision in *BFP* and current case law. Part II.B discusses state inconsistencies and the need for a federal standard. First, it will show that these amendments will prevent avoidance based on the numerous inconsistent

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7 511 U.S. at 542.

8 In protecting the interests of the bankruptcy estate, § 541(c) allows for the invalidation of nonbankruptcy law or state law for the purpose of bringing property into the estate. 11 U.S.C. § 541(c).

9 *Id.* § 541(c)(1).

10 *See, e.g.*, CAL. CIV. PROC. CODE § 726 (2014); GA. CODE ANN. § 44-14-162.2 (2014); MICH. COMP. LAWS § 600.3204 (2014); WASH. REV. CODE § 61.24.040 (2014).

state laws governing foreclosure sales, including the jurisdictional splits in determining the validity of the Mortgage Electronic Registration System and proof of chain of assignments, while maintaining the freedom to avoid foreclosure sales shown to be collusive. Second, it will address the difficulty of determining what minimum bid is sufficient to "shock the judicial conscience" as stated in *BFP*[11] so as to avoid a foreclosure sale on that basis. Third, it will then layout recent decisions pertaining to state law foreclosure notice and advertisement requirements. Fourth, it will highlight the need to shift to a substantial-compliance safe harbor for avoidance powers in regard to foreclosure sales. Finally, Part II.C of this Comment will address collusive sales and the reasons why foreclosure sales should still be subject to avoidance when *actual* fraud, or collusion, is present as opposed to constructive fraud.

I. BACKGROUND

Upon filing a bankruptcy petition, a bankruptcy estate is created pursuant to § 541 consisting of "all legal or equitable interests of the debtor in property."[12] Property that has been subject to a prepetition foreclosure sale is not property of the estate because the debtor no longer has a legal or equitable interest in the property after the sale, and thus no interest at the time of the filing of the petition.[13] Sections 544 through 549 of the Code allow a trustee to avoid these prepetition and postpetition transfers under various circumstances, including actual fraud, constructive fraud, or a lack of state law compliance.[14]

Drafters of the UFTA, the successor to the UFCA, conformed the UFTA to the language in § 548 of the Code.[15] Section 548(a)(1)(A) maps out the avoidance powers based on actual fraud, while § 548(a)(1)(B) allows for avoidance of a sale in which the debtor fails to receive reasonably equivalent value for the property or one that is constructively fraudulent.[16]

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[11] 511 U.S. at 542.

[12] 11 U.S.C. § 541(a)(1).

[13] *See id.*

[14] *Id.* §§ 544–549; *see BFP*, 511 U.S. at 545–46.

[15] 5 COLLIER ON BANKRUPTCY ¶ 548.01[1][b] (Alan N. Resnick & Harry J. Sommer eds., 16th ed. 2010); *see* Asarco LLC v. Ams. Mining Corp., 396 B.R. 278, 336 (S.D. Tex. 2008) ("The UFTA replaced the term 'fair consideration' with 'reasonably equivalent value.'"); Elaine A. Welle, *Is It Time for Wyoming to Update Its Fraudulent Conveyance Laws?*, 5 WYO. L. REV. 207, 215 (2005); *see infra* Part I.B (discussing the drafting of the UFCA and UFTA to promote uniformity among state fraudulent transfer laws). In 2014, the UFTA was amended and its name was changed to the Uniform Voidable Transactions Act ("UVTA"). This Comment refers to the UFTA because the changes were nominal and the new name has not been adopted by a significant number of states. *See* UNIF. VOIDABLE TRANSACTIONS ACT (2014).

[16] 11 U.S.C. § 548(a).

Since the Code does not define reasonably equivalent value,[17] courts have used different tests in determining reasonably equivalent value, especially for a forced sale such as a foreclosure sale. These standards have varied drastically throughout the circuits. The Fifth Circuit used a percentage approach,[18] while the Ninth Circuit Bankruptcy Appellate Panel ("BAP") allowed a rebuttable presumption of sufficient price in a foreclosure sale.[19] The Seventh Circuit added a third approach and looked to the totality of the circumstances in determining reasonably equivalent value.[20] Finally, in 1994, the Supreme Court addressed the issue of reasonably equivalent value.

In *BFP*, the Court held that consideration received at a noncollusive foreclosure sale within one year prepetition satisfies the reasonably equivalent value requirement of § 548.[21] The Court intended to close the door on the reasonably-equivalent-value debate, but it expressly left open the option of avoidance based on lack of state law compliance,[22] thus leaving the door open for more costly and unnecessary litigation.

A. Avoidance Powers Under the Code

Under § 541, a debtor's assets, which include "all legal or equitable interests," are placed into the bankruptcy estate upon the filing of a bankruptcy petition.[23] Occasionally, if a debtor has defaulted on his home loan, the lender would have already foreclosed on the debtor's property before the debtor files a bankruptcy petition. Under the avoidance powers in the Code, a trustee may set aside a prepetition foreclosure sale and bring the foreclosed property, or the value of it, back into the estate for distribution to creditors.[24]

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17 The only term from the phrase "reasonably equivalent value" defined in the Code is "value," defined as "property, or satisfaction or securing of a present or antecedent debt of the debtor." *Id.* § 548(d)(2)(A). Although the language of the UFTA originated from § 548, there remained differences, the main one being that the UFTA contained an absolute defense for enforcement of a security interest in compliance with Article 9 of the Uniform Commercial Code. 5 COLLIER ON BANKRUPTCY, *supra* note 15, at ¶ 548.01[2].

18 *See, e.g.*, Durrett v. Wash. Nat'l Ins. Co., 621 F.2d 201, 203–04 (5th Cir. 1980).

19 *See, e.g.*, Lawyers Title Ins. Corp. v. Madrid (*In re* Madrid), 21 B.R. 424, 428 (B.A.P. 9th Cir. 1982), *aff'd on other grounds*, 725 F.2d 1197 (9th Cir. 1984).

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

21 511 U.S. 531, 534 (1993).

22 *Id.* at 545–46.

23 11 U.S.C. § 541 (2012).

24 *Id.* §§ 544–49.

Sections 544 through 549 of the Code set out the numerous prepetition and postpetition avoidance powers of the trustee.[25] Section 544 allows a trustee to avoid a transfer that could have been avoided under applicable law, including state law, by an unsecured creditor or a hypothetical claimant.[26] This section of the Code is the root of many inconsistencies in the exercise of the avoidance powers, and those inconsistencies are exacerbated by the drastic variation among state foreclosure and property laws.[27] Section 545 of the Code allows a trustee to avoid certain statutory liens.[28] Section 547 allows avoidance of prepetition preferential transfers.[29] Section 548 sets out the fraudulent transfer avoidance powers.[30] Finally, § 549 covers the avoidance of postpetition transfers authorized under § 303(f) or § 542(c).[31]

The purpose of these avoidance powers is to preserve all potential assets of the bankruptcy estate, including property of the debtor that has recently been the subject of a foreclosure sale, and to ensure fair distribution among all the creditors.[32] Courts have long considered foreclosure sales transfers under the Code, and, as such, they are susceptible to the avoidance powers of a trustee.[33]

Mortgage lenders are especially at risk of avoidance under § 548 of the Code, which contains both actual and constructive fraud provisions. Section 548(a)(1) permits a trustee to avoid any transfer of a debtor's property, or any obligation incurred by the debtor:

> [T]hat was made or incurred on or within two years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

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25 *Id.*
26 *Id.* § 544.
27 *See infra* Part II.B.
28 11 U.S.C. § 545.
29 *Id.* § 547.
30 *Id.* § 548.
31 *Id.* Section 303(f) allows the debtor to continue to use, acquire, or dispose of property in an involuntary bankruptcy case. *Id.* § 303(f). Section 542(c) governs good faith transfers of property of the debtor by an entity that had neither actual notice nor actual knowledge of the commencement of the case. *Id.* § 542(c).
32 *See, e.g.*, Bundles v. Baker (*In re* Bundles), 856 F.2d 815, 824 (7th Cir. 1988); Martin v. Phillips (*In re* Butcher), 58 B.R. 128, 130 (Bankr. E.D. Tenn. 1986), *aff'd* 829 F.2d 596 (6th Cir. 1987); Richardson v. Gillman (*In re* Richardson), 23 B.R. 434, 447 (Bankr. D. Utah 1982).
33 Christian v. Ryan (*In re* Christian), 48 B.R. 833, 834 (D. Colo. 1985) ("11 U.S.C. §101(48) [currently § 101(54)] defines 'transfer' as 'every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption.'").

> (A) made such transfer or incurred such obligation with the actual intent to hinder, delay, or defraud any entity to which the debtor was or became . . . indebted . . . .[34]

Under § 548(a)(1)(B), a trustee may also avoid a transfer on the grounds of constructive fraud if the transfer occurred within two years prepetition.[35] Constructive fraud is deemed to have occurred when the debtor has:

> [R]eceived less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (ii)(I) was insolvent on the date that such transfer was made . . . or became insolvent as a result of such transfer . . . ;
>
> (II) was engaged in business or a transaction . . . for which any property remaining with the debtor was an unreasonably small capital;
>
> (III) intended to incur . . . debts that would be beyond the debtor's ability to pay as such debts matured; or
>
> (IV) made such transfer to or for the benefit of an insider . . . .[36]

After a trustee successfully avoids a transfer, § 550 comes into effect. Section 550 allows the trustee to recover the transferred property or the value of the transferred property and bring it back into the estate for distribution.[37] This section would essentially permit the voiding of a prepetition foreclosure sale and require the value of the collateral, or the foreclosed residence, to be restored to the estate for distribution among all creditors of the debtor, not just the lender who originally had the secured loan and rights to the collateral.

B. Avoidance Powers Pre-1938: UFCA and UFTA

In an effort to promote uniformity among state fraudulent transfer laws, in 1918, the National Conference of Commissioners on Uniform State Laws drafted the UFCA.[38] Unfortunately, only twenty-six states adopted the UFCA, defeating the intended uniformity among the states.[39]

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34 11 U.S.C. § 548(a)(1).

35 *Id.* § 548(a)(1)(B).

36 *Id.*

37 *Id.* § 550. Section 550 states: "[T]o the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) . . . the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property . . . ." *Id.*

38 Welle, *supra* note 15, at 212.

39 *Id.*

Originally, federal bankruptcy law addressed only transfers accompanied by actual fraud.[40] Then, in 1938, amendments to the law introduced the concept of avoiding constructively fraudulent transfers.[41] Because these amendments were not intended to preempt state law, a bankruptcy trustee continued to have the option of avoiding a transfer under either federal bankruptcy law or nonbankruptcy state law.[42]

Because of the numerous conflicts that continued to arise between federal and state transfer law, and the large number of states that did not adopt the UFCA, the National Conference of Commissioners on Uniform State Laws promulgated the UFTA to replace the UFCA in 1984.[43] Today, almost all states have adopted the UFTA or a similar version.[44] Similar to § 548 of the Code, the UFTA allows for avoidance of prepetition transfers; however, it extends the statute of limitations to four years, provides a creditor-friendly insolvency definition, and also expands remedies and defenses.[45] The most important defense for mortgage lenders against a fraudulent transfer claim under the UFTA is the absolute defense for transfers that "result[] from . . . enforcement of a security interest in compliance with Article 9 of the Uniform Commercial Code," such as a foreclosure.[46]

Additionally, in determining whether there is a constructively fraudulent transfer, the UFTA examines different "badges of fraud."[47] Those badges include whether:

(1) the transfer or obligation was to an insider;

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[40] 5 COLLIER ON BANKRUPTCY, *supra* note 15, at ¶ 548.01[2] ("Before the Chandler Act, federal bankruptcy law only directly addressed actual intent fraudulent transfers, and then only to the extent made within four months of bankruptcy.").

[41] *Id.*

[42] *See* 11 U.S.C. § 544(b); 5 COLLIER ON BANKRUPTCY, *supra* note 15, at ¶ 548.01[2].

[43] Welle, *supra* note 15, at 215; *see* Asarco LLC v. Ams. Mining Corp., 396 B.R. 278, 336 (S.D. Tex. 2008) ("The UFTA replaced the term 'fair consideration' with 'reasonably equivalent value.'").

[44] As of early 2015, the states that have adopted the UFTA include: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, the District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, U.S. Virgin Islands, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming. *Legislative Fact Sheet*, UNIFORM LAW COMMISSION, http://www.uniformlawcommission.com/LegislativeFactSheet.aspx?title=Fraudulent%20Transfer%20Act%20-%20now%20known%20as%20Voidable%20Transactions%20Act (last visited Jan. 3, 2015); *see also* 5 COLLIER ON BANKRUPTCY, *supra* note 15, at ¶ 548.01B.

[45] 5 COLLIER ON BANKRUPTCY, *supra* note 15, at ¶ 548.01[2][a][i].

[46] *Id.* (quoting UNIF. FRAUDULENT TRANSFER ACT § 8(e)(2) (1984)).

[47] Wolkowitz v. Beverly (*In re* Beverly), 374 B.R. 221, 235–36 (B.A.P. 9th Cir. 2007).

(2) the debtor retained possession or control of the property transferred after the transfer;

(3) the transfer or obligation was disclosed or concealed;

(4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

(5) the transfer was of substantially all the debtor's assets;

(6) the debtor absconded;

(7) the debtor removed or concealed assets;

(8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

(9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

(10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and

(11) the debtor transferred the essential assets of the business to a lienholder who transferred the assets to an insider of the debtor.[48]

Section 548 differs from these UFTA badges of fraud in that the only badges of fraud listed in § 548 are that the transfer was made to an insider, the consideration was a reasonably equivalent value of the asset, and the debtor was insolvent.[49]

Finally, the UFTA carved out a safe harbor for foreclosure sales, defining reasonably equivalent value as the price paid at a noncollusive, regularly conducted foreclosure sale.[50] In its 1984 amendments to the Code, Congress did not include a definition for reasonably equivalent value and did not include a safe harbor for foreclosure sales like that in UFTA.[51]

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[48] UNIF. FRAUDULENT TRANSFER ACT § 4(b) (1984); *see Beverly*, 374 B.R. at 234–35 n.16 (quoting CAL. CIV. CODE § 3439.04(b)).

[49] 11 U.S.C. § 548(a)(1)(B) (2012).

[50] UNIF. FRAUDULENT TRANSFER ACT § 3(b) (1984) ("[A] person gives a reasonably equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale or execution of a power of sale . . . under a mortgage, deed of trust, or security agreement.").

[51] Marie T. Reilly, *A Search for Reason in "Reasonably Equivalent Value" After* BFP v. Resolution Trust Corp., 13 AM. BANKR. INST. L. REV. 261, 266–68 (2005).

C. *Reasonably Equivalent Value Pre-*BFP

Congress's failure to define reasonably equivalent value in § 548 created much debate among jurisdictions in interpreting what constitutes reasonably equivalent value for forced sales, such as residential foreclosure sales.[52] Before the Supreme Court's lender-friendly decision in *BFP*,[53] courts differed when defining reasonably equivalent value for a foreclosure sale, with some courts comparing reasonably equivalent value to fair market value, while other courts refused to equate the two.[54]

1. Durrett v. Washington National Insurance Co.

In 1980, the Fifth Circuit Court of Appeals established the *Durrett* "seventy percent rule."[55] In *Durrett v. Washington National Insurance Co.*, the district court held that $115,400 was a "fair" price for a home with a market value of over $200,000.[56] The district court analyzed the facts of the case under § 67(d) of the former Bankruptcy Act,[57] which required "fair consideration" rather than reasonably equivalent value.[58] On appeal, in analyzing the fairness of the foreclosure sale price, the Fifth Circuit looked to the Tenth Circuit Court of Appeals's decision in *Schafer v. Hammond*,[59] which held that a price of fifty percent of the market value was void for lack of consideration.[60]

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52 The only term from the phrase "reasonably equivalent value" defined in the Code is "value," defined as "property, or satisfaction or securing of a present or antecedent debt of the debtor." 11 U.S.C. § 548(d)(2)(A). Although the text of the UFTA was taken from § 548, differences remain, the main one being UFTA contained an absolute defense for enforcement of a security interest in compliance with Article 9 of the Uniform Commercial Code. 5 COLLIER ON BANKRUPTCY, *supra* note 15, at ¶ 548.01[2][a][i].

53 511 U.S. 531, 543 (1993).

54 *Compare* Durrett v. Wash. Nat'l Ins. Co., 621 F.2d 201, 202 (5th Cir. 1980) (looking to a percentage of fair market value to establish reasonably equivalent value), *with* Lawyers Title Ins. Corp. v. Madrid (*In re* Madrid), 21 B.R. 424, 425 (B.A.P. 9th Cir. 1982) (presuming consideration received at a noncollusive and regularly conducted foreclosure sale to be reasonably equivalent value), *aff'd on other grounds*, 725 F.2d 1197 (9th Cir. 1984), *and* Bundles v. Baker (*In re* Bundles), 856 F.2d 815, 823 (7th Cir. 1988) (looking to the totality of the circumstances to determine reasonably equivalent value).

55 621 F.2d at 203.

56 *Id.* at 202.

57 *See generally* Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (repealed 1978), *amended by* Chandler Act, Pub. L. No. 75-696, 52 Stat. 840 (1938).

58 *See Durrett*, 621 F.2d at 201 n.2 (citing 11 U.S.C. § 107(d)(1)–(2), (6) (1976) (repealed 1978)); *see also* 4 *Madrid*, 21 B.R. at 426 ("Fair consideration [under the Bankruptcy Act of 1898] was defined as a 'fair equivalent' in a good faith exchange."); COLLIER ON BANKRUPTCY ¶ 67.33, at 505–06 (Lawrence P. King, ed., 14th ed. 1975) (defining "fair consideration" as a fair equivalent or not too small in value compared to the value of the transferred property).

59 Schafer v. Hammond, 456 F.2d 15, 16 (10th Cir. 1972).

60 *Durrett*, 621 F.2d at 203 (citing *Schafer*, 456 F.2d at 16).

The Fifth Circuit held that the sale price in *Durrett*, valued at fifty-seven percent of market value, was not a fair equivalent value for the transfer of the property.[61] The court went on to explain that it could not find a single case in which a court approved a transfer of less than seventy percent of market value.[62] Although the *Durrett* seventy percent rule was merely dicta,[63] courts began to automatically invalidate any foreclosure sale that brought less than seventy percent of fair market value.[64]

2. In re Madrid

Four years later, the Ninth Circuit BAP expressly rejected the *Durrett* seventy percent rule and established an alternative rule, allowing a presumption of sufficient price in a foreclosure sale.[65] The effect of the BAP's rule was to make reasonably equivalent value more lender-friendly.[66] In *Lawyers Title Insurance Corp. v. Madrid* (*In re Madrid*), the defendant appealed the lower court's ruling to rescind the foreclosure sale as a fraudulent transfer.[67] The foreclosure sale brought between sixty-four and sixty-seven percent of the market value of the property,[68] which was less than the seventy percent required by the *Durrett* court. After filing for chapter 11, the debtor and the trustee brought an action to set aside the foreclosure sale as a

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61 *Id.*

62 The court stated: "We have been unable to locate a decision of any district or appellate court dealing only with a transfer of real property as the subject of attack under section 67(d) of the Act, which has approved the transfer for less than 70 percent of the market value of the property." *Id.*

63 The court later clarified the *Durrett* seventy percent rule was only dicta, stating "Interestingly, bankruptcy courts frequently cite *Durrett* for the '70% test' based on its dicta. But on the facts actually before the *Durrett* court, it held only that 57.7% of market value does not constitute reasonably equivalent value." FDIC v. Blanton, 918 F.2d 524, 531 n.7 (5th Cir. 1990) (citations omitted).

64 *See* Fed. Nat'l Mortgage Ass'n v. Wheeler (*In re* Wheeler), 34 B.R. 818, 820–21 (Bankr. N.D. Ala. 1983); Wickham v. United No. Am. Bank (*In re* Thompson), 18 B.R. 67, 69 (Bankr. E.D. Tenn. 1982); *see also* Cooper v. Smith (*In re* Smith), 24 B.R. 19, 23 (Bankr. W.D.N.C. 1982) (deciding that the percentage of the amount paid is only one factor in determining reasonably equivalent value).

65 Lawyers Title Ins. Corp. v. Madrid (*In re* Madrid), 21 B.R. 424, 426–27 (B.A.P. 9th Cir. 1984) ("We decline to follow *Durrett*'s 70% fair market value rule for the reason that a regularly conducted sale, open to all bidders and all creditors, is itself a safeguard against the evils of private transfers to relatives and favorites."), *aff'd on other grounds*, 725 F.2d 1197 (9th Cir. 1984), *cited with approval in* BFP v. Imperial Sav. & Loan Ass'n (*In re* BFP), 974 F.2d 1144, 1148 (9th Cir. 1992), *aff'd sub nom.* BFP v. Resolution Trust Corp., 511 U.S. 531 (1994).

66 *Madrid*, 21 B.R. at 426–27.

67 *Id.* at 425.

68 *Id.*

fraudulent conveyance.[69] The lower court agreed, rescinded the sale, and awarded attorney's fees.[70]

On appeal, the BAP recognized the general rule that inadequacy of price was insufficient on its own to avoid a foreclosure sale.[71] It followed the Nevada rule requiring additional "proof of some element of fraud, unfairness, or oppression" that accounts for the inadequate sale price.[72] The court rejected the *Durrett* seventy-percent-rule reasoning, stating that an arbitrary threshold of seventy percent was not required and was counterproductive, since a regularly conducted foreclosure sale, by itself, "safeguards against the evils" of fraudulent transfers.[73] The court justified its ruling based on the policy that "the law of foreclosure should be harmonized with the law of fraudulent conveyances," and it held that the consideration received at a noncollusive and regularly conducted foreclosure sale is presumed to be reasonably equivalent value under § 548 of the Code.[74]

The dissent warned that the only way to question a fraudulent transfer is to examine the adequacy of the foreclosure price.[75] Allowing an irrebuttable presumption of reasonableness of consideration leaves no test for adequacy of price.[76] Because reasonably equivalent value is a federal standard, to allow an irrebuttable presumption would burden the federal court's flexibility to determine an important factual issue under its jurisdiction.[77]

3. In re Bundles

In 1988, the Seventh Circuit Court of Appeals took a third, and the most flexible, approach in defining reasonably equivalent value.[78] In *In re Bundles*, the foreclosure sale of a debtor's property, worth $15,500, resulted in a $5,000

69 *Id.*

70 *Id.*

71 *Id.* at 427 ("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." (citing Golden v. Tomiyasi, 387 P.2d 989 (Nev. 1963))).

72 Oller v. Sonoma Cnty. Land Title Co., 290 P.2d 880 (Cal. Dist. Ct. App. 1955), *quoted in Madrid*, 21 B.R. at 427.

73 *Madrid*, 21 B.R. at 426–27. The *Madrid* court stated a regularly conducted foreclosure sale, by itself, "safeguards against the evils of private transfers to relatives and favorites." *Id.* The court was concerned about fraudulent transfers by a debtor or transfers present actual fraud. *Id.*

74 *Id.* at 427.

75 *Id.* at 428 (Volinn, J., dissenting).

76 *Id.*

77 *Id.*

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

foreclosure sale price.[79] Rejecting both the *Durrett* seventy percent rule and the *Madrid* presumption, the court looked to find a middle ground.[80] It held that all facts and circumstances must be considered when deciding whether a sale obtained reasonably equivalent value[81] and recognized a rebuttable presumption in favor of a purchaser at a "regularly conducted, non-collusive foreclosure sale."[82] Under this approach, the list of factors a court must consider includes, but is not limited to: (1) whether there was a fair appraisal of the property; (2) whether the property was widely advertised; and (3) whether competitive bidding was encouraged.[83]

The court expressly rejected "the view that state law, either directly or as the federal rule of decision, should determine the outcome of a bankrupt's complaint . . . ."[84] It also examined the underlying policy reasons for foreclosure sale avoidance and the language of § 548(a)(2)(A).[85] The court emphasized that § 548(a)(2)(A) "makes no distinction between sales that do and do not comply with state law."[86]

Section 548(a) establishes a standard for avoiding a foreclosure sale independent from state law.[87] The court reasoned that Congress's intentional use of a federal standard made clear that it did not consider reliance on state foreclosure law to avoid a transfer to be sufficient to protect federal interests.[88] The standard established by *Bundles* required bankruptcy courts to consider the transaction in its totality and not just its compliance under state law.[89]

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79 *Id.* at 817.

80 *Id.* at 824 (citing General Indus., Inc. v. Shea (*In re* General Indus., Inc.), 79 B.R. 124 (Bankr. D. Mass. 1987); Adwar v. Capgro Leasing Corp. (*In re* Adwar), 55 B.R. 111 (Bankr. E.D.N.Y. 1985); Ruebeck v. Attleboro Sav. Bank (*In re* Ruebeck), 55 B.R. 163 (Bankr. D. Mass. 1985); First Fed. Sav. & Loan Ass'n v. Hulm (*In re* Hulm), 45 B.R. 523 (Bankr. D.N.D 1984)).

81 *Bundles* at 824. The factors included in this consideration should be fairness of appraisal price, advertisement, and the availability of competitive bidding. *Id.*

82 *Id.* at 823–24.

83 *Id* at 824.

84 *Id.* at 822.

85 *Id.* at 822–23. The court stated its central policy concern was the fear of a "negative effect on the foreclosure market." *Id.* at 822 n.12; *see* Abramson v. Lakewood Bank & Trust Co., 647 F.2d 547 (5th Cir. 1981) (Clark, J., dissenting) (stating that the seventy percent rule "would cast a cloud upon mortgages and trust deeds naturally inhibiting a purchaser . . . from buying at foreclosure . . . press[ing] further the prices of foreclosure sales").

86 *Bundles*, 856 F.2d at 821.

87 *See* 11 U.S.C. § 548 (2012); *Bundles*, 856 F.2d at 824.

88 *Bundles*, 856 F.2d at 824.

89 *Id.* Although the court acknowledged bankruptcy courts should give respect to state law, whether the sale complied with state law "cannot be considered conclusive with respect to the issue of federal law before the bankruptcy court." *Id.* at 825.

In summary, before 1993, there was a split among the three approaches in deciding whether to avoid a transfer based on a lack of reasonably equivalent value paid at a foreclosure sale. The Fifth, Sixth, and Tenth Circuits followed the *Durrett* seventy percent rule, while the Ninth Circuit followed the *Madrid* approach determining any price paid at a noncollusive foreclosure sale was a reasonable equivalent.[90] The Seventh Circuit maintained the third approach established in *Bundles*, looking to the sale in its totality and assessing different factors in addition to state law compliance, including appraisal price, advertisement, and the availability of competitive bidding. The time had come for the Supreme Court to resolve this circuit split.

*D. Reasonably Equivalent Value Post-*BFP

In 1993, the Supreme Court finally stepped into the reasonably-equivalent-value discussion to resolve the circuit split. The Supreme Court granted certiorari in *BFP v. Resolution Trust Corp.* to define reasonably equivalent value for purposes of residential foreclosure sales.[91] In *BFP*, the respondent purchased the petitioner's beachfront home, valued at $725,000, at a foreclosure sale for $433,000.[92] The petitioner later filed bankruptcy and sought to have the sale set aside on the grounds that the sale was a fraudulent transfer under § 548(a).[93] On appeal, the Ninth Circuit, agreeing with the decision in *Madrid*, adopted the presumption that consideration received at a noncollusive, regularly conducted real estate foreclosure sale constitutes reasonably equivalent value under § 548(a) so long as it complies with applicable California property and foreclosure law.[94]

In its attempt at reestablishing what it incorrectly described as "a peaceful coexistence" of fraudulent transfer law and foreclosure law enjoyed pre-*Durrett*, the Supreme Court first looked to the text of the Code to define

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[90] BFP v. Imperial Sav. & Loan Ass'n (*In re* BFP), 974 F.2d 1144, 1148 (9th Cir. 1992) (affirming the reasoning in *Madrid*), *aff'd sub nom.* BFP v. Resolution Trust Corp., 511 U.S. 531 (1994).

[91] 511 U.S. at 536. Courts have extended the *BFP* ruling to tax sales. *Compare* Kojima v. Grandote Int'l Liab. Co. (*In re* Grandote Country Club Co., Ltd.), 252 F.3d 1146, 1152 (10th Cir. 2001), *and* Fisher v. Moon (*In re* Fisher), 355 B.R. 20, 22–23 (Bankr. W.D. Mich. 2006), *with* Sherman v. Rose (*In re* Sherman), 223 B.R. 555 (B.A.P. 10th Cir. 1998), *and* Wentworth v. Town of Acton, Me. (*In re* Wentworth), 221 B.R. 316, 319–20 (Bankr. D. Conn. 1998). Courts have also extended the *BFP* ruling to execution sales. *E.g.*, O'Neill v. Dell (*In re* O'Neill), 204 B.R. 881, 886–87 (Bankr. E.D. Pa. 1997).

[92] 511 U.S. at 534.

[93] *Id.*

[94] *Id.*; *see* Asarco LLC v. Ams. Mining Corp., 396 B.R. 278, 337 (S.D. Tex. 2008) (explaining that, outside of the foreclosure context, "[reasonably equivalent value] will continue to have an independent meaning (ordinarily a meaning similar to fair market value)." (quoting *BFP*, 511 U.S. at 545)).

reasonably equivalent value.[95] The Court noted that both *Durrett* and *Bundles* referred to fair market value.[96] Because Congress used the phrase "fair market value" in other places in the Code, specifically in § 522(a)(2), it could have also used the phrase in § 548(a) if it felt fair market value was the appropriate benchmark for measurement of the consideration in a transfer.[97] Instead, Congress specifically used the phrase reasonably equivalent value.[98] It is a long-standing cannon of interpretation that Congress acts intentionally and purposefully in its choice of statutory language, especially when using language in one section and omitting it from another.[99] For this reason, five justices[100] agreed that consideration received at a noncollusive foreclosure sale satisfies the requirement of § 548(a).[101]

The dissent[102] warned that Congress never intended reasonably equivalent value to allow a "peppercorn" price to be sufficient for a "California beachfront estate."[103] The dissent disagreed with the majority's rationalization that forced-sale prices are the "very antithesis" of fair market value and foreclosed homes are worth "whatever price was paid."[104] The majority refuted the dissent's objection to treating foreclosure transfers differently from all other transfers.[105] However, the majority was not persuaded by the dissent's argument that the property is "subject to forced sale," which affects the property's alienability and worth, and, therefore, should be treated as such.[106]

The Court also stated that the sale could be set aside under state foreclosure law if the price was so low as to "shock the conscience or raise a presumption of fraud or unfairness."[107] This contradicted the Court's earlier statement in

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95 *BFP*, 511 U.S. at 537.

96 *Id.* at 536–37.

97 *Id.* at 537.

98 11 U.S.C. § 548(a)(1)(B)(i) (2012).

99 *See* Chicago v. Envtl. Def. Fund, 511 U.S. 328, 338 (1994), *cited by BFP*, 511 U.S. at 537.

100 Justice Scalia delivered the majority opinion of the Court, in which Chief Justice Rehnquist, and Justices O'Connor, Kennedy, and Thomas, joined. *BFP*, 511 U.S. 531.

101 *Id.* at 534.

102 Justice Souter wrote the dissenting opinion, in which he was joined by Justices Blackmun, Stevens, and Ginsburg. *Id.* at 549 (Souter, J., dissenting).

103 *Id.*

104 *Id.* at 550–51.

105 *Id.* at 548 (majority opinion).

106 *Id.* at 548.

107 *Id.* at 542. The Court held this standard to be satisfied when:

> Any irregularity in the conduct of the sale that would permit judicial invalidation of the sale under applicable state law deprives the sale price of its conclusive force . . . and the transfer may

which it disagreed with *Durrett* on the basis that no other court had ever applied the "grossly inadequate price" badge of fraud under fraudulent transfer law.[108] This contradiction, as seen in Part II.B.2 of this Comment, has left courts scrambling to define what shocks the judicial conscience in an ever-changing housing market.[109]

Justice Souter introduced a third possibility, ignored by the majority, when choosing between avoiding the transfer whenever fair market value was not paid and avoiding the transfer based on collusiveness or improper procedures.[110] This third option looked to the plain meaning of reasonably equivalent value and allowed bankruptcy courts to decide whether reasonably equivalent value had been received on a case-by-case basis.[111] Again, each option presented by the Supreme Court still left prepetition foreclosure sales open to the possibility of being avoided absent actual fraud on the basis of a lack of compliance with the numerous and inconsistent state laws governing foreclosure sales.[112]

The Supreme Court, in its *BFP* decision, wanted to protect mortgagees in their power to foreclose on their collateral by taking away one major avenue for a trustee to avoid the foreclosure sale. Unfortunately, this decision also left foreclosure sales "unsecured" because of the high probability of being avoided by the many inconsistent, and sometimes incorrect, interpretations of state property, contract, and fraudulent transfer laws. Under the Code, an unsecured creditor is not entitled to full payment of its claim, is not afforded priority in payment, and typically receives a pro rata payment, if any payment at all, during distribution.[113] The court's interpretation of reasonably equivalent value should not leave mortgagees, as secured creditors, in a similar position to unsecured creditors. These inconsistencies and avoidance powers based on state law compliance stand "as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[114] The objectives of the most recent Code amendments include limiting debtor abuse of the

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> be avoided if the price received was not reasonably equivalent to the property's actual value at the time of the sale.

Id. at 545–46.

[108] *Id.* at 542–43.
[109] *See infra* Part II.B.2.
[110] *BFP*, 511 U.S. at 551–52 (Souter, J., dissenting).
[111] *Id.* at 560–62.
[112] *Id.* at 545–46.
[113] 11 U.S.C. §§ 506, 507, 726, 1122, 1143, 1326 (2012).
[114] *See* Hines v. Davidowitz, 312 U.S. 52, 67 (1941).

bankruptcy system,[115] remedying unfairness to creditors, and "equitable distribution" of a debtor's assets.[116] The limitations placed on unsecured creditors in the Code are proof that Congress paid respect to secured creditors, including those who took measures to secure their collateral prepetition and at the outset of the lending process.

While the decision in *BFP* was intended to clarify the law, it left open the significant possibility of prepetition foreclosures being avoided as fraudulent transfers absent actual fraud. Avoidance of a foreclosure sale is still allowed if the sale was "collusive" or not in compliance with applicable state law.[117] This complete compliance requirement for state law directly defeats the policy of harmonizing bankruptcy law with state law, which was highlighted by the majority in *BFP*.[118] Contrary to the majority's reasoning in *BFP*, the "peaceful co-existence"[119] of bankruptcy law and state foreclosure law never existed, and it does not exist today, even with *BFP*'s lender-friendly interpretation of reasonably equivalent value. Inconsistent and incorrect state laws governing foreclosure sales subject lenders to even more hurdles in securing their collateral than other creditors to whom Congress has not similarly showed intent on preferential treatment.

II. ANALYSIS

Amending the Code would alleviate the discrepancies and flaws of the trustee's avoidance powers based on state law compliance. The Supreme Court's decision in *BFP* removed the possibility of avoidance of foreclosure sales based on constructive fraud, or reasonably equivalent value, but left open avoidance actions based on lack of state law compliance. Requiring only *substantial* compliance with state law would rightfully allow bankruptcy courts to decide the cases under their jurisdiction, as emphasized by the dissenting opinion in *Madrid*,[120] and would grant lenders the right to secure their

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115 McLaughlin, *supra* note 2, at 378.

116 *In re* Winshall Settlor's Trust, 758 F.2d 1136, 1139 n.4 (6th Cir. 1985); 7 COLLIER ON BANKRUPTCY, *supra* note 15, at ¶ 1100.01 (2009).

117 11 U.S.C. §§ 544, 548; *BFP*, 511 U.S. 531.

118 511 U.S. at 542.

119 *Id.*

120 Lawyers Title Ins. Corp. v. Madrid (*In re* Madrid), 21 B.R. 424, 428 (B.A.P. 9th Cir. 1982) (Volinn, J., dissenting) ("In any event, I believe that the concept of 'reasonably equivalent value' as a test set for 11 U.S.C. § 548(a)(2) requires that the trial court examine the consideration received in such a sale in the factual context of a particular case."), *aff'd on other grounds*, 725 F.2d 1197 (9th Cir. 1984).

collateral while still providing deference to state law. This change would harmonize federal bankruptcy law with state foreclosure law.

A. Proposed Amendments

To comply with the Supreme Court ruling in *BFP* and the intent of Congress, as well as achieve the desired "harmony"[121] between federal bankruptcy law and state foreclosure law, the Code should be amended. The proposed amendments would apply only to real estate foreclosure sales. These proposed amendments could be added to different sections of the Code, the most appropriate one being § 546, titled "Limitations on Avoiding Powers." Section 546 could be amended by adding a new subsection, which would read as follows:

> Except as provided in section 548(a)(1)(A), a trustee shall not avoid a real estate foreclosure sale unless the trustee can prove a lack of substantial compliance with applicable nonbankruptcy law.

Another possible method of achieving the same result would be to amend § 544, which allows the trustee to avoid transfers that could have been avoided under state law or other applicable law. Since § 544(b)(2) expressly limits state-law-compliance avoidance powers in regards to charitable contributions, the substantial-compliance standard could also be amended as § 544(b)(3) and would read as follows:

> Paragraph (1) shall not apply to a real estate foreclosure sale that is in substantial compliance with applicable nonbankruptcy law.

To prevent some litigation over these amendments, both options would also benefit from a definition in § 101 of the Code for "substantial compliance." For efficiency and thoroughness, § 101 of the Code should also include a definition for "real estate foreclosure sale."

In addition to expressly codifying the decision in *BFP*, § 548(a)(1)(B) should be amended to state:

> Consideration received at a noncollusive foreclosure sale constitutes "reasonably equivalent value" under § 548(a)(1)(B).

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[121] *BFP*, 511 U.S. at 542–43; *see* Debra Pogrund Stark, *The Emperor Still Has Clothes: Fraudulent Conveyance Challenges After the* BFP *Decision*, 47 S.C. L. REV. 563, 572 (1996).

Another option for codifying *BFP* would be to amend § 101 of the Code and, looking to the former Bankruptcy Act's definition of "fair consideration,"[122] define reasonably equivalent value as follows:

> The term "reasonably equivalent value" means consideration which is not too small in value compared to the value of the transferred property. In a noncollusive real estate foreclosure sale, reasonably equivalent value is the consideration received at the foreclosure sale.

These proposed amendments would leave open the option for a trustee to avoid a real estate foreclosure sale based on either a lack of *substantial* compliance with state law or actual fraud under § 548(a)(1)(A). The proposed amendments would fulfill the objectives of Congress[123] and the Supreme Court. They would balance the interests of states, secured and unsecured creditors, and the bankruptcy estate. They would harmonize the policy considerations in both *BFP*[124] and *Bundles*.[125] Also, the amendments would comply with *BFP*'s textual arguments pertaining to Congress's use of reasonably equivalent value over fair market value[126] and allow for *BFP*'s emphasized deference to state law.[127]

Additionally, the proposed amendments acknowledge and remedy the argument in *Madrid* that allowing a fair market value definition is unrealistic because foreclosure sales, by their very nature, are riskier and recover less consideration than prices at regularly conducted real estate sales.[128] Finally, the proposed amendments would also recognize *Bundles*'s rejection of allowing "state law . . . [to] determine the outcome of a bankrupt's complaint" and would also have a positive impact on the foreclosure market, relieving it of the "cloud . . . naturally inhibit[ing] a purchaser . . . from buying at [a] foreclosure."[129]

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122 See *supra* Part I.C.1 for a discussion of fair consideration.

123 The objectives of the most recent Code amendments include limiting debtor abuse of the bankruptcy system, remedying unfairness to creditors, and equitable distribution of a debtor's assets. *See In re* Winshall Settlor's Trust, 758 F.2d 1136, 1139 n.4 (6th Cir. 1985); 7 COLLIER ON BANKRUPTCY, *supra* note 15, at ¶ 1100.01.

124 511 U.S. 531.

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

126 *BFP*, 511 U.S. at 537–38.

127 *Id.* at 546.

128 Madrid v. Lawyers Title Ins. Corp. (*In re* Madrid), 725 F.2d 1197, 1202 (9th Cir. 1984).

129 *Bundles*, 856 F.2d at 822 & n.12 (stating the *Durrett* seventy percent rule "would cast a cloud upon mortgages and trust deeds" and "naturally inhibit a purchaser . . . from buying at foreclosure . . . depress[ing] further the prices of foreclosure sales") (quoting Abramson v. Lakewood Bank & Trust Co., 647 F.2d 547, 550 (5th Cir. 1981) (Clark, J., dissenting))).

The inconsistencies among states' property and foreclosure laws, as will be mapped out in Part II.B of this Comment, and the effect they have on a bankruptcy trustee's avoidance powers would be resolved by the above-proposed amendments. An amendment requiring substantial compliance with state law would allow for a uniform avoidance power and would reduce costly and inefficient litigation.

B. State Law Inconsistencies and the Need for a Federal Standard and Substantial-Compliance Safe Harbor

The proposed amendments in Part II.A of this Comment reconcile the Supreme Court's decision in *BFP* with the Code and ameliorate the inconsistencies resulting from reliance on state foreclosure law in bankruptcy. State foreclosure law and the requirements governing foreclosure sales depend on numerous factors—chiefly, whether the state permits non-judicial foreclosure.

In a minority of states, real estate foreclosures may only be conducted by initiating judicial proceedings.[130] In such a judicial foreclosure state, the court governs the foreclosure process from default to final sale. After default, the lender seeking foreclosure must file a complaint and prove a valid mortgage and a homeowner default; the homeowner has the chance to raise all defenses before the court.[131] The court then issues, or refuses to issue, a judgment and order to proceed with the foreclosure sale.[132] After a sale, the court may enter a deficiency judgment and often an appeal will commence.[133] While the strict oversight of foreclosure sales in judicial foreclosure states leaves foreclosure

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[130] *See* Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399, 1403 (2004) [hereinafter Nelson & Whitman, *Reforming Foreclosure*] (citing GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW 558 (4th ed. 2001) [hereinafter NELSON & WHITMAN, REAL ESTATE FINANCE]). *See generally* ANDREA LEE NEGRONI ET AL., RESIDENTIAL MORTGAGE LENDING: STATE REGULATION MANUAL—MID-ATLANTIC (Aug. 2014), *available at* WestlawNext Real Property Texts & Treatises (Delaware and Pennsylvania); ANDREA LEE NEGRONI ET AL., RESIDENTIAL MORTGAGE LENDING: STATE REGULATION MANUAL—NORTH CENTRAL (Aug. 2014), *available at* WestlawNext Real Property Texts & Treatises (Illinois, Indiana, Ohio, and Wisconsin); ANDREA LEE NEGRONI ET AL., RESIDENTIAL MORTGAGE LENDING: STATE REGULATION MANUAL—NORTH EASTERN (Aug. 2014), *available at* WestlawNext Real Property Texts & Treatises (Connecticut and Vermont); ANDREA LEE NEGRONI ET AL., RESIDENTIAL MORTGAGE LENDING: STATE REGULATION MANUAL—SOUTH CENTRAL (Aug. 2014), *available at* WestlawNext Real Property Texts & Treatises (Kansas and Louisiana); ANDREA LEE NEGRONI ET AL., RESIDENTIAL MORTGAGE LENDING: STATE REGULATION MANUAL—SOUTH EASTERN (Aug. 2014), *available at* WestlawNext Real Property Texts & Treatises (Florida, Kentucky, and South Carolina).

[131] Ann M. Saegert, *Commercial Lending Issues in the United States*, 15 PROB. & PROP. 37, 38 (2001).

[132] *Id.*

[133] *See* NELSON & WHITMAN, REAL ESTATE FINANCE, *supra* note 130, at 559.

sales less susceptible to being set aside for failure to comply with applicable state law or for fraud, the judicial process can typically take up to three years after default before a lender can finally obtain satisfaction of the secured debt.[134] This gives ample time for a debtor to completely exhaust the asset's value, with no adequate protection payments, as are typically required during a bankruptcy case.[135]

In a majority of states, a non-judicial option is available to lenders to avoid unnecessary expense and time in securing collateral.[136] In non-judicial foreclosure states, statutes govern the sale, and require specific, and sometimes stringent, notice, advertisement, and auctioning procedures, as well as threshold time requirements to allow a debtor to attempt to cure the default.[137] While these statutes were put in place to procedurally protect the debtor from total loss of equity in the absence of a judicial foreclosure requirement, today, the amount of equity in a home subject to foreclosure is typically much less than it was a decade or two ago.[138] The states with the highest foreclosure rates are also the states with the highest number of underwater, or undersecured, loans, leaving no reason to statutorily protect a "total loss of equity" because the debtor often has little, if any, equity in these homes.[139] Congress made its intention known with regard to negative-equity homeowners in § 362(d)(2), which allows for relief from the automatic stay—to the extent that the debtor "does not have equity in such property" and the property is not necessary for an effective reorganization—and allows for the requisite adequate protection

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134 Saegert, *supra* note 131, at 38.

135 In Florida, the average foreclosure process from default to sale takes 1,027 days. In the District of Columbia., the average process takes 1,053 days and in New York averages 906 days. *See* Les Christie, *Foreclosure Free Ride: 3 Years, No Payments*, CNNMONEY, (Jan. 1, 2012 4:40 PM), http://money.cnn.com/2011/12/28/real_estate/foreclosure.

136 Saegert, *supra* note 131, at 38. As of the writing of this Comment, Alabama, Alaska, Arizona, Arkansas, California, Georgia, Hawaii, Idaho, Maine, Michigan, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Hampshire, New York, North Carolina, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, and Wyoming allow for non-judicial foreclosure sales. Molly F. Jacobson-Greany, *Setting Aside Non-judicial Foreclosure Sales: Extending the Rule to Cover Both Intrinsic and Extrinsic Fraud or Unfairness*, 23 EMORY BANKR. DEV. J. 139, 144 (2006).

137 *See generally* Nelson & Whitman, *Reforming Foreclosure*, *supra* note 130, at 1399.

138 15.2 million mortgages have negative equity as of 2009. Brent T. White, *Underwater and Not Walking Away: Shame, Fear, and the Social Management of the Housing Crisis*, 45 WAKE FOREST L. REV. 971, 973–74 (2010).

139 The worst foreclosure markets include Nevada, with 47% of homeowners having negative equity, Florida at 30%, and Arizona at 29%. *Id.*

payments necessary to protect diminishing value of collateral during a bankruptcy case.[140]

While this non-judicial foreclosure process is less time-consuming than judicial foreclosure, defaulting homeowners in the non-judicial foreclosure states often abuse state law's procedural requirements to delay the foreclosure process.[141] Some debtors file frivolous lawsuits or multiple bankruptcy petitions, seeking protection under the automatic stay provision in the Code.[142] This defeats the purpose of having an efficient non-judicial foreclosure avenue available to lenders who are attempting to secure their collateral upon default.

The following Part will discuss the numerous state law inconsistencies that defaulting homeowners often exploit to shelter themselves from a lender foreclosing on their property. Homeowners often attempt to challenge the legal authority to foreclose and the failure of the secured party to prove a chain of assignments under the many different rulings on the validity of the Mortgage Electronic Registration System ("MERS") and the mortgage securitization process.[143] State law also varies on what exact foreclosure price "shocks the judicial conscience" and is therefore a basis for avoidance. Defaulting homeowners often also challenge notice and procedural requirements, although lenders may find solace under a substantial-compliance standard, similar to the proposed amendment in Part II.A of this Comment.

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[140] 11 U.S.C. § 362(d) (2012) ("On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay (1) for cause, including the lack of adequate protection of an interest in property of such party in interest; (2) with respect to a stay of an act against property under subsection (a) of this section, if (A) the debtor does not have an equity in such property; and (B) such property is not necessary to an effective reorganization.").

[141] Harry Boul, *Repeat Filings under BAPCPA: Stays, Multiple Discharges and Chapter 20*, 4 ABI CONSUMER BANKR. COMMITTEE NEWSL., no. 6, Dec. 2006, *available at* https://web.archive.org/web/20141124022945/http://www.abiworld.org/committees/newsletters/consumer-bankruptcy/vol4num6/RepeatFilings.html ("BAPCPA added provisions designed to deny a stay to persistent filers of bad-faith petitions . . . . [Those petitioners seek] merely to delay legitimate collection procedures, notably inevitable foreclosures.").

[142] 11 U.S.C. § 362(a) (permitting an injunction to stop judicial proceedings or actions against the debtor, enforcement of judgments against the debtor or property of the estate, any act to obtain possession or exercise control over property, any act to create, perfect or enforce a lien, any act to collect, asses or recover a claim against the debtor, and setoff of any debt that arose before the commencement of the case); Boul, *supra* note 141.

[143] *See, e.g.*, U.S. Bank Nat'l Ass'n v. Ibanez, 941 N.E.2d 40 (Mass. 2011) (arguing the creditor failed to prove the chain of assignment); Intengan v. BAC Home Loans Servicing LP, 154 Cal. Rptr. 3d 727 (Ct. App. 2013).

1. *Authority to Foreclose and Difficulty Proving Chain of Assignment*

After the sharp increase in subprime lending in the early 1990's, securitization became widespread. Mortgage securitization is a "process where thousands of mortgage loans are bundled together into financial products called mortgage-backed securities."[144] The securitization process begins with the initial ownership of the note by an entity known as the "sponsor," who bundles together the mortgages and sells them to a subsidiary, known as a "depositor."[145] The second step involves selling the loans to a "trustee bank," which holds the mortgages.[146] Finally, the mortgages are divided by risk, and assigned a tranche level or rating based on that risk.[147] After a risk level is assigned, a servicing entity purchases the income stream of the note, while the trustee bank retains legal interest.[148]

The Pooling and Servicing Agreement ("PSA"), a public record filed through the United States Securities and Exchange Commission, governs the entire securitization process.[149] The PSA identifies both a custodian, who retains possession of the note, and a servicer, who merely collects money for the trustee from the homeowner's mortgage payments.[150] While the PSA sets out the rules for the bundling of mortgages, the Master Loan Schedule is the document that lists the specific mortgages that were transferred into the trust; the Master Loan Schedule is not a public record.[151]

During this securitization process, the note is transferred numerous times, and at the end, the trustee bank holds the final legal interest of the note "for the benefit of the securities holder," or servicing entity.[152] While the trustee bank

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144 Roy D. Oppenheim, *Deconstructing the Black Magic of Securitized Trusts: How the Mortgage-Backed Securitization Process Is Hurting the Banking Industry's Ability to Foreclose and Proving the Best Offense for a Foreclosure Defense*, 41 STETSON L. REV. 745, 753–54 (2012) (quoting Richard Bitner, *Confessions of a Sub-Prime Lender: An Insider's Tale of Greed, Fraud, and Ignorance* 23–24 (2008)); *see* LEON T. KENDALL ET AL., A PRIMER ON SECURITIZATION 2 (Leon T. Kendall & Michael J. Fishman eds., 2000).

145 Oppenheim, *supra* note 144, at 753–54.

146 *Id.* at 754.

147 A tranche is a risk level assigned to the pool. The larger the risk, the larger the potential pay-off. *Id.* Home mortgages backed by Government-Sponsored Entities ("GSEs"), such as Fannie Mae or Freddie Mac, do not require a rating. KENDALL ET AL., *supra* note 144, at 4.

148 Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1376 (1991).

149 Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 31 (2011).

150 Oppenheim, *supra* note 144, at 758.

151 *Id.* at 757 (citing Stephen S. Kudenholdt et. al, *The Massachusetts Supreme Judicial Court Foreclosure Decisions: The Impact on the Securitization Documentation Process*, 128 BANKING L.J. 195, 197 (2011)).

152 Morgan v. Ocwen Loan Servicing, LLC, 795 F. Supp. 2d 1370, 1374–75 (N.D. Ga. 2011).

holds the legal interest of the note, the investor of the securities, or the servicer, owns the income stream from the note, not the legal interest of the note itself.[153]

Due to the rapid rise of mortgage-backed securities, the financial industry sought to maximize time, effort, and resources by developing many structures to support these financial products, a major one being the creation of the MERS, operated by MERSCORP Holdings, Inc.,[154] which "establish[ed] a centralized, electronic system for registering the assignments and sales of residential mortgages."[155] At the initial stage of a real estate property sale, the borrower and lender list MERS on the security deed as nominee for the lender and the lender's successors and assigns.[156] MERS then holds the mortgage on behalf of all subsequent interests of the loan, tracking the transfer of the beneficial interests of the loan as well as changes in the loan servicing entity.[157] While the security deed lists MERS, often the note lists a separate entity, the servicing company, who has an interest in the payments received from the borrower, or the income stream of the note.[158] Upon default, courts look to applicable state property and foreclosure law to determine which entity has the authority to foreclose on the property.

Most jurisdictions today reject a debtor's defense based on the invalidity of the listing of different entities on the deed and note, also known as "note-splitting"; however, some jurisdictions still maintain that both instruments must be held together and list the same entity to establish legal authority to foreclose.[159] This disparity in the jurisdictions regarding the validity of MERS and the note-splitting theory is detrimental to the uniformity of bankruptcy decisions in regard to prepetition foreclosure sales. Not only are courts varying

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153 Shenker & Colletta, *supra* note 148, at 1376.

154 *About Us*, MERS, https://www.mersinc.org/about-us/about-us (last visited Jan. 5, 2015).

155 Taylor, Bean & Whitaker v. Brown, 583 S.E.2d 844, 845 n.1 (Ga. 2003). MERS now holds over 60 million mortgages in the United States. Michael Powell & Gretchen Morgenson, *MERS? It May Have Swallowed Your Loan*, N.Y. TIMES, Mar. 5, 2011, http://www.nytimes.com/2011/03/06/business/06mers.html.

156 *Morgan*, 795 F. Supp. 2d at 1375 n.5; *see Federal Home Loan Mortgage Corporation Authorized Changes for MERS*, FREDDIE MAC, *available at* http://www.freddiemac.com/uniform/doc/unifmersauth.doc (last updated June 2014).

157 Cervantes v. Countrywide Home Loans, Inc., 656 F.3d 1034, 1038–39 (9th Cir. 2011); Phyllis K. Slesinger & Daniel McLaughlin, *Mortgage Electronic Registration System*, 31 IDAHO L. REV. 805, 808 (1995).

158 *Morgan*, 795 F. Supp. 2d at 1374–75.

159 States that have rejected the note-splitting defense theory include, but are not limited to: California (taking different positions in both state and federal court in *Ferguson v. Avelo Mortgage, LLC*, 126 Cal. Rptr. 3d 586, 592–93 (Ct. App. 2011) (depublished) and *U.S. Bank Nat'l Ass'n v. Skelton* (*In re Salazar*), 448 B.R. 814, 823 (Bankr. S.D. Cal. 2011)), Florida, Georgia, Hawaii, Idaho, Maryland, Mississippi, Missouri, Nevada, North Dakota, South Carolina, Texas, Virginia, Washington, and Wisconsin.

in their final determinations, but, often, debtors use this disparity in state foreclosure and property law to fraudulently avoid their mortgage obligations and prolong the bankruptcy distribution process.[160]

In one case, *In re Agard*, the Bankruptcy Court for the Eastern District of New York held that MERS did not have authority to assign the note even though the note named MERS as a nominee.[161] The court came to that conclusion stating, "MERS is not a party to the Note and the record is barren of any representation that MERS, the purported assignee, had any authority to take any action with respect to the Note."[162] On appeal, the district court found that the bankruptcy court lacked subject matter jurisdiction, and, therefore, inappropriately reached the question of MERS's authority to assign a note.[163]

Similarly, in *Cervantes v. Countrywide Home Loans, Inc.*, the Ninth Circuit Court of Appeals held, "The deed and note must be held together because the holder of the note is only entitled to repayment [by the terms of the note], and does not have the right under the deed to use the property as a means of satisfying repayment."[164] In *Cervantes*, the Ninth Circuit was applying Arizona law. Nevada[165] and Washington[166] courts have since expressly rejected the ruling in *Cervantes* and declined to accept the note-splitting theory on state-law grounds.

One New York Appellate Court, in *Bank of New York v. Silverberg*, went as far as to state that MERS was never a lawful holder of the note and therefore had no power to assign the authority to foreclose.[167] The court reasoned that

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160 *See supra* notes 141–42 and accompanying text.

161 444 B.R. 231, 246, 251–52 (Bankr. E.D.N.Y. 2011), *vacated in part sub nom.*, Agard v. Select Portfolio Servicing, Inc., No. 11-CV-1826, 2012 WL 1043690 (E.D.N.Y. Mar. 28, 2012).

162 *Id.* at 246 (citing *In re* Mims, 438 B.R. 52 (Bankr. S.D.N.Y. 2010)); *see Mims*, 438 B.R. 52 ("[A]s a mortgage is but an incident to the debt which it is intended to secure, the logical conclusion is that a transfer of the mortgage without the debt is a nullity, and no interest is acquired from the debt, and exist independently of it." (quoting Merritt v. Bartholick, 36 N.Y. 44, 45 (1867))).

163 *Agard*, 2012 WL 1043690, at *11–12 ("The issue of whether MERS had authority to assign the Mortgage was no longer before the bankruptcy court.").

164 656 F.3d 1034, 1039 (9th Cir. 2011).

165 *See* Aboulafia v. Mortg. Elec. Registration Sys., No. 2:12-cv-02001, 2013 U.S. Dist. LEXIS 81220, at *10–11 (D. Nev. June 8, 2013) (explicitly rejecting application of *Cervantes*); Trombly v. Truckee Meadows Funding Inc., No. 3:11-CV-0285, 2012 U.S. Dist. LEXIS 903, at *3 (D. Nev. Jan. 3, 2012) ("Nevada law does not require the production of the original note before one of the statutorily enumerated parties initiates a non-judicial foreclosure." (citing Weingartner v. Chase Home Fin., LLC, 702 F. Supp. 2d 1276, 1280 (D. Nev. 2010))).

166 *See* Bavand v. OneWest Bank, F.S.B., 309 P.3d 636, 648 & n.88 (Wash. Ct. App. 2013) (declining to apply *Cervantes* because the ruling did not address Washington law).

167 926 N.Y.S.2d 532, 539 (App. Div. 2011).

even if MERS is a nominee for recording purposes, it does not retain title to the note and a transfer of the mortgage without the debt is a nullity.[168] Therefore, because MERS could only assign that to which it was entitled, and since it was never entitled to foreclose, it could not assign the power to foreclose.[169]

In contrast, in *In re Tucker*, the Bankruptcy Court of Missouri found that MERS retained legal title as nominee for the lender, allowing for future assignments.[170] In *Tucker*, the note and the deed identified the mortgage company, New Century, with the deed of trust naming MERS as the nominee for New Century.[171] The note was assigned numerous times before the debtor filed for bankruptcy.[172] After the filing, MERS assigned the deed of trust to the loan servicing company, Aurora, who later filed for relief from the automatic stay.[173] The court held that Aurora was entitled to enforce both the note and the deed of trust because it held the defaulted note, even though it both split the instruments and did not hold the deed of trust on the date of the bankruptcy filing.[174]

Georgia is one of many states that rejects a debtor's note-splitting theory defense, and Georgia courts have long ruled that separation of these instruments does not render them void.[175] Yet up until recently, there was still ongoing confusion as to which party had the right or authority to foreclose—either the holder of the deed or the holder of the promissory note.[176] In a recent Georgia Supreme Court opinion, *You v. JP Morgan Chase Bank*, the court answered the question of who has the authority to foreclose: the entity named on the deed or the entity named on the note.[177] The court first looked to the plain language of the statute,[178] but more importantly, to Georgia common law, which allowed for a "non-judicial foreclosure conducted by one who held legal

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[168] *Id.* at 537.
[169] *Id.* at 539.
[170] 441 B.R. 638, 644–46 (Bankr. W.D. Mo. 2010).
[171] *Id.* at 640.
[172] *Id.*
[173] *Id.*
[174] *Id.* at 647.
[175] *See* Boaz v. Latson, 580 S.E.2d 572, 578 (Ga. 2003), *rev'd on other grounds*, 598 S.E.2d 485 (Ga. 2004); *see also* White v. First Nat'l Bank of Claxton, 162 S.E. 701, 707 (Ga. 1932).
[176] *See* Reese v. Provident Funding Assocs., LLP, 730 S.E.2d 551, 555 (Ga. App. 2012), *abrogated by*, You v. JP Morgan Chase Bank, N.A., 743 S.E.2d 428 (Ga. 2013).
[177] 743 S.E.2d at 429.
[178] *Id.* (citing GA. CODE ANN. § 44-14-162.2 (2013)).

title to the property, but not the underlying note."[179] Looking to § 44-14-64(b) of the Georgia Code,[180] the court held that a holder of a security deed has full authority to exercise power of sale on default, even if that entity does not also have possession of the note.[181]

In addition to challenging the validity of MERS and its process of assigning mortgages, homeowners and trustees have frequently attempted to litigate and avoid real estate foreclosure sales, respectively, based on an arguable lack of authority due to a gap in the chain of mortgage assignments.[182] State courts and law differ drastically on the specific requirements of proving a chain of assignments.

The Massachusetts Supreme Court, in *U.S. Bank National Ass'n v. Ibanez*, noted the requirement of producing the chain of assignments and addressed the issue of whether the securitization trustee had the authority to foreclose, specifically, whether the foreclosures complied with state law in respect to the assignments made after the foreclosure sale.[183] After the foreclosure sale, the trustee attempted to obtain title insurance and was denied because of questions regarding the authority and validity of the sale.[184] The court held that the trustee did not possess the authority to foreclose because it could not show that it held the mortgage.[185] The court went on to explain that a foreclosing entity is required to prove a complete chain of assignments.[186] The court applied the decision both retroactively and prospectively, stating that the ruling did not make significant changes to common law.[187]

The rule in *Ibanez* has since been narrowed, no longer requiring "a physical possession of the mortgage note in order to effect a valid foreclosure" in all circumstances.[188] In *Christiansen v. Bank of America*, the Middle District of

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179 *You*, 743 S.E.2d at 431 (citing *White*, 162 S.E. 701).

180 GA. CODE ANN. § 44-14-64(b) (2013) ("Transfers of deeds to secure debt . . . shall be sufficient to transfer the property therein described and the indebtedness therein secured.").

181 *You*, 743 S.E.2d at 433.

182 *See supra* notes 169–79.

183 941 N.E.2d 40 (Mass. 2011).

184 *Id.*

185 *Id.* at 49–50. ("One who sells under a power of sale must follow strictly its terms. If he fails to do so, there is no valid execution of the power and the sale is wholly void.").

186 *Id.* at 53.

187 *Id.* at 55 ("The legal principles and requirements we set forth are well established in our case law and our statutes. All that has changed is the plaintiff's apparent failure to abide by those principles and requirements in the rush to sell mortgage-backed securities.").

188 Eaton v. Fannie Mae, 462 Mass. 569, 586 (2012).

Tennessee explained in clearer terms that although the entity entitled to enforce a note may be required to produce the note, the entity need not produce the note to enforce it if the borrower has waived his rights to presentment by the terms of the instrument.[189]

The authority to foreclose due to the MERS and securitization process is one of the most inconsistent areas of foreclosure and property law among the states. As explained in this Part, during the securitization process the trustee bank continues to hold the legal interest of the note, while the investor or servicer owns and holds only the income stream of the note.[190] Requiring a complete chain of assignments is not necessary since what is transferred is not the note, but the income stream.[191] The proposed amendment to the Code in Part II.A of this Comment, requiring substantial compliance with state law, would clarify this intersection of bankruptcy, foreclosure, and property law; reduce costly and inefficient litigation; and assist in keeping over $6.5 trillion of securitized mortgage debt[192] secured.

2. *Shocking the Judicial Conscience*

In addition to the inconsistencies regarding the validity of MERS and requirements of proving a chain of assignments, state law also differs greatly on how to gauge whether a foreclosure sale price is too low. *BFP* made clear a foreclosure sale may be set aside under state foreclosure law if the price is so low as to "shock the conscience or raise a presumption of fraud or unfairness."[193] Even though *BFP* stated the price paid at a foreclosure sale is considered reasonably equivalent value under § 548, the "so low as to shock the conscience" loophole remains.[194] Currently, no court has defined what exactly "shocks the judicial conscience," and courts have failed to even note relevant factors used to determine what is "shocking" and whether market conditions would alter previous rulings.

Since 2005, the fair market value of residential real estate has dropped, in some states significantly, which may drastically affect the price that would

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189 No. 3:11-cv-00935, 2013 U.S. Dist. LEXIS 4731, at *4–6 (M.D. Tenn. Jan. 10, 2013).
190 *See supra* notes 148–53 and accompanying text.
191 *See supra* notes 148–53 and accompanying text; *see also* Shenker & Colletta, *supra note* 148, at 1376–78, 1392 (detailing the process of securitization).
192 Austin Hall, *Property: Mortgages, Conveyances to Secured Debt, and Liens*, 25 GA. ST. U. L. REV. 265, 269 (2008).
193 511 U.S. 531, 542 (1993).
194 *Id.*

"shock the judicial conscience." States in the hardest hit areas likely experience much lower bids at foreclosure sales than those states which have not suffered significant drops in price, making the "shock" factor inconsistent across state lines and often inconsistent even within the state.[195]

For almost a century, courts' susceptibility to "shock" relating to foreclosure prices has varied widely throughout the different circuits. In *Deutsche Bank National Trust Co. v. Fineline Development, LLC*, the trial court refused to set aside a bid of $100 when the second bid, coming in a day after the sale, was for over $80,000.[196] The Arkansas Appellate Court reversed and remanded because the $100 bid "shock[ed] the judicial conscience" and was too low for a property with an unpaid principal balance of $112,500.61 and a recent tax appraisal of $121,000.[197]

New York courts have taken a percentage approach in determining what a "shocking" foreclosure sale price looks like, and have consistently held that foreclosure sales under ten percent of the fair market value are "shocking."[198] In *Central Trust Co. v. Alcon Developers, Inc.*, the court set aside a foreclosure sale that brought $1, but also stated a lack of proper notice and posting of the sale as contributing factors.[199] Also in New York, sales above fifty percent of fair market value have been consistently upheld[200] with no bright-line determined.[201] In *Long Island Savings Bank v. Jean Valiquette*, the Court held that a fifty-seven percent foreclosure sale price was "not unconscionable"[202] and thirty percent was sufficient in *Frank Buttermark Plumbing v. Sagarese*.[203] New York courts have not provided a definitive figure as to what shocks the judicial conscience between the ten percent mark and the fifty percent mark.

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195 *Compare* Long Island Sav. Bank v. Jean Valiquette, M.D., P. C., 584 N.Y.S.2d 127, 129 (App. Div. 1992), *with* Frank Buttermark Plumbing & Heating Corp. v. Sagarese, 500 N.Y.S.2d 551, 551–52 (App. Div. 1986).

196 Deutsche Bank Nat'l Trust Co. v. Fineline Dev., LLC, 2013 Ark. App. 216, at 1–2, 2013 Ark. App. LEXIS 230, at *1–3 (2013).

197 *Id.*; *cf.* Looper v. Madison Guar. Sav. & Loan Ass'n, 729 S.W.2d 156, 157, 161 (Ark. 1987) (rejecting a sale for 4.4 percent of the market value).

198 *See, e.g.*, Cent. Trust Co. v. Alcon Developers, Inc., 403 N.Y.S.2d 396 (Sup. Ct. 1978).

199 *Id.* at 397.

200 *In re* 824 S.E. Blvd. Realty, Inc., No. 11-15728, 2012 Bankr. LEXIS 3823, at *25 (Bankr. S.D.N.Y Aug. 17, 2012) (citing Polish Nat'l Alliance of Brooklyn v. White Eagle Hall Co., 470 N.Y.S.2d 642, 649 (App. Div. 1983)); *see, e.g.*, Long Island Sav. Bank v. Jean Valiquette, M.D., P.C., 584 N.Y.S.2d 127, 129 (App. Div. 1992).

201 *See* Frank Buttermark Plumbing & Heating Corp. v. Sagarese, 500 N.Y.S.2d 551, 552 (App. Div. 1986) (upholding a sale at thirty percent of fair market value).

202 584 N.Y.S.2d at 129.

203 500 N.Y.S.2d at 552.

The Mississippi Supreme Court has stated the "rule of thumb" in determining "judicial shock" is that the bid must be so inadequate that it would be "impossible to state it to a man of common sense without producing an exclamation at the inequality of it"[204] or "about forty percent."[205] In *Central Financial Services, Inc. v. Spears*, the Mississippi Supreme Court recognized the fact that a depression or recession may have a large bearing on the amount that "shocks the judicial conscience," stating that "[w]e also note that most of the cases cited . . . involved sales during a time of economic depression" and many of these sales were deemed adequate because the entire country "was in the throes of a depression."[206]

South Carolina courts have a less "shocking" standard, allowing a foreclosure sale to be set aside if the price is "inadequate and this inadequacy is accompanied by other circumstances."[207] In *Eastern Savings Bank, FSB v. Sanders*, the South Carolina Court of Appeals recognized South Carolina's lesser standard for setting aside a sale, explicitly distinguishing the state's approach from that of New York.[208]

In Alabama, in *Berry v. Deutsch Bank*, the Alabama Court of Civil Appeals considered a foreclosure sale that brought $33,915 when the market value was $84,800.[209] In that case, the dissent argued that previous Alabama decisions showed that a sale yielding only one-third of the market price is the "shocking" limit.[210] However, the majority stated that while this number could shock the conscience, the evidence submitted was insufficient to prove the value of the property.[211]

In summary, the states are so divided as to what price would "shock the judicial conscience" that courts sometimes, even in the same jurisdiction, cannot agree. New York holds ten percent too low and fifty percent sufficient,

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204 Cent. Fin. Servs., Inc. v. Spears, 425 So. 2d 403, 405 (Miss. 1983).

205 Fleisher v. S. AgCredit, FLCA, 2010-CA-01594-COA (¶17) (Miss. Ct. App. 2012) (citing Weyburn v. Watkins, 44 So. 145, 145–146 (Miss. 1907)).

206 425 So. 2d at 405.

207 E. Sav. Bank, FSB v. Sanders (*In re* E. Sav. Bank, FSB), 644 S.E.2d 802, 806 (S.C. Ct. App. 2007).

208 *See id.* at 807 ("New York courts consistently hold foreclosure sale bids of less than ten percent of the value are unconscionably low." (citing Investors Sav. Bank v. Phelps, 397 S.E.2d 780, 782 (1990) (citing Polish Nat'l Alliance v. White Eagle Hall Co., 470 N.Y.S.2d 642, 649 (App. Div. 1983)))).

209 57 So. 3d 142, 145 (Ala. Civ. App. 2010).

210 *Id.* at 150 (Pittman, J., dissenting).

211 *Id.* at 146.

but the grey area between these two numbers is not clear.[212] Alabama has suggested that one-third of the market value is sufficient.[213] South Carolina follows the New York ten percent threshold approach, but also looks to the accompanying circumstances.[214] Mississippi attempted to put a number on what would cause "a man of common sense" to find inequality of a foreclosure sale price, setting that threshold at about forty percent of the market value.[215] Mississippi also expressly recognized economic conditions such as the ongoing depression that would cause all of these jurisdictions to alter their "shock factor," resulting in an even less clear test for adequacy, thereby making avoidance powers in a bankruptcy context inconsistent and unpredictable.[216]

3. *Notice Requirements*

The notice requirements contained in the state statutes are one of the most hotly contested areas of litigation surrounding foreclosures among non-judicial foreclosure states. In recent and highly controversial developments in Georgia, the court in *You v. JP Morgan Chase Bank*[217] looked to the plain text of the foreclosure notice statute and abrogated a previous decision, *Reese v. Provident Funding*.[218] Expanding the written requirements of § 44-14-162.2 of the Georgia Code, the Georgia Court of Appeals in *Reese* interpreted the statute such that a foreclosure notice required identification of the secured creditor *and* the person with full authority to negotiate or modify the terms of the note.[219] The court reasoned that a foreclosure notice that "misidentified the secured creditor" was misleading and "violates the spirit and intent of [§ 44-14-162.2 of the Georgia Code]," which is to provide transparency in the foreclosure process.[220] The court expressed its view that requiring the identity of a secured creditor is a "simple requirement, and one that does not impose an

212 824 S.E. Blvd. Realty, Inc. v. Ryan (*In re* 824 S.E. Blvd. Realty, Inc.), No. 11-15728, 2012 Bankr. LEXIS 3823, at *25 (S.D.N.Y. Aug. 17, 2012); *see* Long Island Sav. Bank v. Jean Valiquette, M.D., P. C., 584 N.Y.S.2d 127, 129 (App. Div. 1992); Frank Buttermark Plumbing & Heating Corp. v. Sagarese, 500 N.Y.S.2d 551, 552 (App. Div. 1986), Cent. Trust Co. v. Alcon Developers, Inc., 403 N.Y.S.2d 396 (Sup. Ct. 1978).

213 *See Berry*, 57 So. 3d at 150 (Pittman, J., dissenting).

214 E. Sav. Bank, FSB v. Sanders (*In re* E. Sav. Bank, FSB), 644 S.E.2d 802, 806–7 (S.C. Ct. App. 2007).

215 Fleisher v. S. AgCredit, FLCA, 2010-CA-01594-COA (¶17) (Miss. Ct. App. 2012) (following Weyburn v. Watkins, 44 So. 145, 145–46 (Miss. 1907)).

216 Cent. Fin. Servs., Inc. v. Spears, 425 So. 2d 403, 405 (Miss. 1983).

217 743 S.E.2d 428 (Ga. 2013).

218 730 S.E.2d 551 (Ga. Ct. App. 2012).

219 *Id.* at 554–55.

220 *Id.* at 555 & n.7 ("[A] debtor has a right to know which entity has the authority to foreclose, and there should be no confusion about the identity of that entity.").

undue burden on the banks."[221] It then went on to state that the debtor was entitled to summary judgment, establishing precedent to allow a misleading foreclosure notice to be determined through summary judgment.[222]

In 2013, the Georgia Supreme Court abrogated *Reese* and held that a secured creditor did not need to be identified in the foreclosure notice.[223] Because the language of the statute only required identification of the individual or entity with full authority to modify the note, the court held that only *that entity* needs to be named.[224] That entity could be construed as the holder of the security deed, the holder of the note, an attorney, or a servicing agent.[225] No matter which entity it may be, the one with full authority to modify the note is the only entity or individual that the statute requires listing on the foreclosure notice.[226] This answer avoided the fiasco of having to determine who exactly the secured creditor was.[227]

Looking to other decisions, Georgia courts require lenders to substantially comply with these stringent notice and procedural requirements.[228] In *Stowers v. Branch Banking & Trust Co.*,[229] the Georgia Court of Appeals confirmed its standard stating, "[S]ubstantial compliance with the notice provision of [§ 44-14-162.2 of the Georgia Code] is sufficient."[230]

4. *Procedural Defects in a Foreclosure Sale and the Substantial-Compliance Standard*

The proposed amendment limiting avoidance based on state law to foreclosure sales that fail to substantially comply with state law will balance the federal interests and the "long-established traditions"[231] of deference to state law. It will also expand the safe harbor allowed by many states for sales that substantially comply with procedural laws.

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221 *Id.* at 555.
222 *Id.*
223 You v. JP Morgan Chase Bank, N.A., 743 S.E.2d 428, 430 (Ga. 2013).
224 *Id.* at 433–34.
225 *Id.*
226 GA. CODE ANN. § 44-14-162.2 (2014).
227 *You*, 743 S.E.2d at 434 & n.7. Arguably the secured creditor could be defined as the lender, the servicer, Fannie Mae, MERS, etc.
228 *See, e.g.*, TKW Partners, LLC v. Archer Capital Fund, L.P., 691 S.E.2d 300, 302 (Ga. Ct. App. 2010).
229 731 S.E.2d 367, 368 (Ga. Ct. App. 2012).
230 *Id.* at 369 (citing *TKW Partners, LLC*, 691 S.E.2d at 303) (recognizing its decision in *TKW Partners, LLC* but refusing to apply the it retroactively).
231 *See* BFP v. Resolution Trust Corp., 511 U.S. 531, 546 (1994).

In many states, purely procedural defects, absent other factors, typically will not be sufficient as a basis for invalidating or avoiding a foreclosure sale. California courts, as exemplified in *Residential Capital v. Cal-Western Reconveyance Corp.*, only require a foreclosure to be free of substantial defects in procedure.[232] The court stated that while a defect might make a sale voidable, it does not make it void.[233] The court went on to suggest that a mandatory statutory provision, when ignored or not complied with, is a substantial defect.[234]

By contrast, in Georgia, procedural irregularities do not render a foreclosure sale void.[235] The determining factor is the requirement that the sale price was "not chilled."[236] In *Stripling v. Farmers & Merchants Bank*, the court held that a failure to advertise the sale for the four weeks required under the state statute does not render the sale void absent proof of a chilled price bid.[237]

C. Collusive Sales

The *BFP* court held that consideration received in a noncollusive foreclosure sale satisfies the reasonably equivalent value requirement of § 548.[238] Sales found to be "collusive" are still subject to the avoidance powers of a trustee and should remain so. If the proposed amendments in Part II.A were enacted, collusive foreclosure sales would remain subject to avoidance based on § 548(a)(1)—the "actual fraud" provision. For public policy reasons, courts have long admonished a lender or other party in restricting the opportunity for "full and free" bidding in a foreclosure sale by means of fraud or collusion.[239]

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[232] 134 Cal. Rptr. 2d 162, 173 (Ct. App. 2003).

[233] *Id.* at 167 (citing Little v. CFS Serv. Corp., 233 Cal. Rptr. 923, 924 (Ct. App. 1987)).

[234] *Id.*

[235] *See* Stripling v. Farmers & Merchs. Bank, 332 S.E.2d 373, 374 (Ga. Ct. App. 1985).

[236] *Id.* ("[N]ot every irregularity furnishes a basis for voiding a foreclosure sale. The crucial point of the inquiry on confirmation is to insure that the sale was not chilled and the price bid was in fact market value."); *see also* Cummings v. Anderson (*In re* Cummings), 173 B.R. 959 (Bankr. N.D. Ga. 1994); Walker v. Ne. Prod. Credit Ass'n, 251 S.E.2d 92, 92 (Ga. Ct. App. 1978); Shantha v. W. Ga. Nat'l Bank, 244 S.E.2d 643, 644 (Ga. Ct. App. 1978).

[237] 332 S.E.2d at 374–75.

[238] 511 U.S. 531, 545 (1993).

[239] Detroit Trust Co. v. Agozzinio, 273 N.W. 747, 748 (Mich. 1937); CitiMortgage, Inc. v. Giordano, 791 N.Y.S.2d 454, 455 (App. Div. 2005); Polish Nat'l Alliance v. White Eagle Hall Co., 470 N.Y.S.2d 642, 650 (App. Div. 1983) (citing Manhattan Taxi Serv. Corp. v. Checker Cab Mfg. Corp., 171 N.E. 705 (N.Y. 1930)).

Collusion, as defined by Black's Law Dictionary, is "[a]n agreement to defraud another or to do or obtain something forbidden by law."[240] Collusive sales are more akin to actual fraud under § 548(a)(1), "actual intent to hinder, delay or defraud [creditors]." In fact, the *BFP* decision directly referred to collusive sales as being "subject to attack under § 548(a)(1)."[241] Collusion, similar to actual fraud, can take the form of price-fixing arrangements between a third-party bidder or other activities that "chill the bid" as required in *Stripling*.[242] For a court to deem a foreclosure sale collusive, there must be evidence the price was subjected to "bid rigging or some other form of price fixing."[243]

Collusion in a foreclosure sale also will often take the form of arrangements between a borrower and a senior lender to foreclose for the purpose of wiping out a junior lien.[244] Although, in this instance, a debtor would still have a debt obligation to the junior lien holder,[245] the junior lien holder's interest in the collateral would be extinguished.[246] In bankruptcy, the junior lien holder would change from secured to unsecured and would likely receive a pro rata distribution, if any at all. Avoiding a foreclosure sale under these circumstances would be equitable and fulfill the bankruptcy policy of fair and equitable distribution under the Code.[247]

Additionally, avoidance based on collusion or actual fraud is consistent with the UFTA. The UFTA, which based its avoidance power on § 548, allows for a safe harbor for reasonably equivalent value in foreclosure sales, very similar to the ruling in *BFP*; however, the safe harbor does apply to foreclosure

240 BLACK'S LAW DICTIONARY 300 (9th ed. 2009).

241 *BFP*, 511 U.S. at 545 ("Although *collusive* foreclosure sales are likely subject to attack under § 548(a)(1), which authorizes the trustee to avoid transfers 'made . . . with the actual intent to hinder, delay, or defraud' creditors, that provision may not reach foreclosure sales that, while not intentionally fraudulent, nevertheless fail to comply with all governing state laws.").

242 *Stripling*, 332 S.E.2d at 374–75; *see* Stark, *supra* note 121, at 583.

243 718 Arch St. Assocs. v. Blatstein (*In re* Blatstein), 226 B.R. 140 (E.D. Pa. 1998) (quoting Bennett v. Genoa Ag Center, Inc. (*In re* Bennett), 154 B.R. 140, 147 (Bankr. N.D.N.Y. 1992)), *aff'd in part, rev'd in part*, 192 F.3d 88 (3rd Cir. 1999).

244 Stark, *supra* note 121, at 576.

245 *See, e.g.*, Trs. of MacIntosh Condo. Ass'n v. FDIC, 908 F. Supp. 58, 64 (D. Mass. 1995) ("As a result of the first mortgage foreclosure the second mortgage lien was extinguished but not the second mortgage debt.'" (quoting Osborne v. Burke, 300 N.E.2d 450, 451 (Mass. App. Ct. 1973))).

246 Levenson v. G.E. Capital Mortg. Servs., Inc., 643 A.2d 505, 512 (Md. Ct. Spec. App. 1994), *rev'd on other grounds*, 657 A.2d 1170 (Md. 1995).

247 *In re* Winshall Settlor's Trust, 758 F.2d 1136, 1139 n.4 (6th Cir. 1985); 7 COLLIER ON BANKRUPTCY, *supra* note 15, at ¶ 1100.01.

sales with "actual fraud" present.[248] Maintaining avoidance based on collusion or actual fraud is consistent with the Supreme Court's ruling in *BFP*,[249] the UFTA,[250] and the intent of Congress.[251] The proposed amendments in Part II.A of this Comment reflect these intentions while keeping intact the policy and procedure of avoiding residential foreclosure sales that are based on collusion or actual fraud under § 548(a)(1)(A).

CONCLUSION

While the Code explicitly allows a trustee to avoid a prepetition foreclosure sale based on actual fraud under § 548(a)(1)(A)[252] or constructive fraud under § 548(a)(1)(B),[253] Congress failed to define reasonably equivalent value in the Code.[254] For many decades, this left courts to determine reasonably equivalent value on their own. Some jurisdictions used a percentage approach,[255] others a rebuttable presumption,[256] and still others considered the totality of the circumstances.[257] Finally, the Supreme Court spoke in *BFP*, stating that the consideration received at a noncollusive foreclosure sale satisfies the reasonably equivalent value requirement of § 548(a)(1)(B).[258]

Since the Supreme Court has spoken on the subject, the Code should be amended accordingly to incorporate the ruling in *BFP*. Because *BFP* expressly left open the possibility of a foreclosure sale being avoided for lack of state law compliance,[259] the Code should also be amended to require substantial compliance with state law. The Court incorrectly described the relationship between state law and fraudulent transfer law as a "peaceful coexistence,"[260] and the Code must be amended to reflect the less-than-peaceful reality.

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248 UNIF. FRAUDULENT TRANSFER ACT §3(b) (1984) ("A person gives a reasonably equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale or execution of a power of sale under a mortgage, deed or trust, or security agreement.").

249 511 U.S. 531, 545–46 (1994).

250 *See supra* Part I.B.

251 *See supra* note 2 and accompanying text.

252 11 U.S.C. § 541(a)(1)(A) (2012).

253 *Id.* § 541(a)(1)(B).

254 *See supra* note 17.

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

256 Lawyers Title Ins. Corp. v. Madrid (*In re* Madrid), 21 B.R. 424, 426–27 (B.A.P. 9th Cir. 1982), *aff'd on other grounds*, 725 F.2d 1197 (9th Cir. 1984).

257 Bundles v. Baker (*In re* Bundles), 856 F.2d 815, 825 (7th Cir. 1988).

258 511 U.S. 531, 545 (1994).

259 *Id.* at 545–46.

260 *Id.* at 542.

In its most recent amendments, Congress made its intentions clear that it desired to remedy debtor abuse and give additional protection to secured creditors.[261] The UFTA did exactly this, but the Code was never amended to fully reflect the creditor protections in the UFTA. The majority of states have adopted the UFTA,[262] and both Congress and the Supreme Court have made their intentions known with respect to mortgage lenders in the Code and in *BFP*, respectively. Therefore, secured creditors, especially mortgage lenders, should be given the right to secure their collateral, absent actual fraud, without fear of avoidance during a bankruptcy case.

Although state law inconsistencies are too great to list, the effect of those inconsistencies is significant. One of the most litigated matters in foreclosure proceedings involves the debate over MERS, mortgage securitization, and which entity has the right to foreclose after a mortgage note is split from the deed. Another matter subject to litigation is the foreclosure sale price. *BFP* left the option of avoiding a sale if it "shocks the conscience,"[263] even though this standard is not stated anywhere in the Code. The assessment of what price "shocks the conscience" is also inconsistent among the states, and even inconsistent within jurisdictions. Finally, the costs of focusing judicial resources on enforcing compliance with foreclosure notice statutes outweigh the benefits that those statutes offer. The purpose of foreclosure notice statutes is often to obtain transparency in the foreclosure process, but the notice requirements in many state statutes have the opposite effect, confusing both the debtor and the lender, and leading to a waste of judicial time and depreciation of the value of collateral during the process.

Establishing a substantial-compliance standard for state law avoidance would codify the practice that some states already follow. As discussed, many courts do not find procedural defects in a foreclosure sale sufficient to serve as a basis for invalidating a sale.[264] Requiring substantial compliance with state

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261 McLaughlin, *supra* note 2, at 379 ("One of the 1984 Amendments many purposes was stopping consumer abuse of the Code. Critics of the 1978 Code believed that debtors abused the Code's liberal provisions to discharge payable debts."). *See generally* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23.

262 *Supra* note 44.

263 511 U.S. at 542.

264 *See, e.g.*, Residential Capital, LLC v. Cal-Western Reconveyance Corp., Cal. Rptr. 2d 162, 173 (Ct. App. 2003); Stripling v. Farmers & Merchs. Bank, 332 S.E.2d 373, 374 (Ga. Ct. App. 1985).

law would respect the intentions of Congress and the Supreme Court and would offer creditors and debtors more protection.

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