

# A PALACE FOR A PEPPERCORN: A POST-BFP PROPOSAL TO RESURRECT SECTION 548(A)(2)(A)

## I. INTRODUCTION

As counsel for Octopus National Bank (“ONB”), you must prepare a bidding strategy for an upcoming mortgage foreclosure. The mortgaged property is a piece of commercial real estate upon which a debtor operates a parking garage. The property’s fair market value is one million dollars. The garage is the debtor’s sole asset, and foreclosure will render the debtor bankrupt. What should ONB bid in order to protect its interest in the property?<sup>1</sup>

Prior to the 1994 Supreme Court decision in *BFP v. Resolution Trust Corp.*,<sup>2</sup> a foreclosing lender, or mortgagee,<sup>3</sup> would bid less than seventy percent of the fair market value of the property. Seventy percent of the fair market value was a judicial benchmark<sup>4</sup> that satisfied the Bankruptcy Code (“the Code”) requirement that all involuntary transfers of assets during the year preceding the bankruptcy filing receive “reasonably equivalent value.”<sup>5</sup>

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1. The hypothetical is loosely modeled after *In re Winshall Settlor’s Trust*, 758 F.2d 1136 (6th Cir. 1985). In *Winshall Settlor’s Trust*, the Sixth Circuit allowed the creditor bank to foreclose on commercial real estate valued between \$1 and \$1.8 million for a purchase price of \$400,000. *Id.* at 1138.

2. 114 S. Ct. 1757 (1994).

3. A mortgagee is a “[p]erson that takes or receives a mortgage.” BLACK’S LAW DICTIONARY 1012 (6th ed. 1990). The mortgagor is “[o]ne who, having all or some part of title to property, by written instrument pledges that property for some particular purpose such as security for a debt.” *Id.*

4. The Court in *Durrett v. Washington Nat’l Ins. Co.* adopted the rule that purchasers at foreclosure sales must pay at least 70 percent of the property’s fair market value. 460 F. Supp. 52, 54 (Bankr. N.D. Tex. 1978), *aff’d*, 621 F.2d 201 (5th Cir. 1980). For a discussion of the judicial development of the *Durrett* Rule, see *infra* notes 34-41 and accompanying text.

In the dissenting opinion to *BFP*, Justice Souter commented on the *Durrett* Rule: “To the extent, moreover, that *Durrett* is said to have announced a ‘rule,’ it is better understood as recognizing a ‘safe harbor’ or affirmative defense for bidding mortgagees or other transferees who paid 70% or more of a property’s appraised value at the time of the sale.” *BFP*, 114 S. Ct. at 1773.

5. The “reasonably equivalent value” requirement in 11 U.S.C. § 548(a) provides:

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

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

(2)(A) received less than *reasonably equivalent value* in exchange for such transfer or

Codified in § 548(a)(2)(A) of the Code,<sup>6</sup> the requirement that transfers yield “reasonably equivalent value”<sup>7</sup> is used to preserve the property of the bankruptcy estate.<sup>8</sup> Section 548(a)(2)(A) empowers the trustee in bankruptcy (“TIB”)<sup>9</sup> to set aside<sup>10</sup> pre-filing transfers<sup>11</sup> exchanged for less than

obligation; and

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

11 U.S.C. § 548(a) (1993) (emphasis added).

6. 11 U.S.C. § 548(a) (1993).

7. For a discussion of § 548(a)(2), see Scott B. Ehrlich, *Avoidance of Foreclosure Sales as Fraudulent Conveyances: Accommodating State and Federal Objectives*, 71 VA. L. REV. 933 (1985). Commenting on the purpose of § 548(a)(2), Professor Ehrlich states:

From a bankruptcy perspective, however, a foreclosure sale on the eve of bankruptcy, at which the debtor's interest is sold for a fraction of its true market value, constitutes an estate-depleting windfall to the purchaser at the expense of the debtor's creditors. The long history of fraudulent conveyance provisions strongly support an interpretation of section 548(a)(2) that permits the trustee to recapture such a loss.

*Id.* at 935-36. The authors of the 1973 *Report of the Commission on Bankruptcy Laws of the United States* also commented on the purpose of the fraudulent conveyance provision:

Without such provisions, the estate available for distribution to creditors in the bankruptcy proceedings could be seriously depleted (or perhaps eliminated) by the transfer of most or all of the assets to favored creditors or to friends or relatives or simply to those creditors who exert the most pressure on the debtor.

REPORT OF THE COMMISSION ON BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, 93d Cong., 1st Sess. 18 (1973) (emphasis added). Allowing over-zealous creditors estate depleting wind falls is inconsistent with the Code's goal to ensure equitable distribution of the assets of the bankruptcy estate. See 3 DANIEL R. COWANS, *BANKRUPTCY LAW AND PRACTICE* § 12.22, at 74-77 (6th ed. 1994) (discussing the basic concept of equal treatment of creditors); see also Robert F. Finke et al., *Undoing the Excesses of the 1980s: Avoidance Actions and Equitable Subordination*, C880 ALI-ABA 197, \*348 (1994), available in WESTLAW, TP-ALL database (noting “the Bankruptcy Code's purpose in a fair and equitable distribution among creditors.”). Thus, § 548(a)(2) provides a tool by which the TIB may prevent such windfalls and preserve the assets of the estate. See Ehrlich, *supra*, at 935-36.

8. In their treatise on bankruptcy, Professors Warren and Westbrook artfully explain the concept of the “bankruptcy estate”:

At the moment a bankruptcy petition is filed (voluntary or involuntary) an “estate” is created by operation of law, just as if a new corporation had been established or a new trust created. The most direct analogy is with the decedent's estate created by law upon someone's death. Bankruptcy is in a sense a financial demise, which creates an estate consisting of all the interests in property previously owned by the debtor.

ELIZABETH WARREN & JAY L. WESTERBROOK, *THE LAW OF DEBTORS AND CREDITORS* 200 (2d ed. 1991).

9. The TIB is the “person in whom the property of a debtor is vested in trust for the creditors.” BLACK'S LAW DICTIONARY 1514 (6th ed. 1990).

10. “Set aside” is a bankruptcy term of art meaning “[t]o reverse, vacate, cancel, annul, or revoke a judgment, order, etc.” BLACK'S LAW DICTIONARY 1372 (6th ed. 1990). Under § 550 of the Code, the TIB “may recover, for the benefit of the estate, the property transferred, or . . . the value of such property” that is voidable under § 548. 11 U.S.C. § 550(a) (1993).

Section 544 authorizes TIBs to set aside such voidable transfers and allows the TIB to “avoid any transfer . . . incurred by the debtor that is voidable” and to “avoid any transfer of an interest of the

reasonably equivalent value and to bring the transferred assets back into the bankruptcy estate. This ensures that all creditors will benefit from the debtor's assets.

In bankruptcy parlance, transfers for less than reasonably equivalent value under § 548(a)(2)(A) are termed "fraudulent conveyances."<sup>12</sup> Although a transfer for less than reasonably equivalent value may not rise to the level of actual fraudulent conduct, the lack of reasonably equivalent value triggers a presumption of fraud, under which the debtor's actual intent is irrelevant.<sup>13</sup> Because transfers exchanged for less than reasonably equivalent value within one year of the bankruptcy filing are constructively fraudulent conveyances,<sup>14</sup> § 548(a)(2)(A) allows the TIB to set aside such

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debtor in property . . . that is voidable." 11 U.S.C. § 544(a), (b) (1993). Referred to as the "Strong Arm Clause," § 544 allows the TIB to "undo prebankruptcy transactions between the debtor and certain creditors, to the benefit of all unsecured creditors." WARREN & WESTERBROOK, *supra* note 8, at 498 (2d ed. 1991). This Note argues that *BFP* improperly carves out a foreclosure sale exception to the TIB avoidance powers. See *infra* notes 118-20 and accompanying text.

11. Because the term "transfer," defined in 11 U.S.C. § 101(54), specifically includes *involuntary* dispositions of property, parties may challenge foreclosure sales under § 548. 11 U.S.C. § 101(54) (1993). Before Congress amended the Code in 1984 to include this language, this issue was hotly debated. For a discussion of the legal debate surrounding the time of transfer, see *infra* note 47.

12. Section 548 of the Code is labeled "Fraudulent transfers and obligations" and is commonly referred to as the fraudulent conveyance provision of the Code. 11 U.S.C. § 548 (1993). However, only subsection (1) of this provision is intended to reach actual fraudulent conduct. See *supra* note 5. Subsection 548(a)(2)(A) does not regulate actual fraudulent conduct. Rather, it establishes a "federal basis-independent of state law-for setting aside a foreclosure sale," regardless of the debtor's intent or good faith. WARREN & WESTERBROOK, *supra* note 8, at 138-40, discusses fraudulent conveyance law. Thus, § 548(a)(2)(A) reaches constructively fraudulent conduct and allows the TIB to set aside a transfer for less than reasonably equivalent value regardless of the debtor's intent.

The four elements of a constructively fraudulent conveyance are: "(1) [a] transfer of an interest of the debtor (2) within one year of the date of filing of the petition (3) for less than reasonably equivalent value (4) while the debtor was insolvent, or rendering him insolvent." *In re Verna*, 58 B.R. 246, 248 (Bankr. C.D. Cal. 1986). This Note limits discussion to the issue of reasonably equivalent value.

13. *But cf.* Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 781-84 (1984) (criticizing the application of fraudulent conveyance law to nonbankruptcy foreclosure rules which do not entail "debtor misbehavior" and thus are the "wrong vehicle" for addressing such transfers).

14. In their discussion of fraudulent conveyance law, Warren and Westbrook comment on the distinction between actual fraudulent intent and constructive fraud:

The most important aspect of the original 1915 statute [the Uniform Fraudulent Conveyance Act] was that it codified in fraudulent conveyance law a concept usually called "constructive fraud" or "presumptive fraud." Both terms are misnomers because the new concept permitted a creditor to avoid—to set aside—a transfer even though the debtor was entirely innocent of any fraudulent intent. The statute defined circumstances in which the transfer was regarded as unfairly disadvantageous to the debtor's creditors, regardless of intent. Such a transfer could be avoided without any showing of fraud, constructive or otherwise, so there was no need for any "presumption" and there was nothing to rebut.

WARREN & WESTERBROOK, *supra* note 8, at 139. For a discussion of the UFCA's adoption, see *infra*

transfers just as if the debtor had engaged in actual fraud.

Before *BFP*, debtors or TIBs could move the bankruptcy court to review foreclosure sale transfers that yielded inadequate value and depleted the bankruptcy estate.<sup>15</sup> However, under *BFP*, bankruptcy courts may no longer review or set aside such transfers.<sup>16</sup> The price paid at a regularly-conducted, noncollusive foreclosure sale is presumed to be the reasonably equivalent value.<sup>17</sup>

Thus, *BFP* allows mortgage lenders such as ONB to bid any amount so long as they comply with state foreclosure law.<sup>18</sup> *BFP* represents a huge victory for mortgage lenders. So long as lenders follow the state process for properly conducting foreclosure sales, *BFP* allows them to repossess collateral by bidding the mortgage balance regardless of the fair market value of the property. *BFP* allows mortgagees to purchase valuable real estate for mere pocket change, or for a "peppercorn" as Justice Souter so

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notes 25-27 and accompanying text.

15. These parties could make such a motion pursuant to § 550 of the Code. 11 U.S.C. § 550 (1993). For a discussion of § 550, see *supra* note 10.

16. For a discussion of *BFP* and the irrebuttable presumption rule, see *infra* part III.

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

18. The state foreclosure sale process is inadequate and shocking. One commentator criticized the system:

[T]he state-mandated procedure is intrinsically defective and has caused imperfect market results . . . . In an age of computer data accessibility, sophisticated and widespread brokerage listing services, available credit financing, easily accessible title insurance, and reliable escrow companies, state-foreclosure laws are woefully inadequate, occasionally shocking, and in drastic need of upgrading.

Ehrlich, *supra* note 7, at 961-62.

The foreclosure process does not yield equitable results. One study concluded that "[i]n 99.3% of 'public' sales, the mortgagee is the buyer." William C. Prather, *A Realistic Approach to Foreclosure*, 14 BUS. LAW. 132, 135 (1958). Subsequent studies reinforce these statistics. Steven Wechsler, *Through the Looking Glass: Foreclosure by Sale as De Facto Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850, 896 (1985) (concluding that judicial foreclosures are a "meaningless charade" in which the mortgagee forecloses, purchases the property at the sale and resells it at a significant profit).

Frequently, mortgagees are the only bidders at foreclosure sales because the process discourages third-party bidders. GRANT S. NELSON & DALE S. WHITMAN, REAL ESTATE FINANCE LAW 622-26 (3d. ed. 1994). Third parties are reluctant bidders because at a foreclosure sale they must pay in cash. However, mortgagees receive a credit for the outstanding mortgage debt and thus do not have to pay this amount in cash. *Id.* at 623. Additionally, foreclosure statutes only require limited notice and sale publication. Most often, such notice is published in newspapers with low circulation. *Id.* Further, state foreclosure laws do not provide third-party purchasers with a warranty of good title. *Id.* Finally, third-party purchasers are rarely given an opportunity to physically inspect the property. *Id.* Either the debtor in possession refuses access or the foreclosing mortgagee discourages such access by limiting the information available on the property. *Id.* See also UNIF. LAND TRANS. ACT, 13 U.L.A. §§ 3-501 to 3-513 (setting forth a model for state foreclosure law).

artfully termed it in his dissent to *BFP*.<sup>19</sup>

The difficulty with the irrebuttable presumption rule becomes apparent when applied to our hypothetical. Without any standard for reasonably equivalent value or fear of a subsequent set aside,<sup>20</sup> ONB has no incentive to bid more than the outstanding balance of the mortgage. If the balance was \$250,000, ONB's bid would represent only one quarter of the property's fair market value. Thus, ONB would satisfy its mortgage, deplete the bankruptcy estate of seventy-five percent of the debtor's equity in the property, and gain a windfall profit upon resale of the property.<sup>21</sup> Because

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19. *BFP*, 114 S. Ct. at 1767. Justice Souter summarizes the majority's opinion saying, "[t]oday the Court holds that by the terms of the Bankruptcy Code Congress intended a peppercorn paid at a noncollusive and procedurally regular foreclosure sale to be treated as the 'reasonabl[e] equivalent' of the value of a California beachfront estate." *Id.*

Although technically a "peppercorn" is a "dried berry of Black Pepper," The Oxford English Dictionary explains that the term is also used colloquially to connote a "very small, insignificant[, or] trivial" amount of rent or payment for an interest in real estate. 11 THE OXFORD ENGLISH DICTIONARY 510 (2d ed. 1989).

20. Generally, under state law, foreclosure sales may not be challenged for "mere inadequacy of price." See *Central Nat'l Bank v. Bell*, 5 Cal.2d 324, 328 (Cal. 1936). To challenge foreclosure sales, the price received must be so low as to "shock the conscience." *Gottlieb v. McArdle*, 580 F. Supp. 1523, 1525 (E.D. Mich. 1984) (citing *United States v. Wells*, 403 F.2d 596 (5th Cir. 1968)); *Golden v. Tomiyasu*, 387 P.2d 989, 992 (Nev. 1963). "Reasonably equivalent value" clearly connotes a higher threshold of value than the state standard. The discrepancy between these two standards is irreconcilable.

Bankruptcy law supplements the state law process to secure the assets of the bankruptcy estate. The inadequacy of the foreclosure system necessitates § 548. On this issue, Professor Lynn LoPucki concluded that sales procedures used by bankruptcy courts are "vastly superior to those employed in the state remedies subsystem . . . . In bankruptcy sales it is usual to receive more than 75 percent of the appraised value of the property." Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 Wis. L. REV. 311, 320-21 & n.52 (1982).

This Note acknowledges that reforming state foreclosure law is essential. However, this Note does not attempt to duplicate existing reform proposals. For a sample of such proposals, see Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489 (1991); Michael L. Walcott, *Avoidance of Foreclosure Sales As Fraudulent Transfers Under Section 548(a) of the Bankruptcy Code: An Impetus to Changing State Foreclosure Procedures*, 66 NEB. L. REV. 383 (1987).

Instead, this Note proposes that Congress must amend § 548 to allow bankruptcy courts to review the state foreclosure process to ensure that foreclosure sale prices are reasonably equivalent to fair market value.

21. Justice Souter predicted similar bidding strategies in his dissent in *BFP*:

At a typical foreclosure sale, a mortgagee has no incentive to bid any more than the amount of the indebtedness, since any "surplus" would be turned over to the debtor (or junior lienholder), and, in some states it can even be advantageous for the creditor to bid less and seek a deficiency judgement. And where property is obviously worth more than the amount of the indebtedness, the lending mortgagee's interests are served best if the foreclosure sale is poorly attended; then, the lender is more likely to take the property by bidding the amount of the indebtedness, retaining for itself any profits from resale.

*BFP*, 114 S. Ct. at 1775 (citations omitted).

a bankruptcy court would be powerless to review the sale and recapture the property, *BFP* legalizes constructively fraudulent conveyances.

This Note assesses *BFP*'s impact on the balance of power between federal bankruptcy courts and state foreclosure law. Part II analyzes the historical development of bankruptcy law as a vehicle to set aside foreclosure sales. Part III analyzes and critiques *BFP*. Part IV proposes amending the Code to allow bankruptcy courts to review constructively fraudulent transfers. Alternatively, Part IV proposes a narrow judicial interpretation of *BFP*. Finally, Part V concludes that the use of fraudulent conveyance law to set aside state foreclosure sales complements federal bankruptcy policy.

## II. BACKGROUND ON SECTION 548 CONFLICT

Members of the legal community have hotly contested the use of fraudulent conveyance law to set aside foreclosure sales that transfer property for less than "reasonably equivalent value."<sup>22</sup> Historically, lawyers used fraudulent conveyance law to prevent debtors from transferring assets with the "intent to hinder, delay or defraud" their creditors.<sup>23</sup> Because actual intent is difficult to prove, courts developed "badges of fraud" or factual settings that were presumptively fraudulent.<sup>24</sup>

Supplementing federal bankruptcy law, state statutes constitute the primary source of fraudulent conveyance law. State statutes developed simultaneously with the federal provisions and reflect similar policy considerations. In 1918, constructive fraud was codified in the Uniform Fraudulent Conveyance Act ("UFCA").<sup>25</sup> The Conference of Commissioners on Uniform Laws adopted the UFCA to provide a model for state

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22. "Reasonably equivalent value" is defined in 11 U.S.C. § 548(a)(1) (1993). For the full text of § 548, see *supra* note 5.

23. This language originated in the Statute of 13 Elizabeth. 13 Eliz., ch. 5 (1570), cited in *BFP*, 114 S. Ct. at 1763. The Statute of 13 Elizabeth allowed "covinous and fraudulent" transfers made with the intent to "delay, hinder or defraud creditors and others" to be set aside. *Id.*

The Bankruptcy Act of 1898 adopted the intent language in the Elizabethan statute, and the language remained unchanged for the next forty years. Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544 (codified as amended at 11 U.S.C. §§ 1-1255 (1976)), repealed by Bankruptcy Reform Act of 1978, Pub. L. No. 98-598, 92 Stat. 2549 (1978).

24. *Twyne's Case*, 3 Coke 806, 76 Eng. Rep. 809 (Star Chamber, 1601) (invalidating gift made with the "mark of fraud" as a fraudulent conveyance), cited in WARREN & WESTERBROOK, *supra* note 8, at 137-38.

25. UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 430 (1975) [hereinafter U.F.C.A.].

fraudulent conveyance statutes.<sup>26</sup> The UFCA grants creditors standing to challenge debtor conveyances incurred without “fair consideration.”<sup>27</sup>

Over the next sixty years, Congress incorporated the UFCA’s constructive fraud standards into the federal Bankruptcy Code. In 1938, Congress enacted the Chandler Act, removing the intent requirement from the section on fraudulent conveyances and adopting the UFCA’s “fair consideration” language.<sup>28</sup> Ultimately, the 1978 Bankruptcy Act removed the “good faith” transfer requirement.<sup>29</sup> These amendments removed the historical limits on fraudulent conveyance law by allowing transfers to be set aside for constructive fraud.<sup>30</sup> The adoption of the presumptive fraud provision placed foreclosure sales within the reach of the TIB’s avoidance powers.<sup>31</sup>

Through these amendments, Congress shifted the focus from the debtor’s mental state to the transfer’s impact upon creditors and the bankruptcy estate.<sup>32</sup> However, Congress did not remove the term “fraudulent.” The use of fraudulent conveyance law to regulate non-fraudulent behavior has created a confusing paradox that has sparked scholarly and judicial criticism.<sup>33</sup>

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26. See Kevin J. Carey, *Protecting Assets While Avoiding Fraudulent Conveyances*, C950 ALI-ABA 691, 693-94 (1994), available in WESTLAW, TP-ALL Database; Note, *Good Faith and Fraudulent Conveyances*, 97 HARV. L. REV. 495, 496 (1983).

27. U.F.C.A., *supra* note 25, §§ 3, 4, at 448-49, 474.

28. The Chandler Act removed the intent requirement and allowed transfers made for less than “fair consideration” to be set aside regardless of the debtor’s state of mind. Chandler Act § 67(d) (current version at 11 U.S.C. § 548 (a)(2)) (original at Bankruptcy Act of June 22, 1938, ch. 575, § 67d(2)(a), 52 Stat. 840, 877 (codified at 11 U.S.C. § 107(d)(2) (1976)) (repealed 1978)). See also H.R. REP. NO. 1409, 75th Cong., 1st Sess. (1937); *BFP*, 114 S. Ct. 1757, 1769 n.5 (1994) (discussing the impact of the Chandler Act).

29. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101-151326 (1982)); H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 375 (1977), reprinted in 1978 U.S.C.A.N. 5787, 5963, 5971.

30. For a discussion of the distinction between actual fraudulent intent and constructive fraud, see *supra* notes 12, 14.

31. Discussing the impact of the Bankruptcy Amendments and Federal Judgeship Act of 1984 (“BAFJA”), Justice Souter addressed his apprehension in the dissenting opinion saying, “whether or not one believes (as the majority seemingly does not) that foreclosure sales rightfully belong within the historic domain of ‘fraudulent conveyance’ law, that is exactly where Congress has not put them, and our duty is to give effect to these new amendments along with every other clause of the Bankruptcy Code.” *BFP*, 114 S. Ct. at 1770 (citations omitted). See also Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 463(a), 98 Stat. 333, 378 (1984).

32. *BFP*, 114 S. Ct. at 1769 n.5 (discussing the impact of the Chandler Act and the 1978 Bankruptcy Amendments).

33. Discussing this paradox, Judge Schermer of the United States Bankruptcy Court for the Eastern District of Missouri argued that if § 548(a)(2) were extracted from § 548(a) and renamed “The Estate Preservation Provision,” the distinction between fraudulent transfers, prohibited under 548(a)(1), and

After the 1978 Bankruptcy Act, the courts divided over the application of fraudulent transfer law to foreclosure sales. The first case to apply fraudulent transfer law to foreclosure sales was *Durrett v. Washington National Insurance Co.*<sup>34</sup> In *Durrett*, a case brought under the 1978 version of the Code,<sup>35</sup> the Chapter XI debtor in possession petitioned the court to set aside or void a nonjudicial property foreclosure for 57.7 percent of the fair market value.<sup>36</sup> The Fifth Circuit Court of Appeals held that the foreclosure price paid did not constitute a "fair equivalent" for the transfer of the property.<sup>37</sup>

Courts interpreting *Durrett* have focused on the seventy percent dictum, rather than the whole opinion. The *Durrett* court noted that it was, "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."<sup>38</sup> Courts and mortgage lenders interpreted this language as a mandate of the "Seventy Percent Rule" or "*Durrett* Rule," which requires that mortgagees bid seventy percent of the fair market

transfers for less than reasonably equivalent value, prohibited under § 548(a)(2)(A), would be apparent. Interview with the Hon. Barry S. Schermer, United States Bankruptcy Judge, United States Bankruptcy Court for the Eastern District of Missouri, in St. Louis, Mo. (Oct. 31, 1994).

34. 460 F. Supp. 52 (Bankr. N.D. Tex. 1978), *aff'd*, 621 F.2d 201 (5th Cir. 1980).

In *BFP*, Justice Scalia commented on the novelty of the *Durrett* decision saying, "[f]raudulent transfer law and foreclosure law enjoyed over 400 years of peaceful coexistence in Anglo-American jurisprudence until the Fifth Circuit's unprecedented 1980 decision in *Durrett*." *BFP*, 114 S. Ct. at 1764.

35. The debtor claimed that the price paid was not "fair consideration" or a "fair equivalent" under section 67(d) of the 1978 Bankruptcy Act, 11 U.S.C. § 107(d) (1978). *Durrett*, 621 F.2d at 202. Section 67(d) provided, in relevant part:

(1) For the purposes of, and exclusively applicable to this subdivision: . . .

(e) consideration given for the property or obligation of a debtor is "fair"

(1) when, in good faith, in exchange and as a fair equivalent therefor, property is transferred

. . .

11 U.S.C. § 107(d) (1978), *cited in Durrett*, 621 F.2d at 202.

36. *Durrett*, 621 F.2d at 203. The fair market value of *Durrett's* property on January 4, 1977, the date of the foreclosure sale, was \$200,000. *Id.* *Durrett* had executed a note in the amount of \$180,000 on the property in 1969. *Id.* at 202. The balance owed to the mortgagee, Washington National Insurance Company, was \$119,278.38. *Durrett*, 460 F. Supp. 52, 53. The third party purchaser bid \$115,400 at the foreclosure sale. *Id.*

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

38. *Id.* This statement is criticized in subsequent case law because the *Durrett* court cited a single case as precedent for this bald assertion. *Id.* The case, *Schafer v. Hammond*, 456 F.2d 15 (10th Cir. 1972), involved a prepetition conveyance of assets from a debtor corporation to the mother of the principal stockholder of the debtor corporation. *Id.* at 16.

value.<sup>39</sup> Despite criticism that it “cast a cloud upon mortgages and deeds of trust” which would “inhibit a purchaser other than the mortgagee from buying at foreclosure . . . [and] depress further the prices of foreclosure sales,”<sup>40</sup> the *Durrett* Rule set the industry standard for foreclosure bidding in the Fifth Circuit until *BFP*.<sup>41</sup>

In 1984, the Ninth Circuit Court of Appeals rejected the *Durrett* Rule in *Madrid v. Lawyers Title Insurance Corp.*<sup>42</sup> The *Madrid* court set forth the “Irrebuttable Presumption Rule” or “*Madrid* Rule,” which presumes that, so long as the sale is noncollusive and regularly conducted, the foreclosure price constitutes “reasonably equivalent value.”<sup>43</sup> In *Madrid*, a Chapter 11

39. See, e.g., *In re Cole*, 81 B.R. 326, 331 (Bankr. E.D. Pa. 1988) (avoiding foreclosure sale yielding between 47.7 and 65.1% of the fair market value); *In re New Yorktown Assocs.*, 40 B.R. 701, 706-07 (Bankr. E.D. Pa. 1984) (avoiding forced sale of commercial realty with fair market value in excess of \$2 million for bid price of \$297,000); *In re Berge*, 33 B.R. 642, 649-50 (Bankr. W.D. Wis. 1983) (avoiding strict foreclosure of farm for 44.9% of the \$2,555,000.00 market value); *In re Wheeler*, 34 B.R. 818, 821 (Bankr. N.D. Ala. 1983) (avoiding forced sale of debtor's residence for 62.7% of fair market value); *In re Richardson*, 23 B.R. 434, 448-49 (Bankr. D. Utah 1982) (avoiding forced sale of debtor's residence for 21% of fair market value); *In re Ocean Dev. of America, Inc.*, 22 B.R. 834, 835-37 (Bankr. S.D. Fla. 1982) (avoiding fraudulent transfer on half-interest in Palm Beach mansion to debtor's girlfriend for 65% of the fair market value); *In re Coleman*, 21 B.R. 832, 834 (Bankr. S.D. Tex. 1982) (avoiding forced sale of debtor's residence for 28% of fair market value); *In re Thompson*, 18 B.R. 67, 70 (Bankr. E.D. Tenn. 1982) (upholding forced sale of debtor's residence for 80.8% of the fair market value).

40. Justice Clark penned this commonly cited critique in the dissenting opinion in *Abramson v. Lakewood Bank and Trust*, 647 F.2d 547, 549 (5th Cir. 1981). In *Abramson*, the Fifth Circuit employed the *Durrett* rationale and held that a nonjudicial foreclosure sale was a “transfer” within the Bankruptcy Code. Further, the court determined that a sale could be set aside as fraudulent if it was made without fair consideration. *Id.* at 547. Many subsequent foreclosure sale opinions and bankruptcy treatises have cited Justice Clark's famous “cloud” dissent:

By our decision here and in *Durrett* we cast a cloud upon mortgages and trust deeds. Foreclosure within twelve months before a filing creates a sale voidable by a trustee in bankruptcy if the public sale did not bring a “fair consideration” . . . . The cloud created over mortgages and trust deeds by making foreclosure sales subject to being voided by a bankruptcy trustee will naturally inhibit a purchaser other than the mortgagee from buying at foreclosure. This tends to depress further the prices of the foreclosure sales and thus increase the potential size of the deficiency in each foreclosure in all six states comprising this circuit.

It is interesting to me that *Durrett* is the first case treating this problem—after 90 years of bankruptcy law and mortgages of a time greater than the memory of man. It again establishes what an imaginative lawyer can do when he adds persuasion.

*Id.* at 550.

41. For a discussion of case law following *Durrett*, see *supra* note 39.

42. 10 B.R. 795 (Bankr. D. Nev. 1981), *rev'd*, 21 B.R. 424 (Bankr. 9th Cir. 1981), *aff'd*, 725 F.2d 1197 (9th Cir. 1984).

43. *Madrid*, 725 F.2d at 1199-1203. *Madrid* represents policy driven legal interpretation. In granting an irrebuttable presumption of validity to the price paid at a foreclosure sale, the Ninth Circuit Bankruptcy Appellate Panel explained:

We decline to follow *Durrett*'s 70% fair market value rule for the reason that a regularly

debtor sought to rescind a nonjudicial foreclosure sale of her beachfront property.<sup>44</sup> At the foreclosure sale, the bona fide purchaser bought the house for between sixty-four and sixty-seven percent of the fair market value.<sup>45</sup>

The court in *Madrid* never resolved whether the sale price constituted reasonably equivalent value.<sup>46</sup> Instead, the court held that because the foreclosure sale did not constitute a "transfer" under § 548(a), the court did not need to reach the issue of reasonably equivalent value.<sup>47</sup> Despite this holding, the Ninth Circuit addressed the debate surrounding "reasonably equivalent value" in dicta.

In *Madrid*, the majority of the Bankruptcy Appellate Panel rejected the *Durrett* court's reasoning,<sup>48</sup> fearing the adverse effect of such a rule on commercial and real estate law.<sup>49</sup> The majority criticized the *Durrett* Rule

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conducted sale open to all bidders and all creditors, is itself a safeguard against the evils of private transfers to relatives and favorites.

*Madrid*, 21 B.R. at 426-27.

44. *Id.* at 425.

45. *Id.* at 424, 429 n.3. The property's fair market value was estimated between \$380,000 and \$400,000. *Madrid*, 10 B.R. at 798. At the time of the January 9, 1981 foreclosure sale, the debtor owed \$175,000 on the first deed of trust and \$80,224.39 on the second deed of trust. *Id.* at 797. The third-party purchaser bought the property for \$256,000. *Id.*

46. *Madrid*, 725 F.2d at 1197.

47. *Id.* at 1199. The court concluded:

[T]he foreclosure sale was not a transfer under § 548(a), and [we] do not decide whether the amount paid at foreclosure was a reasonably equivalent value. . . . [T]he transfer of *Madrid*'s property interest under § 548(a)(2)(A) occurred at the time the second deed of trust was perfected under Nevada law. That transfer was carried out more than one year prior to filing of the bankruptcy petition. Thus, the transfer was not voidable as a § 548(a)(2)(A) fraudulent conveyance.

*Id.* This argument is erroneous. Prior to Congress' 1984 amendment to § 101, defining transfers to include involuntary dispositions, critics debated whether or not a foreclosure sale constituted a transfer. Alden, *supra* note 17, at 1608-13. Concluding that foreclosures were not transfers, the Ninth Circuit based its determination on the "One Transfer Rule." *Id.* at 1609 (citing *In re Also*, 14 B.R. 982 (Bankr. D. Alaska 1981)). The "One Transfer Rule" posits that the date of the foreclosure should relate back to the date of the underlying security interest. *In re Also*, 14 B.R. at 986. Thus, for purposes of § 548, there is only a single transfer of the property interest. So long as the mortgage agreement occurred outside the one year avoidance period, the foreclosure sale cannot be challenged. Steven M. Alden, et al., *Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the Durrett Problem*, 38 BUS. LAW 1605, 1608-13 (1983). See also Robert M. Zinman et al., *Fraudulent Transfers According to Alden, Gross and Borowitz: A Tale of Two Circuits*, 39 BUS. LAW 977 (1984).

However, following the *Madrid* decision, Congress amended the definition of transfer, clarifying its application to foreclosure, sales and implicitly rejecting the "One Transfer Rule." For a discussion of the 1984 amendments to the Bankruptcy Code, see *infra* notes 60-67 and accompanying text.

48. *Madrid*, 725 F.2d at 1202.

49. However, little or no empirical data has been collected to legitimize this "adverse effect." In fact, one commentator's empirical study concluded that although *Durrett* "was expected to wreck havoc

as inappropriately extending federal bankruptcy law into the domain of state foreclosure law. The court argued that *Durrett's* interpretation of § 548(a)(2)(A) created a de facto right of redemption.<sup>50</sup> The court reasoned that a federally-imposed right of redemption contravened state property law.<sup>51</sup>

Further, the *Madrid* court feared that such judicial innovation would “chill participation at foreclosure sales” and inhibit creditors from lending funds secured by a mortgage or deed of trust.<sup>52</sup> The *Madrid* majority endorsed an irrebuttable presumption of reasonably equivalent value when a judicial foreclosure sale is both noncollusive and complies with state law.<sup>53</sup> Numerous courts, as well as the real estate lending community, endorsed this policy.<sup>54</sup>

Just four months later, in *In re Hulm*,<sup>55</sup> the Eighth Circuit rejected the

on the mortgage credit markets . . . the anticipated harms did not materialize . . . .” Philip Schuchman, *Data On the Durrett Controversy*, 9 CARDOZO L. REV. 605, 607 (1987). Professor Schuchman studied the effects of the *Durrett* and *Madrid* decisions on national, Texas, and California mortgage interest rates and on total mortgage loans created between 1979 and 1985. *Id.*

50. *Madrid*, 725 F.2d at 1202. Judge Volinn’s dissent in the Ninth Circuit Bankruptcy Appellate Panel *Madrid* opinion refuted this criticism:

Section 548 transcends the dispute between this debtor and the secured creditor. It brings into focus the claims of the debtor’s other creditors that they have been deprived of recourse to an asset by an improvident sale. The majority would hold that despite the widespread differences in law and practices relating to foreclosure, no bankruptcy court may entertain the factual issue of whether, under § 548, the consideration paid was reasonably equivalent value. By concluding that a regularly conducted sale in absence of collusion satisfies the “reasonably equivalent value” test, the majority has excised vital language from § 548 in order to create an exception to the statute where a forced sale of the debtor’s property is involved. There is nothing in the Code nor its legislative history to suggest that such an exception was intended. . . . I would hold that the price paid at a regularly conducted foreclosure sale should be given, at best, a strong presumption of adequacy.

*Madrid*, 21 B.R. at 428.

51. *Madrid*, 725 F.2d at 1202.

52. *Id.*

53. *Id.* at 1203. Specifically, the court stated: “[W]e do not add to the arsenal of bankruptcy powers the right to avoid a nonjudicial, regularly conducted foreclosure sale of real property.” *Id.*

54. *See, e.g., In re Ehring*, 900 F.2d 184, 187 (9th Cir. 1990) (discussing the impact of the 1984 Bankruptcy Amendments and Federal Judgeship Act on the *Madrid* Rule); *In re Winshall Settlor’s Trust*, 758 F.2d 1136, 1138-40 (6th Cir. 1985) (refusing to set aside forced sale of commercial realty for 22 to 40% of the fair market value); *In re Kachanizadeh*, 108 B.R. 734, 738 (Bankr. C.D. Cal. 1989) (refusing to set aside forced sale of a debtor’s residence for 71% of the fair market value); *In re Verna*, 58 B.R. 246, 252 (Bankr. C.D. Cal. 1986) (refusing to set aside forced sale of a debtor’s residence for 44% of the fair market value); *In re Ristich*, 57 B.R. 568, 580 (Bankr. N.D. Ill. 1986) (refusing to set aside forced sale of undeveloped realty for 70.9% of the debtor’s equity); *In re Upham*, 48 B.R. 695, 697 n.1 (Bankr. W.D.N.Y. 1985) (refusing to set aside forced sale of a debtor’s residence for 71 to 78% of fair market value).

55. 738 F.2d 323 (8th Cir.), *cert. denied*, 469 U.S. 990 (1984).

*Madrid* court's assumption that a regularly conducted foreclosure sale automatically provided reasonably equivalent value.<sup>56</sup> In *Hulm*, the foreclosing mortgagee purchased the property, a single-family home, for \$64,443.64 and resold it nine months later for \$95,000.<sup>57</sup> Thus, the mortgagee deprived the bankruptcy estate and the unsecured creditors of \$30,556.36.<sup>58</sup> Criticizing the *Madrid* Rule as a policy determination which Congress alone should address, the court declared that an evidentiary hearing was necessary to determine reasonably equivalent value.<sup>59</sup>

Immediately following the *Hulm* decision, Congress debated the Bankruptcy Amendments and Federal Judgeship Act of 1984 ("BAFJA").<sup>60</sup> BAFJA proposed three changes to address the conflict between the circuits. First, it proposed amending the definition of transfer in § 101 of the Code to specifically include foreclosure sales.<sup>61</sup> By including foreclosure sales as voidable transfers within the purview of § 548,<sup>62</sup> Congress accepted *Durrett's* analysis of the "transfer" issue. Second, BAFJA proposed that Congress include the language "voluntarily or involuntarily" in § 548 to emphasize its applicability to foreclosure sales.<sup>63</sup> This would bring involuntary transfers within the TIB's avoidance

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56. 738 F.2d at 327. For an interesting discussion of the *Hulm* decision's impact on the development of fraudulent transfer law, see Frank W. Koger & Paula C. Acconcia, *The Hulm Decision: A Milestone for Creditors*, 91 COM. L. J. 301 (1986).

57. *In re Hulm*, 45 B.R. 523, 525-26 (Bankr. D.N.D. 1984).

58. *Id.* at 529. On remand, the United States Bankruptcy Court for the District of North Dakota ordered that the mortgagee, First Federal Savings & Loan, pay the trustee \$35,556.36, which represented "the value of the interest transferred which was not represented in the price bid in by First Federal." *Id.*

59. *Id.* at 327. In support of this assertion, the court explained:

We do not believe that the sale price at a regularly conducted foreclosure sale, although absent fraud or collusion, can automatically be deemed to provide a reasonably equivalent value in exchange for the interest of the debtor transferred within the meaning of section 548(a). . . .

We are aware of expressed concern that the result we have reached will affect the strategies of purchasers at judicial foreclosure sales. The Bankruptcy Code provisions are clear, however, and direct the result we have reached. Hence, policy considerations cannot affect the outcome in this case, but must be addressed, if at all, by Congress.

*Id.* (citations omitted).

60. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 463(a), 98 Stat. 333, 378 (1984). The Eighth Circuit decided *Hulm* on July 5, 1984. *Hulm*, 45 B.R. at 323. Congress enacted BAFJA on July 10, 1984, just five days later. For an excellent discussion of BAFJA, see *In re Verna*, 58 B.R. 246, 250-51 (Bankr. C.D. Cal. 1986).

61. Pub. L. No. 98-535; § 463(a), 98 Stat. 333, 378 (1984). For a discussion of the transfer issue, see *supra* note 47.

62. *Id.*

63. *Id.* For the current statutory text of § 548, see *supra* note 5.

power under § 548 and overrule *Madrid*. Ultimately, Congress codified both of these proposals in BAFJA.<sup>64</sup>

The third BAFJA proposal adopted the language of the *Madrid* Rule. The proposed amendment read, "A secured party or third party purchaser who obtains title to an interest of the debtor in property pursuant to a good faith prepetition foreclosure . . . takes for reasonably equivalent value."<sup>65</sup> However, Congress deleted this provision before enactment.<sup>66</sup> Congress refused to resolve the *Madrid/Durrett* problem,<sup>67</sup> leaving the issue open to further judicial interpretation.

In the same year, the National Conference of Commissioners on Uniform State Laws promulgated the Uniform Fraudulent Transfer Act ("UFTA")<sup>68</sup> to clarify, improve and replace the UFCA.<sup>69</sup> The UFTA adopted the language of § 548, which allowed parties to challenge and set aside transfers for less than reasonably equivalent value.<sup>70</sup> However, the Commissioners also incorporated the *Madrid* Rule into the UFTA definition

64. Pub. L. No. 98-353, § 463(a), 98 Stat. 333, 378 (1984).

65. S. 445, 98th Cong., 1st Sess., § 360(c) (1983) (proposing the inclusion of this amendment in § 548(d)(2)). See also *Verna*, 58 B.R. at 250.

66. However, the provision was not deleted before a lengthy debate. In 1984, Senators Robert Dole (R. Kan.) and Dennis DeConcini (R. Ariz.) "inserted into the Congressional Record a scripted colloquy . . . in which Senator Dole reported that the statute was amended 'to delete . . . all provisions dealing with the Durrett issue.'" *Verna*, 58 B.R. at 250. In this colloquy, Senator Dole stated,

Consequently, no provision of the bankruptcy bill as passed by the this body was intended to intimate any view one way or the other regarding the correctness of the position taken by the U.S. Court of Appeals for the Fifth Circuit in the *Durrett* case, or regarding the correctness of the position taken by the U.S. Court of Appeals for the Ninth Circuit in *Lawyer's Title Insurance Co. v. Madrid*, which reached a contrary result.

*Id.* (citing 130 CONG. REC. S13771-72 (daily ed. Oct. 5, 1984) (statement of Sen. Dole)) (citations omitted). Senator DeConcini questioned. "Then I am correct in concluding that parties in bankruptcy proceedings who seek avoidance of pre-petition foreclosure sales would find no support for their arguments in these amendments?" *Id.* at 13772 (statement of Sen. DeConcini). Senator Dole responded, "The Senator's conclusion is correct." *Id.* (statement of Sen. Dole).

In *BFP*, the dissent also emphasized Congress' inaction, noting that "Congress considered, but did not enact, an amendment that said precisely what the majority now says the current provision means." *BFP*, 114 S. Ct. at 1767.

67. 130 CONG. REC. S13771-72 (daily ed. Oct. 5, 1984).

68. UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 643 (1985) [hereinafter UFTA].

69. Carey, *supra* note 26, at 693-94. In his 1994 study of the UFCA and the UFTA, Carey found that 29 states had adopted variations of the UFTA, while nine states still retain the UFCA. *Id.* For a discussion of the UFCA's initial adoption, see *supra* notes 25-27 and accompanying text.

70. UFTA § 4 provides that "(a) A transfer made . . . by a debtor is fraudulent as to a creditor . . . if the debtor made the transfer . . . (2) without receiving reasonably equivalent value[.]" U.F.T.A., *supra* note 68, at 652-53.

of value.<sup>71</sup> This definition precludes state law challenges to prepetition foreclosure sales.<sup>72</sup>

Despite contrary UFTA amendments, the Seventh Circuit endorsed the use of fraudulent conveyance law to set aside a forced sale.<sup>73</sup> In 1988, in *Bundles v. Baker*,<sup>74</sup> the Seventh Circuit adopted a case-by-case analysis looking at the "totality of the circumstances."<sup>75</sup> In *Bundles*, the debtor-appellant sought to set aside<sup>76</sup> foreclosure of his residence.<sup>77</sup> The property, valued at \$15,500, was sold for \$5,066.80, barely covering the balance of the mortgage.<sup>78</sup> After refuting both *Madrid* and *Durrett*, the court adopted a middle ground approach, setting aside the foreclosure sale.<sup>79</sup> The Seventh Circuit required that the bankruptcy court examine the

71. In fact, the language of the UFTA is more expansive than that of the *Madrid* court. UFTA § 3(b) defines "value" as:

(b) For purposes of Sections 4(a)(2) and 5 [the fraudulent transfer provisions], a person gives a reasonable 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 for the acquisition or disposition of the interest of the debtor upon default under a mortgage, deed of trust, or security agreement.

U.F.T.A., *supra* note 68, § 3(a), at 650. The *Madrid* Rule involved a third-party purchaser at a judicial foreclosure sale. *Madrid* 21 B.R. at 426. The UFTA uses "person" broadly, granting mortgagees as well as third-party purchasers an irrebuttable presumption of adequate value. U.F.T.A., *supra* note 68, § 3(a), at 650. Further, the UFTA extends this presumption to involuntary transfers by means of the non-judicial power of sale agreements and Article 9 security interests. *Id.* § 3(b). Thus, the UFTA protects more transactions from challenge under state fraudulent transfer law.

72. *Id.*

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

74. *Id.*

75. *Id.* at 824. Many other courts have utilized variations of the case-by-case analysis. *See, e.g., In re Littleton*, 888 F.2d 90, 92-94 (11th Cir. 1989) (refusing to set aside nonjudicial foreclosure sale of debtor's residence that realized 63.49% of the fair market value); *In re Bates*, 32 B.R. 40 (Bankr. E.D. Cal. 1983) (avoiding forced sale of debtor's residence for 5 percent of fair market value); *In re Richard*, 26 B.R. 560 (Bankr. D.R.I. 1983) (avoiding forced sale of debtor's residence for less than one percent of debtor's equity).

76. Under § 522(h), a debtor may file a motion asking the court to set aside the foreclosure. Section 522(h) provides:

(h) The debtor may avoid a transfer of property of the debtor or recover a setoff to the extent that the debtor could have exempted such property under subsection (g)(1) of this section if the trustee had avoided such transfer, if—

(1) such transfer is avoidable by the trustee under section 544, 545, 547, 548, 549, or 724(a) of this title or recoverable by the trustee under section 553 of this title; and  
(2) the trustee does not attempt to avoid such transfer.

11 U.S.C. § 522(h) (1994).

77. *Bundles*, 856 F.2d at 817.

78. *Id.*

79. *Id.* at 824.

“foreclosure transaction in its totality”<sup>80</sup> by focusing on the property’s fair market value and determining how the foreclosure affected this value.<sup>81</sup>

The Seventh Circuit admonished the district court for using the actual intent to defraud requirement.<sup>82</sup> The court noted that the focus in bankruptcy law has shifted from subjective intent to objective results.<sup>83</sup> Further, the *Bundles* court found that § 548, “makes no distinction between sales that do and sales that do not comply with state law. If we take the statute at face value, we must conclude that its unambiguous language requires the reviewing court to make an independent assessment of whether reasonable equivalence was given.”<sup>84</sup> The *Bundles* court declined to consider the policy implications of its holding.<sup>85</sup> The court concluded that Congress, not the judiciary, is the proper forum for changing bankruptcy laws.<sup>86</sup> The *Bundles* court contended that granting an irrebuttable presumption of reasonableness improperly engrafted a good faith requirement onto § 548(a)(2)(A).<sup>87</sup> The *Bundles* court also found that the *Madrid* Rule “renders section 548(a)(2) merely duplicative of other Code provisions.”<sup>88</sup>

Finally, several courts have applied a “commercial reasonableness” standard in adjudicating fraudulent transfer challenges under § 548.<sup>89</sup> The United States Bankruptcy Court for the District of Massachusetts adopted this novel standard in *In re General Industries, Inc.*<sup>90</sup> In *General Indus-*

80. The court considered many factors, including:

whether the [foreclosure] procedures were calculated not only to secure for the mortgagee the value of its interest but also to return the debtor-mortgagor his equity in the property. . . . whether there was a fair appraisal of the property, whether the property was advertised widely, and whether competitive bidding was encouraged.

856 F.2d at 824.

81. *Id.*

82. *Id.* at 823.

83. *Id.* at 818.

84. *Id.* at 821.

85. *Id.* at 823.

86. The court noted:

[i]t is beyond our scope of review to consider the policy implications of permitting the debtor to set aside the foreclosure of his home. Any change deemed desirable on policy grounds should be addressed to Congress rather than this court. Our duty is to simply interpret the language of the statute.

*Id.*

87. *Id.*

88. *Id.*

89. See, e.g., *In re Lindsay*, 98 B.R. 983, 992-93 (Bankr. S.D. Cal. 1989) (setting aside a deed of trust foreclosure sale under commercial reasonableness standard); *In re General Industries, Inc.*, 79 B.R. 124, 134 (Bankr. D. Mass. 1987) (holding that a sale price constituting only 53% of the property’s value did not establish a “reasonably equivalent value”).

90. 79 B.R. 124 (Bankr. D. Mass. 1987).

tries, the Chapter 11 Creditor's Committee brought an action to set aside a real property prepetition foreclosure for fifty-three percent of the fair market value.<sup>91</sup> The court examined Massachusetts state foreclosure procedures and concluded that they were "inherently ineffective in producing equivalent value."<sup>92</sup> Thus, the court found the *Madrid* Rule inappropriate because it shielded all foreclosure sales from fraudulent transfer attack.<sup>93</sup> The court also rejected the *Durrett* Rule because it improperly equated value with sale price, rather than focusing on whether the sale process was conducted in a commercially reasonable manner.<sup>94</sup> In adopting the commercial reasonableness standard, the court emphasized the reasonableness of the "sales efforts made rather than the price achieved."<sup>95</sup>

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91. 79 B.R. at 127, 129. In *General Industries*, the real property was a manufacturing plant with a fair market value of \$90,000. *Id.* at 129. The mortgagee bid the amount of the mortgage, plus taxes—a sum of \$36,952.16. *Id.* at 127. The mortgagee asserted that the possibility of environmental damage should be considered when determining the value of the property. *Id.* However, the court refused to speculate on such damages. *Id.*

In addition to the real property issue, the court in *General Industries* considered what constitutes reasonably equivalent value for personal property under Article 9 of the Uniform Commercial Code. In *General Industries*, the Creditor's Committee objected to the foreclosure of business equipment, valued at \$20,000, for \$5,000—only 25% of the fair market value. *Id.* at 127. The court applied the commercial reasonableness standard set forth in U.C.C. § 9-504(3) and concluded that the transfer had not yielded a reasonably equivalent value. *Id.* at 131, 134.

92. *Id.* at 132. Emphasizing the lackluster statutory notice requirements under state foreclosure law, the court stated "the Massachusetts procedural requirements for real estate foreclosure are too minimal to control the question of reasonably equivalent value under § 548." *Id.*

93. *Id.* at 131. The court identified three prongs to the *Madrid* argument: (1) that fraudulent transfer law is intended to address debtor's conduct; (2) that state foreclosure procedures provide debtors and creditors with ample protection; and (3) that set aside will chill the foreclosure and mortgage lending markets. *Id.* The court critiqued this three-pronged argument:

All of these arguments have a common flaw: they assume that state foreclosure procedures are designed to attract bidders and to bring the highest price possible under the circumstances for real property. Quite often the opposite is true. Most state real estate foreclosure laws require little in the way of advertising or other promotional efforts, regardless of whether or not sales are judicially supervised.

*Id.* at 131-32.

94. *Id.* at 130-31.

95. See also *In re Lindsay*, 98 B.R. 983 (Bankr. S.D. Cal. 1989). In *Lindsay*, the United States Bankruptcy Court for the Southern District of California adopted the *General Industries* commercial reasonableness standard. *Id.* *Lindsay* involved a fraudulent transfer attack upon a Texas real estate foreclosure for 64% of the fair market value. *Id.* at 992. Finding ambiguity in Ninth Circuit law, the court adopted a commercial reasonableness standard that "examine[s] the price obtained at a foreclosure sale only when we are persuaded that the foreclosing creditor failed to take commercially reasonable efforts to achieve the best price." *Id.* at 990. The court utilized a three part inquiry:

(1) whether the foreclosure sale was properly conducted; (2) whether the totality of the circumstance indicate that commercially reasonable steps were taken to achieve the best price at the foreclosure; and (3) whether a lack of commercial reasonableness had a negative effect of the price achieved.

### III. BFP AND THE IRREBUTTABLE PRESUMPTION RULE

#### A. BFP v. Resolution Trust Corp.

In 1994, in *BFP v. Resolution Trust Corp.*,<sup>96</sup> the Supreme Court rejected the use of fraudulent conveyance law to set aside a foreclosure sale.<sup>97</sup> The Court adopted the Ninth Circuit's reasoning in *Madrid*.<sup>98</sup> In *BFP*, the Chapter 11 debtor<sup>99</sup> petitioned the United States Bankruptcy Court for the Central District of California to set aside a prepetition foreclosure sale of a beachfront estate.<sup>100</sup> The property, worth in excess of \$725,000, was sold at a nonjudicial foreclosure sale to a third-party purchaser<sup>101</sup> for \$433,000, or approximately sixty percent of the fair market value.<sup>102</sup> The Court<sup>103</sup> concluded that the price received at a noncollusive, regularly conducted foreclosure sale irrefutably constitutes

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*Id.* *Lindsay* sets forth the backdrop for the Ninth Circuit's *BFP* opinion.

96. 114 S. Ct. 1757 (1994).

97. *Id.* Compare Kenneth M. Block & Jeffrey B. Steiner, *Ending The Threat Of "Durrett:" BFP Settles Application Of Fraudulent Transfer To Foreclosures*, N.Y.L.J., July 20, 1994, at 5 (arguing that *BFP* settles the dispute over the use of fraudulent conveyance law) with Johnny L. Woodruff, *Certiorari to In re BFP: The Eve of Decision to a Dozen Years of Durrett Conflict—Will Resolution of the Issue Solve the Real Problem?*, 24 MEM. ST. U. L. REV. 773 (1994) (arguing that because reform of the state foreclosure process is necessary to resolve the *Durrett* conflict any decision by the Supreme Court will be irrelevant).

98. For a discussion of the *Madrid* Rule, see *supra* notes 42-54 and accompanying text.

99. The debtor in *BFP* was a three-member partnership formed for the purpose of purchasing the Newport Beach property. *BFP*, 114 S. Ct. at 1759. The partnership, comprised of Wayne and Marlene Pedersen and Russell Barton, arranged with the subsequent owners, the Foremans, to purchase the home for \$356,250, plus some rare coins. *BFP v. Imperial Sav. & Loan Ass'n*, 974 F.2d 1144, 1145 (9th Cir. 1992). The Pedersens granted Barton an 180 day option to purchase the home in exchange for Barton's promise pay the Pedersens 25% of the profits from resale. *Id.* This peculiar arrangement was riddled with well-founded allegations of fraud. The Pedersens, under investigation for fraudulent sales of rare coins, conveyed the property twice, once to the partnership and again to an entity called "Off Road Vehicles—Recreation and Family Campground." *Id.* Ultimately, these actions lead to a quiet title judgment in favor of the Foremans. *Id.* at 1145-46. However, because the Ninth Circuit held that *BFP* "did indeed have a property interest in the Foreman home at the time of Imperial's foreclosure sale," the court found *BFP* the proper party to challenge the sale. *Id.* at 1147-48.

100. *BFP*, 114 S. Ct. at 1759.

101. The bankruptcy court determined that the third-party purchaser, Osborne, was a bona fide purchaser for value, without notice. *Id.*

102. *Id.*

103. Justice Scalia wrote for the majority, which consisted of Justices Rehnquist, O'Connor, Kennedy, and Thomas. *Id.* Justice Souter wrote the dissenting opinion, joined by Justices Blackmun, Stevens and Ginsberg. *Id.* at 1767.

reasonably equivalent value.<sup>104</sup>

The Court could not locate a clear definition of “reasonably equivalent value” within the Code and therefore, deferred to state law.<sup>105</sup> The majority considered three possible interpretations of “reasonably equivalent value”: fair market value, reasonable forced-sale price, and foreclosure sale price.<sup>106</sup> Ultimately, the Court defined “reasonably equivalent value” as the price actually received at the foreclosure sale.<sup>107</sup> The Court reasoned that a per se validity rule avoids judicial interference with state regulation and inappropriate judicial policy determinations.<sup>108</sup> Further, the Court determined that granting an irrebuttable presumption prevents judicial disruption of stable and secure real property titles.<sup>109</sup>

The Court rejected fair market value because it “has no applicability in the forced sale context.”<sup>110</sup> It further asserted that fair market value cannot be the standard in the foreclosure sale context because of the “strictures of state-prescribed foreclosure.”<sup>111</sup> The Court also rejected the reasonable foreclosure sale price proffered in *Bundles*, because defining “reasonable” would require policy judgments that would inappropriately extend federal bankruptcy law into an area of state regulation.<sup>112</sup>

Finally, the Court suggested that its holding did not render § 548 superfluous.<sup>113</sup> The majority asserted that reasonably equivalent value “will continue to have independent meaning (*ordinarily a meaning similar to fair market value*) outside the foreclosure context.”<sup>114</sup> The Court explained that its interpretation of reasonably equivalent value only applies to real estate foreclosures, indicating that “considerations bearing upon other foreclosures and forced sales (to satisfy tax liens, for example) may be different.”<sup>115</sup> The Court asserted that such a legal interpretation did not create two different and inconsistent meanings or carve out a foreclosure

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104. 114 S. Ct. at 1765.

105. *Id.* at 1766.

106. *Id.*

107. *Id.* at 1767. The Court emphasized that “[a]ny irregularity . . . that would permit judicial invalidation of the sale under applicable state law deprives the sale price of its conclusive force under § 548(a)(2)(A).” *Id.* at 1765.

108. *Id.* at 1761-62.

109. *Id.* at 1758.

110. *Id.* at 1761.

111. *Id.* at 1762.

112. *Id.*

113. *Id.*

114. *Id.* at 1765 (emphasis added).

115. *Id.* at 1761 n.3.

sale exception to § 548.<sup>116</sup> The Court reasoned that the real estate foreclosure construct has “altered reality,” replacing the rules of free-market exchange with more restrictive rules governing state foreclosure sales.<sup>117</sup>

### B. Analysis

The majority’s logic alters reality. The Court asserts that it is not creating a real estate foreclosure sale exception, but that is exactly what it has done. Creating a distinct legal interpretation of “reasonably equivalent value” in the foreclosure context is judicial innovation at its worst.<sup>118</sup> *BFP*’s holding creates a “foreclosure-sale exemption” to the trustee’s avoidance powers in derogation of congressional intent.<sup>119</sup> Further, *BFP* renders § 548(a)(2)(A) superfluous and restricts the bankruptcy courts’ review to a checklist of state foreclosure procedure.<sup>120</sup>

Furthermore, the Court uses circular logic. First, the Court determined that state foreclosure processes do not yield fair market value and therefore, bankruptcy courts should just defer to such inadequacy.<sup>121</sup> Second, the Court implies that because § 548 interferes with state property law, this provision should be excised from the Code. Third, the Court found that § 548 interferes with secure title to real property and thus, determined that

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116. 114 S. Ct. at 1767.

117. *Id.*

118. *Id.* at 1771 (citing *Bray v. Alexandria Women’s Health Clinic*, 113 S. Ct. 753, 765 (1993)). The dissent notes the “common rule of construction calls for a single definition of a common term occurring in several places within a statute.” *Id.* Appalled by the majority’s novel statutory interpretation, Justice Souter declared that “to give a single term two different and inconsistent meanings (one procedural, one substantive) for a single occurrence is an offense so unlikely that no common prohibition has ever been thought necessary to guard against it.” *Id.*

119. For a discussion of § 548’s development, see *supra* notes 22-33, 60-67 and accompanying text.

120. The United States Bankruptcy Court for the Eastern District of New York recently applied *BFP* in *In re Barr*, 170 B.R. 772 (Bankr. E.D.N.Y. 1994). In *Barr*, a foreclosing lender purchased land worth approximately \$156,000 for a bid of approximately \$72,000, including assumed mortgages. *Id.* at 773-74. The court did not analyze the sale pursuant to § 548. Instead, citing *BFP*, the court reasoned that “the disposition of the case depends on whether the foreclosure sale sub judice was accordant procedurally and substantively with applicable South Carolina state foreclosure law.” *Id.* at 776. The Bankruptcy Court concluded that under South Carolina law, “inadequacy of price was not ‘so gross as to shock the conscience.’” *Id.* at 777 (citation omitted).

*Barr* exemplifies *BFP*’s impact on § 548. If the debtor had brought a state court action, the court’s analysis would not differ. *BFP* completely guts § 548(a)(2)(A). The courts are now powerless to review cases such as *Barr*.

Furthermore, the state standard of price inadequacy—“so gross as to shock the conscience”—is not even analogous to the concept of reasonably equivalent value. See *supra* note 20. Equating the two is absurd.

121. *BFP*, 114 S. Ct. at 1765-66.

it should not be applied to real property transfers.<sup>122</sup>

Having identified tensions between bankruptcy and state law, the Court errs by following state law without any deference to federal policy or the Code's straightforward import. In carving out an exception for real property foreclosures, the majority suggests that "the 'important' policy favoring security of title should count more and the 'important' bankruptcy policies should count less."<sup>123</sup> This rationale is illogical and unprecedented. The majority circumvents the statute's straightforward language<sup>124</sup> to the benefit of the mortgage lending community and the real estate bar.

The majority criticizes the use of fraudulent conveyance law in the foreclosure sale context as a radical interference with state regulation.<sup>125</sup> However, such interference is not uncommon or inappropriate.<sup>126</sup> For example, the Code commonly interferes with state regulation of tort law and criminal restitution.<sup>127</sup> Similarly, the Code permits the TIB to set aside transfers consummated within ninety days of filing as preferential transfers.<sup>128</sup> Yet, the Court has not carved out an exception for preferential transfers. Interference with state interests constitutes an essential component of the bankruptcy system—allowing the TIB to recapture improvidently transferred assets for the benefit of the estate.<sup>129</sup>

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122. 114 S. Ct. at 1758.

123. *Id.* at 1777 (Souter, J., dissenting opinion).

124. *Id.* at 1766-67. In fact, Justice Scalia interprets "reasonably equivalent value" as ambiguous language. *Id.* at 1766. However, Scalia engrafts policy issues upon the statute before analyzing the language. He argues that the "highly generalized reformulation of the 'plain meaning' of reasonably equivalent value" continues to leave unanswered the one question central to this case, wherein the ambiguity lies: *What is the foreclosed property worth?*" *Id.* (emphasis added). Scalia recognizes that fair market value is the widely accepted benchmark for determining reasonably equivalent value, but he refuses to apply it to real property foreclosures. Under § 548, it is clear that the value of foreclosed property equals fair market value. Scalia's argument constitutes artful dodging rather than sound legal reasoning.

125. *Id.* at 1766-67.

126. The dissent indicates that "[the Court has], on many prior occasions, refused to depart from plain Code meaning in spite of arguments that doing so would vindicate . . . equally 'important' state interests." *Id.* at 1776 (citations omitted).

127. See, e.g., *In re Hartley*, 869 F.2d 394, 395 (8th Cir. 1989) (discharging debtor's state law intentional tort judgment); Pa. Dept. of Pub. Welfare v. Davenport, 495 U.S. 552, 564 (discharging Chapter 13 debtor's criminal restitution for welfare fraud); see also *BFP*, 114 S. Ct. at 1777 (Souter, J., dissenting) (noting how federal bankruptcy law already preempts state domestic relations law by allowing TIBs to set aside transfers by marital dissolution decree).

128. Under § 547 of the Code, the TIB may avoid preferential transfers incurred by the debtor within 90 days of her bankruptcy filing. 11 U.S.C. § 547(b)(4)(A) (1993). For a discussion of the TIB avoidance powers, see *supra* note 10.

129. For a discussion of the TIB avoidance powers, see *supra* note 10.

The *BFP* decision shifts the emphasis away from preservation of the bankruptcy estate, and forces rigid adherence to state foreclosure law, which is outdated, ineffective and overly formalistic.<sup>130</sup> *BFP* equates reasonably equivalent value with state fraudulent conveyance standards, which require only that the price be "so gross as to shock the conscience."<sup>131</sup> It is absurd to equate these standards.

Blind deference to state procedure prevents equal distribution of the estate as mandated by the Code.<sup>132</sup> By granting procedural compliance per se validity, the Court engrafts a good faith presumption upon the foreclosing mortgagee in direct opposition to the purpose of § 548.<sup>133</sup> *BFP* deprives the bankruptcy estate, junior lienors, and unsecured creditors of the value of the foreclosed property and effectively legalizes constructively fraudulent transfers.

#### IV. PROPOSALS

The judicial legalization of constructively fraudulent conveyances is a victory for the mortgage lending community. Although bothered by the absence of "clearer textual guidance" on what constitutes reasonably equivalent value, the *BFP* Court crafted a foreclosure sale exception supported solely by policy arguments.<sup>134</sup> Nothing in § 548(a) or its legislative history supports the outcome in *BFP*.<sup>135</sup> Nor does the Code require compliance with state law.<sup>136</sup> In fact, Congress explicitly rejected the irrebuttable presumption rule during the 1984 BAFJA debates.<sup>137</sup> The *BFP* dissent aptly noted that "Congress, and not this Court, is the

130. For a discussion of the structural inadequacies of state foreclosure law, see *supra* note 18.

131. *BFP*, 114 S. Ct. at 1775 n.16 (citations omitted). The majority discusses "black letter" state foreclosure law, stating:

When these [state] procedures have been followed, however, it is "black letter" law that mere inadequacy of the foreclosure price is no basis for setting the sale aside, though it may be set aside (under state foreclosure law, rather than fraudulent transfer law) if the price is so low as to "shock the conscience or raise a presumption of fraud or unfairness."

*Id.* at 1763-64 (citations omitted).

132. For a discussion of the bankruptcy goal of equitable distribution, see *supra* note 7.

133. For a discussion of the removal of the good faith requirement, see *supra* note 29 and accompanying text.

134. *BFP*, 114 S. Ct. at 1764.

135. For the text of § 548(a), see *supra* note 5. For a discussion of § 548's legislative history, see *supra* notes 22-33, 60-67 and accompanying text.

136. See *Bundles v. Baker*, 856 F.2d at 821.

137. For a discussion of the impact of BAFJA on the *Durrett/Madrid* conflict, see *supra* notes 61-68 and accompanying text.

appropriate body” to make such policy determinations.<sup>138</sup>

Application of *BFP* clarifies the need for a legislative response to this statutory derogation. Suppose you are counsel representing a junior lienor, Second National Bank (“SNB”), on the commercial real estate discussed at the outset of this Note. The fair market value of the property is one million dollars. SNB holds a \$50,000 second mortgage on the property. ONB is foreclosing the first mortgage of \$500,000 in a judicial sale conducted under state law.

At the properly conducted public sale, ONB is the high bidder and purchases the property for \$500,000. The sale discharges all subsequent liens including SNB’s second mortgage. One month later, ONB resells the asset under commercially reasonable terms for one million dollars and captures \$500,000 of the debtor’s equity. May SNB challenge the adequacy of the sale?

Under *BFP*, so long as ONB complies with state law governing the foreclosure procedure, SNB is powerless to upset the sale.<sup>139</sup> *BFP* renders bankruptcy courts powerless to review the sale process and equates reasonably equivalent value with the price actually received. Ultimately, ONB pockets \$500,000 of equity as a windfall, and SNB, as well as the estate, receives nothing.

To prevent such estate depletions, Congress should amend § 548 to allow bankruptcy courts to review foreclosure sale transfers. Congress should create a definition of reasonably equivalent value that establishes fair market value as the benchmark, without designating a percentile cut-off, as in *Durrett*.<sup>140</sup>

In order to apply this definition of reasonably equivalent value, Congress

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138. *BFP*, 114 S. Ct. at 1777.

139. Conceivably, SNB could bring a state action. However, under state law, price inadequacy alone is not sufficient to void a sale. Absent other factors, SNB would not prevail. *See supra* note 18 (setting forth the state avoidance standards).

140. *Durrett v. Washington Nat’l Ins. Co.*, 621 F.2d 203 (5th Cir. 1980). *See also* William H. Henning, *An Analysis of Durrett and Its Impact on Real and Personal Property Foreclosures: Some Proposed Modifications*, 63 N.C. L. REV. 257 (1985). Written immediately after *Madrid* and *BAFJA*, Professor Henning’s proposal stands alone in its support of *Durrett*. Henning encourages parties to use fraudulent conveyance law to set aside inadequate real property foreclosure sales. *Id.* at 284-85. However, Henning opposes the 70% benchmark. *Id.* at 285. Henning proposes significant limitations on *Durrett*’s application, such as: a three month rather than the one year avoidance period; a nine month statute of limitations; limited monetary rewards; a provision protecting good faith purchasers of residential property; and a prohibition on the recovery of collateral from parties other than the secured lender. *Id.*

should include a provision incorporating the *Bundles* case-by-case rule.<sup>141</sup> The rule should require bankruptcy courts to conduct evidentiary hearings on prepetition foreclosures when a transfer deprives the bankruptcy estate of the approximate fair market value.

Incorporating the rationale of *General Industries*,<sup>142</sup> courts should measure such deprivation by analyzing the sale process and the diminution of the debtor's equity. The fact-specific test for reasonably equivalent value should be whether or not the foreclosing lender took commercially reasonable<sup>143</sup> steps to preserve the debtor's equity in the property.

Alternatively, courts should narrowly construe *BFP*. *BFP* should only apply where there is a third party purchaser or a bona fide purchaser for value. Where the foreclosing lender is also the purchaser, there should be a higher level of judicial scrutiny. At most, foreclosing lenders should be given a rebuttable presumption of reasonably equivalent value.<sup>144</sup>

Finally, *BFP* should be limited to real estate foreclosures.<sup>145</sup> Courts

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141. *Bundles*, 856 F.2d at 824. See also *supra* notes 73-88 and accompanying text (discussing *Bundles*).

142. See *supra* notes 90-95 and accompanying text (discussing the commercial reasonableness standard).

143. Section 9-504(3) of the Uniform Commercial Code ("UCC") requires that a secured party dispose of collateral in a "commercially reasonable" manner. U.C.C. § 9-504(3) (1993). However, the UCC does not define "commercially reasonable," acknowledging that such an issue is fact specific. *Id.* at § 9-504(3) (c. 1).

144. *Alden*, *supra* note 47, at 1624. In his analysis of *Durrett*, Alden concluded: "In order to harmonize the distinct policies underlying foreclosure and fraudulent conveyance laws, the courts should consider awarding an irrebuttable presumption of reasonably equivalent value to a third-party purchaser while granting no more than a rebuttable presumption to the mortgagee which bids in its debt." *Id.*

145. Despite the argument that bankruptcy law should not interfere with the Uniform Commercial Code, many courts have applied the § 548 analysis to foreclosures of personal property under U.C.C. § 9-504. See *Covey v. Commercial Nat'l Bank*, 960 F.2d 657, 663 (7th Cir. 1992) (rejecting a Chapter 7 TIB's § 548(a)(2) challenge to the fraudulent conveyance of a collections guarantee); *In re Jeffrey Bigelow Design Group*, 956 F.2d 479, 485 (4th Cir. 1992) (applying a depletion-of-the-estate test to payments fraudulently conveyed under a line of credit); *In re Morris Communications*, 914 F.2d 458, 424-45 (4th Cir. 1990) (challenging allegedly fraudulent transfer of stock in partnership); *In re Roco Corp.*, 701 F.2d 978, 984-85 (1st Cir. 1983) (challenging redemption of corporate stock and note given as a security interest in a constructively fraudulent conveyance); *In re Royal Coach Country*, 125 B.R. 668, 674 (Bankr. M.D. Fla. 1991) (setting aside foreclosure of a used car for less than reasonably equivalent value, which the court equated with fair market value in the used car market); *In re Corp. Jet Aviation*, 57 B.R. 195, 197 (Bankr. N.D. Ga. 1986) (rejecting application of *Durrett* in stock sale); *In re Join-in Int'l*, 56 B.R. 555, 560 (Bankr. S.D.N.Y. 1986) (applying a reasonableness test to the bulk transfer of inventory challenged as a fraudulent conveyance).

Similar policy arguments can be made for the application of *BFP* to personal property sales under Article Nine of the UCC. Henning, *supra* note 140, at 278. However, the majority specifically limits *BFP* to real property foreclosures. *BFP*, 114 S. Ct. at 1765. See also *supra* note 112 and accompanying text. One court followed this limiting language. *In re Pajaro Dunes Rental Agency*, 1994 WL 575445

applying a per se validity rule to the foreclosure of personal property would further derogate congressional intent by creating another judicial exception where no statutory distinction exists. Under § 548 courts should continue to review personal property foreclosures that fail to yield reasonably equivalent value.<sup>146</sup>

Under the first proposed amendment, the junior lienor in our hypothetical, SNB, could challenge the adequacy of the foreclosure sale. The bankruptcy court would conduct an evidentiary hearing to determine whether the parties conducted the sale in a commercially reasonable manner. If the court determines the sale was not commercially reasonable, ONB would be forced to reconduct the foreclosure sale, obtain a sale price reasonably equivalent to the fair market value, and allow the bankruptcy estate to recapture the surplus equity.

Under the second proposal, a narrow interpretation of *BFP*, SNB could still challenge the sale's adequacy because ONB is the foreclosing lender and the purchaser. The court would only grant a rebuttable presumption of equivalent value. Thus, ONB would have the burden of proving the sale was commercially reasonable.

However, the second proposal does not rectify price inadequacies when a bona fide third party purchases the property. Further, administering the implementation of a narrow judicial interpretation would be much more difficult. For these reasons, a congressional amendment is the best solution to the *BFP* problem.

The proposed amendments provide the bankruptcy court with flexibility to determine when circumstances require review of state procedures. Not

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(Bankr. N.D. Cal. 1994). In *Pajaro Dunes*, the United States Bankruptcy Court for the Northern District of California refused to apply *BFP* to a Chapter 11 debtor's challenge to the satisfaction of a \$1 million note for \$541,895.55. *Id.* at 30. The court recognized that "neither the majority nor the dissent [in *BFP*] outlined any benchmarks . . . as to what [reasonably equivalent value] should normally be." *Id.* at 30. However, the court concluded that it need not choose between the *Durrett* Rule or the *Bundles* Rule because under either rule "PDRA's receipt of \$541,895.55 in value in return for its one million dollar obligation . . . would not be held as reasonably equivalent." *Id.*

*Pajaro Dunes* exemplifies the inconsistencies in *BFP*. Why should courts scrutinize real property foreclosures less stringently than personalty foreclosures? Why is reasonably equivalent value not applicable inside the foreclosure context? The majority fails to answer these questions.

146. One commentator argues that because "personal property sold in a commercially reasonable manner obtains reasonably equivalent value with no more certainty than real property sold in accordance with state foreclosure laws, sales pursuant to U.C.C. section 9-504 should be no less subject to scrutiny under section 548 of the Bankruptcy Code." Alden, *supra* note 47, at 1624.

all state foreclosure statutes are inadequate.<sup>147</sup> Not all sales necessitate review. However, when state law is particularly deficient, judicial intervention by the federal bankruptcy courts is appropriate.

Further, given the diverse nature of real property, the case-by-case evidentiary review is essential. In order to determine whether the procedure was commercially reasonable, the courts must examine the unique characteristics of the collateral. Courts should consider factors such as use, location, and surrounding market. Additionally, an evidentiary hearing is necessary to preserve the assets of the estate.

The proposed amendments to § 548 rectify state law inadequacies where necessary. Section 548's purpose is not to preempt state procedure or to impose federal reform of the state foreclosure system. The structural deficiencies in the state foreclosure system will not be solved via federal bankruptcy law. However, the proposed amendments provide a means for challenging those sales which comply with state procedure but contradict federal bankruptcy policy.

## V. CONCLUSION

*BFP* legalizes constructively fraudulent conveyances, leaving the bankruptcy courts powerless to preserve the assets of the estate from overzealous creditors. The use of fraudulent transfer law to set aside irregular foreclosure sales furthers federal bankruptcy policy.<sup>148</sup> If state foreclosure laws are so inadequate as to "alter[] reality,"<sup>149</sup> the courts must be allowed to review and set aside such transfers. Bankruptcy courts must be allowed to review foreclosure sales when such sales result in an unjust diminution of the bankruptcy estate. Congress did not intend to allow mortgagees to purchase palaces (valuable real estate) for a "peppercorn."<sup>150</sup> Adoption of these amendments will resurrect § 548(a)(2)(A), allowing TIBs, unsecured creditors, and debtors to recapture equity lost to the improvident state foreclosure process.

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147. See Woodruff, *supra* note 97, at 798. Woodruff suggests that the Illinois foreclosure procedures, modeled after the Uniform Land Transaction Act, adequately address the common deficiencies of the state system. *Id.*

148. See *supra* notes 26-65 and accompanying text (discussing federal bankruptcy policy).

149. *BFP*, 114 S. Ct. at 1767. Justice Scalia notes that "[u]nlike most other legal restrictions, however, foreclosure has the effect of completely redefining the market." He then concludes that "[g]iven this altered reality, and the concomitant inutility of the normal tool for determining what property is worth (fair market value), the only legitimate evidence of the property's value . . . is the foreclosure sale price itself." *Id.* (emphasis added).

150. *Id.* at 1767. See *supra* note 19.

By amending the Code to define reasonably equivalent value as proposed in Part IV, Congress would provide TIBs with a useful tool to preserve the assets of the estate. Allowing the bankruptcy courts to review and set aside state foreclosures via federal fraudulent transfer law is an effective and beneficial method of ensuring the equitable distribution of the debtor's assets.

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