Tax Forfeitures: The 6th Circuit Calls Strict Foreclosure State Sponsored Theft

November 1, 2022

Michael H. Traison
Chicago/NYC – 312.860.4230

Jocelyn E. Lupetin
Garden City – 516.296.9109

Bozena M. Diaz
New York City – 212.510.2227

Lawyers reading the text of a recent decision issued by the Court of Appeals for the Sixth Circuit (*Hall v. Meisner*, Case No. 21-1700, Oct. 13, 2022) will likely feel they are back in law school.

In reaching its determination that a lower court erred in dismissing homeowner suits where a County in Michigan ("County") had forcibly taken homes "worth vastly more than the debts these plaintiffs owed," the Court takes a deep dive into the history of strict foreclosure and its historical treatment and analysis by English courts, American courts, the Magna Carta and the U.S. Constitution.

The central issue in the *Hall* case is whether the state may cause owners of real estate to forfeit the entire value of their real property in satisfaction of delinquent property tax bills – particularly when the value of the real property far exceeds the amount of the tax debt and the homeowners receive nothing in exchange for the taking of the equity remaining in the property. Here, the Sixth Circuit confidently determined that such practice is in violation of the "Takings Clause" of the U.S. Constitution, and remanded the case to ensure the lower court revises its position to be consistent with its findings. We are reminded that this issue, upon which there remains a 4/3 split among the circuits, is far from resolved.

To understand the gravity of this decision, it is important to discuss the difference between strict foreclosure – which is at issue here – and the more familiar foreclosure by sale. Strict foreclosure is a form of judicial foreclosure which allows the foreclosing party to receive title to the real property without requiring a sale. Strict foreclosure is still permitted in some U.S. jurisdictions. However, it is typically reserved for situations where the amount of the debt exceeds the value of the property.

The reason the Hall case deserves special attention is that the County, in satisfaction of delinquent property taxes, transferred title to the real property in question, which had a value far exceeding the amount owed, to itself, and gave nothing to the homeowners/tax debtors in exchange for the equity they held in the property prior to the taking. Thus, the homeowners/tax debtors were effectively robbed of their equity and the Court concluded that such action violates the "Takings Clause," which reads: "Nor shall private property be taken for public use, without just compensation."

This is not to say that all foreclosure proceedings violate the U.S. Constitution. In fact, the more common foreclosure by sale, be it judicial or non-judicial, allows that the real property be sold for an amount reasonable within the market and any sale proceeds which are not needed to satisfy outstanding tax, mortgage or other debts be paid back to the homeowner. The return of that surplus compensates the homeowner/tax debtor for his or her equitable interest in the property, and has been standard practice under both Michigan law and the law of virtually every state for the past 200 years. Clearly, this practice, which dominates the foreclosure landscape, does not violate the rights of the homeowner/tax debtor, and properly enables creditors to be made whole. What made this situation different was that the Michigan General Property Tax Act created an exception to this rule for a single creditor - namely, the State itself (or a county thereof) - who alone among all creditors could take a landowner's equitable title without paying for it in the process of collecting a tax debt. In that respect, the Michigan statute proved self-dealing and an aberration from some 300 years of decisions by English and American courts, which barred precisely the action that the County took here.

In addition to the constitutionality of the strict foreclosure process, the *Hall* case also causes us to question whether such practices, if violative of the "Takings Clause," are also fraudulent transfers. As we have discussed in prior client alerts * (see below), Sections 544 and 548 of the Bankruptcy Code permit trustees or debtors in possession to set aside fraudulent transfers. 11 U.S.C. § 548. In other words, transfers of property which were made for "less than a reasonably equivalent value in exchange for such transfer" are considered constructively fraudulent and can be set aside by the bankruptcy trustee or debtor in possession. 11 U.S.C. § 548(a)(1)(B). Additionally, Section 544 of the Bankruptcy Code incorporates applicable state law governing voidable or fraudulent transfers. Accordingly, it must follow that, a strict foreclosure of the type at issue in the *Hall* case, which render a debtor insolvent should be considered constructively fraudulent and may be set aside as there has been no reasonably equivalent value given to the debtor in exchange for the transfer.

As this is an area which is actively evolving, we will continue to monitor and provide further updates as appropriate.

Please note this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding voidable transactions or fraudulent transfers, please contact Michael H. Traison (mtraison@cullenllp.com) at 312.860.4240, Bozena M. Diaz (bdiaz@cullenllp.com) at 212.510.2227 or Jocelyn E. Lupetin (jlupetin@cullenllp.com) at 516.296.9109.

Footnotes

*Prior client alerts discussing the topic of fraudulent conveyances include: Update: Voidable Transfers At Issue In Sandy Hook Litigation: The Statute of Elizabeth Lives On (9/28/22); Voidable Transfers At Issue In Sandy Hook Litigation: The Statute of Elizabeth Lives On (9/13/22); **Tuition Payments by Parents as Fraudulent Conveyances - Cullen and Dykman LLP (cullenllp.com)**, **Corporate Executives & Bonuses on the Eve of Bankruptcy: Merely an Affront or a Fraud? - Cullen and Dykman LLP (cullenllp.com)**, and **When is a Bonus a Fraud? - Cullen and Dykman LLP (cullenllp.com)**.

Practices

- Bankruptcy and Creditors' Rights

Attorneys

- Michael H. Traison
- Bozena M. Diaz
- Jocelyn E. Lupetin