REPRINTED FROM

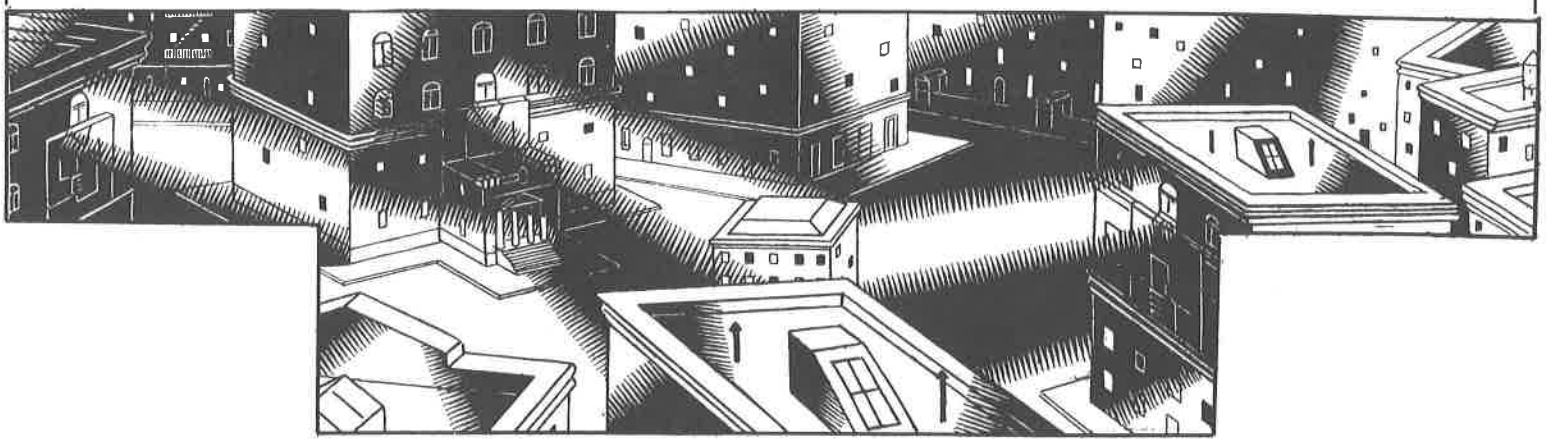
New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

Today's Classified Section Begins on Page 10

VOLUME 214—NO. 103 NEW YORK, WEDNESDAY, NOVEMBER 29, 1995 PRICE $2.75

REAL ESTATE UPDATE



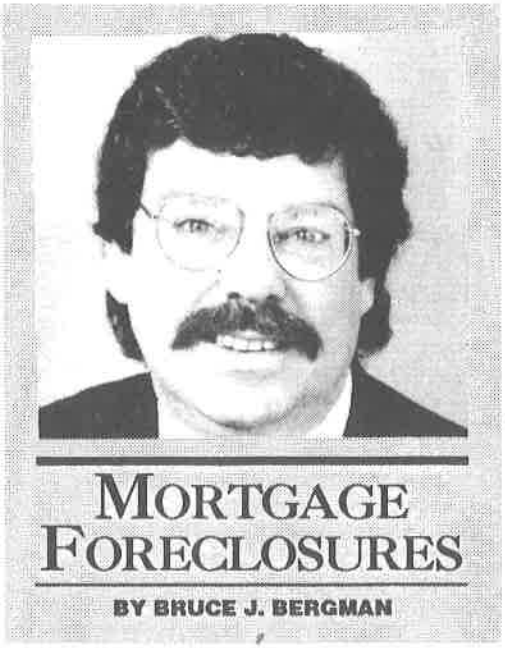
Foreclosure Sales

Unlocking the Bidding 'Mystery': There Shouldn't Even Be One

FORECLOSING lenders have (or had) become timorous when contemplating the amount to bid at their own foreclosure sales. Bidding too high could diminish or eliminate the amount of any deficiency which might otherwise be pursued. Bidding too low, many believed, could incur jeopardy in either state court (where the conscience of the court might have been shocked), or in bankruptcy court (where a paltry bid amount could elicit a fraudulent conveyance finding.)

In actuality, many foreclosing plaintiffs did not even refine the equation to the noted degree. They amorphously knew there was some degree of danger lurking if their bid was low, so an oft-repeated directive to plaintiff's counsel became, "bid the upset price."

While this concern had been rationally founded in the instance of a post-foreclosure sale bankruptcy filing, its validity was considerably less under other circumstances. And, some questions had to be asked first which were perhaps uniformly neglected. The initial inquiry needed to be, is a low bid which may run afoul of court condemnation made by a third party or by the plaintiff itself? The second question should have been, are we concerned with the rules in state court, or are we addressing the case of a borrower who files a bankruptcy petition after the foreclosure sale and then assaults the bid price as deleteriously parsimonious?



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Deficiency Equation

The amount of a deficiency is a sum equal to the quantum of the debt owed to the mortgagee, less the sale (i.e. bid) price, or fair market value of the foreclosed premises, whichever is higher.[1] In other words, those liable for a deficiency (such as the borrower and any guarantors) get the benefit in the formula for the value of the property, even though the bid price may be low. Further protection for the parties liable is afforded because the burden of establishing a prima facie showing that the fair market value of the mortgaged property is less than the debt due devolves to the mortgagee.[2]

Two consequences emerge from the noted maxim. Because the greater of bid price or property value is credited in the deficiency formula, when the foreclosing plaintiff is the successful bidder it must endeavor not to bid above the property's fair market value. If a plaintiff does cross that line, even though in actuality it may have incurred a loss, there will be no basis to seek recompense. Additionally, in seeking to avoid bidding beyond the property's value, the plaintiff once had to fear that too low a bid might suffer invalidation if attacked.

One of the most compelling questions to be asked in behalf of nervous lenders is, if obligors always derive the protection of market value — so that they cannot suffer from a low bid — why should a low bid ever be the basis to vacate a foreclosure sale?[3]

Who Is the Bidder?

It is perhaps understandable that the jumble created by confluence of state court dictates and bankruptcy case decisions, neither of which were traditionally firm and precise, led to lenders' consternation in deciding how much to bid. But a neglected factor worthy of greater clarity was examining who the successful bidder was. It is one thing to say that the property was sold at foreclosure to a third party for a deficient sum — although the message here is that even that should not be the case. It is another, however, to visit condemnation upon the sale when the foreclosing plaintiff itself was the highest bidder. (That the plaintiff was the only bidder is not such an unusual occurrence.)

Through a number of circumstances, not the least of which can be the prudence of a mortgage loan and the vicissitudes of the bidding process, a foreclosing plaintiff will itself often be the successful bidder, quite frequently at a nominal sum. Regardless of an apparently nominal bid amount, however, the property is deemed received as a substitute for the debt, so that what appears to be a deficient bid is in actuality not so defined. Case law specifically recognizes this and holds that such a nominal bid by the plaintiff is not a basis to vacate a sale.

For example, where the mortgagee was the purchaser for $1,000 upon premises valued at $600,000, the price was held not inadequate because the indebtedness of $585,000 was extinguished by the foreclosure.[4] The same theory applied when a mortgagee bid a nominal $150 on property worth up to $260,000. The court found no inadequacy of price because the consequence of the bid was to give the mortgagor full credit for the balance due on the mortgage debt together with the expenses of the sale.[5]

Combining credit to parties liable for the value of the property (when it is higher than the bid amount) with the concept that a bid by the plaintiff is a substitute for the debt, suggests a conclusion that no plaintiff's bid can ever be too low. But then there is the concept of a bid price which shocks the conscience of the court.

This is an arena where case law pronouncements are particularly misleading. There appear to be two maxims generated by decisional law which tend to confuse. The older one is the widely and repeatedly stated mantra that absent fraud, collusion or other irregularity, a foreclosure sale will not be set aside solely upon inadequacy of sale price, unless the inadequacy is so great that it shocks the conscience of the court.

Up to the point of shocking, there is no doubt about the accuracy of the statement, and quite correctly so. As to shocking the court's conscience, it certainly sounds reasonable and appropriate, especially mindful of another common aphorism, that courts have broad discretion to set aside a foreclosure sale where fraud, collusion, mistake or misconduct casts suspicion upon the fairness of the sale,[6] even if such conduct does not amount to a violation of law.[7]

Reasonable though it appears, analysis urges that the conscience of the court is never shocked in isolation. In more than a few cases where a court cited the "shocking" principle, the sale was upheld.[8] (If a truly shocking precipice exists, it just was not reached.) Other cases likewise cited the principle and overturned the foreclosure sale, but combined inadequacy of price (whether shockingly low or otherwise) with some error or irregularity. None of these rulings ever vacated a sale based solely upon inadequacy of bid price.

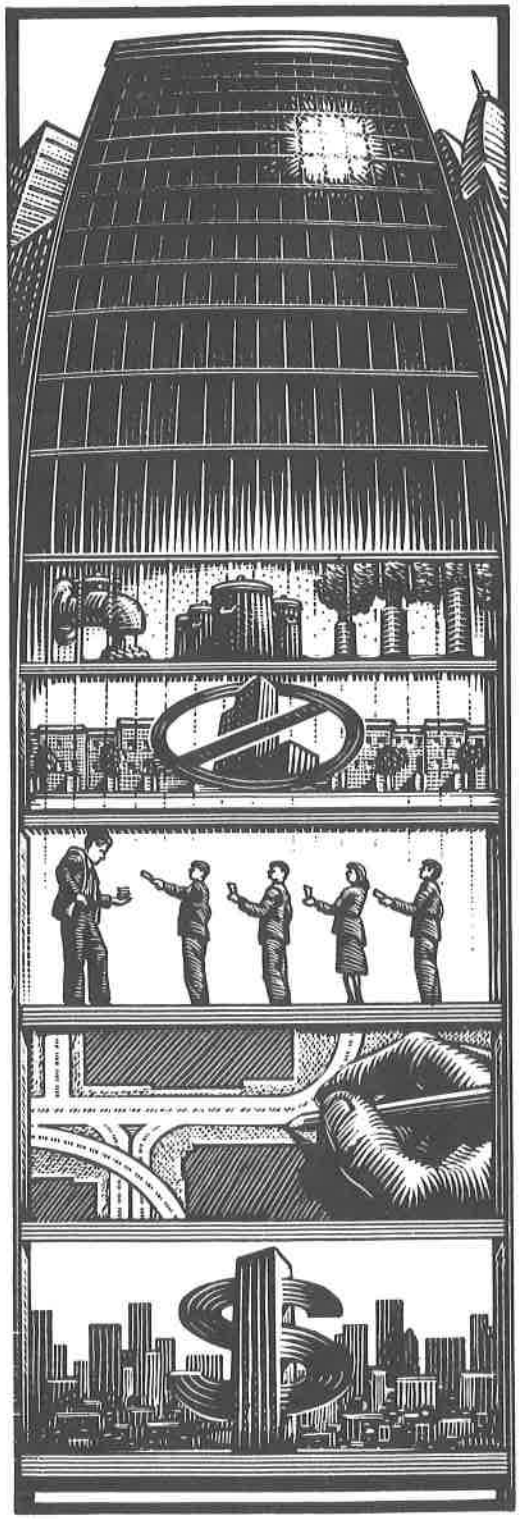

ILLUSTRATION BY JOHN MacDONALD

A second and somewhat related axiom originated in one of the most frequently cited foreclosure cases: *Polish Nat'l Alliance of Brooklyn v. White Eagle Hall Company.*[9] In assessing a bid price and attempting to categorize results based upon the percentage relationship of bid amount to property value, the court opined that " . . . foreclosure sales at prices below 10 percent of value have consistently been held unconscionably low in this state . . . "

The likely conclusion from the noted quote is that bid prices below 10 percent of value fall into the conscience shocking category. Again, though, analysis of the cases relied upon does not support the inference. *Polish National Alliance* cites *Central Trust Co. v. Alcon Developers,*[10] *Alben Affiliates v. Astoria Term.,*[11] *Chemical Bank & Trust Co. v. Schumann Assoc.*[12] and *Purdy v. Wilkins.*[13] These cases in turn were founded upon *Long Island City Sav. & Loan Ass'n v. Suggs,*[14] *In re Superintendent of Banks of State of New York*[15] and *Fisher v. Hersey.*[16] Yet, none of these cases presents the proposition set forth in *Polish National Alliance*, nor do they speak in terms of 10 percent being a meaningful threshold.

To be sure, "shocked conscience" verbiage is found in these cases, and these are also instances where the foreclosure sale was vacated. Critically, though, each represented a scenario where both inadequacy of price (below 10 percent) and some other factor of casting suspicion on the sale coincided.

Polish National Alliance synthesized this group of cases to stand for a principle which is incompletely stated. Where less than 10 percent of value is bid, it is a strong indication that whatever irregularity, mistake or other mishap existed — including of course fraud or collusion — caused actual prejudice, or in some fashion inhibited robust bidding. If open bidding has in essence been thwarted, vacatur of the sale is befitting. The low bid price, however, is not in and of itself the reason to vacate, but rather serves as confirmation that the foreclosure sale process went awry.

Bankruptcy Arena

Case law generated in bankruptcy cases may have been the primary source of lender agitation relating to bid amounts. By way of foundation, Bankruptcy Code §548(a)(2)(A) authorizes a trustee in bankruptcy to avoid a conveyance in which the debtor has "received less than a reasonably equivalent val-

ue in exchange for such transfer . . ."[17] It must also be shown that the debtor "was insolvent on the date that such transfer was made . . . or became insolvent as a result of such transfer . . ."[18]

If the foreclosure sale renders the borrower insolvent, or if the borrower was already insolvent at the time of the sale, and if a petition in bankruptcy is filed within one year after the sale, the issue of whether reasonably equivalent value was paid for the foreclosed property becomes important.

Since extinguishment of an antecedent debt (in this case, the sum due on the mortgage) constitutes valid consideration,[19] it is necessary to compare the amount of debt extinguished by the sale with the value of the property.

Defining reasonably equivalent value is difficult. Divergent views generated a series of confusing decisions which created uncertainty as to the durability of foreclosure sales. Ultimately, the issue came before the U.S. Supreme Court where the dilemma for mortgage holders was effectively solved.[20]

Previously, the landmark case, the one that so vexed lenders, *was Durrett v. Washington National Ins. Co.*,[21] in which the court proscribed as a fraudulent conveyance a foreclosure sale where the proceeds were 57.7 percent of the fair market value of the property. The court in *Durrett* urged that 70 percent or more would be sufficient.

Although some courts had followed *Durrett*,[22] others had developed different rules. The Ninth Circuit held in *In re Madrid*[23] that when there has been a regularly conducted foreclosure sale, the proceeds obtained will be deemed the fair equivalent of the property's value. A third formulation rejected both *Durrett* and *Madrid* and held that a case-by-case approach should be employed to determine whether reasonably equivalent value was obtained.[24]

The same conflict existed among bankruptcy courts within New York. The Western district followed *Madrid*[25] while the Eastern District adopted the case by case method.[26] It is no wonder lenders faced the formulation of a foreclosure sale bid with trepidation — at least until unraveling emerged from the U.S. Supreme Court.

In *BFP* v. *Resolution Trust Corp.*,[27] the Court ruled that the amount bid at a regularly conducted non-collusive foreclosure sale establishes reasonably equivalent value,[28] essentially rendering such a sale immune from attack in the bankruptcy court.

Conclusion

The threat of *Durrett* disoriented many lenders and begat a general view in many quarters that 70 percent of value was a required bid. That was never the case in New York, but the issue was still blurry for some until the ruling in *BFP*. While that case effectively removed the danger to foreclosures of a post-sale assault in bankruptcy court[29] (for the regularly conducted sale), imprecision in state court kept lenders off balance.

Indeed, it may not have been clear to many lenders when the issue was in state court as opposed to bankruptcy court. There was some general feeling that any low bid might be a source of peril.

But the *real* issue — now stated specifically in the instance of bankruptcy; unspecified in state court — devolves around the regularity of the sale.

If the sale suffers no infirmities, then even a nominal bid will resist a thrust to overturn the sale. On the other hand, a very low bid, joined with some miscue, even one which otherwise would be viewed as de minimus, can be the basis to void a sale.

Perhaps the U.S. Supreme Court hit the mark way back in 1907 with this portion of the holding in *Ballentyne v. Smith*,[30] " . . . if there be great inadequacy, slight circumstances of unfairness in the conduct of the party benefited by the sale will be sufficient to justify setting it aside." It will be especially calming and enlightening if state courts will refine decisional verbiage to adopt this view, in so many words.

(1) RPAPL §1371(2); See also 2 *Bergman on New York Mortgage Foreclosures*, §34.06, Matthew Bender & Co. Inc. (Rev. 1995) and cases therein cited. The debt owed to the mortgagee is determined by the judgment of foreclosure and sale, with interest, together with amounts owing on all prior liens and encumbrances (including unpaid taxes, water charges and penalties to which the property remains subject), with interest, plus costs and disbursements of the action, inclusive of referee's fees and expenses.

(2) See, *inter alia*, *Marine Midland Bank v. Harrigan Enterprises Inc.*, 118 A.D.2d 1035, 500 NYS2d 408 (3d Dept. 1986); *Mastan Co. v. Weil*, 84 A.D.2d 657, 444 NYS2d 315 (3d Dept. 1981); *National Bank of North Am. v. Systems Home Improvement*, 69 A.D.2d 557, 419 NYS2d 606 (2d Dept. 1979), aff'd, 50 NY2d 814, 430 NYS2d 49, 407 N.E.2d 1345 (1980).

(3) The reverse situation of a surplus not achieved could be harmful to the borrower. But if no one wanted to bid above the upset price, the issue cannot be that the bids were just low, but rather that perhaps there was some irregularity attendant to the sale which somehow inhibited the bidding process.

(4) *Guardian Fed. Sav. & Loan Ass'n v. Horse-Hawk Holding Corp.*, 72 A.D.2d 737, 421 NYS2d 244 (2d Dept. 1979).

(5) *Polish Nat'l Alliance of Brooklyn v. White Eagle Hall Co.*, 98 A.D.2d 400, 470 NYS2d 642 (2d Dept. 1983).

(6) *Guardian Loan Co. v. Early*, 47 NY2d 515, 419 NYS2d 56, 392 N.E.2d 1240 (1979); *Clapp v. McCabe*, 155 N.Y. 525, 50 N.E. 274 (1898); *Riggs* v. *Pursell*, 66 N.Y. 193 (1876); *Hale v. Clawson*, 60 N.Y. 339 (1875); *Glenville & 110 Corp. v. Tortora*, 137 A.D.2d 654, 524 NYS2d 747 (2d Dept. 1988); *Polish Nat'l Alliance of Brooklyn v. White Eagle Hall Co.*, 98 A.D.2d 400, 470 NYS2d 642 (2d Dept. 1983); *Mullins v. Franz*, 162 A.D. 316, 147 N.Y.S. 418 (2d Dept. 1914); *House Mart Inc. v. Giacalone*, 28 Misc.2d 674, 210 NYS2d 376 (1960); *Collier v. Whipple*, 13 Wend. 224 (1834).

(7) *Fisher v. Hersey*, 78 N.Y. 387 (1879); *Central Trust Co. Rochester v. Alcon Dev., Inc.*, 93 Misc.2d 686, 403 NYS2d 396 (1978); *Woodside Sav. & Loan Ass'n v. Banks*, 36 Misc.2d 954, 233 NYS2d 541 (1962); *Dime Sav. Bank v. Thomas*, 24 Misc.2d 850, 209 NYS2d 160 (1960).

(8) *In re Superintendent of Banks of State of New York*, 207 N.Y. 11, 100 N.E. 428; *Trustco Bank New York v. Collins*, 213 A.D.2d 819, 623 NYS2d 642 (3d Dept. 1995); *Manufacturers and Traders Trust Company v. Niagara Square Associates*, 199 A.D.2d 975, 608 NYS2d 22 (4th Dept. 1993); *Glenville & 110 Corp. v. Tortora*, 137 A.D.2d 654, 524 NYS2d 747 (2d Dept. 1988); *Frank Buttermark Plumbing & Heating Corp. v. Sagarese*, 119 A.D.2d 540; 500 NYS2d 551 (2d Dept. 1986); *Guardian Fed. Sav. & Loan Ass'n v. Horse-Hawk Holding Corp.*, 72 A.D.2d 737, 421 NYS2d 244 (2d Dept. 1979).

(9) 98 A.D.2d 400, 470 NYS2d 642 (2d Dept. 1983).

(10) 93 Misc.2d 686, 403 NYS2d 396 (1978).

(11) 34 Misc.2d 246, 226 NYS2d 1007 (1962).

(12) 150 Misc. 221, 268 N.Y.S. 674 (1934).

(13) 95 Misc. 706, 160 N.Y.S. 17 (1916).

(14) 355 N.Y.S.2d 550 (1974).

(15) 207 N.Y. 11, 100 N.E. 428.

(16) 78 N.Y. 387 (1879).

(17) 11 U.S.C. §548(a)(2)(A).

(18) 11 U.S.C. §548(a)(2)(B)(i).

(19) 11 U.S.C. §548 (a)(2)(B)(i).

(20) *BFP* v. *Resolution Trust Corp.*, 511 U.S. _, 128 L.Ed. 556, 114 S.Ct. 1757 (1994).

(21) 621 F.2d 201 (5th Cir. 1980).

(22) See *Abramson v. Lakewood Bank & Trust Co.*, 647 F.2d 547 (5th Cir. 1981), cert. denied, 454 U.S. 1104 (1982); *In re Lakeview Inv. Group Inc.*, 40 B.R. 449 (Bankr. E.D.N.C. 1984); In re *Richardson*, 23 B.R. 434 (Bankr. D. Utah 1982); In re *Perdido Bay Country Club Estates Inc.*, 23 B.R. 36 (Bankr. S.D. Fla. 1982).

(23) 21 B.R. 424 (9th Cir. 1982).

(24) See *In re Bundles*, 856 F.2d 815 (7th Cir. 1988); *In re Hulum*, 738 F.2d 323 (8th Cir. 1984), cert. den., 105 S.Ct. 398 (1984).

(25) *In re Upham*, 48 B.R. 695 (Bankr. W.D.N.Y. 1985).

(26) *In re Pruitt*, 72 B.R. 436 (Bankr. E.D.N.Y. 1987); *In re Adwar*, 55 B.R. 111 Bankr. E.D.N.Y. 1985).

(27) 511 U.S. _, 128 L.Ed. 556, 114 S.Ct. 1757 (1994).

(28) *BFP v. Resolution Trust Corp.*, 511 U.S. _, 128 L.Ed. 556, 114 S. Ct. 1757 (1994).

(29) Some bankruptcy commentators (including in these very pages) opine that loopholes remain notwithstanding the decision in *BFP* v. *Resolution Trust Corp.* That may very well be so, but for the purpose of this broader review, the issue is no longer significant.

(30) 205 U.S. 285, 291 (1907).