No. 15-1166

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

In re:

Keith Smith and Dawn Smith,
Debtors;

Keith Smith and Dawn Smith,
Plaintiffs-Appellants;

v.

SIPI, LLC, and
Midwest Capital Investments, LLC

Defendants-Appellees.

On appeal from a decision of
the United States District Court
for the Northern District of Illinois,

Case No 1:13-cv-06422

The Honorable Harry D. Leinenweber

which reversed a decision of
the United States Bankruptcy Court
for the Northern District of Illinois

Adversary Proceeding 07 A 00239

The Honorable Bruce W. Black

BRIEF AND ARGUMENT OF *AMICI CURIAE*
NACBA and LAF

IN SUPPORT OF KEITH SMITH AND DAWN SMITH
PLAINTIFFS-APPELLANTS,
AND IN SUPPORT OF REVERSAL.

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(2) The names of all law firms whose partner or associates have appeared for the party in the case (including proceedings in the district court or before an administrative agency) or are expected to appear for the party in this Court:
LAF

(3) If the party or amicus is a corporation:
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ii) list any publicly held company that owns 10% or more of the party's or amicus's stock:
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National Association of Consumer Bankruptcy Attorneys

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STATEMENT OF IDENTITY AND INTEREST OF *AMICI CURIAE*

The National Association of Consumer Bankruptcy Attorneys, or NACBA, is a non-profit organization of more than 3000 consumer bankruptcy attorneys practicing throughout the country. Incorporated in 1992, NACBA is the only nationwide association of attorneys organized specifically to protect the rights of consumer bankruptcy debtors. Among other initiatives and directives, NACBA works to educate the bankruptcy bar and the community at large on the uses and misuses of the consumer bankruptcy process. NACBA also advocates for consumer debtors on issues that cannot be addressed adequately by individual member attorneys. NACBA has filed numerous *amicus* briefs in cases involving the rights of consumer debtors. *See, e.g.*, *Schwab v. Reilly*, 560 U.S. 770 (2010); *United Student Aid Funds, Inc. v. Espinosa*, 559 U.S. 260 (2010). NACBA's breadth of experience will assist this Court in understanding how application of 11 U.S.C. § 548(a)(1)(B) to transfers resulting from tax sales not only comports with the language and purpose of that section, but with policies embodied in the Bankruptcy Code generally.

LAF is a not-for-profit organization that provides free legal representation and counsel in civil cases to disadvantaged people and communities throughout Cook County. Each year LAF's advocates represent thousands of clients in a wide range of civil legal matters, including bankruptcy, consumer, education, employment, housing, immigration, orders of protection, and public benefits. LAF's breadth of experience will assist this Court in understanding important background

principles and policies governing bankruptcy and the tax purchasing industry, as well as provide context helpful to understanding the particular challenges faced by debtors who have fallen behind on property tax payments.

LAF and NACBA can also assist the Court in understanding that restricting the amount that Chapter 13 debtors can recover impairs the proper functioning of the bankruptcy system and harms a wide array of parties. When a tax deed is completely avoided as a fraudulent transfer, it reverses a windfall that benefits a single creditor at the expense of the debtor's other creditors as well as the debtor. While a recovery limited to the amount of the homestead exemption does provide a safety net for homeowners and ameliorate the societal costs that otherwise result from the loss of shelter, full avoidance enables the reorganizing Chapter 13 debtor to remain in or return to the family home while also increasing payments to unsecured creditors.

Both NACBA and LAF thus submit this brief to support the position of the debtors, Keith Smith and Dawn Smith, that § 548(a)(1)(B) may be applied to tax sales. NACBA and LAF also support the Smiths' position that when the Chapter 13 trustee does not exercise avoidance powers, those powers devolve to the debtors for the benefit of the bankruptcy estate.

No counsel for a party authored this brief in whole or in part, and no person or entity other than NACBA or LAF, its members, and its counsel made any monetary contribution toward the preparation or submission of this brief.

SUMMARY OF THE ARGUMENT

The district court's holding that an Illinois tax deed can never, as a matter of law, be avoided under 11 U.S.C § 548(a)(1)(B) is contrary to both the plain language of the Bankruptcy Code ("Code") and its two main purposes—equality of distribution for creditors, and a fresh start for the debtor.[1] A tax deed issued in Illinois is often precisely the kind of windfall benefitting a single creditor, at the expense of other creditors, that § 548(a)(1)(B) is designed to address. Avoiding such transfers increases fairness and rationality in the management of bankruptcy estates. This is true under Chapter 7, 11 and 12, as well as Chapter 13. A *per se* rule that § 548(a)(1)(B) never applies to tax deeds needlessly thwarts express bankruptcy policy. *Amici* therefore urge this Court to reverse the decision of the district court.

Amici also urge this Court to reverse the decision of the bankruptcy court to limit the Smiths' recovery to only one exemption for a home they both lived in. Since the Smiths were reorganizing under Chapter 13, they had standing to use the trustee's power to avoid the entire transfer.

[1] The Bankruptcy Code refers to Title 11 of the United States Code, 11 U.S.C. §§ 101 *et seq*.

ARGUMENT

I. Section 548(a)(1)(B) Applies to Transfers Pursuant to Illinois Tax Deeds.

The Smiths provide sound arguments that the plain language of § 548(a)(1)(B), its purpose, and the decision in *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), fail to support the district court's decision arbitrarily to exclude tax deeds from scrutiny under § 548(a)(1)(B) as a matter of law. Without repeating those arguments, *amici* offer the following points. First, the actual functioning of the tax sale process in Illinois makes clear that extending the holding in *BFP* to encompass tax deeds would thwart important bankruptcy policy. Not only would this impact all insolvent debtors who had lost real property to tax deeds, it would also restrict their bankruptcy estates, and therefore amounts that their creditors could recover. Priority creditors, such as child support creditors, unpaid former employees, and tax creditors, would suffer the most. Second, application of § 548(a)(1)(B) to tax deeds comports with the history of that provision and an overarching purpose of the Code, to maximize creditor recovery fairly and rationally. Application of § 548(a)(1)(B) to the Illinois tax deed process does not create perverse results or "wreak havoc," as the district court opined. (*See* Dist. Ct. Op. 18*,* Short Appendix ("S.A.") 90.)

A. The Tax Sale Process in Illinois, By Its Very Design, Does Not Provide Reasonably Equivalent Value to a Property Owner.

The Smiths aptly argue that because the tax sale process in Illinois provides no opportunity to obtain anything approximating reasonably equivalent value,

BFP 's rationale for protecting mortgage foreclosure sales does not apply to Illinois tax deeds. (Smith Br. 20-22.) Without repeating those arguments, *amici* point out additional salient features of the tax sale process in Illinois to support this point.

1. Illinois's Method of Collecting Delinquent Taxes Does Not Allow for Competitive Bidding Based on the Value of the Property.

The methods states use to raise revenue when a property owner does not pay property taxes in full and on time vary. *See* National Consumer Law Center ("NCLC"), *The Other Foreclosure Crisis: Property Tax Lien Sales* ("*Tax Sales Report*") (2012) at 14-15.[2] Three distinct procedures are used: the overbid method, the percentage ownership method, and the interest rate method. *Id.* Under the overbid method, the property itself is sold at a public sale where there is competitive bidding, and the bidder who offers to pay the most wins the property. *Id.* If the winning bid exceeds the unpaid taxes, interest, penalties, and costs, the surplus usually goes to the owner or to a lien holder, such as a mortgagee. *Id.* at 15. The percentage ownership method also involves competitive bidding. The winning bidder is the person who is willing to accept the smallest percentage interest in the property. *Id.* at 14. Under this system, bidding may start at 100% percent and decrease. *Id.* The interest rate method limits competitive bidding to the interest rate; there is no bidding on the price to acquire the lien. *Id.* The tax lien purchaser

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[2]Available at http://www.nclc.org/images/pdf/foreclosure_mortgage/tax_issues/tax-lien-sales-report.pdf (last visited May 4, 2015).

who bids the lowest percentage wins. The property owner must pay interest on the delinquent taxes at that winning rate to redeem the delinquent taxes.

Illinois uses the interest rate method.[3] The maximum bid is 18% for each six-month period. *See* 35 Ill. Comp. Stat. Ann. §§ 200/21-215; 200/21-355(b) (West 2015).

The district court erred in deeming the tax sale "dynamics" in Illinois to be like the mortgage foreclosure process, in that the scheme "balances the interests of the parties involved." (Dist. Ct. Op. 17-18, S.A. 89-90.) *BFP*'s holding depended not on general deference to state legislative balancing, but on the specific features of the mortgage foreclosure sale process. Illinois tax sales do not share those features. An Illinois tax sale auction has almost nothing in common with a mortgage foreclosure sale, in which buyers bid competitively on price, with the surplus going to the owner or junior secured creditors.

2. Tax Deeds Almost Necessarily Do *Not* Represent Transfers for Reasonably Equivalent Value.

A tax investor who buys a tax lien that matures into a tax deed obtains a profit that almost *necessarily* will be many times the property's value.[4] (For a number of striking examples, *see* Argument I(C), *infra*.)

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[3] The process for collecting delinquent real estate taxes in Illinois has been described by the Seventh Circuit in several cases, as well as by the United States Supreme Court. *See In re Lamont,* 740 F.3d 397 (7th Cir. 2014); *BCS Servs., Inc. v. Heartwood 88, LLC*, 637 F.3d 750 (7th Cir. 2011); *In re Smith (Smith I)*, 614 F.3d 654, 656-57 (7th Cir. 2010); *Bridge v. Phoenix Bond & Indem. Co.,* 553 U.S. 639, 641 (2008).

[4] Because taxes are determined as a small fraction of market value, homes transferred by tax deeds are *ipso facto* worth many times more than the tax lien—

Furthermore, foreclosure sales rarely involve consumers who have equity in the property, whereas tax sales that result in tax deeds often do.[5] Nonetheless, foreclosure laws typically require that any surplus at the sale be paid to other lienholders and then to the consumer (similar to what would happen in a bankruptcy). Tax sale procedures do not—the surplus equity goes to the purchaser as a windfall.

B. Applying § 548(a)(1)(B) to Tax Deeds Is Consistent with the Code's General Purpose of Promoting Fairness to Creditors.

The district court relied in part on its assessment that "[i]t would turn the fraudulent transfer statute on its head to use it to allow the debtors to recover property lost years earlier by their own inaction, *to the detriment of their creditors*." (Dist. Ct. Op. 18, S.A. 90 (emphasis added).) This comment reveals the district court's fundamental misunderstanding of the operation of avoidance powers. If § 548(a)(1)(B) cannot be used by debtors to avoid a tax deed, it cannot be used by a Chapter 7 trustee or a Chapter 11 debtor in possession either. Avoidance under § 548(a)(1)(B) benefits junior secured creditors and unsecured creditors. Only one creditor benefits when a tax deed is not avoided—the tax purchaser.

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even if not redeemed over several years. This is particularly the case given that any amount of tax arrearage may be sold—there is no minimum. *See* 35 Ill. Comp. Stat. Ann. §§ 200/21-5 *et seq.* (For properties rendered uninhabitable or unfit for occupancy, the tax purchaser can get a refund of the taxes paid by requesting a "sale in error." *See id.*, §§ 200/21-310(b)(2) and (b)(4). This reduces the number of tax deeds issued for marginal properties.)

[5] When there is a creditor with a substantial lien on the property, the redemption rates are very high.

The Code provides for avoidance of constructively fraudulent transfers to reverse windfalls that benefit a single creditor at the expense of other creditors and the debtor. As the Smiths argue, this is clear from the plain language of the statute. The purpose and history of § 548(a)(1)(B), furthermore, support its application to tax deeds. A "central policy of the Bankruptcy Code" is the "equality of distribution among creditors," which is furthered by avoidance provisions. *Begier v. IRS*, 496 U.S. 53, 58 (1990). Fraudulent transfers are avoidable because they diminish the assets of the debtor "to the detriment of some or all creditors." *In re Chase & Sanborn Corp.*, 813 F.2d 1177, 1181 (11th Cir. 1987).

> 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, pt. 1, at 18 (1973).

When SIPI obtained the tax deed, not only was it repaid for the amount of the delinquent taxes, it also extracted value many times that amount. SIPI thus removed substantial assets from the Smiths' impending bankruptcy estate, harming not just the Smiths, but their creditors. Permitting the trustee or other appropriate party to avoid a transfer that meets the conditions set forth in § 548(a)(1)(B) serves the purpose of equitable and orderly distribution of assets.

C. When Debtors Acting in Their Personal Capacity Avoid a Transfer Using § 522(h) and § 548(a)(1)(B) This Furthers the Code's Policy of Providing a Fresh Start to Honest But Unfortunate Debtors.

Contrary to the district court's assertion that application of § 548(a)(1)(B) to tax deeds turns the provision "on its head," since the tax deed resulted from the Smiths' "own inaction" (Dist. Ct. Op. 18, S.A. 90), the Code has specific provisions to allow debtors to avoid transfers for their personal benefit. *See* 11 U.S.C. §§ 522(g) and 522(h). Debtors' ability to use § 548(a)(1)(B) and § 522(h) to avoid a tax deed for their personal benefit is a result intended by Congress.

In *Listecki v. Official Committee of Unsecured Creditors,* this Court recognized the Code as a remedial statute serving a compelling governmental interest, similar to the Social Security system.

> While the social security system aids those who have reached a certain age or are disabled, the Code aids those who have reached a certain financial condition and who need assistance repaying or recovering a debt. Both the Code and the social security system ensure the financial stability of the citizenry.

Listecki, 780 F.3d 731, 746 (7th Cir. 2015). Allowing a debtor to keep some property while discharging debts does not represent an unfair advantage, but instead constitutes a critical, minimal protection to further one of bankruptcy's fundamental goals, providing a "fresh start" for the honest but unfortunate debtor. *See Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). As the House Report on H.R. 8200 noted,

> The historical purpose of . . . exemption laws has been to protect a debtor from his creditors, to provide him with the basic necessities of

> life so that even if his creditors levy on all of his nonexempt property, the debtor will not be left destitute and a public charge.

H.R. Rep. No. 95-595, at 126 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6087.

When the debtor's fresh start is restricted by the improper denial of exemptions, the adverse consequences extend beyond just the debtor. *See In re Dipalma*, 24 B.R. 385, 390 (Bankr. D. Mass. 1982) ("[P]rotection of a debtor's necessities requires a shifting of the burden of social welfare from the community, who otherwise would be responsible for support of an indigent debtor and his dependents, to creditors."); *Matter of Hahn*, 5 B.R. 242, 244 (Bankr. S.D. Iowa 1980) (purpose of exemptions is to permit the debtor to survive, preserve his dignity, afford a means to financial rehabilitation, protect his family from impoverishment, and "spread the burden of the debtor's support from society to his creditors").

The homestead exemption in particular is designed "to secure the debtor and his family the necessary shelter from creditors, thereby protecting his fresh start in bankruptcy." *In re Laredo*, 334 B.R. 401, 409 (Bankr. N.D. Ill. 2005); *see also In re Drenttel*, 403 F.3d 611, 615 (8th Cir. 2005) (noting that state's "homestead exemption protects the debtor's family and helps to reduce the need for state services," recognizing that "the state benefits from the sense of security and connection to the community nurtured in the home," and that it "may even serve the long-term interests of creditors," because debtors' obligations are more likely to be fulfilled by those with stabilized connections to the community).

In Illinois the homestead exemption is set at a modest amount. *See* 735 Ill. Comp. Stat. Ann. § 5/12-901 (setting homestead exemption at $15,000, permitting

two owners to double the amount). This is the lowest homestead exemption in the states in the Seventh Circuit. Indiana's is $17,600, and Wisconsin's is $75,000. *See* Ind. Code Ann. § 34-55-10-2 (West 2015), 750 Ind. Admin. Code § 1-1-1 (2015); Wis. Stat. Ann. § 815.20. Illinois's exemption is less than the federal homestead exemption, available in states that have not opted out of the federal exemptions. *See* 11 U.S.C. § 522(d)(1) ($22,975).

Allowing debtors to salvage some value equal to an amount deemed necessary by the state legislature does not work an injustice. Failure to pay taxes frequently results from circumstances beyond a family's control, such as disability, and often brings about extremely inequitable, devastating penalties, far disproportionate to the infraction, including loss of the family's only shelter. This reality, as *amicus* LAF knows from the experience of many of its clients, has been documented nationally in recent years by journalists and advocates for consumers, the elderly, and the disabled. NCLC recently noted that "[h]omeowners most at risk are those who have fallen into default because they are incapable of handling their financial affairs, such as individuals suffering from Alzheimers, dementia, or other cognitive disorders." *Tax Sales Report* at 5. The report also notes that "[l]ocal studies have shown that property tax foreclosures are highly concentrated among low-income communities with large African American and Latino populations, groups also targeted by subprime lenders." *Id.* at 5.

Others have documented the vulnerability of the disabled to loss of their homes in this manner. *See, e.g.,* Robert F. Harris, *et al.*, *When Disabled*

Homeowners Lose Their Homes for a Pittance in Unpaid Property Taxes: Some Lessons from In Re Mary Lowe, 5 NAELA Journal 159, 163-65 (2009), *available at* http://www.guardianship.org/reports/NAELA_Disabled_Homeowners.pdf (last visited May 4, 2015). According to the lead author, Cook County's Public Guardian, disabled homeowners frequently lose title to their homes due to small amounts of unpaid taxes. *Id.* at 163. In the typical case, the taxpayer has owned the home for decades, has paid the mortgage and has substantial equity, and has developed a condition compromising mental cognition, such as Alzheimer's disease, which results in missed tax bill payments. *Id.* Despite a lengthy legal challenge, one of the Guardian's wards, Mary Lowe, who suffered from schizophrenia, lost her home of 20 years as the result of an unpaid property tax bill of $347. *Id.* at 161. Other wards suffered similar losses. *See id.* at 164-65. *See also* Michael Sallah *et al.*, *Left with Nothing*, The Washington Post (Sept. 8, 2013), *available at* http://www.washingtonpost.com/sf/investigative/2013/09/08/left-with-nothing/ (last visited May 4, 2015) (76-year-old Marine Corp veteran who suffered from dementia lost home worth $197,000 due to non-payment of $134 property tax bill).

Furthermore, the Code itself prevents a Chapter 7 debtor from claiming an exemption in property recovered by the trustee if the transfer was voluntary or if the debtor had concealed the property.[6] This limit, and not the district court's sanction for "negligent" failure to pay, represents the distinction Congress drew between "deserving" and "undeserving" debtors.

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[6] 11 U.S.C. § 522(h) incorporates § 522(g)(1), which contains those limitations.

D. Section 548(a)(1)(B) Does Not Wreak Havoc on Tax Sale Procedures or Tax Collection.

The district court expressed concern that application of § 548(a)(1)(B) to tax deeds would "wreak havoc" on the balance of interests represented by tax sale procedures. The bankruptcy court was unpersuaded by this argument. (Bankr. Ct. Op. S.A. 57, 64.) The Smiths rightly point out that this fear contravenes the evidence in their case. (Smith Br. 26.) Further, it is belied by courts having applied § 548(a)[7] to tax sales for many years, without apparent havoc. *See In re McKeever,* 166 B.R. 648 (Bankr. N.D. Ill. 1994); *City of Milwaukee v. Gillespie*, 487 B.R. 916 (E.D. Wis. 2013); *In re Berley Associates, Ltd.*, 492 B.R. 433, 439-40 (Bankr. D.N.J. 2013); *Wentworth v. Town of Acton (In re Wentworth)*, 221 B.R. 316, 319–320 (Bankr. D. Conn. 1998); *Sherman v. Rose (In re Sherman)*, 223 B.R. 555, 559 (B.A.P. 10th Cir. 1998); *D'Alfonso v. A.R.E.I. Inv. Corp. (In re D'Alfonso)*, 211 B.R. 508, 518 (Bankr. E.D. Pa. 1997).

Tax purchasers are well aware that bankruptcy increases their risks. *See* National Tax Lien Association ("NTLA"), FAQ's Common Questions About Tax Liens ("NTLA FAQs"), http://www.thentla.com/?page=FAQ (last visited May 4, 2015) (noting, "Tax certificates are not risk-free investments. Bankruptcy, litigation, and certificates declared invalid due to procedural errors are all factors that may impact any investor's portfolio."). The Bankruptcy Code is not the only federal law that disrupts state tax sales procedures. *See, e.g., Conroy v. Aniskoff*,

[7] Before the 2005 amendments to the Code, § 548(a)(1)(b) was § 548(a)(2).

507 U.S. 511 (1993) (Section 525 of former Soldiers' and Sailors' Civil Relief Act tolled period of redemption); *see also* Servicemembers Civil Relief Act, 50 App. U.S.C.A. § 526(b) (West 2015) (tolling period of redemption).

Incentives for tax purchasers to participate remain strong, despite application of § 548(a)(1)(B). As NCLC points out, interest rates for redemption generally give "tax sale purchasers profits at much higher rates than ordinary investments," even when the sale does not result in a tax deed. *Tax Sales Report* at 8. While banks currently provide less than 1% interest on bank deposits, many states, including Illinois,[8] permit tax purchasers to charge rates that "'beat the heck out of any certificate of deposits.'" *Id., quoting* Howard Liggett, NTLA director (internal quotation marks omitted); *see also* NTLA FAQs ("Because interest rates are determined by state law, tax lien certificates are immune to many of the fluctuations in the financial markets which affect more traditional forms of investment."). General participation in tax sales increases when interest rates available from other investments are low. *See Tax Sales Report* at 17. That investors have concocted schemes to obtain more than their permitted share of the tax liens offered for sale evidences the attractiveness of the process. *See BCS Serv. v. B.G. Invest., Inc.*, 728 F.3d 633, 637-38 (7th Cir. 2013).

Application of § 548(a)(1)(B) to Illinois tax deeds will not decimate these strong incentives, which do not depend on the tax lien maturing to a deed in every

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[8] The NCLC report identifies Illinois as a state in which tax sale investments yield the highest returns. *Tax Sales Report* at 18 & n.57.

case, or even most cases. Further, other protections shield tax purchasers from risk. For example, § 550(e) grants a lien that protects any investments made by a good faith transferee when the trustee has avoided the transfer. *See* 11 U.S.C. § 550(e).

There is no evidence that decisions in other jurisdictions that avoided tax deeds by applying § 548(a)(1)(B) have destroyed tax collections there, nor is there any reason to believe that rejecting the district court's position would "wreak havoc" in Illinois. The argument that a straightforward application of § 548(a)(1)(B) to tax deeds cannot be what Congress intended because of the catastrophic implications is unsupported. A ruling reversing the district court will, of course, cause ripples in the tax sale ecosphere and in society at large. Speculation about the cost to benefit ratio of applying § 548(a)(1)(B) to Illinois tax deeds is ultimately beside the point; that is a matter for the political process.

E. The Language and History of § 548(a)(1)(B) Reveal that It Applies Regardless of Whether the Transfer Created Otherwise Enforceable Property Rights and Regardless of Intent.

In holding that transfers by tax deed may never, as a matter of law, be avoided under § 548(a)(1)(B), the district court noted that under Illinois law, the tax buyer "is supposed to earn rights to the foreclosed property that are 'uncontestable,'" that SIPI followed required procedures and therefore was "entitled to own" the property, and that the Smiths "did not transfer their property to evade creditors." (Dist. Ct. Op. 18, S.A. 90.) These remarks reveal two erroneous premises—that § 548(a)(1) requires (1) that the transfer have been done for the purpose of evading creditors, and (2) that the transfer create an ownership right

otherwise "contestable" under non-bankruptcy law. The language of § 548(a)(1)(B), and its purpose and that of the Code generally, belie these premises.

1. Section 548(a)(1)(B) Encompasses Otherwise Lawful Transfers.

The statutory text belies the assumption that only transfers otherwise contestable may be avoided. The Code defines "transfers" to include "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property." 11 U.S.C. § 101(54). The definition expressly includes "the foreclosure of a debtor's equity of redemption."[9] *Id.* Congress intended the term "transfer" to be construed as broadly as possible. *In re FBN Food Servs., Inc.*, 185 B.R. 265, 271-72 (N.D. Ill. 1995), *aff'd and remanded sub nom. Matter of FBN Food Servs., Inc.*, 82 F.3d 1387 (7th Cir. 1996). Many constructively fraudulent transfers are accomplished through legal means, creating property rights perfectly legitimate under state law, but still qualifying as fraudulent transfers. *See, e.g.*, *In re Neal*, 461 B.R. 426, 438 (Bankr. N.D. Ohio 2011), *aff'd* 541 Fed. Appx. 609 (6th Cir. 2013) (parties' court-approved allocation of marital assets in a marriage dissolution proceeding set aside pursuant to § 548(a)(1)(B)); *In re Apollo Hollow Metal & Hardware Co., Inc.*, 71 B.R. 179, 182-83 (Bankr. W.D. Mo. 1987) (judicial sale of personal property). The limitations period and provisions protecting *bona fide* purchasers reflect congressional balancing of finality of transfers against the purposes of avoidance. Where avoiding an otherwise

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[9] This language was added in the 1984 amendments to the Code, the same enactment that added the language "voluntarily or involuntarily" to § 548(a). *See* Pub. L. 98-353, §§ 421(i), 463(l), July 19, 1984, 98 Stat. 333, 368, 378.

lawful, final transaction means a windfall may be restored to the bankruptcy estate to the benefit of creditors generally, such an outcome is consistent with the statute's language and purpose.

2. Section 548(a)(1)(B) Requires No Subjective Motive To Evade Creditors.

The Code "permits to be set aside not only transfers infected by actual fraud but certain other transfers as well—so-called constructively fraudulent transfers." *BFP,* 511 U.S. at 535. Section 548(a)(1)(A) requires actual fraud; § 548(a)(1)(B) does not. *See also In re Randy*, 189 B.R. 425, 443 (Bankr. N.D. Ill. 1995). The district court's reasoning renders the statute's provision regarding involuntary transfers superfluous, violating the fundamental canon that a statute be interpreted "so as not to render one part inoperative." *Colautti v. Franklin*, 439 U.S. 379, 392 (1979).

II. The Smiths' Recovery Is Not Limited to $15,000.

The Smiths argue that as debtors in possession, they are entitled to use § 548(a)(1)(B) to avoid the transfer in its entirety, not solely to the extent of their exemptions. (Smiths' Br. 28-32.) Chapter 13 debtors when acting for the benefit of the bankruptcy estate must have concurrent standing with the trustee to avoid transfers completely.[10] The Smiths' derivative standing comports with applicable

[10] While undecided in this circuit, courts in other circuits have reached differing results. *Compare In re Barbee,* 461 B.R. 711 (B.A.P. 6th Cir. 2011); *In re Cohen*, 305 B.R. 886 (B.A.P. 9th Cir. 2004) (holding that Chapter 13 debtor has standing to use § 548(a)), *with In re Hamilton*, 125 F.3d 292 (5th Cir. 1997) (Section 548(a) not available, but transfer could be avoided entirely under § 522(h) because of Texas' unlimited homestead exemption).

provisions of the Code, overall bankruptcy policy, the practical realities of Chapter 13 litigation, and the binding effect of a confirmed Chapter 13 Plan.

A. Chapter 13 Debtors Acting For the Benefit of the Bankruptcy Estate Have Concurrent Standing to Use the Trustee's Avoiding Powers to Their Full Extent.

The Code does not make avoidance actions the exclusive province of trustees; both the structure of the Code and relevant legislative history make clear that debtors share the trustee's powers to seek avoidance of fraudulent transfers. The legislative history of § 1303 makes clear that the list of exclusive powers in that section "does not imply that the debtor does not also possess other powers concurrently with the trustee." 124 Cong. Rec. H11106 (daily ed. Sep. 28, 1978); S. 17423 (daily ed. Oct. 6, 1978); *In re Cohen,* 305 B.R. at 894. For example, § 323 (authorizing trustees to sue and be sued) is not listed in § 1303, but "'certainly it is intended that the debtor has the power to sue and be sued.'" *Cohen*, 305 B.R. at 894, *quoting* 124 Cong. Rec. H11106; S. 17423.

Chapter 13 of the Code, considered as a system intended to function harmoniously, makes clear that § 548 avoidance powers are among the trustee powers necessary to be exercised by a Chapter 13 debtor concurrently with the trustee.

To be confirmed, a Chapter 13 plan must provide for distribution of assets to allowed unsecured creditors in amounts at least equal to what those creditors would have been paid had the case been filed under Chapter 7. 11 U.S.C. § 1325(a)(4). (This is known as the "best interests of creditors" requirement.) In a Chapter 7 case,

the trustee has both legal standing and financial incentives to avoid fraudulent transfers. In calculating how much would be received in a hypothetical Chapter 7 case, the Chapter 13 debtor must consider how much the Chapter 7 trustee could have increased the bankruptcy estate by using the avoiding powers in Sections 544, 545, 547, 548 and 553 of the Code. In many cases the Chapter 13 debtor cannot replicate the results that can be obtained by a Chapter 7 trustee unless the debtor has the same avoidance powers.

This is particularly so given that the Chapter 13 trustee has no express duty to pursue avoidance claims. *See In re Einoder*, 55 B.R. 319, 322-24 (Bankr. N.D. Ill. 1985); *Cohen*, 305 B.R. at 894-95; *In re Dickson,* 427 B.R. 399, 405 (B.A.P. 6th Cir. 2010), *aff'd on other grounds*, 655 F.3d 585 (6th Cir. 2011). Chapter 13 trustees are directed to perform almost all of the same duties as Chapter 7 trustees, but *not* § 704(1). *See* 11 U.S.C. §§ 1304(b)(1) and 1304(c). Section 704(1) requires the Chapter 7 trustee "to collect and reduce to money the property of the estate." 11 U.S.C. § 704(1). Thus, the list of Chapter 13 mandatory trustee duties *omits* the single Chapter 7 trustee duty that obliges the Chapter 7 trustee to pursue § 548 avoidance actions. *See Cohen,* 305 B.R. at 896.

In *Cohen* the court provided an apt illustration of how these provisions, and Chapter 13's structure generally, indicate that Congress must have contemplated that Chapter 13 debtors would share standing to bring avoidance actions. *Id.* at 897. The court supposed a debtor with a plan funded solely with $30,000 of future income, where the debtor had made a voluntary transfer unquestionably subject to

avoidance by the trustee that would recover $100,000. *Id.* The court noted that the "best interests of creditors" test would not permit the plan to be confirmed if it paid creditors less than what they would have received under Chapter 7. *Id.* Given the Chapter 7 trustee's duty to avoid the transfer, the trustee would be required to recover $100,000 to distribute to creditors. *Id.* The Chapter 13 debtor in such an instance, because he has only his income of $30,000 to fund a plan, could only propose a confirmable plan that required the avoidance of the $100,000 transfer. *Id.* As the court observed,

> It would be an odd system that would require a chapter 13 debtor to depend upon the recovery of an avoidable transfer in order to have a confirmable plan but not permit the debtor to avoid the transfer.

Id.

The result is particularly incongruous in light of the reality that although Chapter 13 trustees have the power to pursue avoidance claims, their case load and compensation system make it all but impossible for them to do so. *See Einoder*, 55 B.R. at 322-24. In a Chapter 13 bankruptcy, the debtor retains both possession of property of the estate, and the power to dispose of it, so that "[u]nlike in a Chapter 7, the Chapter 13 trustee cannot sell estate assets to fund a 'war chest' by which to pursue potentially expensive avoidance actions." *Dickson,* 427 B.R. at 405. Chapter 13 trustees thus "lack[] the resources to pursue meritorious avoidance claims." *Id.* For that reason, the bankruptcy system would break down if the avoidance power were vested solely in the trustee under Chapter 13. *Id.*

Not only do they lack the resources to pursue avoidance actions, Chapter 13

trustees lack incentive to do so:

> [I]n Chapter 13 cases the trustee rarely, if ever, pursues such actions because the trustee reaps little benefit for the amount of time and effort involved. The trustee would have to hire an attorney and litigate the action. Should the trustee succeed, any recovery becomes property of the estate and goes to the debtor.

Einoder, 55 B.R. at 322. The trustee's essential role is "to review plans, advise the Court with respect to plans and act as a disbursing agent under confirmed plans. The Chapter 13 trustee is in a poor position to litigate actions under the avoiding powers." *Id.* at 323. Given their caseloads, "Chapter 13 trustees would become seriously overburdened and inefficient if they chose to set aside preferences, fraudulent conveyances, and the like on a routine basis." *Id.* It is thus "only reasonable" to "allow the debtor to exercise the avoiding powers for his or her own benefit and for the creditors' indirect benefit as the trustees are unlikely ever to pursue those matters on their own;" otherwise, the trustee's inactivity would "result in windfalls to those creditors who have received avoidable transfers from Chapter 13 debtors." *Id.*

Because derivative standing is the only likely way in which fraudulent transfers will be avoided, such standing is essential to ensure the purpose of § 548 is met. To the extent that a transfer is completely avoided under § 548, it results in a more equitable distribution to all creditors.

Contrary to the bankruptcy court's reasoning, the exemption provisions of the Code, set forth in Chapter 5, do not limit Chapter 13 debtors' avoidance powers. Section 522 provides that for transfers avoidable under § 548, but which the trustee

does not avoid, the "debtor may avoid a transfer of property of the debtor . . . 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." 11 U.S.C. § 522(h).

The bankruptcy court wrongly surmised that this provision implies that Congress intended the circumstances of § 522(h) to be the *only* ones in which a debtor may exercise the trustee's avoidance powers. (Bankr. Ct. Op. S.A. 66.) Section 522(h) cannot be read as a limitation of avoidance power to the described circumstances, however, because that section also applies to Chapter 11 and 12 debtors, whose right to avoid involuntary transfers of nonexempt property is express. *See* 11 U.S.C. §§ 1107(a) and 1203. Instead, § 522(h) must be read to confer power on debtors in all Chapters to recover exempt property, while not limiting the power of Chapter 13 debtors to avoid transfers that benefit the estate. A Chapter 13 debtor's use of the trustee's avoidance power to render a plan feasible "contrast[s] with the debtor's avoidance power under 11 U.S.C. § 522(h), where the debtor is acting for the debtor's *personal* benefit, to recapture exempt assets." *Dickson*, 427 B.R. at 405 & n.4. Recognizing Chapter 13 debtors' derivative standing to pursue avoidance does not render § 522(h) superfluous. *Id.*

Chapter 13 debtors' standing to seek avoidance under § 548 does not result in unfair distributions to those debtors. Any recovery of property by a Chapter 13 debtor becomes property of the estate, which must be preserved for the benefit of the estate. The ultimate disposition is made only after 'notice and a hearing,' which subjects such matters to the control of the court." *Cohen*, 305 B.R. at 897-98. In

other words, while § 522(h) does not limit Chapter 13 debtors' avoiding power to their exemptions, it may limit their *recovery*, except in cases where the transfer results in surplus after full satisfaction of all creditors' claims.

B. There Is No Reason to Deny the Smiths Standing to Use § 548(a)(1)(B) to Its Full Extent to Avoid the Tax Deed.

As demonstrated above and in the Smiths' brief, as a general proposition Chapter 13 debtors have concurrent standing with the Chapter 13 trustee to use avoiding powers in general, and § 548(a)(1)(B) in particular. The bankruptcy court did not state any reasons that would justify denying the Smiths full use of the trustee's avoiding powers in this case.

1. The Smiths Have Not Waived or Forfeited Their Concurrent Standing.

The Smiths' Plan contains a special provision that they will prosecute the adversary proceeding and recover legal title to the property. (Modified Chapter 13 Plan at 5, § G.1, Doc. 25 in Case 07 B 06631.) The Chapter 13 trustee filed no objection, and the bankruptcy court confirmed the Plan with the special provision intact.

Congress did not give Chapter 13 debtors the exclusive right to bring avoidance actions, because under some circumstances, the trustee may be the more appropriate plaintiff. For example, if a debtor had knowingly engaged in a scheme to hinder and delay creditors, derivative standing could be inappropriate.

No such factors are present in this case. The Smiths are proceeding under § 548(a)(1)(B), which does not require prior fraudulent intent. The tax deed was an

involuntary transfer to a stranger. Avoidance of the tax deed will facilitate full payment to their creditors. If they were acting in bad faith, the Smiths' Plan would not have been confirmed. *See* 11 U.S.C. § 1322(a)(3).

2. The Bankruptcy Court Approved the Debtor's Plan Which Proposed Full Use of the Trustee's Avoiding Powers.

Section 1327 of the Code states that "the provisions of a confirmed plan bind the debtor and each creditor." 11 U.S.C. § 1327(a). Thus a defendant in an avoidance action who challenged a Chapter 13 debtor's standing lost, because the confirmed plan specifically provided that the debtor had standing to pursue a "strong-arm" avoidance action under § 544(a). *In re Hazelwood,* 513 B.R. 323 (Bankr. W.D. Ky. 2014); *see also In re Hearn*, 337 B.R. 603 (Bankr. E.D. Mich. 2006). By confirming the Smiths' Plan, the bankruptcy court authorized the Smiths to use the avoiding powers referred to in the adversary complaint to recover legal title to the property. No fair reading of the Plan could conclude that the debtors can only recover $15,000, when the Plan states that they will recover legal title (a 100% interest in the property). The Smiths thus have standing to use the avoiding powers in § 548(a)(1)(B) to the same extent as a trustee.

C. If This Court Reaches the Question of How Many Exemptions the Debtors May Claim, It Should Certify the Question to the Illinois Supreme Court.

This Court need not decide how many homestead exemptions the Smiths are entitled to. (*See* Argument II(A), *supra*.) However, if this Court does reach that issue, it should certify the question to the Illinois Supreme Court.

The question of whether a family member who is not on title could claim a

homestead exemption under Illinois law was before this Court in *In re Belcher*, 551 F.3d 688 (7th Cir. 2008). This is an issue that is important to many LAF clients. In *Belcher* this Court stated that it might have certified this question to the Illinois Supreme Court, but it was impractical to so because the *Belcher*'s attorney had withdrawn from the case after oral argument. *Id.* at 692 n.3. No such impracticality exists in this case. Certification of this question to the Illinois Supreme Court would be as appropriate now as it was before.

CONCLUSION

For all the above reasons, this Court should reverse the decision of the district court. The decision of the bankruptcy court that the tax deed was an avoidable transfer under § 548(a)(1)(B) should be affirmed, but its decision to limit the Smiths' recovery against SIPI to $15,000, should be reversed. *Amici* take no position on whether SIPI's codefendant, Midwest Capital Investments, proved its claim that it was a good faith purchaser for value under 11 U.S.C. § 550(b)(1).

Respectfully submitted,

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RULE 32(A)(7) CERTIFICATION

This brief complies with the type-volume limitation of Federal Rule of Appellate Procedure 32(a)(7)(B) because this brief contains 6928 words, excluding the parts of the brief exempted by Federal Rule of Appellate Procedure 32(A)(7)(B)(iii).

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PROOF OF SERVICE

I hereby certify that on May 4, 2015, I electronically filed the foregoing with the Clerk of the Court for the U.S Court of Appeals for the Seventh Circuit by using the CM/ECF system. I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the CM/ECF system.

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