

# No. 20-3865-BK

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IN THE  
UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT

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BRIAN L. GUNSALUS AND GLIEE V. GUNSALUS,  
*Plaintiffs-Appellees,*

v.

COUNTY OF ONTARIO, NEW YORK,  
*Defendant-Appellant*

JOHN DOE, fictitious, it being the intention to name any 3rd-party purchaser of  
Plaintiffs' home at 1338 White Road, Phelps, NY 14532 during the property tax  
foreclosure auction scheduled by Ontario Cty at 2914 County Rd 48, Canandaigua NY at  
7 pm 5/17/17,  
*Defendant,*

GEORGE REIBER,  
*Trustee.*

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Appeal from the United States District Court for the Western District of New York

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BRIEF OF AMICI CURIAE NATIONAL CONSUMER BANKRUPTCY  
RIGHTS CENTER, NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY  
ATTORNEYS, AND NATIONAL CONSUMER LAW CENTER, IN SUPPORT OF  
APPELLEES AND SEEKING AFFIRMANCE OF THE BANKRUPTCY COURT'S  
DECISIONS

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RULE 26.1 CORPORATE DISCLOSURE STATEMENT

*Gunsalus v. County of Ontario, NY*, No. 20-3865

Pursuant to 2d Cir. R. 26.1, Amici Curiae, the National Association of Consumer Bankruptcy Attorneys, the National Consumer Bankruptcy Rights Center, and the National Consumer Law Center make the following disclosure:

1) Is party/amicus a subsidiary or affiliate of a publicly owned corporation? If yes, list below the identity of the parent corporation or affiliate and the relationship between it and the named party. NO

2) Is there a publicly owned corporation, not a party to the appeal, that has a financial interest in the outcome? If yes, list below the identity of the corporation and the nature of the financial interest. NO

This day of May 22, 2021.

*s/ Tara Twomey*

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Attorney for Amici Curiae

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INTEREST OF AMICI CURIAE<sup>1</sup>

NCBRC is a nonprofit organization dedicated to preserving the bankruptcy rights of consumer debtors and protecting the bankruptcy system's integrity. The Bankruptcy Code grants financially distressed debtors rights that are critical to the bankruptcy system's operation. Yet consumer debtors with limited financial resources and minimal exposure to that system often are ill-equipped to protect their rights in the appellate process. NCBRC files amicus curiae briefs in systemically-important cases to ensure that courts have a full understanding of the applicable bankruptcy law, the case, and its implications for consumer debtors.

NACBA is also a nonprofit organization of more than 2,500 consumer bankruptcy attorneys nationwide. NACBA advocates nationally on issues that cannot adequately be addressed by individual member attorneys. It is the only national association of attorneys organized for the specific purpose of protecting the rights of consumer bankruptcy debtors.

The National Consumer Law Center (NCLC) is a public interest, non-profit legal organization incorporated in 1971. It is a national research and advocacy

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<sup>1</sup> Pursuant to Fed. R. App. P. 29(a)(4)(E) and Local Rule 29.1(b), amici curiae affirm that no counsel for a party authored this brief in whole or in part, and no person or entity other amici and their counsel made any monetary contribution toward the preparation or submission of this brief.

organization focusing specifically on the legal needs of low income, financially distressed, and elderly consumers.

Amici have a vital interest in the outcome of this case. Along with the fresh start for the debtor, a principal objective of the Bankruptcy Code is to ensure a fair and equitable distribution of assets of the debtor among all creditors. In order to achieve this objective, the Code gives bankruptcy trustees, and in some circumstances debtors, the authority to bring back into the bankruptcy estate property that the debtor lost within a fixed period of time before the bankruptcy filing. In this case, as a result of tax debts, title to the debtors' properties passed to the county tax authority for later sale. That sale resulted in the county receiving 80 – 95% in excess of the tax debts. Unlike typical mortgage foreclosures where the mortgagee is entitled to retain sale proceeds only in the amount of the underlying debt, the strict foreclosure procedure followed by the county tax authority in these cases allows the county to retain the excess. Here, the county received a windfall at the expense of the debtors and their other creditors.

Amici believe the issue presented to this Court is of fundamental importance to the bankruptcy system and seek to provide the Court with additional background on the principles of law at stake in this case.

## SUMMARY OF ARGUMENT

The County of Ontario (“the County”) took title to the Gunsalus’ home valued at \$28,000 because they owed \$1,236.52 in property taxes. The Hamptons’<sup>2</sup> home had been appraised at between \$60,000 and \$87,000. The County took title to the Hamptons’ home because they owed \$5,157.73 in taxes. The County acquired both homes through a process known as “strict foreclosure.” In a strict foreclosure a creditor asks a court to set a deadline for payment of a debt secured by the property. If the debt is not paid by the deadline, the court enters an order transferring title and possession of the property to the creditor. There is no foreclosure sale. Instead, by operation of the court’s order the property owner cedes all equity in the property to the creditor. The creditor can later sell the property to a third party. Unlike in a traditional mortgage foreclosure, the creditor in a strict foreclosure does not have to give back to the foreclosed property owner any surplus from the sale proceeds over the debt owed. Not surprisingly, a strict foreclosure can result in a substantial windfall for the foreclosing creditor. For this reason, strict foreclosure has been widely regarded as an unfair and draconian remedy.

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<sup>2</sup> By Order dated November 16, 2020 this Court consolidated the proceedings docketed under No. 20-2314 (the Gunsalus appeal) and No. 20-2321 (the Hampton appeal). The two appeals present the same legal issues and do not involve disputed facts. This Amicus brief will therefore refer to proceedings in the consolidated cases.

After obtaining title the County sold the Gunsaluses' property and received a net gain of \$20,763.48 over the amount of the tax debt owed. The County sold the Hampton's property for a net gain of \$21,798.13. In both cases the County insists that it has the right to keep 100% of the surpluses it received from these sales following strict foreclosure.

Within a short time after the courts transferred title to their homes to the County, the Gunsaluses and the Hamptons filed for chapter 13 bankruptcy relief. Along with the fresh start for the debtor, a principal objective of the Bankruptcy Code is to ensure a fair and equitable distribution of assets of the debtor among all creditors. In order to achieve this objective, the Code gives bankruptcy trustees, and in some circumstances debtors, the authority to bring back into the bankruptcy estate property that the debtor lost within a fixed period of time before the bankruptcy filing. Under one of these Code provisions the trustee or the debtor may avoid a transfer of the debtor's property that occurred within two years before the bankruptcy filing date if the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation;" 11 U.S.C. § 548(a)(1)(B). In the instant case there is no dispute that within two years before the bankruptcy filings, the properties of the Gunsaluses and the Hamptons were transferred to the County in return for the release from debts that equaled only 5% and 19% of the values of the respective properties.

These strict foreclosures had all the hallmarks of transfers that must be set aside under section 548(a)(1)(B). The County's strategy for holding on to the windfalls is to claim that the strict foreclosures were like sales that occur in traditional mortgage foreclosures. In *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), the Supreme Court held that the price received in a mortgage foreclosure sale conducted in accordance with state law presumptively represents the "reasonably equivalent value" of the property for purposes of section 548(a)(1)(B). According to the Supreme Court, the forced public auctions of properties conducted under state mortgage foreclosure laws determine the values of the properties sold.

The problem with the County's argument is that the strict foreclosures under New York's tax lien statutes do not involve sales. It is true that the County sells the properties at public auctions after strict foreclosures. However, the transfer of all rights, title, and interests of the former property owner to the County, which is the transfer that is relevant for section 548(a)(1)(B) purposes, has already occurred when the County auctions off the property. The auction is conducted solely for the benefit of the County. The sale proceeds bear no relation to the amount of the tax debt that led to the strict foreclosure. The County is not accountable to any other creditors or to the debtor for what it does with the proceeds. When the sale following a strict foreclosure produces a windfall, as it did in the two instant cases,

this puts the County squarely in the position of the creditor clinging to an unfair pre-bankruptcy transfer to the detriment of the bankruptcy estate and the debtor.

Bankruptcy courts within the Second Circuit have often held that strict foreclosures do not fall within the ambit of the *BFP* decision. In their most egregious forms, as in the New York tax foreclosure system, strict foreclosures effectuate a legal transfer of title to property without any vehicle for assessing the property's value. Courts outside the Second Circuit have similarly refused to apply *BFP* to strict foreclosures.

### ARGUMENT

I. Taxing authorities cannot hide behind the *BFP* decision to hold on to unfair windfalls from strict foreclosures.

A. Application of *BFP* to tax foreclosures depends upon the method of foreclosure used.

*BFP* involved a mortgage foreclosure, and the Supreme Court expressly left open the decision's application to tax foreclosures. 511 U.S. at 537 n.3. Since *BFP* was decided in 1994, many courts have addressed the decision's impact on tax foreclosures. Although the rulings may initially appear to be wildly inconsistent, they are not. Each decision depends on the type of tax foreclosure system in use in a particular state. Viewed in terms of the specific methods of tax foreclosure involved, the decisions have in fact been very consistent. Courts have considered

state tax foreclosure systems using procedures that fall into three general categories: the overbid method, the interest rate method, and strict foreclosure.

The overbid method resembles the typical mortgage foreclosure. The taxing authority auctions off the tax-delinquent property at a public sale. Bidders compete based on their assessments of the property's value. After the auction, title is transferred to the winning bidder. If a surplus remains after applying the sale proceeds to the tax debt, the former property owner (and sometimes other lienholders) are entitled to the surplus. Because these procedures closely resemble those that *BFP* referred to as typical for mortgage foreclosures, courts have consistently held that *BFP* applies to tax sales conducted using the overbid method. Decisions applying *BFP* to overbid tax sales are summarized in Part I.F, below.

The interest rate method of tax foreclosure is fundamentally different. Auctions take place under this system, but bids are not related to the property's value. Instead, participants bid on the rate of interest accruing on a tax lien. The bidder willing to accept the lowest interest rate wins. If the property owner does not redeem by paying off the lien by a deadline, the winning bidder can obtain title to the property through a strict foreclosure procedure. Because this strict foreclosure does not involve any consideration of the property's value, courts have consistently held that *BFP* does not apply to tax foreclosures using the interest rate bidding method. These decisions are discussed in Part I.F, below.



Finally, several states, including New York, allow taxing authorities to foreclose using a purely strict foreclosure procedure. In these strict foreclosures title of a tax-delinquent property passes directly to a taxing authority without a sale or auction of any kind. The taxing authority can later sell the property and retain any surplus gained over the amount of the tax debt owed. To date, no court of appeals has considered *BFP*'s application to purely strict foreclosure tax forfeitures. However, lower courts have consistently held that *BFP* does not control when a court extinguishes property rights in a foreclosure without considering a property's value. The lower court rulings on strict tax foreclosures are discussed in Parts D, E, and F, below.

The County's Brief ignores the distinctions in state law that have been critical to the decisions applying section 548 to tax foreclosures, focusing instead only on rulings from overbid jurisdictions to support its position. Appellant's Brief pp. 19-29. Those 54sions are simply not relevant to the issue presented in this appeal.

- B. This appeal involves a strict foreclosure in which an owner's rights in property are extinguished by court order without consideration of the property's value.

The Gunsaluses and Hamptons did not lose their homes through foreclosure sales. They lost their homes through strict foreclosure. "Strict foreclosure does not

involve a foreclosure sale.” Baxter Dunaway, 2 *Law of Distressed Real Estate* § 16.50 (Nov. 2020). In a strict foreclosure the plaintiff creditor requests that the court set a deadline for the property owner to pay a redemption amount. If the owner fails to pay the amount by the designated time, the creditor is given the immediate right to title and possession of the property. *Id.* The court’s judgment order extinguishes the owner’s rights in a property. For example, in a New York strict tax foreclosure case the court’s judgment awards possession of the property to the tax district and directs the district “to prepare, execute and cause to be recorded a deed conveying to such tax district full and complete title to such parcel.” N.Y. Real Prop. Tax Law § 1136. By virtue of the court’s judgment the tax district is forthwith “seized of an estate in fee simple absolute in such parcel” and all persons, “who may have had any right, title, interest, claim, lien or equity of redemption in or upon such parcel shall be barred and forever foreclosed of all such right, title, interest, claim, lien or equity of redemption.” *Id.*

Mortgage foreclosures in New York follow fundamentally different procedures. N.Y. Real Prop. Acts. Law §§1301-1392. In a mortgage foreclosure action, the court enters a judgment order of sale to “discharge the mortgage debt.” *Id.* §1351.1 After the sale, the official who conducted the sale executes a deed to the purchaser. *Id.* §4. The official pays off the debt owed to the mortgagee and other lienholders with the proceeds from the sale, with any surplus deposited with

the court. *Id.* §1354. The New York mortgage foreclosure statutes carefully regulate the distribution of sale proceeds, requiring a verified report from the official who conducted the sale and court supervision of distribution of the surplus. *Id.* §§1355, 1361, 1362. Any party, including the mortgagor, can make a claim for the surplus. *Id.* §1361.3.

There are two salient differences between a New York strict tax foreclosure and a New York mortgage foreclosure by sale. First, in the strict tax foreclosure the owner's interest in the property is extinguished before the taxing authority offers the property for sale to third parties. Second, following the strict tax foreclosure, the former owner has no right to claim any of the sale proceeds and the taxing authority can retain all the value of the former owner's equity in the property. *Hoge v. Chautauqua*, 104 N.Y.S. 3d 813 (N.Y. App. Div. 2019) (in a New York strict tax foreclosure, unlike in a mortgage foreclosure, foreclosed party loses rights to surplus from creditor's post-foreclosure sale of the property).

Strict foreclosure wielded by a taxing authority is a particularly potent weapon. In a strict foreclosure of a mortgage, a mortgagee may take title subject to certain existing liens. By contrast, tax liens have statutory priority over all other liens on a property, giving the government unencumbered title upon strict foreclosure of a tax lien. Taxing authorities therefore have every incentive to use strict foreclosure as a revenue enhancement device. By taking properties with

small arrearages and significant equity, a taxing authority can augment revenues by amounts far greater than the taxes recovered. In the Gunsalus' case, for example, only 5% of the funds the County collected from the foreclosure went to pay for taxes. The County kept the other 95% of the sale proceeds as general revenue to the County.

- C. The states have overwhelmingly rejected the strict foreclosure remedy because it allows a forfeiture without consideration of the property's value.

Strict foreclosure is rarely used in the United States. It is routinely used to foreclose mortgages in only two states. *In re Canney*, 284 F.2d 362, 368 (2d Cir. 2002) ("Strict foreclosure is the normal method of foreclosure only in Connecticut and Vermont."). All other jurisdictions use a sale procedure for the foreclosure of mortgages. The Supreme Court in *BFP* prefaced its analysis with a review of the history of foreclosure laws in England and the United States. 511 U.S. at 541-42. The Court noted that early in this history courts employed strict foreclosure. The remedy was called "strict" because "the borrower's entire interest in the property was forfeited, regardless of any accumulated equity." *Id.* at 541. By the nineteenth century American courts had moved away from strict foreclosure and adopted foreclosure by sale "with the surplus over the debt refunded to the debtor." *Id.* Returning the foreclosure sale surplus to the debtor was "a means of avoiding the

draconian consequences of strict foreclosure.” *Id.* The *BFP* Court observed that contemporary state foreclosure laws typically required certain procedures, and these included “publication of a notice of sale, and strict adherence to prescribed bidding rules and auction procedures.” *Id.* at 542.

States discarded strict foreclosure because the procedure caused loss of substantial property rights without taking into account the value of a property. As one treatise describes:

It is thought that strict foreclosure unjustly enriches mortgagees by allowing them to acquire land worth much more than the balance of the secured obligation. Foreclosure by public sale is preferred because it allows the property’s value to be tested by auction and requires that any surplus be distributed to mortgagors or others whose interests are extinguished by the foreclosure.

12 *Thompson on Real Property* § 101.04(a) (3d ed. 2020); see also 5 *Tiffany Real Property* § 1518 (3d ed. 1939 and 2020 Supp.) (“This method of [strict] foreclosure has not been favored in this country, since it is liable to result in forfeiting the whole property on account of a debt considerably less than the value of the property.”). Allowing a “property’s value to be tested by auction,” as the Thompson treatise describes it, ensures that there is a measure for “reasonably equivalent value” in the context of section 548(a)(1)(B).

New York has strongly disfavored the “unusual, exceptional and severe remedy” of strict foreclosure of mortgages. *Moulton v. Cornish*, 138 N.Y. 133, 142 (1893) (referencing a contemporary treatise concluding that “strict foreclosure is

very rarely resorted to in the American courts; that in a large majority of the states it is not recognized; that in two it is the usual mode of procedure; and that in six of the states, including New York it is permitted in exceptional cases.”).

The Appellant asks this court to hold that when Congress created a Code provision designed to control pre-bankruptcy transfers of bankruptcy estate property for “less than a reasonably equivalent value” it intended that courts defer to a rarely used state forfeiture remedy that extinguishes property rights without any consideration of the property’s value. The Supreme Court in *BFP* did not envision such a bizarre result. On the contrary, the *BFP* Court acknowledged that foreclosure by sale is the predominant method used to foreclose mortgages in the United States. When it crafted an exception to use of fair market value as the measure of value for determining whether a transfer was subject to avoidance the *BFP* Court referred repeatedly to foreclosure sales. The Court articulated a special rule to apply to properties that are “legally subject to forced sale.” *BFP*, 511 U.S. at 548. According to the Court, a property’s value is redefined when it “is offered for sale” as part of a foreclosure. *Id.* This was because “far more restrictive rules governing forced sales” apply in foreclosures. *Id.* Because normal market rules do not apply to mortgage foreclosure sales, “the only legitimate evidence of the property’s value at the time it is sold is the foreclosure-sale price itself.” *Id.* at 549.

The Court's reasoning makes no sense in the context of a strict foreclosure that occurs without a sale.

- D. In the two states where strict foreclosure of mortgages is routinely used the courts have applied section 548(a)(1)(B) to set aside foreclosures conducted without consideration of the property's value.

Bankruptcy courts in Connecticut and Vermont are familiar with the issue raised in this appeal. They have addressed the same issue in the context of strict foreclosures of mortgages still allowed in these two states. The County's view of how section 548(a)(1)(B) impacts a strict foreclosure runs counter to the prevailing views of the Connecticut and Vermont bankruptcy courts.

- i. Connecticut strict foreclosures of mortgages may be set aside under section 548(a)(1)(B).

Connecticut has traditionally allowed strict foreclosure of mortgages. *In re Fitzgerald*, 237 B.R. 252, 261-62 (Bankr. D. Conn. 1999) (summarizing Connecticut mortgage foreclosure procedures). Upon failure to redeem by a "law day" set by a court, the title to mortgaged property becomes "absolute" in the mortgagee. Conn. Gen. Stat. Ann. § 49-16. Two Connecticut bankruptcy courts have ruled that the state's strict foreclosures of mortgages do not create a presumption of reasonably equivalent value under section 548(a)(1)(B). *In re Pantini*, 377 B.R. 28, 30-31 (Bankr. D. Conn. 2007); *In re Fitzgerald*, 255 B.R.

807, 812 (Bankr. D. Conn. 2000) (chapter 7), *earlier decision*, 237 B.R. 252, 266 (Bankr. D. Conn. 1999) (chapter 13). In her two related *Fitzgerald* decisions Judge Weil focused on *BFP*'s conclusion that "the only legitimate evidence of the property's value at the time it is sold is the foreclosure-sale price itself." *Fitzgerald*, 237 B.R. at 265 (quoting *BFP*, 511 U.S. at 549). When the *Fitzgerald* court compared foreclosure by sale to strict foreclosure without a sale, it was clear that a failure to redeem by a fixed date did not produce any "legitimate evidence" that the transfer was not for less than a reasonably equivalent value. *Fitzgerald*, 255 B.R. at 811. Therefore, *BFP*'s rationale did not apply to a Connecticut strict mortgage foreclosure without a sale<sup>3</sup>

One Connecticut bankruptcy court disagreed with the *Fitzgerald* court's conclusion. *In re Talbot*, 254 B.R. 63 (Bankr. D. Conn. 2000). The court's reasoning in *Talbot* is illuminating for the issue presented in the instant appeal. Judge Krechevsky found that Connecticut strict foreclosures fell within the scope of *BFP* because they included significant procedural protections for defendants. Under the Connecticut procedures the borrower (or any party) had the option to

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<sup>3</sup> In a later decision agreeing with *Fitzgerald*'s analysis a Connecticut bankruptcy court held that the state's process for tax foreclosure *did* fall within *BFP*'s ambit. *In re Jacobson*, 523 B.R. 13, 22 (Bankr. D. Conn. 2014). The *Jacobson* court examined the overbid auction system that Connecticut used for tax sales and concluded that, unlike mortgage foreclosures in the state, the tax sale procedures included competitive bidding and other procedural protections outlined by *BFP*. *Id.* at 19-20.



request a foreclosure by sale as an alternative to strict foreclosure. Conn. Gen. Stat. Ann. 49-24.<sup>4</sup> More significantly, the court adjudicating a strict foreclosure was required to make a determination of the property's fair market value and exercise reasonable discretion to order a sale when the property had significant value over the debt. Historically, this judicial assessment of value in Connecticut strict foreclosures was an important deterrent to transfers that might produce windfalls for the foreclosing mortgagee. *Fidelity Trust Co. v. Irick*, 538 A.2d 1027, 1030 (Conn. 1988) (reversing strict foreclosure where trial court failed to consider that substantial excess equity over debt was available that could have benefited other secured creditors and the borrower); *Connecticut Sav. Bank v. Burger*, 579 A.2d 1097, 1099 (Conn. App. Ct. 1990) (same). Notably, the strict foreclosure regime for New York's tax foreclosures does not include any of the protections available for Connecticut mortgage foreclosures.

- ii. Vermont strict foreclosures of mortgages may be set aside under section 548(a)(1)(B).

Vermont, like Connecticut, has traditionally used strict foreclosure as the primary method for foreclosure of mortgages. *Canney*, 284 F.2d at 368. In *In re Chase*, 2005 WL 189711, \*6 (Bankr. D. Vt. Jan. 27, 2005), the court ruled that

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<sup>4</sup> In 2015, the Connecticut legislature added a third option beyond strict foreclosure and foreclosure by sale. The defendant mortgagor may also seek court approval to conduct a fair market sale (or "short sale") as an alternative to a foreclosure sale and strict foreclosure. Conn. Gen. Stat. Ann. §§ 49-24a to 24g.

mortgage foreclosures conducted under Vermont's strict foreclosure procedures did not establish reasonably equivalent value for purposes of section 548(a)(1)(B). The *Chase* court examined the rulings from the Connecticut courts in *Fitzgerald* and *Talbot*, discussed above. The Vermont court viewed the two Connecticut decisions as consistent in requiring that certain minimal safeguards were essential if a foreclosure process were to be treated as establishing reasonably equivalent value under section 548(a)(1)(B). *Chase*, 2005 WL 189711, at \*6. The Connecticut bankruptcy courts had disagreed over whether Connecticut's strict foreclosure laws met this level of protection. Comparing the procedural protections available under Vermont's strict foreclosure laws with those of Connecticut, the *Chase* court found that Vermont offered none of the essential safeguards available under Connecticut statutes. *Id.* Under the Vermont law there was no requirement that the court make a determination of the amount of equity in the property before allowing a strict foreclosure. In Vermont the defendant had no unilateral right to demand a foreclosure by sale. *Id.* In other words, the Vermont strict foreclosure procedures functioned like those under the New York tax forfeiture laws.

Following the *Chase* decision, the Vermont legislature amended the state's foreclosure statute to add a provision which requires courts to find that there is no

substantial excess equity in the property before allowing strict foreclosure.<sup>5</sup>

Otherwise the foreclosure must proceed by sale. *See In re Willette*, 395 B.R. 308, 317-18 (Bankr. D. Vt. 2008) (discussing the 2005 amendments as response to the court's ruling in *Chase*).

- iii. Lower courts in New York have widely held that strict tax foreclosures do not establish reasonably equivalent value for purposes of section 548(a)(1)(B)

Lower courts in New York have been addressing the issue raised by this appeal for nearly two decades. While Judge Warren rendered inconsistent decisions leading up to this appeal, rulings of all other district and bankruptcy courts considering the impact of section 548(a)(1)(B) on strict foreclosures of tax liens under New York law have been consistent. The transfer of title under N.Y. Real Prop. Tax Law § 1136 does not establish evidence of reasonably equivalent value under section 548(a)(1)(B) because the tax foreclosure does not involve a sale. *Clinton County Treasurer v. Wolinski*, 511 B.R. 34 (N.D.N.Y. 2014); *County of Clinton, et al. v. Warehouse at Van Buren St., Inc.*, 496 B.R. 278, 283 (N.D.N.Y.

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<sup>5</sup> The amendment states: “No decree foreclosing the right of redemption without sale shall be issued absent a finding by the court that there is no substantial value in the property in excess of the mortgage debt found by the court to be due to the plaintiff and any other lienholder, plus assessed but unpaid property taxes due on the property. The court shall include in its order a summary of the evidence upon which its finding is based.” 12 V.S.A. § 4941(c) amending former 12 V.S.A. § 4528(b).

2013); *Martyak v. Tioga County*, 432 B.R. 25, 37 (Bankr. N.D.N.Y. 2010); *In re Murphy*, 331 B.R. 107, 118 (Bankr. S.D.N.Y. 2005); *In re Harris*, 2003 WL 25795591 (Bankr. N.D.N.Y. Mar. 11, 2003).

The County spends a great deal of time in its Brief with conjecture about dire consequences that may follow from an affirmance of the bankruptcy court. According to the County, title to properties will be thrown into confusion and local governments will face financial ruin. In reality, courts in the Second Circuit have been following the legal rulings articulated by the bankruptcy court below for many years. The sky has not fallen. The County failed to produce any evidence to support its claims of doom.

- iv. Courts outside the Second Circuit apply *BFP* to foreclosures in accordance with the availability of a sale mechanism that tests the property's value.

Decisions applying *BFP* to tax foreclosures turn on the nature of each state's tax foreclosure procedures. As exemplified in the decisions discussed in this section, courts typically compare the state's procedures for tax foreclosures with its procedures for mortgage foreclosures. If the state's tax foreclosure procedures closely follow those for foreclosure of mortgages and include public sales, courts find *BFP* controlling for the tax sales. Similarly, courts consider the specific procedural protections that the *BFP* court listed as typically available under state mortgage foreclosure laws. These are: notice, a substantial lead time before a sale,

publication of sale notices and “strict adherence to prescribed bidding rules and auction procedures.” *BFP*, 511 U.S. at 542. If the state tax foreclosure laws incorporate these safeguards, the courts find the tax foreclosure entitled to *BFP*’s presumption.

As described above, state tax foreclosure systems can be divided into three basic types: strict foreclosure, sale of tax liens based on bids for an interest rate, and foreclosure by sales that allow for overbids. Rulings applying *BFP* (or refusing to apply *BFP*) have been consistent within these groupings.

Rulings within and outside the Second Circuit have consistently found *BFP* inapplicable to enforcement of tax liens through strict foreclosure. *In re Yourelo Your Full-Service Relocation Corp.*, 2020 WL 6927549, \*3-4 (Bankr. D. Mass. Nov. 23, 2020); *City of Milwaukee v. Gillespie*, 437 B.R. 307 (Bankr. E.D. Wis. 2012), *aff’d* 487 B.R. 916, 921 (E.D. Wis. 2013). In *In re Wentworth*, 221 B.R. 316 (Bankr. D. Conn. 1998), the court considered a Maine tax foreclosure system that operated as strict foreclosure. In finding *BFP* inapplicable the court held that a strict foreclosure, unlike a foreclosure sale, “eliminates rather than redefines the market” and produces “no evidence whatsoever of a property’s value.” *Id.* at 320.

Several states enforce tax liens through a mechanism that is distinct from both strict foreclosures and foreclosure sales based on overbids. These states use auctions where bids are based on the rate of interest accruing on a tax lien. The

party willing to accept the lowest rate of interest wins the auction. Because the bids bear no relation to a property's value, these procedures are more analogous to strict foreclosures than to overbid auctions where bids take the property's value into account. The Seventh Circuit has held that *BFP* was inapplicable to tax sales under the Illinois system of interest-rate based bidding for tax liens. *Smith v. SIPI, LLC, et al.*, 811 F.3d, 228, 238 (7th Cir. 2016), *cert. denied*, 137 S. Ct. 102 (2016).

New Jersey also uses a system of interest-rate bidding in tax foreclosures. Over the past ten years, five different New Jersey bankruptcy courts held that these tax foreclosures do not establish reasonably equivalent value under section 548(a)(1)(B). *In re Heidt*, 2021 WL 886369, \*3 (Bankr. D.N.J. Mar. 9, 2021) (collecting cases). The New Jersey system bears a close resemblance to a strict foreclosure because the property owner loses title based on a judicial decree and not through a sale of the property. *In re Berley Assoc., Ltd.*, 492 B.R. 433, 441 (Bankr. D.N.J. 2013).

In a recent decision, the Third Circuit held that a New Jersey tax sale could be set aside as a preference pursuant to 11 U.S.C. § 547(b). *Hackler v. Arianna Holding Co., LLC*, 938 F.3d 473, 479 (3d Cir. 2019). The court considered New Jersey tax foreclosures to be "strict foreclosures" because the property owners lose title solely by operation of a court order. *Id.* at 475. While bidding over the interest rate takes place, this bidding bears no relation to the property's value:

The main conclusion of *BFP* – that the price reached via a foreclosure conducted according to state law should be considered to be the “reasonably equivalent value” of the property – is not pertinent here, because in New Jersey, the relationship between the winning bid and the value of the underlying property is not merely attenuated but nonexistent.

*Id.* at 479. As in New Jersey, property owners subject to New York tax foreclosures lose title through a judicial process that disregards the property’s value.

Many state tax foreclosure systems use the overbid system where bids are based on an assessment of the property’s value. These tax foreclosures are analogous to the typical mortgage foreclosure procedures that *BFP* addressed. Not surprisingly, several courts of appeals have held that *BFP* applies to tax sales that allow bidders to take into account the value of properties. *In re Tracht Gut, LLC*, 836 F.3d 1146, 1149 (9th Cir. 2016) (“California tax sales have the same procedural safeguards as the California mortgage foreclosure sale at issue in *BFP*”); *In re Grandote Country Club Co., Ltd.*, 252 F.3d 1146, 1152 (10th Cir. 2001) (“the decisive factor in determining whether a transfer pursuant to a tax sale constitutes ‘reasonably equivalent value’ is a state’s procedure for tax sales, in particular statutes requiring that tax sales take place publicly under a competitive bidding procedure”); *Matter of T.F. Stone Co., Inc.*, 72 F.3d 466, 471 (5th Cir. 1995) (in Oklahoma tax foreclosure Treasurer acquired all rights in property through “forced sale”). Lower courts similarly focused on the procedures for

competitive bidding when they applied *BFP* to tax foreclosures conducted through the overbid system. *In re Crespo*, 569 B.R. 624, 631-33 (E.D. Pa. 2017); *In re Washington*, 232 B.R. 340, 343-44 (Bankr. E.D. Va. 1999); *In re Samaniego*, 224 B.R. 154, 158 (Bankr. E.D. Wash. 1998); *In re Russell-Polk*, 200 B.R. 218, 221-22 (Bankr. E.D. Mo. 1996); *In re Hollar*, 184 B.R. 243, 252 (Bankr. M.D.N.C. 1995).<sup>6</sup>

- II. Applying section 548 to strict tax foreclosures conducted without consideration of the property's value does not impair tax collection.

Making New York tax forfeitures subject to section 548 does not interfere with collection of taxes. It may interfere with the collection of windfalls in certain instances. However, collection of windfalls is not an essential government function. The County seized the Hamptons' home for a tax debt of \$5,201.87 and later sold it for \$27,000.00, generating a \$21,798.13 windfall for the County. The County seized the Gunsalus' home for a tax debt of \$1,236.52 and later sold it for \$22,000, producing another \$20,763.48 windfall. Section 548(a)(1)(B) does not impact tax foreclosures when there is a reasonable relationship between the amount of the tax debt and the property's value. *Wentworth*, 221 B.R. at 320.

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<sup>6</sup> The County also cites to Michigan tax sale decisions to support its position. Appellant's Brief pp. 27-29. After these decisions were rendered the Michigan Supreme Court ruled that the state's tax foreclosures work as a forfeiture in violation of property owners' constitutional rights. *Rafaelli, LLC v. Oakland County*, 952 N.W.2d 434 (Mich. 2020).



Application of section 548(a)(1)(B) does nothing more than treat the County like any other creditor and limit its ability to claim bonuses well in excess of any debt that it was owed.

As the Seventh Circuit noted, applying section 548(a)(1)(B) to tax foreclosures may make purchases of properties that were subject to tax foreclosure “marginally less attractive as investments.” *Smith*, 811 F.3d at 240. Yet, even this marginal impact affects only the amount of the windfall and not collection of the underlying tax debt. The facts in the instant cases resoundingly disprove the County’s “cloud on title” claims. Appellant Brief pp. 44-46. After the County acquired title to the Hamptons’ home it sold the property for \$27,000. Based on all the evidence before it, the Bankruptcy Court found that this sum was equivalent to the property’s fair market value at the time. *In re Hampton*, 2020 WL 833045, \*5 (Bankr. W.D.N.Y. Feb. 19, 2020). The County sold the Gunsalus’ home for \$22,000, and there was little dispute that the fair market value of the property at the time of the sale was \$28,000. *In re Gunsalus*, 613 B.R. 1, 6 (Bankr. W.D.N.Y. 2020). When these post-strict foreclosure auctions took place, the Hamptons and Gunsalus had already filed for bankruptcy relief. Their adversary proceedings challenging the County’s title in the properties were already pending. There was clearly a very dark “cloud” looming over title to these properties. Yet, bidders were willing to pay sums close to the properties’ fair

market values despite the clouds. The County had no problem selling these properties and recovering not only the full amounts owed for taxes, but substantial windfalls as well.

Bankruptcy facilitates collection of tax debts in many ways. *In re CGI Properties, LLC*, 568 B.R. 231, 248 (Bankr. D.N.J. 2017) (summarizing Code provisions that prioritize and protect claims for tax debts in bankruptcy). Debtors in chapter 13 must pay tax debts in full as priority claims under their plans. The tax debts that debtors pay through their plans include all of the substantial interest charges and penalties that the County added to the tax debt before the bankruptcy filings. The instant debtors continue to pay interest at 12% on top of the County's pre-bankruptcy claims during the five years of their payment plans. The Gunsalus' and Hamptons have faithfully made all their plan payments since filing for bankruptcy relief.

Finally, to the extent that "clouds" on title created by section 548 ever impaired tax collection through New York tax foreclosures, the legislature could easily amend the statutory procedures. The Vermont legislature did this in 2005 immediately after the *Chase* decision held that section 548(a)(1)(B) applied to Vermont strict foreclosures of mortgages.<sup>7</sup> All that New York would need to do is conform its statutes to those of the many states it cites in its Brief where

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<sup>7</sup> See *supra*, note 4.

procedures include competitive bidding and taxing authorities do not keep surpluses from sales as windfalls.

III. Congress can impose bankruptcy protections over state law statutory schemes that undermine them.

A central concern of the Bankruptcy Code is “[e]quality of distribution among creditors,” *Begier v. IRS*, 496 U.S. 53, 58 (1990). Section 548 furthers the fair distribution policy by calling for scrutiny of transfers of the debtor’s property that benefit a single creditor to the detriment of other creditors and the debtor’s fresh start. *Smith*, 811 F. 3d at 238.

In construing section 548(a)(1)(B), the *BFP* court noted that there must be a “clear and manifest” federal purpose in order to “displace traditional state regulation.” *BFP*, 511 U.S. at 544-45. The County is defending a system where one creditor can take a substantial asset from a debtor in advance of a bankruptcy filing and keep the asset without accounting in any way for its value. The term “value” is at the heart of section 548(a)(1)(B). *BFP* designated a category of transfers for which value must be defined in a particular way. The *BFP* court never directed courts to disregard all consideration of a property’s value. The fair and equitable distribution of assets in bankruptcy has no meaning if all reference to an asset’s value must be discarded simply because one particular type of creditor (the

government) seized it. The Massachusetts bankruptcy court recently rejected the same argument for special treatment that the County raises here:

The Massachusetts strict foreclosure tax collection scheme does not provide any mechanism for determining the value of a property in relation to the amount of the tax lien or protections for the interest of general unsecured creditors of the taxpayer and, as such, directly conflicts with the legislative goals of Congress reflected in the fraudulent conveyance avoidance remedies of the Bankruptcy Code.

*Yourelo*, 2020 WL 6927549, \*6. Other courts have similarly rejected claims that strict tax foreclosures were entitled to a special exemption from federal bankruptcy law simply because a state law allowed tax collectors to act as they did. *Smith*, 811 F.3d at 238; *Gillespie*, 487 B.R. at 921; *CGI Properties*, 568 B.R. at 246-48; *In re Murphy*, 331 B.R. at 120. In these decisions the federal courts made clear that they were not invalidating the state tax collection laws. They were merely subjecting tax collectors as creditors to the same property valuation standards that all other creditors faced in bankruptcy cases.

IV. Bankruptcy debtors can claim the homestead exemption in property despite the existence of a tax lien.

Bankruptcy Code section 522(c) begins with a general statement that property exempted under section 522 is not liable for debts of the debtor. This is a broad statement of the debtor's right to exempt property under a wide range of state and federal exemption provisions. Section 522(c) goes on to list several exceptions to the debtor's general right to claim exemptions in property. One

exception applies to “a debt secured by a lien that is – (B) a tax lien, notice of which is properly filed.” 11 U.S.C. 522(c)(2)(B). The correct reading of the statute is that the debtor can exempt property, such as a homestead, but the otherwise exempt property remains subject to a tax lien. If the debtor owes unsecured debts to twenty other creditors, the exemption bars enforcement of the claims of all of those other creditors against the property. But the exemption claim has no effect on the tax lien.

This common-sense interpretation is implicit in the court rulings that held that debtors cannot void a tax lien by claiming an exemption in the property. *In re Bourque*, 123 F.3d 705, 706 n.2 (2d Cir. 1997) (while a tax lien may not be avoided, it is “is effective against exempt property”) (emphasis added); *see also DeMarah v. United States*, 62 F.3d 1248, 1251 (9th Cir. 1995) (“[i]t is pellucid that property exempted from the estate remains subject to the tax liens.” *Id.* (emphasis added); *In re Ridgley*, 81 B.R. 65, 68 (Bankr. D. Or. 1987) (“Subsection (c) [of § 522] insulates exempt property from prepetition claims other than tax claims” quoting S. Rep. No. 989, 95<sup>th</sup> Cong. 2<sup>nd</sup> Sess. 76 (1978), reprinted in 1978 U.S. Code Cong. & Admin News 5787, 5862) (emphasis added). Acceptance of the County’s interpretation of section 522(c) would mean that no bankruptcy debtor with a tax lien on his or her home, regardless of the minuscule amount (it could be a tax lien for \$10.00) could claim a homestead exemption.

The plans approved by the bankruptcy court for the Hampton and Gunsalus debtors preserved the County's tax liens. The debtors will continue paying off the liens until they have satisfied them by paying in full the amounts owed.

CONCLUSION

The Bankruptcy Court appropriately applied 11 U.S.C. § 548(a)(1)(B) to the facts of this case and its decision should be affirmed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing brief with the Clerk of the Court for the United States Court of Appeals for the Second Circuit by using the appellate CM/ECF system on May 22, 2021. All participants that are registered as CM/ECF users will receive service via appellate CM/ECF system.

*s/ Tara Twomey*

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CERTIFICATE OF COMPLIANCE

1. This brief complies with the type-volume limitation of Fed. R. App. P. 29(d) because this brief contains 6,905 words, excluding parts exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

2. This filing complies with Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word in Times New Roman 14-point type.

*s/ Tara Twomey*

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