



LENDER UPDATE

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Legislature Restricts Strict Foreclosure To Save It From Bankruptcy Demise

By: Andre D. Bouffard

Effective May 5, 2006, the Legislature substantially amended Vermont's strict foreclosure law to restrict its application to only a limited category of cases. The Legislature took this action in response to a series of 2005 decisions by the U.S. Bankruptcy Court for the District in Vermont in In re: Chase, in which the court ruled that transfers of title via strict foreclosure can be voided as fraudulent transfers if the debtor in the foreclosure later files for bankruptcy protection. Because of the four year statute of limitations for fraudulent transfer claims under Vermont law, the Chase decision called into question all titles obtained via strict foreclosure in the last several years, and rapidly transformed strict foreclosure from a primary to a highly suspect method of foreclosure.

The evil at which the Chase decisions were aimed is the potential for strict foreclosure to result in a foreclosing party obtaining a windfall if the property value significantly exceeds the debt at the time of foreclosure. This windfall is not possible when a foreclosure involves a public sale, as any surplus sale proceeds must go to the borrower. Under the Chase decisions, whenever any substantial

surplus is arguably retained by the foreclosing party in a strict foreclosure, the title can be challenged in a bankruptcy proceeding years later, even if the foreclosing party has already sold the property. This raises difficult problems with sale of property that has been involved in strict foreclosure, as it is often very difficult to determine years after the fact if the foreclosing party received any surplus, and if so, whether the amount of the surplus was sufficient to raise a potential Chase problem.

The amendments to the law address this problem with a dual-pronged approach. First, the Vermont fraudulent transfer statute (9 V.S.A. § 2292) is amended to create a safe harbor for a real estate foreclosures that comply with the foreclosure law, as revised. Second, the strict foreclosure statute is revised to limit its reach to those cases where there is no potential for a windfall to the foreclosing party. Although the new rules clearly apply to mortgage foreclosure cases brought after May 5, 2006, it is not clear if the new rules will have any effect on previously completed foreclosures or those in progress before the law's effective date. Chase problems can be addressed in pending foreclosures by requesting a public sale

at the conclusion of foreclosure, or confirming through appraisal or other reliable means that the property value does not cover the debt. It remains to be seen if previously completed strict foreclosures will still be subject to a fraudulent transfer challenge.

Under the amended strict foreclosure law, the court cannot permit strict foreclosure without first making a finding, based on competent evidence such as an appraisal, that there is "no substantial value in the property in excess of the mortgage debt." The term "value" is defined as "fair market value less all reasonable expenses that would be incurred in selling the property." Absent such a finding, there must be a public sale.

In a change benefiting mortgage holders, the amended law allows the court to consider a broader range of factors in deciding whether to shorten the redemption period, which must still be six months unless there are reasons to limit its length. The court can now consider whether there is value in the property in excess of the mortgage debt and debt owed to other lienholders, unpaid property taxes, as well as the condition of the property.

Another important change made to the strict foreclosure law is that the court is given expanded power to order a public sale of the property. There is no longer any requirement that the mortgage contain a power of sale clause, and the court may order a sale whether or not either party requests a sale. This is likely to increase the number of foreclosures including a public sale of the property.

While Vermont still retains strict foreclosure in name, in substance the harsh result of forfeiture of surplus value in excess of the mortgage debt is now precluded by the law. Strict foreclosure is now limited to those cases where there is no substantial value in the property in excess of the mortgage debt. Case

law will have to determine the meaning of "substantial value," but in close cases foreclosing parties may simply opt for a public sale to avoid the cost and expense of litigating this issue where there is marginal value in the property in excess of the debt. In those cases, the better strategy may be to request a sale, but push for a shorter redemption period in advance of the sale.

Only time will tell if institutional mortgage holders will fare better under a regime that forces more public sales, instead of allowing lenders to take title and market foreclosed property for private sale. The revisions to the law will put a premium on the timing of foreclosures, as public auction sales in the winter months present obvious problems.

Another potential consequence of these changes is that non-judicial foreclosure may become more advantageous when commercial property is involved. If a public sale is likely to be required in any event because there may be excess value in the property, a commercial lender may elect to proceed to non-judicial foreclosure sale, which avoids the time and expense of a judicial proceeding.

Mortgage lenders will need to re-evaluate their foreclosure practices in light of these changes, and prepare for a greater number of public sales of foreclosed property. While mortgage lenders have obtained greater finality to foreclosures by elimination of fraudulent transfer risks, they will need to adapt their practices to take advantage of the changed legal landscape for foreclosure.

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Andre Bouffard chairs DRM's Commercial Finance and Bankruptcy Group and focuses his practice on creditor's rights law, loan restructuring, bankruptcy and insolvency, and related litigation.