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Avoidability of Foreclosure Sales Under Section 547 of the Bankruptcy Code

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Introduction

Should foreclosure sales that comply with state law be subject to avoidance under federal bankruptcy law? In *BFP v. Trust Resolution Corp.*,[1] the Supreme Court said no, at least when dealing with alleged section 548 fraudulent conveyances, as doing so would, *inter alia*, undermine state interests and raise substantial federalism concerns.[2] Some courts have taken this reasoning and applied it to section 547 preferences as well,[3] while others feel that the plain language of section 547 prohibits such an application.[4] One recent case in the latter category is *In re Whittle Development, Inc.*[5]

In general, transfers are avoidable as fraudulent conveyances when the debtor receives less than a "reasonably equivalent value" for some property interest.[6] The Court in *BFP* held that a foreclosure sale that complied with state law must necessarily be considered a "reasonably equivalent value," as to hold otherwise would lead to a federally generated cloud over almost all

[1] 511 U.S. 531 (1994).
[2] *See generally, id.*
[3] *Chase Manhattan Bank v. Pulcini (In re Pulcini)*, 261 B.R. 836 (Bankr. W.D. Pa. 2001); *In re FIBSA Forwarding, Inc.*, 230 B.R. 334, (Bankr. S.D. Tex. 1999).
[4] *In re Whittle Development, Inc.*, No. 10-37084-HDH-11, 2011 WL 32268398 (N.D. Tex. July 27, 2011); *In re Rambo*, 297 B.R. 418 (Bankr. E.D. Pa. 2003); *In re Andrews*, 262 B.R. 299 (Bankr. M.D. Pa. 2001); *In re Villareal*, 413 B.R. 633 (Bankr. S.D. Tex. 2009).
[5] *In re Whittle Development, Inc.*, No. 10-37084-HDH-11, 2011 WL 32268398.
[6] 11 U.S.C. § 548(a)(1)(B)(i).

property bought at foreclosure sales.[7] In contrast, transfers are avoidable as preferential when the creditor simply receives more than he would under a chapter 7 liquidation.[8]

Section one of this memorandum will describe sections 547 and 548 of the Bankruptcy Code. The second section will focus on the *BFP* case. Section three will discuss the current split on the applicability of the *BFP* logic to preference cases. Lastly, section four defends the *Whittle* court's decision, as the bankruptcy code explicitly preempts state law, and the plain language of section 547 draws a bright line rule, as opposed to the fuzzier test of section 548's "reasonably equivalent value."

I. The Statutory Framework

The trustee in bankruptcy has two main avoidance powers under the bankruptcy code. The trustee may avoid preferential payments or fraudulent conveyances, these powers being laid out in sections 547 and 548 of the Bankruptcy Code, respectively.[9] Both of these sections apply to transfers by the debtor.[10] "Transfer(s)" is a defined term under the code, including "the foreclosure of a debtor's equity of redemption."[11]

A. Preferences Under Section 547

Under section 547(b)(5)(A) of the Bankruptcy Code, transfers made within 90 days of filing are avoidable if the transfer is to or for the benefit of a creditor, for a pre-existing debt, made while the debtor is insolvent, that allows the creditor to receive more than such creditor would receive under a chapter 7 liquidation.[12] This power exists in order to prevent the debtor

[7] *BFP*, 511 U.S. at 544.
[8] 11 U.S.C. § 547(b)(5)(A)
[9] 11 U.S.C. §§ 547-48.
[10] 11 U.S.C. §§ 547-48.
[11] 11 U.S.C. 101(54)(C).
[12] 11 U.S.C. § 547(b)(5)(A)

from paying off one creditor over another, thereby giving that creditor preferential treatment. As even involuntary foreclosures are covered,[13] the preference power also assists in preventing eager creditors from advancing debts and foreclosing on properties from an insolvent debtor, as they will likely have to give money back to the estate afterwards.

B. Fraudulent Transfers Under Section 548

Under Section 548(a)(1)(B)(i), transfers are avoidable if the debtor receives less than a reasonably equivalent value in exchange for some interest of the debtor in property, for up to two years prior to the filing.[14] This avoidance power applies whether the debtor makes the transfer voluntarily or involuntarily.[15] Section 548 permits the avoidance not only of actual fraudulent transfers, but also of constructively fraudulent transfers.[16] "Reasonably equivalent value" is an undefined term under the Code.[17]

II. *BFP*

In *BFP*, BFP defaulted on a loan and its property was sold at a foreclosure sale for $433,000 in June 1989.[18] That October, BFP filed for bankruptcy and, as debtor in possession, filed a complaint to have the foreclosure sale avoided as a fraudulent transfer.[19] BFP alleged that the property was in fact worth over $725,000, therefore making the $433,000 foreclosure price less than a reasonably equivalent value.[20]

[13] While section 547 doesn't explicitly mention involuntary transfers as does section 548, the inclusion of foreclosures in section 101's definition of transfer implies that at least involuntary foreclosures are included in section 547.
[14] 11 U.S.C. § 548.
[15] 11 U.S.C. § 548(a)(1).
[16] *BFP*, 511 U.S. at 535
[17] *Id.* at 537.
[18] *Id.* at 533-34
[19] *Id.* at 534.
[20] *Id.*

The *BFP* Court began by noting that "reasonably equivalent value" was not a defined term in the Code, stating that the term in fact appeared to be novel to section 548.[21] BFP's $725,000 value was the alleged fair market value for the property.[22] The Court felt that fair market value had no place in the "reasonably equivalent value" determination.[23] The Court acknowledged that the term "fair market value" was a "well-established concept," but noted that it appears nowhere in section 548.[24] Noting that the term "fair market value" appeared in other sections of the Code, such as sections 522(a)(2) and 346(j)(7)(B),[25] the Court concluded that section 548 "seemingly goes out of its way to avoid [using the term "fair market value"]."[26] In reaching its conclusion, the Court relied on the maxim that "[I]t is generally presumed that Congress acts intentionally and purposely when it includes particular language in one section of a statute but omits it in another."[27]

The Court went on to interpret the language of section 548(a)(2)(A) as "requir[ing] judicial inquiry into whether the foreclosed property was sold for a price that approximated its worth *at the time of sale*."[28] The Court ruled that this language inherently included the fact that the property was being sold at a time-constrained forced sale, stating that "property that *must* be sold within [such] strictures is simply *worth less*."[29] The Court went on to state that perhaps there could be some hypothetical fair forced-sale price; however, the Court noted that these would vary state to state, as foreclosure practices vary state to state, and that "[t]o specify a federal 'reasonable' foreclosure-sale price is to extend federal bankruptcy law well beyond the

[21] *Id.* at 537.
[22] *Id.* at 534.
[23] *Id.* at 537.
[24] *Id.*
[25] *Id.*; 11 U.S.C. §§ 522(a)(2), 346(j)(7)(B).
[26] *BFP*, 511 U.S. at 537.
[27] *Id.* quoting *Chicago v. Environmental Defense Fund*, 511 U.S. 328, 338 (1994).
[28] *BFP*, 511 U.S. at 539, emphasis added.
[29] *Id.*, emphasis in original.

traditional field of fraudulent transfers, into realms of policy where it has not ventured before."[30] The Court then recounted extensive history dating back to 1570 England, delineating over 400 years of peaceful coexistence between fraudulent transfer law and foreclosure law.[31]

The Court noted that in 1980, the Fifth Circuit had come down with an "unprecedented" decision in *Durrett v. Washington Nat'l Ins. Co.*,[32] applying a "'grossly inadequate price' badge of fraud under fraudulent transfer law to set aside a foreclosure sale."[33] The Court denounced this decision and refused to adopt the test. The Court ruled that "reasonably equivalent value" in the foreclosure context would simply mean that the foreclosure sale complied with state foreclosure law.[34] This ruling does not render the "reasonably equivalent value" language completely useless, as it will still apply outside of the foreclosure context.[35] While the Court conceded that the Bankruptcy Code can override state law by implication, it felt that any congressional intent to override state foreclosure practices regarding section 548 was doubtful.[36] "[W]here the intent to override is doubtful, our federal system demands deference to long-established traditions of state regulation."[37] If the Court left state-sanctioned foreclosure sales open to attack under section 548, "the title of every piece of realty purchased at foreclosure would be under a federally created cloud."[38]

[30] *Id.* at 540.
[31] *Id.* at 540-41.
[32] 621 F.2d 201 (1980).
[33] *BFP*, 511 U.S. at 542.
[34] *Id.* at 545.
[35] *Id.*
[36] *Id.* at 546.
[37] *Id.*
[38] *Id.* at 544.

III. Section 547 Cases in the Wake of *BFP*

A. Some courts have applied the *BFP* deference to state foreclosure practices to section 547 cases

BFP in essence told bankruptcy courts to give state foreclosure laws a certain level of deference when dealing with the fairness of the value realized at such foreclosures.[39] This led some courts to apply the same test, or lack thereof, to preferential payment cases. In *In Re Pulcini*,[40] the Bankruptcy Court for the Western District of Pennsylvania held that the *BFP* decision "compels the conclusion that a pre-petition transfer of a debtor's interest in real property to a lien creditor who purchases the property at a regular-conducted non-collusive sheriff's sale and who then sells the property to a third party for an amount greater than the amount of its lien is not avoidable in accordance with § 547(b) as a preference."[41] The court went on to say that, "[i]n particular, the lien creditor does *not* "receive more" for purposes of § 547(b)(5) than it would receive in a chapter 7 liquidation."[42] Presumably, this is because a chapter 7 liquidation sale would too be a forced-sale situation, decreasing the expected price. The bankruptcy court conceded that, "at first blush," the language of section 547(b) seemed to apply, making foreclosure sales potentially avoidable as preferences, the court failed to find a "clear and manifest" indication that Congress, in enacting section 547(b), "intended to override the long-standing law of Pennsylvania concerning title to real property."[43]

Similarly, in *In re FIBSA Forwarding*,[44] the Bankruptcy Court for the Southern District of Texas also applied the *BFP* reasoning to a section 547 case. The bankruptcy court did so even

[39] *See generally, Id.*
[40] 261 B.R. 836 (Bankr. W.D. Pa. 2001
[41] *Id.* at 844.
[42] *Id.*
[43] *Id.*
[44] 230 B.R. 334, (Bankr. S.D. Tex. 1999).

though it acknowledged that allowing the foreclosure to stand allowed the bank to receive and retain more money than it was due on its loan, a windfall achieved at the expense of unsecured creditors who went unpaid.[45] "By contrast, if the transaction were avoided, all creditors would be paid in full and some funds might even be left over for the Debtor."[46] The court felt constrained by *BFP*, even though it acknowledged that through "simple arithmetic," the creditor was receiving more than it would under chapter 7.[47] The court noted that, "[t]o hold this foreclosure to be a preferential transfer would create the same problems with state real property title records that would have been created by classifying the transaction as a fraudulent transfer."[48] The court ended its opinion by stating that "[t]he apparent lesson of *BFP* is that if a creditor is oversecured, the Debtor must file a bankruptcy petition (or creditors must file an involuntary petition) before foreclosure to prevent the secured creditor from reaping a windfall at the expense of other creditors."[49] This holding, and others like it, essentially create a foreclosure carve-out, making all pre-petition foreclosures unavoidable under both sections 547 and 548.

B. Other courts have found *BFP* inapplicable to section 547 cases

Recently, in *In re Whittle Development, Inc.*,[50] the Bankruptcy Court for the Northern District of Texas denied a motion to dismiss a preference claim regarding a foreclosure action. In *Whittle*, Branch Banking and Trust Company ("BB & T") declared a default on its loan with Whittle Development, Inc. ("Whittle"), and thereafter foreclosed upon the real property securing the loan on September 7, 2010.[51] The property was sold at auction for $1,220,000.[52] On October

[45] *Id.* at 338.
[46] *Id.*
[47] *Id.* at 337.
[48] *Id.* at 341.
[49] *Id.*
[50] No. 10-37084-HDH-11, 2011 WL 32268398 (N.D. Tex. July 27, 2011).
[51] *Id.* at *1.
[52] *Id.*

4, 2010, Whittle filed for bankruptcy under chapter 11.[53] BB & T filed a proof of claim for $2,855,243.29, alleging that $1,181,513.27 of the claim represented the deficiency from the foreclosure sale.[54] Whittle disputed BB & T's deficiency claim and argued that the approximate value of the property was $3,300,000, that BB & T's claim was approximately $2,200,000 at the time of foreclosure, and that BB & T was therefore over-secured by $1,100,000.[55]

As the court was considering a motion to dismiss pursuant to Federal Rule 12(b)(6), the court accepted this alleged property value as a fact.[56] Therefore, in the court's view, the only question was whether the transfer could have "enable[d] [the] creditor to receive more than [it] would receive if the case were a case under chapter 7 of" the Code.[57] The court held that Whittle set out a facially plausible claim, thereby declaring that a foreclosure sale may in fact be avoided as a preferential transfer in some circumstances.[58]

The court considered the issue in *BFP* to be of a "wholly different quality" than the one presented in *Whittle*.[59] The court noted that, whereas with fraudulent transfers the entire foreclosure sale would be avoided, with preference avoidance only the "additional amount of benefit conferred to the creditor is . . . brought back into the estate."[60] The court also noted that the *FIBSA* language above regarding the apparent lesson of *BFP* regarding filing before foreclosure creates just the "'race to the court house' that the Code tries to prevent."[61]

[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.* at *1-*2.
[57] *Id.* at *3.
[58] *Id.* at *7.
[59] *Id.* at *5.
[60] *Id.*
[61] *Id.*

In another case holding *BFP* inapplicable to section 547 cases is *In re Villareal*.[62] In *Villareal*, the court noted that "a chapter 7 trustee has the time and incentive to promote a competitive auction or to find a buyer willing to pay a fair market value."[63] The *Whittle* court commented that "there are obvious situations whereby a foreclosing creditor could obtain a valuable piece of real estate for less than what it is actually worth."[64] The courts in these cases held that where, as here, the creditor is receiving more than it would under a chapter 7 liquidation, the plain language of section 547 can be met by foreclosure sales.[65] The *Whittle* court explicitly said that the "Supreme Court's decision in *BFP* is not controlling, because the plain meaning of section 547 allows the avoidance of the foreclosure sale, and the federalism concerns that other courts have cited in cases subsequent to *BFP* are inapplicable to section 547 actions."[66] The hypothetical federally created cloud on all foreclosed property does not exist here, as only the extra value garnered by the creditor would be avoided. Therefore, the foreclosure sale would still be valid and title would remain completely unaffected unless the creditor was the purchaser.[67]

IV. What This Means for Creditors Going Forward

If the reasoning of *Whittle* gains widespread popularity, creditors should be more careful when foreclosing upon a debtor's property, as their foreclosure sales may now be subject to preference attacks under section 547 of the Code, regardless of whether the creditor followed all state practices. The creditor must either take more painstaking efforts when conducting a

[62] 413 B.R. 633 (Bankr. S.D. Tex. 2009).
[63] *Id.* at 641.
[64] *In re Whittle*, No. 10-37084-HDH-11, 2011 WL 32268398, *6 (N.D. Tex. July 27, 2011).
[65] *See generally*, *Id.*; *In re Villareal*, 413 B.R. 633.
[66] *In re Whittle*, No. 10-37084-HDH-11, 2011 WL 32268398, *6.
[67] *Id. at*

foreclosure sale in order to insure that the full value of the property is realized, returning any excess funds to the debtor, or accept that the foreclosure sale will be subject to attack. Even if the court eventually finds the preference attack to be unfounded, the creditor will still have legal costs. Therefore, either way, *Whittle*'s ruling will increase costs to creditors.

However, even with the increased costs, this is likely the right decision. The Bankruptcy Code explicitly preempts state law, and the plain language meaning of section 547 draws a clear line: the creditor can not receive more than it would under a chapter 7 liquidation. This bright line rule stands in stark contrast with section 548's fuzzy and undefined "reasonably equivalent value" test. Additionally, leaving foreclosures open to attack under section 547 won't produce *BFP*'s feared general cloud on title, as only the additional value gained by the creditor is subject to avoidance, not the entire transaction itself.

Conclusion

Since *BFP*, foreclosure sales have essentially been unavoidable. No bankruptcy court has wanted to avoid foreclosure sales, even as preferences, because of federalism concerns. This has led to exactly the "race to the courthouse" that the Code tries to avoid. It has additionally led to such anomalous results as *In re FIBSA Forwarding*, where the court acknowledged that the creditor was receiving more than it would under chapter 7, putting it square in the meaning of section 547, yet felt constrained to hold the sale unavoidable, allowing the creditor to reap a windfall at the expense of both the debtor and other creditors. *Whittle*, and other cases like it, change all that. Following the plain meaning of the statute, they hold that foreclosure sales can be attacked, at least as preferences, where it can be shown that the creditor received more than it would under chapter 7. However, this seemingly fairer, common sense ruling does not come

without a cost. As shown above, costs to a potentially foreclosing creditor have increased whether the creditor decides to foreclose or not, and whether or not such creditor receives more than it would under chapter 7. These costs will likely be passed down onto the debtors in the form of stricter policies and/or costlier mortgages. Whether debtors and unsecured creditors will actually benefit from rulings such as this in the aggregate remains to be seen.