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Expert Analysis

'Whittle': Just When You Thought Foreclosure Sales Were Sacrosanct

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On July 27, 2011, the U.S. Bankruptcy Court for the Northern District of Texas in *Whittle Development Inc. v. Branch Banking & Trust Co.* (*In re Whittle Development Inc.*)[1] issued an opinion finding that a debtor may avoid as a preferential transfer under Bankruptcy Code section 547 a prepetition real property foreclosure sale, even if the foreclosure sale complied with state requirements for a valid foreclosure. *Whittle* is significant not only because it throws into question the long-accepted notion that foreclosure sales are sacrosanct and their results final, but also because it represents a departure from Supreme Court precedent in the related area of fraudulent transfers under Bankruptcy Code section 548.

Prepetition Transfers

The Bankruptcy Code provides a number of tools that a debtor may use to avoid and recover prepetition transfers that favor one creditor to the detriment of other creditors, including Bankruptcy Code sections 547 and 548.

Section 547(b) allows a debtor in possession or a trustee to avoid a transfer of "an interest of the debtor in property" (i) to or for the benefit of a creditor; (ii) for or on account of a preexisting debt; (iii) made while the debtor was insolvent; (iv) made on or within 90 days of the debtor's petition filing date; and (v) that enables the creditor to receive more than it would under a chapter 7 liquidation plan if the transfer had not been made.[2] There is a presumption that the debtor was insolvent during the 90-day period preceding the petition filing date.[3]

Section 547 exemplifies two fundamental bankruptcy policies. First, it discourages creditors from "racing to the courthouse to dismember the debtor during his slide into bankruptcy."[4] Second, section 547 ensures that similarly situated creditors share equally in the debtor's estate.

Similarly, section 548(a) allows a debtor in possession or a trustee to avoid a constructively fraudulent transfer, which is a transfer of "an interest of the debtor in property" or "an obligation incurred by the debtor" that was made for "less than reasonably equivalent value" while the debtor was insolvent.[5] A debtor-in-possession or trustee may avoid any constructively fraudulent transfer made by the debtor within the two-year period preceding its bankruptcy filing.[6] Section 548 serves to protect creditors from prepetition transfers that are intended to, or have the effect of, diluting the pool of assets available to satisfy the claims of creditors in the debtor's bankruptcy case.

Supreme Court Precedent

In *BFP v. Resolution Trust Corp.*,[7] the Supreme Court addressed whether a foreclosure sale could be avoided as a constructively fraudulent transfer under section 548. The key issue in *BFP* was whether the foreclosure sales price could qualify as "reasonably equivalent value" or whether the purchaser had to pay fair market value for the property to be insulated from avoidance under section 548.

BFP purchased real property located in Newport Beach, Calif., and took title subject to a deed of trust granted in favor of Imperial Savings Association. The deed of trust secured a $356,250 loan made in connection with BFP's purchase. When BFP stopped servicing the loan, Imperial entered a notice of default and scheduled a foreclosure sale. The property was sold on July 12, 1989, for $433,000 at a foreclosure proceeding that complied in all aspects with state law.

In October 1989, BFP filed for a petition for bankruptcy under chapter 11. BFP then filed a complaint seeking to set aside the conveyance of the property to the purchaser on the grounds that the foreclosure sale was a constructively fraudulent transfer under section 548. BFP argued that because the fair market value of the property at the time of the foreclosure sale was $725,000, the $433,000 foreclosure sale price was not "reasonably equivalent value."

The Court first noted that Congress purposefully used the phrase "reasonably equivalent value" in section 548 instead of "fair market value," which appears in other provisions of the Bankruptcy Code. The Court then found that reasonably equivalent value cannot be the same as fair market value because fair market value assumes market conditions that do not apply in the context of a forced sale. The Court also found that it would be an infringement on state sovereignty to require foreclosure sales to yield fair market value. A foreclosure sale may be set aside under state law only if the purchase price is so low that it "shock[s] the conscience or raise[s] a presumption of fraud or unfairness."[8]

A requirement that foreclosure sales yield fair market value extends far beyond the specifications of state foreclosure law. Furthermore, the Court noted that security of real estate titles is an important state interest, and if the Court adopted BFP's position, "the title of every piece of realty purchased at foreclosure would be under a federally created cloud."[9] The Court refused to displace existing state regulation without clear direction from Congress. Accordingly, the Court held that the "reasonably equivalent value" of a foreclosed property is the price received at the foreclosure sale, as long as the foreclosure sale complies with state law requirements.

The 'Whittle' Decision

In *Whittle*, the Bankruptcy Court addressed whether a foreclosure sale could be avoided as a preferential transfer under section 547. The key

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issue in *Whittle* was whether the creditor had received a greater recovery as a result of the foreclosure sale than it would have received under a chapter 7 liquidation.

The facts of *Whittle* are similar to those in *BFP*. In December 2007, Whittle Development Inc. and Colonial Bank, N.A. entered into a Development Loan Agreement by which Colonial agreed to loan Whittle $2.7 million, evidenced by a promissory note. The loan was secured by certain real property located in Rockwell, Texas. Colonial was later acquired by Branch Banking & Trust Co. (BB&T), which succeeded to Colonial's interest in the note.

In August 2010, BB&T declared a default on the note, accelerated the payments owed thereunder, and notified Whittle of its intent to foreclose on the property. BB&T foreclosed on the property on Sept. 7, 2010, and sold it at a foreclosure sale to an affiliate for $1.22 million, far short of the $2.2 million that Whittle owed on the note. Shortly after the foreclosure sale, on Oct. 4, 2010, Whittle filed for protection under chapter 11 of the Bankruptcy Code. BB&T filed a $1.18 million deficiency claim against Whittle based on the amount outstanding on the note after applying the proceeds of the foreclosure sale.

Whittle argued that BB&T did not have a deficiency claim related to the foreclosure sale. Whittle asserted that the property was worth its fair market value of $3.3 million, rather than its foreclosure sale price of $1.2 million. Thus, under Whittle's valuation, BB&T was oversecured by the $1.1 million difference between the property's fair market value and the amount outstanding on the note. The crux of the debtor's argument was that, because the property was worth more than the $2.2 million owed to BB&T, BB&T received more through the foreclosure sale than it would have received in a chapter 7 liquidation, and thus the foreclosure sale was avoidable under section 547 as a preferential transfer.

In response, BB&T argued that under *BFP* the price at which the property was sold during the foreclosure sale is the amount that it would have received under a chapter 7 liquidation.

Although a number of courts have applied *BFP* in the section 547 context,[10] the court rejected BB&T's argument and permitted Whittle to avoid the foreclosure sale as a preferential transfer. The court found that the application of *BFP* to preferential transfers is misplaced because *BFP* dealt specifically with "reasonably equivalent value," which is not a requirement of section 547. Instead, the court looked to the plain meaning of section 547 and found that "[i]f a creditor executes on a secured property and obtains the property for what is found to be less than what it would have garnered in a hypothetical liquidation, then the transfer may be avoided under the plain meaning of section 547(b)."[11]

The court also found that the federalism concerns raised by the Supreme Court in *BFP* were not present in *Whittle*. The court noted although a creditor that has received a fraudulent transfer must turn over the property at issue, a creditor that receives a preferential transfer is only required to return the additional benefit. Thus, the court found that avoiding a foreclosure sale as a preferential transfer does not have the same implications on a state's interests in maintaining the security of property titles. In addition, the court found that the risks to third-party purchasers are "non-existent" because a third-party purchaser would not be subject to a preference action. The court determined that "[t]he risk is to a creditor-purchaser who buys the property at foreclosure at an artificially low price and either sells it for a profit or holds it for later investment or use."[12] As a result, the court found that "the concerns addressed in *BFP* are moot in the context of [a] section 547 avoidance action."[13]

Analysis

The *Whittle* decision demonstrates the tension between the Bankruptcy Code's avoidance provisions, which are designed to protect the interests of the debtor and its general creditors, and state law foreclosure remedies, which are designed to protect the interests of secured lenders. While the *Whittle* court believed it had the "optimal approach" in balancing these competing interests,[14] the court's analysis falls short because it failed to successfully distinguish the federalism concerns that the Supreme Court raised in *BFP* and is dismissive of the risks to creditors and other purchasers of foreclosed property.

> 'Whittle' represents a departure from Supreme Court precedent in the related area of fraudulent transfers under Bankruptcy Code section 548.

The *Whittle* court found the concerns of *BFP* "moot" with respect to section 547 because the purchaser is only disgorged of its "windfall," rather than the property itself, and because third-party purchasers are not affected. However, the court disregards the core of the *BFP* decision—that without a clear mandate from Congress, the Bankruptcy Code should not infringe on state interests in title security and foreclosure law. The court ignores the remedies that state law provides to a debtor who believes that the foreclosure sale price was inadequate, and creates a new remedy whereby a debtor can avoid a foreclosure sale as a preferential transfer if it receives less than fair market value for the property.

Moreover, it is arguable that the court's statement regarding the "non-existent" risk to third-party purchasers is incorrect. Section 547 allows a debtor-in-possession or a trustee to avoid a transfer "to or for the benefit of a creditor." The proceeds from a foreclosure sale belong to the secured creditor. Even if a third party purchases property at a foreclosure sale, the purchase is a transfer "for the benefit of a creditor." Thus, the *Whittle* court's decision may exceed its intended scope by disturbing the security of a bona fide purchaser's title, as well as a creditor-purchaser's title.

The result of the *Whittle* decision is increased risk to creditors and third-party purchasers of foreclosed properties. In addition to the risk of state foreclosure remedies, purchasers of a foreclosed property must also take into account the risk that the property owner will file a petition and avoid the sale as a transfer under section 547. Purchasers may discount the price they are willing to pay for foreclosed properties to account for this additional risk, a result that is detrimental to the secured creditor, the debtor and its general creditors.

Conclusion

The *Whittle* decision represents a shift in favor of debtor and general creditor rights to the detriment of secured creditor rights. The opinion provides an additional remedy to property owners in foreclosure, but creates additional risks for creditors disposing of collateral and third parties participating in foreclosure sales. However, the *Whittle* decision currently only affects foreclosures within the Northern District of Texas. The long-term effect of *Whittle* remains to be seen, as it depends on whether other courts adopt its standard, or whether courts will instead apply the Supreme Court's *BFP* analysis to avoidance actions under section 547.

1. 2011 WL 3268398 (Bankr. N.D. Tex. July 27, 2011).
2. See 11 U.S.C. §547(b).
3. Id. § 547(f).
4. *Whittle*, 2011 WL 3268398 at *2 (internal citations omitted).
5. See 11 U.S.C. §548(a)(1)(B).
6. Id.
7. 511 U.S. 531 (1994).
8. Id. at 542 (internal citations omitted).
9. Id. at 544.
10. See *Whittle*., 2011 WL 3268398 at *4 (citing *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, 341 (Bankr. S.D. Tex. 1999) aff'd 244 B.R. 94 (S.D. Tex. 1999).
11. *Whittle*, 2011 WL 3268398 at *6.
12. Id.
13. Id.
14. Id. at *5.