

BANKRUPTCY LAW—WHETHER A DEBTOR-IN-POSSESSION CAN AVOID A PRE-PETITION REAL PROPERTY FORECLOSURE THAT COMPLIES WITH STATE LAW AND IS NON-COLLUSIVE ON THE GROUNDS THAT THE FORECLOSURE CONSTITUTED A PREFERENTIAL TRANSFER.

By David E. Brezik*

Whittle Dev., Inc. v. Branch Banking Trust Co. (In Re Whittle Dev., Inc.), Case No. 10-37084-HDH-11, Adv. No. 11-03150, 2011 Bankr. LEXIS 2956 (Bankr. N.D. Tex. July 27, 2011).

In July 2011, the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, denied a creditor bank's motion to dismiss the complaint, filed by a debtor-in-possession seeking to avoid the bank's pre-petition foreclosure on the debtor's real property.¹ In doing so, the court held that a Chapter 11 debtor-in-possession can avoid a pre-petition foreclosure on the grounds that the foreclosure constituted a preferential transfer, even though the foreclosure complied with state law and was non-collusive.²

In December 2009 Whittle Development, Inc. (Whittle) and Colonial Bank, N.A. (Colonial) entered into a Development Loan Agreement in which Colonial agreed to loan Whittle \$2,700,000, secured by real property owned by Whittle.³ Colonial was later acquired by Branch Banking and Trust Company (BB&T), who became the successor in interest to Colonial.⁴ In 2010, BB&T declared Whittle in default on its loan, accelerated payments, and notified Whittle of its intent to foreclose on the property securing the loan.⁵ On September 7, 2010, BB&T foreclosed on the property in a sale that was stipulated by both parties as having complied with all relevant Texas requirements for a valid foreclosure.⁶ Upon foreclosure, the property was sold to Eagle TX I SPE, LLC, a subsidiary of BB&T, for \$1,220,000.⁷

On October 4, 2010, Whittle filed a petition under Chapter 11 of Title 11 of the United States Code (Bankruptcy Code), claiming that the approximate value of the property secured by the loan was \$3,300,000.⁸ Whittle argued that BB&T was over secured by \$1,100,000 because, at the time of the foreclosure sale, BB&T's claim on the property was approximately \$2,200,000.⁹ In response, on February 7, 2011 BB&T filed a proof of claim in the bankruptcy case in the amount of \$2,855,243.29.¹⁰ BB&T alleged that, in addition to the \$1,220,000 it received from the foreclosure sale, it was also entitled to \$1,181,513.27, which constituted the deficiency from the foreclosure sale.¹¹

The court began its analysis with an examination of federal principles regarding preferential transfers. "A preference is a transfer that enables a creditor to receive payment of a greater percentage of his claim against the debtor than he would have received if the transfer

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¹ *Whittle Dev., Inc. v. Branch Banking Trust Co. (In Re Whittle Dev., Inc.)*, Case No. 10-37084-HDH-11, Adv. No. 11-03150, 2011 Bankr. LEXIS 2956, at *17-18 (Bankr. N.D. Tex. July 27, 2011).

² *Id.* at *17.

³ *Id.* at *2-3.

⁴ *Id.*

⁵ *Id.* at *3.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

had not been made and he had participated in the distribution of the assets of the bankruptcy estate.”¹² However, the court noted that the Bankruptcy Code contains a statutory mechanism which allows for a trustee or debtor-in-possession to avoid these pre-petition transfers deemed to be preferential. Section 547(b) of the Bankruptcy Code provides that a trustee or debtor-in-possession may avoid a transfer of an interest of the debtor in property that enables a creditor to receive more than the creditor would receive if the property were disposed of in accordance with chapter 7 of the Bankruptcy Code.¹³ Further, the court noted that the basic goals of this code provision are to facilitate and secure the equal distribution of the debtor’s assets among his creditors¹⁴ and to discourage these creditors from “racing to the courthouse to dismember the debtor as they slide into bankruptcy.”¹⁵

The parties disagreed as to whether Whittle met the requirements of section 547(b), specifically subsection (b)(5), in order to avoid the preferential sale of the property. Subsection (b)(5) requires a finding that the creditor received more during the foreclosure sale than it would under chapter 7 of the Bankruptcy Code.¹⁶ BB&T argued that subsection (b)(5) could not be satisfied as a matter of law because of the Supreme Court’s decision in *BFP v. Resolution Trust Corp.*¹⁷ In *BFP*, the U.S. Supreme court held that “a fair and proper price, or a ‘reasonably equivalent value,’ for foreclosed property, is the price in fact received at the foreclosure sale, so long as all the requirements of the State’s foreclosure law have been complied with.”¹⁸ Thus, it was BB&T’s contention that the price it received at the foreclosure sale was, as a matter of law, the fair market value for the property and that Whittle failed to meet the requirements of section 547(b) to avoid the transfer.¹⁹

Whittle argued that BB&T was over secured by more than \$1,000,000 and received more through the foreclosure sale than they would have under chapter 7 because the property was worth more than the amount Whittle owed to BB&T.²⁰ Whittle asserted that BB&T received claims and real property with an aggregate net value of \$3,261,513.27, in satisfaction of a debt that amounted to no more than \$2,220,000 (the maximum that BB&T would have been able to recover under a chapter 7 of the Bankruptcy Code).²¹ Additionally, Whittle argued that BB&T misplaced its reliance on the Supreme Court’s decision in *BFP* because the dispute in that case involved the issue of whether a foreclosure sale could be avoided as a fraudulent conveyance under section 548 of the Bankruptcy Code. Whittle asserted that section 548 could not be used in the preference context, such as in this case, because the statutory language in sections 547 and 548 are not the same and concern different points in time.²² Thus, as a result of BB&T’s receiving more under the foreclosure sale than they would under chapter 7, Whittle argued that the foreclosure sale constituted a preferential transfer and, under section 547(b), was avoidable.²³

Addressing the arguments of the parties, the court noted that in the context of bankruptcy cases, statutory analysis ends with the text if the language of the statute is “clear and

¹² *Id.* at *5 (citing Barrett Dodge Chrysler Plymouth, Inc. v. Cranshaw (In re Issac Leaseco, Inc.), 389 F.3d 1205, 1209 (11th Cir. 2004) (quoting Union Bank v. Wolas, 502 U.S. 151, 160-61 (1991))).

¹³ 11 U.S.C. § 547(b) (LexisNexis 2011).

¹⁴ *Whittle*, 2011 Bankr. LEXIS 2956 at *5-6.

¹⁵ *Id.*

¹⁶ 11 U.S.C. § 547(b)(5)(A).

¹⁷ *Whittle*, 2011 Bankr. LEXIS 2956 at *8.

¹⁸ *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 545 (1994).

¹⁹ *Whittle*, 2011 Bankr. LEXIS 2956 at *8.

²⁰ *Id.*

²¹ *Id.*

²² *Id.* at *8-9.

²³ *Id.* at *9-10.

does not lead to an absurd result.”²⁴ All Whittle had to show in this case was that BB&T did receive more from the pre-petition transfer than it would have under chapter 7 in order for the section 547(b)(5)(A) to be satisfied.²⁵ However, in its discussion the court pointed out that there is a disagreement among the jurisdictions concerning the applicability of the *BFP* decision in the context of section 547(b).

As illustrated by the court, some courts follow the approach taken in *In re Villarreal*, in which the trial judge found a creditor’s \$3,250,000 windfall from a foreclosure sale avoidable notwithstanding the fact that the foreclosure sale was non-collusive and complied with state laws.²⁶ In that case the court took the approach, as Whittle argued in this case, that if the amount obtained through the foreclosure sale was less than the hypothetical amount that the court deems would have been recovered under chapter 7, the requirements of section 547(b) have been met.²⁷ The court in *Whittle* then noted that other courts have found that *BFP* is inapplicable in the section 547(b) context.²⁸

As observed in *Whittle*, other courts have disagreed. For these courts, federalism concerns override the application of section 547 and it is suggested that, by allowing a debtor to avoid a foreclosure, state interests would be undermined where foreclosure sale complied with state law.²⁹ As seen in *BFP*, the Supreme Court declined to measure “reasonably equivalent value” according to any valuation method other than the price received at a complying foreclosure sale because they believed that this would have infringed upon an important state interest, the security of titles to real estate, by overshadowing it with a “federally created cloud” on all property bought and sold through foreclosure sales.³⁰ Despite the concerns of some courts, the *Whittle* court held that BB&T’s reliance on the *BFP* case was misplaced, finding that the issue addressed in *BFP* was the meaning of “reasonably equivalent value” in section 548(a)(2) of the Bankruptcy Code, which was not an issue before this court.³¹ The court noted that the question before the court was simply one of avoidance: “whether the creditor did in fact receive more than it would have had the transfer not occurred.”³²

The *Whittle* court posited that the “optimal approach” to this issue is that if an otherwise valid foreclosure sale is found to enable a creditor to obtain more than he would in a chapter 7 liquidation, then any additional amount of benefit conferred to that creditor would simply be brought back into the estate.³³ Under this approach, the court suggests that state interests in the securing of titles would be furthered without subverting the policy behind the Bankruptcy Code of ensuring equality among creditors.³⁴ Further, the court stated that this approach would pose no risk to third-party purchasers of foreclosed property because a purchaser without a claim against the debtor would fall within the protection of section 547(b)(1),³⁵ which only allows avoidance of transfers “to or for the benefit of a creditor.”³⁶ For these reasons and because the Code provides for a distinction between the creditor and the third party

²⁴ *Id.* at *9.

²⁵ *Id.* at *9-10.

²⁶ *Id.* at *10. (See *Villarreal v. Showalter (In re Villarreal)*, 413 B.R. 633 (Bankr. S.D. Tex. 2009)).

²⁷ *Villarreal*, 413 B.R. at 642.

²⁸ *Whittle*, 2011 Bankr. LEXIS 2956 at *10-11.

²⁹ *Id.* at *12.

³⁰ *Id.* at *11 (quoting *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 544 (1994)).

³¹ *Id.* at *13.

³² *Id.*

³³ *Id.* at *14.

³⁴ *Id.*

³⁵ *Id.* at *16.

³⁶ 11 U.S.C. § 547(b)(1) (LexisNexis 2011).

bona fide purchaser, this court stated that the concerns addressed in *BFP* are a non-issue in the context of section 547 avoidance actions.³⁷

Following from its analysis, the *Whittle* court held that a chapter 11 debtor-in-possession can avoid a pre-petition foreclosure that was non-collusive and complied with state law on the grounds that the foreclosure sale constituted a preferential transfer.³⁸ The court found *BFP* inapplicable in this case because section 547 allows the avoidance of a foreclosure sale.³⁹ Additionally, the court found that the federalism concerns noted in *BFP* and subsequent cases do not apply to section 547 actions.⁴⁰ Thus, because *Whittle* had set out a claim that was facially plausible with regard to BB&T's foreclosure sale, the court held that BB&T's motion to dismiss was denied.⁴¹

³⁷ *Whittle*, 2011 Bankr. LEXIS 2956 at *16-17.

³⁸ *Id.* at *17.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.* at *18.