CREDITORS BEWARE:
FORECLOSURE SALE AVOIDED AS PREFERENTIAL TRANSFER UNDER § 547(b) OF THE BANKRUPTCY CODE WHEN SALE RESULTED IN CREDITOR RECEIVING MORE THAN IT WOULD HAVE IN A CHAPTER 7 LIQUIDATION

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In a recent decision, the United States Bankruptcy Court for the Southern District of Texas (the "Court") held that the United States Supreme Court's decision in *BFP v. Resolution Trust Corp.* does not preclude a debtor from having a pre-bankruptcy foreclosure sale of its property set aside as a preferential transfer where the creditor that foreclosed received more than it would have under a chapter 7 liquidation sale of the property. *In re Villarreal*, 413 B.R. 633 (Bankr. S.D. Tex. 2009).

In *Villarreal*, Armando Orta and various other parties (the "Orta Parties") held a third deed of trust (the "Deed of Trust") on certain real property owned by Gregorio B. Villarreal and Estella Villarreal (together, the "Debtors"), consisting primarily of a restaurant and a ballroom (the "Property"). The Deed of Trust secured an obligation owed by the Debtors to the Orta Parties in the original principal amount of $70,000.00 (the "Debt"). David Showalter (the "Trustee") was the trustee under the Deed of Trust. After the Debtors defaulted on their obligations to the Orta Parties, the Trustee conducted a foreclosure sale of the Property under the Deed of Trust (the "Foreclosure"). The Trustee was the successful bidder at the Foreclosure by credit bidding the outstanding amount of the Debt.

Less than two months after the Foreclosure, the Debtors filed a petition for relief under Chapter 13 of the Bankruptcy Code. The Debtors thereafter filed an adversary proceeding seeking to avoid the Foreclosure of the Property as a preferential transfer under 11 U.S.C. § 547(b).

Section 547(b) of the Bankruptcy Code provides that a trustee may avoid the transfer of an interest of the debtor in property as a preference if the transfer was:

(1) To or for the benefit of a creditor;
(2) For or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) Made while the debtor was insolvent;
(4) Made –
    (A) On or within 90 days before the date of the filing of the petition; or
    (B) Between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
(5) Enabled such creditor to receive more than such creditor would receive if –
    (A) The case were a case under chapter 7 of this title;
    (B) The transfer had not been made; and

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(C) **Such creditor received payment of such debt to the extent provided by the provisions of this title.**

11 U.S.C. § 547(b) (emphasis added).

At trial, there were three major disputed factual issues: (1) whether the Foreclosure was conducted at the proper place and in the proper manner; (2) whether the Debtors were insolvent at the time of the Foreclosure; and (3) whether the Foreclosure resulted in the Orta Parties receiving more than they would have in a hypothetical liquidation under chapter 7 of the Bankruptcy Code.

The Court determined that the Foreclosure had been conducted at the proper place and in the proper manner and that the Debtors were insolvent at the time of the Foreclosure. In analyzing the third disputed issue, the Court found that, pursuant to § 547(b)(5) of the Bankruptcy Code, the Orta Parties did in fact receive more through the Foreclosure than they would have in a chapter 7 liquidation. The Property was worth approximately $4,020,000.00 at the time of the Foreclosure, and the obligations secured by the Property were less than $750,000.00, including the amount of the Debt. Thus, the Orta Parties received at least $3,270,000.00 in value to satisfy the Debt, which principal amount did not exceed $70,000.00. In contrast, in a chapter 7 liquidation sale of the Property, the Orta Parties, as oversecured creditors, would have received approximately $100,000.00 in principal, interest, fees and expenses, which amount is substantially less than the value received through the Foreclosure.

However, the Court did not end its analysis there. Rather, it then considered whether such a § 547(b)(5) analysis of how much the Orta Parties would have received in a chapter 7 liquidation was even proper or whether the Supreme Court's decision in *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), mandated a finding that a chapter 7 liquidation sale of the Property would not have realized a greater sale price than was attained through the Foreclosure.

In *BFP*, the Supreme Court considered whether a mortgage foreclosure sale that resulted in a sale of the foreclosed property for less than fair market value was a fraudulent conveyance under § 548 of the Bankruptcy Code. One of the elements of a fraudulent transfer under § 548 is that the debtor "received less than a reasonably equivalent value" for the property that was transferred. The debtor in *BFP* argued that the foreclosure sale of his property did not result in the receipt of reasonably equivalent value in that, at the time of the foreclosure sale, the property had a fair market value of $725,000.00 but was sold for only $435,000.00. The Supreme Court rejected the debtor's argument. It held that the amount obtained from a non-collusive foreclosure sale conducted in accordance with applicable state law was, as a matter of law, "reasonably equivalent value." The Supreme Court found that any other ruling would interfere with the essential state interest of ensuring the security of the titles to real estate.

Courts that have held the *BFP* analysis to apply in a § 547(b)(5) context have assumed that a chapter 7 liquidation would produce the same proceeds as a pre-petition foreclosure sale conducted in accordance with state law. *Villareal*, 413 B.R at 640. The *Villareal* Court did not adopt the reasoning of this line of cases. *Id.* Rather, the Court held that the *BFP* analysis does not apply to § 547(b)(5) because the plain language of this section precludes such a judicial interpretation.

In analyzing the application of *BFP* to § 547, the Court focused on the basic rule of statutory construction that judicial inquiry ends when a statute is found to be plain and unambiguous on its face. *Id.* at 642. In clear and plain language, § 547(b)(5) requires a court to determine both the value of what the creditor actually received from the pre-petition transfer of property and the value of what that same creditor would have received in a chapter 7 liquidation of the debtor's property if the pre-petition transfer had not occurred. *Id.* at 639. Once these two values are determined, the court must then undertake a straightforward mathematical comparison of these two numbers: if the amount actually received is greater than the amount that would have been received in a Chapter 7 liquidation, the requirement of § 547(b)(5) is met. *Id.* The language of § 547 in no way suggests that a Court may simply assume that a chapter 7 liquidation will never result in a greater sales price than a pre-petition foreclosure sale. "There is nothing in § 547 equivalent to § 548's ambiguous use of 'value' . . . There is no ambiguity about the meaning of 'more' or 'chapter 7 liquidation' or the clear purpose of § 547." *Id.* at 642. Thus, although the same the federalism concerns raised in *BFP* with respect to state property laws apply equally in a § 547(b) avoidance action and a § 548 fraudulent conveyance action, the plain language of § 547(b) does not permit a court to find as a matter of law that a chapter 7 liquidation will never result in a creditor receiving more than it did in a pre-petition foreclosure sale.

The practical effect of this ruling is that a foreclosure sale can never truly be considered final until at least 91 days after the sale occurs because, if a debtor files for bankruptcy in the interim, he may be able to have the sale avoided as a preferential transfer under § 547(b). Creditors that credit bid at a foreclosure sale where the property is worth more than the amount of the debt should be especially aware of the possibility of the sale being avoided in bankruptcy.