# CLIENT ALERT: Buyer Beware: Bankruptcy Court Rules That A Non-Collusive Foreclosure Sale May Be A Bankruptcy "Preference"

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Secured lenders seeking to enforce their remedies have sought refuge in the safety net of complying with state law foreclosures as a means of ensuring the validity of the sale. However, a recent case requires lenders to take notice. *In re Whittle Development, Inc.*,[1] presents a case where a U.S. Bankruptcy Court in Texas ruled that a debtor may be able to avoid a validly conducted prepetition foreclosure sale and credit bid of the secured lender on the grounds that the foreclosure constituted a “preferential transfer” under the Bankruptcy Code.

A preference is generally defined in the Bankruptcy Code as a transfer within the ninety days (one year, for transfers to insiders) prior to a bankruptcy filing that results in a payment on a creditor’s antecedent claim that is larger than the payment the creditor would have received if the transfer had not been made and the debtor’s assets were sold under a hypothetical Chapter 7 liquidation. Preference laws were drafted to ensure equality of treatment of creditors and to guard against favorable treatment of certain creditors over others during a defined period preceding a bankruptcy filing.

**Background**

In *Whittle*, a secured lender was owed $2.2 million. After default, the lender chose to foreclose on its real property collateral, and subsequently to purchase the collateral at a foreclosure sale by means of a $1.2 million credit bid. The borrower thereafter filed for bankruptcy and sought to set aside the foreclosure sale and the sale to the credit bidding lender as a preferential transfer. The debtor believed the property was worth $3.3 million, and argued that by purchasing the property through a below-market credit bid, the lender was able to recover more than the $2.2 million the lender was owed, thus resulting in a preference.

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**Lender's Argument**

The lender moved to dismiss. The lender pointed to the U.S. Supreme Court's decision in *BFP v. Resolution Trust Corp.*,[2] where the Supreme Court ruled that the price paid at a foreclosure sale conducted pursuant to state law was *per se* "reasonably equivalent value" in the context of a fraudulent conveyance attack. The lender argued that, accordingly, consistent with *BFP* the price determined by bid at the foreclosure sale is the fair market value of the property, and thus no preference could be alleged.

**The Bankruptcy Court's Ruling**

The Bankruptcy Court denied the motion to dismiss and ruled that the lender could be sued for a preference to avoid the foreclosure sale, even though the sale complied with state law and was non-collusive.

The Bankruptcy Court disagreed with the lender's argument, holding that *BFP* applied to a fraudulent transfer analysis only, since the term "reasonably equivalent value" is not a requirement of the Bankruptcy Code's preference provision, and thus *BFP* was inapplicable to the dispute. Rather, the Bankruptcy Court stated that the question is whether the creditor is getting more than what it would have received in hypothetical liquidation, an issue the Court said required a trial.

**Conclusion**

The *Whittle* court's reasoning is curious, since it is hard to imagine that a properly conducted foreclosure sale could conclusively establish fair value for purposes of fraudulent transfers, but not for purposes of preferential transfers. The result in such an analysis — which has been rejected by bankruptcy courts in other districts — is that state law foreclosure sales may be viewed by lenders and other buyers as a riskier method of purchasing assets.

While lenders and bidders may take comfort that other courts have not followed *Whittle's* ruling, lenders should be aware of this decision and consider potential bankruptcy risks that may occur after a foreclosure sale when bidding in foreclosure sales.

[1] No. 11–03150, 2011 WL 3268398 (Bankr. N.D. Tex. July 27, 2011)

[2] 511 U.S. 531 (1994)

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