

## REVERSING (VOIDING) FORECLOSURE SALES IN BANKRUPTCY

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### 1. Foreclosures Can Not Be Reversed In Bankruptcy as a Fraudulent Conveyance

Until recently, most bankruptcy attorneys (including the author of this article) were of the opinion that a bankruptcy filing can not be used to reverse (or void) a completed foreclosure sale unless the foreclosing creditor failed to strictly follow the foreclosure process required by Texas state law. This rule applies regardless of the price paid by the foreclosing creditor or third party at the foreclosure sale. The rule was reinforced by the U.S. Supreme Court case of *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), which ruled that the amount paid by a foreclosing lender or third party purchaser at a foreclosure sale is *per se* “reasonably equivalent value” so long as state law foreclosure procedures were followed. As a result, a bankruptcy court can not reverse a foreclosure sale as a *fraudulent conveyance* under Bankruptcy Code § 548 so long as the sale was conducted in accordance with state law.

### 2. The Growing Trend – Completed Foreclosure Sales Can Be Voided (Reversed) as an Unlawful Preference

A growing line of case authority supports the view that the bankruptcy preference rules contained in Bankruptcy Code § 547 may be an overlooked tool that will now permit the Bankruptcy Court to avoid (void, undo or reverse) a procedurally valid foreclosure sale under limited circumstances. Initially, this view

not accepted. Court opinions issued in the following cases rejected the legal theory that a foreclosure sale could be reserved on the basis that it was a preference. *Ehring*, 900 F.2d 184 (9th Cir. 1990), 900 F.2d 184 (9th Cir. 1990); *FIBSA Forwarding, Inc.*, 244 B.R. 94 (S.D. Tex. 1999); *Chase Manhattan Bank v. Pulcini*, 261 B.R. 836 (Bankr. W.D. Pa. 2001).

However, the legal theory that a properly conducted foreclosure sale can be avoided as an unlawful preference has gained acceptance in recent years. It is now the majority view in the published opinions. Court opinions issued in the following cases now support the theory that a foreclosure sale can be reversed as a preference in a bankruptcy case. *Norwest Bank Minn., N.A. v. Andrews*, 262 B.R. 299 (Bankr. M.D. Pa. 2001); *Rambo v. Chase Manhattan Mortg. Corp.*, 297 B.R. 418 (Bankr. E.D. Pa. 2003); *Villarreal v. Showalter*, 413 B.R. 633 (Bankr. S.D. Tex. 2009) (Isgur); *Whittle Dev., Inc. v. Branch Banking Trust Co.*, 463 B.R. 796 (Bankr. N.D. Tex. 2011) (Hale); *Nguyen v. Wells Fargo Home Mortg.*, 2013 Bankr. LEXIS 1605 (Bankr. S.D. Tex. 2013) (Isgur); *Berley Assocs. v. Eckert*, 2013 Bankr. LEXIS 2025 (Bankr. N.J. 2013) (Kaplan). The view that a prepetition foreclosure sale can be voided as a preference has also been adopted by at least one of the five bankruptcy judges in the Houston Division of the Southern District of Texas.

### **3. Requirements for Establishing an Avoidable Preference**

A homeowner must establish the following elements of proof to reverse a foreclosure sale as a preference.

#### **(a) Transfer of property**

The first element of proof needed to establish a voidable preference is that a “transfer” of the homeowner’s property took place. In the Fifth Circuit (which includes all Houston bankruptcy courts), a non-judicial foreclosure sale constitutes a “transfer” of a homeowner’s interest in the property. *Durrett v. Washington National Insurance Co.*, 621 F.2d 201 (5th Cir. 1980). Therefore, the issuance of a deed to the buyer at a foreclosure sale will automatically satisfy the first element of a preference – that a “transfer” took place.

Some early bankruptcy court opinions outside of the Fifth Circuit held that a foreclosure sale was not a transfer of a property interest of a homeowner. One such case was *Madrid*, 725 F.2d 1197 (9th Cir. 1984), where the court ruled that there was no transfer at the time of the foreclosure sale and that the only relevant transfer occurred when the creditor recorded the mortgage in the real property records (normally a few days after the homeowner originally buys the property). The *Madrid* opinion agreed with other preference cases which found that the enforcement of a mortgage within 90 days before a bankruptcy filing could not

be struck down as a preference where the mortgage lien was recorded outside the 90 day look back period.

However, the bankruptcy code definition of the word “transfer” was amended in 1984 to define the “foreclosure of the debtor’s equity of redemption” as a transfer. Since this amendment, there has been no doubt in any bankruptcy court that a foreclosure sale constitutes a “transfer” of a homeowner’s property and will be considered a preference if the other legal elements of a preference are satisfied. Ehring, 900 F.2d 184 (9th Cir. 1990).

#### **(b) Existing creditor**

The second element of proof needed to establish a preference is that the property was transferred to an existing creditor of the property owner. In other words, the buyer at the foreclosure sale must be a creditor of the homeowner on the date the bankruptcy case is filed.

As a practical matter, this requirement limits the ability to avoid a foreclosure sale as a preference to cases where the mortgage lender is the successful bidder at the sale. A foreclosure sale that results in the property being sold to a third party can not be reversed in bankruptcy as a preference because the third party is almost never a pre-existing creditor of the homeowner.

It is very common for the foreclosing lender to make a credit bid for some or all of the debt owed to it. The requirement that the foreclosure sale result in a transfer of the property back to the lender will be met in the overwhelming majority of Texas foreclosure sales. At least 90 percent of all houses sold at a Texas foreclosure sale are deeded back to the lender that conducted the sale rather than being sold to a third party.

#### **(c) Antecedent debt**

The third requirement to establish an unlawful preference is that the foreclosure sale must be motivated by an attempt to collect an “antecedent debt.” An antecedent debt is a debt owed by the property owner to the foreclosing creditor before the foreclosure sale was held.

This requirement will be automatically met in almost all residential home foreclosure sales. In most foreclosure situations, the home serves as collateral to secure repayment of a loan obtained to buy the house. A homeowner’s failure to pay the loan is the normal motive for a lender to foreclose. The antecedent debt requirement will almost always be met if a homeowner’s failure to pay a mortgage loan is the reason for the lender’s attempt to foreclose.

Although not common, a lender or other creditor can attempt to foreclose due to non-monetary defaults such as: (i) a failure to maintain insurance, (ii) a failure to pay property taxes, or (iii) deed restriction violations. Almost all mortgage loan documents require the property owner to pay taxes and keep the property insured, and permit the lender to foreclose if the homeowner defaults on these non-monetary obligations. A foreclosure sale conducted due to these types of defaults can not be reversed as a preference because the foreclosure sale was not based on a failure to pay an antecedent debt.

**Example #1:** Homeowner obtains a \$100,000 mortgage loan to purchase a house which he uses as a personal residence. Payments of principal and interest are \$800 per month. There is no escrow account to collect a monthly reserve for the insurance or property taxes. The loan documents contain a standard clause requiring Homeowner to pay property taxes when due and keep the house insured.

Homeowner fails to buy insurance or pay property taxes. Lender posts the house for a foreclosure sale solely because of Homeowner's failure to pay taxes or obtain insurance. Homeowner was current on all mortgage payments on the foreclosure sale date. Lender buys the house at the sale.

Homeowner files for bankruptcy and attempts to void the foreclosure sale as a preference. Homeowner will lose because the foreclosure sale was motivated by Homeowner's non-monetary default of failing to obtain insurance or pay taxes, not as a result of a failure to pay an antecedent debt.

#### **(d) Insolvency**

The fourth requirement to establish a voidable preference is that the homeowner was insolvent when the foreclosure sale was conducted. The test for insolvency is a balance sheet test – whether the homeowner's debts exceeded the value of his non-exempt property on the foreclosure sale date. The property owner is presumed to be insolvent at all times within the 90 days before the bankruptcy is filed. The lender or other creditor will have the burden to prove that the homeowner is not insolvent.

The insolvency test will be easily satisfied in most situations unless the homeowner owns a business or other valuable non-exempt (legally seizable) assets. The bankruptcy code definition of insolvency specifically excludes all exempt assets (assets legally protected from seizure). However, the law does not exclude loans collateralized by exempt assets in calculating whether debts are greater than the value of the homeowner's assets. It is very unusual for a property owner to have non-exempt assets that exceed the amount of his debts

when the debts include loans collateralized by exempt assets such as houses and cars.

**Example #2:** Homeowner has the following debts and property on the date Lender forecloses on his house for failing to pay the mortgage debt:

Assets					
Description	Value	Loan Amnt	Equity	Exempt	Counted Amnt
House	200,000	180,000	20,000	yes	0
2 Cars	40,000	35,000	5,000	yes	0
Furniture	15,000	0	15,000	yes	0
Clothes	4,000	0	4,000	yes	0
Jewelry	7,500	0	7,500	yes	0
Stocks	200,000	0	200,000	no	200,000
<b>Total Assets</b>					<b>200,000</b>
Liabilities					Amnt Owed
Home Mortgage					180,000
Car Loans					35,000
Credit Card Debt					5,000
Medical Bills					5,000
<b>Total Liabilities</b>					<b>225,000</b>

**Result:** Homeowner is considered insolvent regardless of the fact that he owns \$200,000 of non-exempt stock.

**(e) Bankruptcy Must Be Filed within 90 Days After Foreclosure Sale** 

The fifth requirement to establish an unlawful preference is that the bankruptcy case must be filed within 90 days after foreclosure sale date. A homeowner will not be able to reverse the sale as a preference if he waits to file a bankruptcy case for more than 90 days after the foreclosure sale date.

**(f) Property Value Must Exceed Payoff Balance Owed to Foreclosing Creditor** 

The sixth element of proof required to void a foreclosure sale as a preference is the most important. The homeowner must establish that the sale back to the creditor will enable the foreclosing creditor to receive more value for the house than it would receive if the property was sold by a trustee in a hypothetical Chapter 7 bankruptcy case.

A chapter 7 trustee is permitted to sell property in a relaxed, unforced sale, at fair market value. Therefore, this requirement essentially means that the foreclosure sale can be avoided as a preference if the payoff balance owed to the foreclosing creditor is less than the fair market value of the house on the foreclosure sale date. A foreclosing lender (except for a small private company or an individual) will never bid more at a foreclosure sale than the payoff balance due on the loan. Therefore, put another way, a foreclosure can be reversed as a preference only if the homeowner has some equity in the property – only if the market value of the house is more than the payoff balance due on the first mortgage loan.

### **(g) Bankruptcy Must Be Filed Before Lender Sells the Property to a Bona Fide Purchaser**

This final consideration is whether the property has been sold to a bona fide purchaser. A foreclosure sale can not be voided as a preference if the foreclosing lender sells the house to a bona fide purchaser after the foreclosure sale but before the bankruptcy case is filed. In this situation, a bona fide purchaser would be a third party, without knowledge that the transfer could be avoided as a preference who pays value for the home. In this context, the payment of “value” means a transfer of valuable property, or the satisfaction of an antecedent debt owed by the third party to the foreclosing creditor.

The preference claim is not completely defeated if the foreclosed property is sold to a bona fide purchaser. The homeowner can still recover damages from the foreclosing creditor measured by the difference between the payoff balance due on the loan owed to the foreclosing creditor and the fair market value of the foreclosed home. However, the original homeowner would not be able to recover the house from the bona fide purchaser (the third party that bought the house from the foreclosing creditor).