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Solving the Problem of Abusive Mortgage Foreclosure Sales

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Commentary

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Solving the Problem of Abusive Mortgage Foreclosure Sales

It is an old well-worn scenario: *R* is the owner of a house worth $60,000, and is personally liable on a $40,000 mortgage on the property to the *E* Co. *R* is in financial trouble and defaults on the loan. *E* Co. begins foreclosure and in a judicial sale of the house, *E* Co. is the only bidder and buys in for $31,000. *E* Co. does not have to put up that amount in cash but merely credits the $31,000 bid price against the balance due on the loan; now *R* owes $9,000 plus any interest that has accrued. *E* Co. gets a "deficiency judgment" against *R* for that amount, and proceeds to garnish his wages until the balance plus any additional accrued interest is finally collected. In the meantime as soon as the foreclosure sale is confirmed, *E* Co. puts the house on the market and in a quick sale disposes of it for a net of $55,000 after commissions and other expenses. As a result, in addition to the normal interest charges, *E* Co. has recovered the principal amount of $64,000[1] on a $40,000 loan. At the same time, *R* has been deprived of the $20,000 equity in his home, and in addition has had to pay *E* Co. a $9,000 deficiency judgment. Thus, in effect *R* has given $69,000 to pay off a $40,000 loan, in addition to the normal interest charges.[2]

R has two major complaints in this situation. First, to enforce the loan, *E* Co. is taking property whose value is in excess of the amount owed to it. Second, to add insult to injury, *E* Co. is claiming R owes still more, in the face of the fact that it has already been made more than whole. Both of these problems stem from one flaw in the present system; viz., that a mortgagee can, through the device of a foreclosure sale, acquire the secured property for its own account at a fictitiously low figure, and then use that unfairly small amount as the appropriate dollar credit against the amount due on the loan.

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1. This consists of the $55,000 net proceeds on the house and the $9,000 deficiency judgment.
2. This consists of the $60,000 fair market value of the house that *R* is losing, plus the $9,000 deficiency judgment.

One could ask just how prevalent this double-bind situation is. There is not extensive empirical data on the subject of just what happens in the typical foreclosure in the United States, but there are several studies[3] that seem to verify much of the mostly anecdotal material that every professional in the law of mortgages has heard. The most useful for our purposes appears in a recent article by Professor Wechsler.[4] Wechsler made an empirical study of the 118 mortgage foreclosures that were commenced during 1979 in Onondaga County, New York. He studied court files which revealed the terms of the original loan, land description, amount due as of the time of foreclosure sale, identity of the successful bidder, amount bid, whether the mortgagee sought a deficiency judgment, and other relevant data. In addition he examined the subsequent history of the foreclosed property to see whether it was resold in a normal competitive market and for how much.

The study disclosed some very interesting and, in some cases, surprising data. First of all, mortgagees bought in at only 77% of the foreclosure sales. The balance of the purchases were made by unrelated third parties. The conventional wisdom is that mortgagees are the successful bidders in over 99% of foreclosure sales. A number of reasons are usually stated for this overwhelming number. It is said that outsiders are discouraged from bidding, because they have to put up fresh cash to buy the property at foreclosure sale, while the mortgagee does not need to put up any cash, since it merely has to deduct the amount of its bid from any mortgage balance already owing it. Further, real estate is not generally bought at an auction sale. Parties buying realty like to have time to examine the property, inquire about possible financing, and negotiate the price. In addition, foreclosure sales are not advertised in the same way that realty offerings are ordinarily advertised, so that buyers possibly interested do not even know that it is available. Lastly, in some states buyers at foreclosures are not entitled to a marketable title, and therefore a title search is necessary before a person is in a position to bid at the sale. It is indisputable that these arguments are correct, and there is little doubt that typically a very large proportion of the foreclosure sales end up with the mortgagee as the only bidder. Nevertheless, the Wechsler study indi-

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3. Bauer, *Statutory Redemption Reconsidered: The Operation of Iowa's Redemption Statute in Two Counties Between 1881 and 1980*, 70 IOWA L. REV. 343 (1985); Bridewell, *The Effects of Defective Mortgage Laws on Home Financing*, 5 LAW & CONTEMP. PROBS. 545 (1938); Carey & Brabner-Smith with Lansden & Sullivan, *Studies in Foreclosures in Cook County* (pts. 1-4), 27 ILL. L. REV. 475, 595, 717, 849 (1933); Skilton, *Government and the Mortgage Debtor* 1940-1946, 95 U. PA. L. REV. 119 (1946).

4. Wechsler, *Through the Looking Glass: Foreclosure by Sale as De Facto Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850 (1985).

cates that at least in certain localities, there is a substantial third-party market in foreclosed properties.

A second finding of the study was that when mortgagees bought in, upon their resale of the property on the open market, they made profits in about half of the cases and sustained losses in the other half. Overall, the dollar amount of the losses exceeded the gains. From the standpoint of this commentary, this finding is not terribly important. The fact that, overall, mortgagees are losing money on their defaulted mortgages hardly justifies their being unjustly enriched in some individual cases at the expense of particular defaulting customers. This point is emphasized by the fact that in those cases where mortgagees held the properties for a short time after foreclosure and made a profit, the profits as an annualized percentage of investment ranged from 56% to over 1000%. Parenthetically, it should also be noted that when third parties bought in at foreclosure and resold rather than keeping the property for their own use, they made a profit in 14 out of 15 cases. The implication was that third parties purchased only the most attractive and saleable properties.

In spite of the fact that third parties seemed to do better than mortgagees when they resold, the study nevertheless found that more than half of the foreclosure sales to third parties produced a surplus over the amount of the debt. This should be contrasted with cases where the mortgagee bid in, where only one produced a surplus for the account of the mortgagor. At the same time over 90% of the sales to mortgagees were for less than the amount of the debt, while this was the case in only 39% of the sales to third parties. It is perfectly apparent that when third party bidders appear, sales yield a much higher percentage of market value than when the mortgagee is the only bidder, and everyone (except for perhaps a windfall-seeking mortgagee) seems to benefit thereby.

The last finding of importance was that, though there were deficiencies in 94 of the 118 cases, mortgagees actually obtained a deficiency judgment in only one of them. This is in accord with other current reports on the subject.[5] In many of the cases, a nominal bid was made by a mortgagee who had no intention of seeking a deficiency judgment, so that the relatively low percentage of the bid amount as compared to market value was not very important, except in those cases where the market value greatly exceeded the amount of the debt.

As has oft been noted,[6] various devices, both court invented and

5. Wall Street Journal, Aug. 7, 1985, at 19, col. 1. The article indicates that except in cases of perceived mortgagor misconduct, most lenders are not seeking deficiency judgments against necessitous borrowers.

6. *See, e.g.*, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW §§ 7.16, 7.21, 7.22, 8.1-8.8 (2d ed. 1985).

statutory, have been tried over the years to solve the problem of the inadequate bid at foreclosure sales and the resulting additional burden of the deficiency judgment. I will summarize them very briefly. Courts in most states reserve to themselves the power to refuse to confirm a judicial sale, if the bid is "so grossly inadequate as to shock the judicial conscience." This rule has proved to be a weak reed, indeed, because in practice courts have approved bids as low as one-third of fair market value.

In a few jurisdictions, in response to the horrendous effects on the economy during the Great Depression wrought by abnormally large numbers of foreclosures that yielded very low sale prices, courts have fashioned rules more protective of debtors. Such courts might (1) refuse to confirm the sale if the price was "substantially inadequate," or (2) fix an upset price—a price below which they would not confirm, or (3) require a credit against the debt of a judicially determined figure for fair market value. Most states have not adopted these rules as a part of their common law, and it is doubtful that even where so adopted the rules have, as a practical matter, resulted in the debtor's getting the maximum feasible return on his property. The reason is that debtors in most foreclosure proceedings do not have the money to properly defend a foreclosure action, which therefore tends to go by default. In such a situation, it is very difficult for the judge, on his own motion, to assure that the price yielded at sale is a fair one. To have a device that works, then, the mortgagee must have a built-in incentive to maximize the debtor's return; or else, with no one on the other side of the lawsuit, the mortgagee will seek to maximize only his return.

Some states have responded to the two problems of inadequate foreclosure sale prices and oppressive deficiency judgments by passing various kinds of legislation. The statutory right of redemption was a response to the problem of inadequate sale prices. Under it, the mortgagor and junior lienors are given the right to redeem *after* foreclosure. The statutory right of redemption should be contrasted with the equitable right of redemption which was a creature of the courts. In equitable redemption the person redeeming must pay the balance of the loan plus interest and costs *before the foreclosure process is completed* or be barred thenceforward from ever doing so. Under the statutory right of redemption the person redeeming must pay the amount of the foreclosure sale price, rather than the loan balance, within a certain period of time after foreclosure or be forever barred thereafter from doing so. The purpose of statutory redemption, which exists in a little more than half the states, is to give the person bidding in at foreclosure a strong incentive to bid a fair price. His penalty for getting the property at an unfairly low price is the likelihood that the mortgagor or lienor will statutorily redeem at that price. A strong criticism of statutory redemption is that it has not had the intended effect. The reason is that third parties are discouraged from bidding at foreclosure at all for fear that there will be a redemption a year or more after the sale. Another strong deterrent to bidding by third parties is the fact that under the law of most states having statutory redemption, the successful bidder does not get possession of the property he has purchased until after the period for statutory redemption has run. This could entail a delay of up to two years, thus preventing the buyer's use of his own property while substantial deterioration of it might occur.

Professor Bauer in a recent empirical study of the operation of Iowa's statutory redemption law in two counties has concluded that it does work to a degree to mitigate the problem of price inadequacy.[7] He inferred this from the fact that over a period of 100 years, redemptions took place in the counties studied in a little more than 10% of the cases. However, Bauer did not study what happened to the 90% of the cases where redemption did not take place and therefore was unable to tell how many of the nonredemptions were accounted for by the fact that the foreclosure sale prices were adequate and how many by the fact that prospective redeemers had insufficient funds. In my view it is not important whether statutory redemption is counterproductive, as its critics say, or useful, as its advocates say, if we can devise a system of selling land in foreclosure that will approach the results of a competitive free market.

The second problem sought to be mitigated by state legislation was the abusive deficiency judgment. Such can occur, of course, when a foreclosure sale price, though well below what the property can bring in the open market, is used to determine what should be credited against the mortgage debt owed by the mortgagor. Various solutions were enacted in many of the states. In some the use of foreclosure sale price as the appropriate credit against the debt was completely abandoned, and in its place was substituted a credit of the fair market value of the property. A few states applied this rule only to cases where the mortgagee himself bought in at foreclosure. It is questionable how effective the fair market value credit is, because, as mentioned earlier, most mortgage foreclosures are not defended and end up in a decree for plaintiff by default. It becomes quite difficult then for the court to get a fair approximation of the appropriate amount to credit on the debt.

Another approach to the problem of unfair deficiency judgments is to prohibit deficiency judgments outright at least under certain circumstances. For example, in a few states the statutes prohibit deficiency judgments where foreclosure is by exercise of a non-judicial

7. Bauer, *supra* note 3, at 383-89.

power of sale.[8] In others there is a prohibition where the mortgage being foreclosed is of the purchase money variety. The Uniform Land Transactions Act prohibits deficiency judgments on purchase money mortgages given by residential owner-occupants.[9] Again a more effective way of solving the difficulty of the abusive deficiency judgment is to make sure that the foreclosure procedure results in the highest possible price for all parties concerned.

A Proposal

In order to bring the highest possible price—the price that everyone except the most rapacious of lenders would favor—state laws should mandate that property in foreclosure be marketed in the same way that rational owners, not involved in a forced sale situation, sell their property. Different kinds of property are marketed in different ways. For example, one might market a foreclosed single family dwelling by first attempting to sell it through newspaper advertising in the real estate section, and then, if unsuccessful, list it with a local real estate broker who deals in that kind of property. On the other hand, if the property involved is a shopping center, one might first directly contact established firms that are in the business of buying such distressed property and then resort to nationally connected brokers who specialize in dealing with shopping centers.

Sometimes unusual approaches to marketing property may be appropriate because of atypical location or special economic conditions. For example, as this is written, new residential condominiums in some parts of the Sunbelt are in oversupply and are being marketed by well advertised and attended auctions. In normal times the best way to sell such properties is to market them through resident sales agents or real estate brokers, but currently the traditional methods simply have not been working in certain localities. Unusual market conditions can call for the use of unconventional methods. The proper approach for the law should always be to require that the property be marketed in the way knowledgeable sellers of that kind of property, in that vicinity and at that time, are doing it.

The Uniform Land Transactions Act (not enacted in any state) provides for a similar approach,[10] which seems to me, however, to be flawed. It says in section 3-508(a) that "Sale may be at a public sale or by private negotiation, by one or more contracts, as a unit or in parcels, at any time and place, and on any terms including sale on credit, but every aspect of the sale, including the method, advertising, time,

8. A non-judicial power of sale involves the use of some sort of public sale without the necessity for permission or supervision of a court of law.
9. UNIF. LAND TRANSACTIONS ACT § 3-510(b), 13 U.L.A. 618 (1977).
10. *Id.* at §§ 3-508(a), 3-509(d).

place, and terms, must be reasonable."[11] The Act does not require that the sale be conducted by a disinterested third party, but rather allows the mortgage creditor to conduct the sale itself and if it wishes to, to buy the property for its own account. The difficulty that I see in the Act is that the mortgagee is given great economic incentive not to sell the property for the best price, so that it can buy in and make a profit on resale. Indeed, if the property is sold in foreclosure directly to a third party at a fair price, the mortgagor and not the mortgagee will get the full benefit of the excess of the selling price over the amount of the debt. With that kind of system, there is every danger that mortgage companies will try to evade the legal requirements of selling in the regular market.

An alternative suggested by Professors Nelson and Whitman[12] is to have the sale conducted by an independent public official who, in addition to a small flat fee, would be given the incentive to maximize the price by giving him personally a commission based on a percentage ranging from 1% to 1 3/4% of any portion of the price that exceeds the amount of the debt. A few very serious criticisms of this approach should be made. First, the addition of a new bureaucracy to solve the problem of selling real property in foreclosure is hardly inviting. There is no reason to think that public officials as a group are better than private parties at doing things which the private economy has handled very well for hundreds of years. Second, such a small commission would not provide very much incentive to maximize the price. In such a situation, it would not matter a great deal to the administrator whether he got 1% of $100,000 or of $125,000. But if one increased the amount of the commission to solve that, then it would merely exacerbate the complications of the third problem, that of possible corruption. The appointment of a public official, who can personally make a great deal of money through the sale of foreclosed property, opens the potential for serious corruption in the process of deciding who will get that exceedingly remunerative sinecure. Surely, then, there is a better way than the appointment of a public official to handle the problem of maximizing the returns in foreclosure.

My suggestion is a simple one, which would require the changing of only a few rules. First, forbid the mortgagee from buying in at foreclosure as the English do. This would prevent the mortgagee from arranging to buy the property at a "public" sale at which he was the only bidder and then later selling the property for what it was really worth for his own account. Second, to bring in the highest possible price for the benefit of all concerned, have the *mortgagee*, as agent for all the parties in interest sell the property in the manner above described, that is, in the way that such assets, not in foreclosure, are ordinarily

11. *Id.* at § 3-508(a).
12. G. NELSON & D. WHITMAN, *supra* note 6, at § 8.8.

marketed. If after such a sale, a deficiency remained, then as under prior law, those personally liable on the original debt would be liable for that unpaid balance. Third, the traditional rule regarding the distribution of foreclosure proceeds requires that liens be paid off in order of priority, with the balance, if any, then going to the mortgagor. Obviously, if that rule were not changed, the mortgagee would have absolutely no incentive to maximize the amount of the selling price above the amount of its own lien. The incentive needed to prod the mortgagee to do its best would necessarily consist of a substantial sum of money. My suggestion would be that the mortgagee get a percentage of the excess left after all liens and charges are paid. That percentage should range downward from perhaps 40% of amounts up to $25,000, to 25% of amounts over $100,000. For very large amounts, even a smaller percentage might be appropriate.[13] One might make the criticism that such a system would give mortgagees a beneficial interest in the property of the mortgagor, something which the law has never before done. That is true but only in theory. Under the present system the mortgagee can get the entire equity in the property by merely bidding in at foreclosure at a fictitiously low price, and then later taking for itself the entire proceeds of the real sale at market value. Surely that is an infinitely worse situation than under the plan proposed here with the mortgagee getting only a limited portion of the equity.

To see how the system would work, let us examine the fact pattern that began this commentary. When *E* Co. forecloses the $40,000 mortgage on the property worth $60,000, it will take control of the property after default and its acceleration of the debt. Then it would take care of the sale of the property just as any owner who wanted to sell would do. If the property were not immediately saleable, it would rent it out, if that were the reasonable way to handle the problem. Just as under present law, *E* Co. would be liable to account for its unreasonable failure to maximize the income available from property under its control. The mortgagee would have a maximum reasonable period of time (perhaps two years) to dispose of the property. After that, sale would occur through a well-advertised auction at which the mortgagee could not bid in. In this case, if *E* Co. promptly sold the property through normal channels for its $60,000 market value, less $5,000 in brokerage

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13. Compare my suggestion with that of the author in Wechsler, *supra* note 4, at 884-90. There the author suggests a system to maximize recovery where there has been a resale by the mortgagee who bought in, suggesting that the entire surplus be returned to the mortgagor, if but only if it is residential property and the mortgagee resells within one year. I cannot imagine why a mortgagee would not seek to avoid this result by waiting for more than a year. Nor is it clear to me why if the mortgagee sells within the year, it would have any incentive to sell at full value in view of its obligation to return to the mortgagor any excess over debt produced by the sale.

and other expenses, the resulting proceeds of $55,000 would be distributed as follows:

To the mortgagee, (A) $40,000 for the principal amount of the debt, plus costs and accrued interest, less the amount of the rents for the property collected by it, plus (B) 40% of the difference between $55,000 and (A);

To the mortgagor, 60% of the difference between $55,000 and (A).

In this case, assuming there were no accrued interest, costs or rents, this would mean the mortgagee would get its $40,000, plus 40% of the difference between $55,000, the amount yielded at sale, and the $40,000, for a total of $46,000. Mortgagor would get the balance of $9,000. There obviously would be no deficiency judgment. Thus, the matter would end with mortgagor giving up, after expenses, assets worth $51,000[14] to pay off a $40,000 loan. This should be compared with the unfair result possible under present law, where the mortgagee recovered $64,000 on a $40,000 debt and the mortgagor was liable for a $9,000 deficiency judgment and ended up paying and giving up assets worth a total of $69,000.[15] There is an $18,000 improvement in favor of the mortgagor in the proposed law. It is accounted for by the fact that mortgagor is not liable for a $9,000 deficiency judgment and is in addition getting a refund of $9,000.

Obviously one could criticize this proposal by saying that the above numbers are merely made up and that the proposed system would not work as beautifully in the real world as in the hypothetical world here constructed. It is true that I have painted the present law in the grimmest way, in that I have hypothesized a situation where the mortgagee went for a deficiency judgment, whereas it seems to be true that mortgagees often do not do so as a matter of course.[16] However, I must say in reply that in my own experience, mortgagees do still occasionally seek deficiency judgments in the same kind of unfair circumstances depicted here. The numbers represented in this hypothetical are, unfortunately, not atypical ones at all. There are, indeed, too many abuses in this area of the law. The reforms that I have suggested

14. This consists of the $60,000 market value less the $9,000 refund by mortgagee from the excess yielded by the sale.

15. The result is perhaps clearer in the following chart:

	Present Law	Proposed Law
Mortgagee receives in foreclosure	$64,000	$46,000
Mortgagor gives up this amount to pay off the $40,000 obligation	$69,000	$51,000

16. Of course, I am not suggesting that mortgagees fail to seek deficiency judgments for altruistic reasons. Rather, it seems that pursuit of mortgagors for the last dollar typically does not yield enough to cover the costs of doing so. In addition, many lenders believe they would invite a serious public relations problem if they aggressively sought to recover and collect such judgments as a matter of course.

would go a long way to right the presently existing unfair balance between mortgagor and mortgagee in foreclosure cases.