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Take the Home but Spare the Equity: A Proposal to Bifurcate the Foreclosure Process

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I. INTRODUCTION

Homebuyer (H) buys a house for $100,000. He pays $10,000 in cash and obtains the other $90,000 by taking out a mortgage on the property with Lender (L). H makes payments for ten years before losing his job and defaulting on the mortgage. During those ten years, the value of the property increases to $200,000 and H pays the principal balance of the mortgage down to $60,000. L forecloses on the property. At auction, L is the only bidder and wins with a bid of $60,000. Although H had $140,000 of equity, he recovers nothing.

In 2008, lenders foreclosed on more than 2.3 million properties within the United States.[1] As the above hypothetical suggests, many homeowners lose both the foreclosed property and the equity[2] they had acquired—a financial disaster.[3]

Lenders are also harmed by inefficient foreclosure proceedings. In situations where the homeowner *does not* hold any equity in his property, lenders are often still forced to hold unnecessary and economically inefficient foreclosure auctions.[4] The increased costs from these proceedings are then passed on to future borrowers in the form of higher interest rates. As a result, all parties suffer from foreclosure's flaws.

This Comment argues that the existing foreclosure system unduly harms both buyers and lenders. To solve these problems, this Comment suggests a bifurcated foreclosure process which would benefit mortgagees, mortgagors, the borrowing public, and third-party creditors.

Part II of this Comment provides an overview of mortgage obligations and describes the foreclosure process. This section emphasizes the need for reform, illustrating the importance of the mortgage as security for debt and the extent of the current foreclosure crisis. This section then explains the various foreclosure

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1. RealtyTrac, Foreclosure Activity Increases 81 Percent in 2008, Jan. 15, 2009, http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=5681&accnt=64847 (on file with the *McGeorge Law Review*).

2. *See* Debra Pogrund Stark, *Facing the Facts: An Empirical Study of the Fairness and Efficiency of Foreclosures and a Proposal for Reform*, 30 U. MICH. J.L. REFORM 639, 640 n.1 (1997) (defining "equity" in property as "the extent to which the fair market value of the property exceeds the amount of debt secured by the property").

3. Basil H. Mattingly, *The Shift from Power to Process: A Functional Approach to Foreclosure Law*, 80 MARQ. L. REV. 77, 77 n.1 (1996).

4. *See infra* Part II.B (explaining that lenders are often forced to sell foreclosure properties twice: once at auction and again through traditional means).

proceedings used throughout the fifty states, concluding with a brief discussion of anti-deficiency legislation and other statutory safeguards.

Part III critiques current foreclosure law, arguing that existing law fails to protect a borrower's equity in his or her property while providing lenders with an economically inefficient method of debt collection. In particular, this section identifies and explains factors inherent in current foreclosure law that serve to eliminate competitive bidding and produce artificially low sale prices at foreclosure auctions. This section then discusses the costs of the foreclosure process and concludes that foreclosure auctions are unnecessary and economically inefficient in cases where mortgage debt exceeds homeowner equity.

Part IV proposes a foreclosure reform which would protect homeowner equity while reducing overall process costs. Specifically, Part III proposes a bifurcated foreclosure process in which the court would mandate either a judicial strict foreclosure proceeding or a standard foreclosure auction with the imposition of a fair value limitation, depending upon the homeowner's equity in the foreclosure property. This proposal draws substantial support from fraudulent transfer law.

II. MODERN FORECLOSURE LAW

A. *The Mortgage*

1. *Overview*

Without question, homeownership represents a key component of the "American Dream."[5] For many Americans, the prospect of homeownership represents fiscal responsibility, financial success, and security.[6] Indeed, homeownership "has been a principal source of wealth creation for low- and moderate-income people."[7]

Hoping to realize the substantial financial benefits that can come with homeownership, many Americans have invested substantial portions of their net wealth in residential property.[8] In 2004, homeownership peaked at 69.3% of households.[9] While this statistic may seem impressive, it rests on shaky and unsustainable foundations.[10] Between 1983 and 2004, the percentage of

5. *See generally* ERIC S. BELSKY ET AL., CHASING THE AMERICAN DREAM: NEW PERSPECTIVES ON AFFORDABLE HOMEOWNERSHIP (William M. Rohe & Harry L. Watson eds., 2007).

6. *Id.*

7. Bloomberg News, *Homeownership Declines for Fourth Consecutive Quarter*, N.Y. TIMES, Oct. 27, 2007, at C2.

8. *See* Vikas Bajaj & Edmund L. Andrews, *Broader Losses from Mortgages*, N.Y. TIMES, Oct. 25, 2007, at A1 (noting that more Americans own homes than own stock).

9. Bloomberg News, *supra* note 7.

10. *See id.* ("[A]s much as 70 percent of the increase in the aggregate homeownership rate over the

homeowners between the ages of 55 and 65 who owned their homes free of debt dropped from 52% to 36%.[11] Although homeownership as a whole may have risen, "[n]ever before have homeowners actually had such a small ownership stake in the houses they occupy."[12]

Because the vast majority of Americans cannot afford to buy property in cash, many obtain financing by taking out a mortgage (or deed of trust)[13] on the purchased property.[14] A mortgage allows the buyer (the *mortgagor*) to put a relatively small amount of money down and to finance the rest through a loan secured by the mortgaged property.[15] To ensure repayment of the loan, the lender (the *mortgagee*) acquires an interest in the collateral property.[16]

Prior to the 1980s, residential mortgages were relatively simple.[17] Most loan companies offered "fully amortized fixed interest rate" mortgages that guaranteed mortgagors a fixed payment amount for the life of the loan.[18] Homebuyers knew what to expect from their mortgages and could plan their finances accordingly.

However, the typical mortgage began to change in the 1980s.[19] With the introduction and rapid proliferation of mortgage loans containing adjustable rates, postponing principal payments, and providing for negative amortization, many homebuyers entered into loans that they did not understand and could not afford.[20] At least in part due to these questionable lending practices, many Americans are no longer able to meet their mortgage payments.[21]

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decade was a result of the introduction of new mortgage products.").

11. Louis Uchitelle, *A False Sense of Security? You Must Own a Home*, N.Y. TIMES, July 1, 2007, http://www.nytimes.com/2007/07/01/business/yourmoney/01view.html (on file with the *McGeorge Law Review*).

12. *Id.*

13. A deed of trust is treated as a mortgage for all intents and purposes. JESSE DUKEMINIER ET AL., PROPERTY 545 (Vicki Been et al. eds., 6th ed. 2006).

14. *Id.* at 541-42.

15. *Id.*

16. *Id.* at 542. Depending upon state law, the interest may be classified either as a lien on the secured property, a transfer of title to the secured property, or a combination of the above two approaches in which "the mortgagee is entitled to possession of the property only upon the mortgagor's default but before foreclosure is completed." The different theories are referred to respectively as the *lien theory*, *title theory*, and *intermediate theory*. JOHN G. SPRANKLING, UNDERSTANDING PROPERTY LAW 343 (1st ed. 2000).

17. *See* DUKEMINIER ET AL., *supra* note 13, at 542 (contrasting the relatively simple pre-1958 mortgage financing process with the current process which, spurred by the recently developed secondary loan market, created numerous types of complex loans).

18. *Id.*

19. Michael H. Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 S. CAL. L. REV. 1261, 1265-71 (1991) (suggesting that this change was the product of "deregulation, the growth of the secondary mortgage market, securitization, and technological advances").

20. Gretchen Morgenson, *Can These Mortgages Be Saved?*, N.Y. TIMES, Sept. 30, 2007, http://www.nytimes.com/2007/09/30/business/30country.html (on file with the *McGeorge Law Review*) (citing numerous examples of homeowners who entered into different types of complex and confusing loans that ultimately played a role in the homeowners defaulting on their mortgages).

21. *Id.*

By the time a mortgagor becomes delinquent on her payments, she is already in dire straits. Although she must act quickly to avoid foreclosure, research indicates that "half of all homeowners facing foreclosure are afraid to contact their lender for help."[22] Compounding this problem, even those who do attempt to avoid foreclosure often procure unsatisfactory and inequitable results. According to borrowers' advocates, homeowners who seek help from their lender "encounter hostility and are charged large and unexplained fees throughout the foreclosure process—whether or not they wind up keeping their homes."[23] Put simply, it is extremely difficult for a homeowner to avoid foreclosure once she becomes delinquent on her mortgage payments.

2. *Crisis*

The bubble of unsustainable mortgage loans has burst. "For the first time since the Carter administration, homeownership in the United States is set to decline over a president's tenure."[24] According to RealtyTrac, an online provider of foreclosure data, foreclosure filings rose by 242% between the third quarter of 2008 and the same period two years earlier.[25] In the third quarter of 2008, new foreclosure filings reached 765,000.[26] Some areas have seen extraordinary increases; foreclosure filing rates in New Hampshire increased by 2,785% in one year.[27] As one commentator predicted, the national foreclosure wave has now become a tsunami.[28]

The foreclosure crisis has had a profound impact on the national economy. In December 2008, the United States officially entered a recession.[29] Further, the foreclosure crisis is far from over.[30] "As home prices continue to decline

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22. Jay Romano, *When Borrowers Face Foreclosure*, N.Y. TIMES, Oct. 14, 2007, http://www.nytimes.com/2007/10/14/realestate/14Home.html (on file with the *McGeorge Law Review*).

23. *See* Morgenson, *supra* note 20 (giving the example of homeowners who attempted to reach Countrywide, "the nation's largest mortgage originator and loan servicer").

24. Editorial, *The American Dream in Reverse*, N.Y. TIMES, Oct. 8, 2007, at A18.

25. David Stout & Brian Knowlton, *Senators Press for Action to Stem Foreclosures*, N.Y. TIMES, Oct. 23, 2008, http://www.nytimes.com/2008/10/24/business/economy/24cong.html?_r=1&sq=2nd%20quarter%20foreclosure%20realtytrac&st=cse&adxnnl=1&scp=1&adxnnlx=1230665499-6w21MHN4GwP1K0Y4aDAnUQ (on file with the *McGeorge Law Review*); RealtyTrac, Foreclosure Activity up 30 percent in Third Quarter, http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=3567&accnt=64847 (last visited Mar. 21, 2009) (on file with the *McGeorge Law Review*).

26. Stout & Knowlton, *supra* note 25.

27. RealtyTrac, *supra* note 25.

28. Morgenson, *supra* note 20.

29. Edmund L. Andrews, *Officials Vow to Act Amid Signs of Long Recession*, N.Y. TIMES, Dec. 1, 2008, http://www.nytimes.com/2008/12/02/business/economy/02econ.html?ref=business (on file with the *McGeorge Law Review*).

30. RealtyTrac, *Is Negative Equity Important?*, Dec. 17, 2008, http://www.foreclosurepulse.com/blogs/mainblog/archive/2008/12/17/is-negative-equity-important.aspx (on file with the *McGeorge Law Review*) ("Several economists believe home prices need to fall further in order to make housing more affordable. MarketWatch chief economist Irwin Kellner says housing needs to fall another 20 percent, while Princeton

nationwide, many homeowners find themselves with negative equity, owing more on their loans than their houses are worth."[31] In September 2008, "7.5 million mortgages, or 18 percent of all homes with mortgages, were underwater."[32] Some commentators predict that this number may rise as high as 15.3 million before the foreclosure wave passes.[33] Inevitably, many of these homes will go through the foreclosure process. To best deal with the current and oncoming housing crisis, it is prudent to reevaluate the fairness and efficiency of the foreclosure process.

B. The Foreclosure Process

1. Initial Steps

When a mortgagor defaults on a mortgage payment, the mortgagee may force a sale of the collateral property to ensure repayment of the mortgage debt.[34] To begin the foreclosure process, the mortgagee first notifies the mortgagor in writing that the mortgagor is in default and that the mortgagee intends to initiate foreclosure proceedings.[35] In every jurisdiction, the mortgagor[36] then has a right to restore title to the mortgaged property by paying the full remaining amount of the mortgage.[37] This right, commonly referred to as the "equity of redemption," materializes after a default has occurred and terminates at the conclusion of the foreclosure sale.[38] Although some states allow the mortgagor to redeem the property after the conclusion of the foreclosure sale, this remedy must be statutorily granted.[39]

If the mortgagor does not redeem the property, the mortgagee may force a sale of the collateral property. Three methods of foreclosure are used in the

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economist and *New York Times* columnist Paul Krugman suggests a 30 percent decline is needed.").

31. *Id.* ("Negative equity, or being 'underwater,' exposes borrowers to foreclosure because they usually can't refinance or sell their homes in a declining real estate market.").

32. *Id.*

33. *Id.*

34. GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW 569-70 (5th ed. 2007); *see also* Holt v. Citizens Cent. Bank, 688 S.W.2d 414, 414-15 (Tenn. 1984) (giving an example of a mortgagor who defaulted on his mortgage payment, resulting in the bank foreclosing and selling the property); SPRANKLING, *supra* note 16, at 349 (outlining the foreclosure process).

35. SPRANKLING, *supra* note 16, at 349.

36. In addition to the mortgagor, "[a]ny person who may have acquired any interest in the premises, legal or equitable, by operation of law or otherwise, in privity of title with the mortgagor, may redeem, and protect such interest in the land." Smith v. Austin, 9 Mich. 465, 474 (1862); *see also* Dawson v. Overmyer, 40 N.E. 1065 (Ind. 1895) (holding that an administer of an estate which had an interest in real property had the same rights in the land as the original estate holder).

37. Although a mortgagor must pay the full amount remaining on the mortgage to exercise the equitable right of redemption, the mortgagee may consent to partial redemption in lieu of full payment. NELSON & WHITMAN, *supra* note 34, at 569-75.

38. *Id.* at 569-70; SPRANKLING, *supra* note 16, at 349.

39. NELSON & WHITMAN, *supra* note 34, at 745.

United States: strict foreclosure, judicial foreclosure, and foreclosure by power of sale.[40] The two predominant methods are judicial foreclosure and foreclosure by power of sale; strict foreclosure is allowed in only two states.[41]

2. *Foreclosure*

a. *Judicial Foreclosure*

Judicial foreclosure is a statutorily created remedy that allows the mortgagee to force a sale of security property when the debt secured by the property has fallen into default.[42] Judicial foreclosure is permitted in all jurisdictions and is justified when a mortgage is in default.[43] In a judicial foreclosure, the mortgagee must first conduct a title search to determine all persons holding an interest in the property, and must subsequently notify such persons.[44] Following notice and service of process, the mortgagor and other interested parties may contest the foreclosure in a hearing.[45]

If the court deems the foreclosure justified, it orders a public sale of the property, subject to the mortgagor's equitable right of redemption.[46] The mortgagee must then notify the public of the pending sale.[47] The most common method of notification is newspaper advertisements.[48] If the mortgagor does not exercise his equitable right of redemption, the sale takes place in a public location and is open to the mortgagor, mortgagee, and the public.[49] "The mortgagee, however, enjoys an important advantage in the process: it can bid without cash [something no other bidder can do], using instead the unpaid loan balance owed to it."[50]

The mortgagee must then seek judicial confirmation of the sale and must deliver the deed to the highest bidder.[51] Although the court has the power to

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40. *See id.* at 596 (describing strict foreclosure); SPRANKLING, *supra* note 16, at 349 (describing judicial foreclosure and foreclosure by power of sale).

41. Both Connecticut and Vermont allow strict foreclosure. *See* CONN. GEN. STAT. ANN. § 49-15 (1975); 12 VT. STAT. ANN. § 4528 (1982); Dieffenbach v. Att'y Gen., 604 F.2d 187 (2d Cir. 1979); Brooklyn Sav. Bank v. Frimberger, 617 A.2d 462 (Conn. 1992); NELSON & WHITMAN, *supra* note 34, at 596-97; SPRANKLING, *supra* note 16, at 349.

42. NELSON & WHITMAN, *supra* note 34, at 601; SPRANKLING, *supra* note 16, at 349, 350-51.

43. *Id.*

44. *See* NELSON & WHITMAN, *supra* note 34, at 601-02 (pointing out the disadvantages of judicial foreclosure, including the need to conduct "a preliminary title search to determine all parties in interest" and file a "foreclosure bill of complaint and lis pendens notice").

45. NELSON & WHITMAN, *supra* note 34, at 601-02; SPRANKLING, *supra* note 16, at 350.

46. SPRANKLING, *supra* note 16, at 350.

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.* at 350-51.

refuse to confirm a sale, "in most states the mere inadequacy of the sales price is not a basis for refusing confirmation."[52] Accordingly, it is difficult for a mortgagor to upset a completed sale and courts rarely do so.[53] While this practice promotes stability of title in completed foreclosure sales, it also creates the potential for inequitable results.[54] "In the vast majority of cases, the sale price realized . . . will be so inadequate that not only will the mortgagor lose her home but she will also lose any equity she owns in the property."[55]

b. *Power of Sale Foreclosure*

Power of sale foreclosure is a contractual remedy and must be "authorized by the express terms of the mortgage."[56] Unlike judicial foreclosure, in a power of sale foreclosure the mortgagee does not need to file a lawsuit or involve the court to force sale of the security property.[57] Power of sale is by far the most dominant method of foreclosure within states that permit such contracts.[58] Over thirty states currently allow parties to provide for a power of sale foreclosure through contract.[59] Power of sale foreclosure is an economic alternative to judicial foreclosure because it eliminates the substantial burdens of judicial oversight while facilitating the satisfaction of debt and effective transfer of property.[60]

Although the lack of judicial oversight creates the potential for abuse, states "usually provide statutory safeguards for the mortgagor."[61] The Uniform Land Transactions Act (ULTA)[62] provides an example of common statutory safeguards, including advance notice to interested parties, a grace period in which the mortgagor may exercise his right of redemption, and special protection for owner-occupied residences.[63]

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52. *Id.* at 350.

53. *Id.*

54. *See* NELSON & WHITMAN, *supra* note 34, at 631-33 (noting that judicial foreclosures produce a more stable title than power of sale foreclosures).

55. Alex M. Johnson, Jr., *Critiquing the Foreclosure Process: An Economic Approach Based on the Paradigmatic Norms of Bankruptcy*, 79 VA. L. REV. 959, 959 (1993) (noting that a large number of foreclosed properties sell for significantly less than their fair market value at foreclosure sales).

56. SPRANKLING, *supra* note 16, at 351.

57. *See* NELSON & WHITMAN, *supra* note 34, at 633-36 (outlining power of sale foreclosure and comparing it to judicial foreclosures); SPRANKLING, *supra* note 16, at 351 (explaining that power of sale foreclosure is "without judicial involvement or approval").

58. NELSON & WHITMAN, *supra* note 34, at 633-36.

59. *Id.* at 633 n.1.

60. *Id.* at 636.

61. SPRANKLING, *supra* note 16, at 351.

62. "No state thus far has adopted the ULTA in whole or in part." NELSON & WHITMAN, *supra* note 34, at 634 n.8.

63. *Id.* at 634-35.

Following notification of interested parties, the mortgagee sells the property at a public sale similar to a judicial foreclosure.[64] Unlike judicial foreclosure, however, the mortgagee need not seek judicial confirmation of the sale.[65] To upset a completed power of sale foreclosure, the mortgagor (or other interested party) must show fraud, unfairness, or other irregularity in the sale.[66] As in judicial foreclosure proceedings, inadequacy of sale price alone is not enough to upset a sale[67] and it is extremely rare for a court to upset a sale based on fraud, unfairness, or irregularity.[68]

c. *Strict Foreclosure*

Although strict foreclosure was once the predominate method of foreclosure,[69] it is now authorized in only two states: Connecticut and Vermont.[70] Strict foreclosure is the most economically efficient method of foreclosure, as it does not involve a forced sale of the property.[71]

Following default on a loan, the mortgagor receives notice of the pending foreclosure and is granted the equitable right to redemption.[72] If the mortgagor cannot repay the outstanding debt, the mortgagee simply takes title to the property to satisfy the debt.[73] Although a mortgagor or other defendant (such as a junior leinholder) may argue that the property is worth more than the unpaid loan amount and should be sold in a forced sale, the court requires a strong showing of inequity and has wide discretion in deciding the issue.[74] While economically efficient, the strict foreclosure method can easily be abused and can work great inequity to the mortgagor and other interested parties.[75]

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64. SPRANKLING, *supra* note 16, at 351.

65. *Id.*

66. NELSON & WHITMAN, *supra* note 34, at 640-41.

67. *Id.* at 640. Mortgagors may also attempt to overturn a sale by proving defects in the time, place, or manner of the sale. *Id.* at 640-50.

68. *Id.* at 640.

69. *See* Mattingly, *supra* note 3, at 89-94 (explaining how the United States inherited England's strict foreclosure process).

70. NELSON & WHITMAN, *supra* note 34, at 597.

71. *See id.* ("[T]he defaulting mortgagor is given a period of time by the court to pay the mortgage debt. Failure to do so within the prescribed time will result in title to the mortgaged real estate vesting in the mortgagee without sale.").

72. *Id.*

73. *Id.*

74. *Id.* at 597-600.

75. *See* Mattingly, *supra* note 3, at 89-94 (explaining that after inheriting strict foreclosures from England, American courts "viewed strict foreclosure as unduly harsh because it did not protect a borrower's equity in the property").

d. Deed of Trust Sales

Before the proliferation of power of sale mortgages, lenders issued deeds of trust as a way to circumvent the statutory requirements of the judicial foreclosure process. To create a deed of trust,

> [t]he borrower (the *trustor*) execute[s] a written instrument conveying legal title to a neutral third party (the *trustee*), as security for an obligation owed to the lender (the *beneficiary*). If the trustor duly repaid the loan, the trustee would *reconvey* title. On the other hand, if the trustor defaulted on the debt, the trustee would conduct an auction sale of the property; after the sale, the trustee would repay the beneficiary and affected creditors and distribute any remaining sales proceeds to the trustor.[76]

Despite their name, deeds of trust do not create true trust relationships.[77] Instead, a deed of trust creates a relationship analogous to a mortgage relationship.[78] Accordingly, mortgagees cannot expect to be protected by the trustee in charge of the public auction; no true fiduciary relationship exists.[79] Although some courts require that sales conducted pursuant to a deed of trust be "commercially reasonable," most jurisdictions view the lender's remedy as the functional equivalent of a power of sale.[80]

3. After the Sale

a. Deficiency Judgments

What happens if a foreclosed property sells for less than the amount necessary to pay the remaining mortgage debt? In many states, the mortgagee may file a deficiency judgment suit against the mortgagor to recover the difference between the sale price and the outstanding mortgage debt.[81] The

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76. SPRANKLING, *supra* note 16, at 357.

77. Monterey S.P. P'ship v. W.L. Bangham, Inc., 777 P.2d 623, 628 (Cal. 1989) ("The similarities between a trustee of an express trust and a trustee under a deed of trust end with the name. 'Just as a panda is not a true bear, a trustee of a deed of trust is not a true trustee.'" (quoting Stephens, Partian & Cunningham v. Hollis, 242 Cal. Rptr. 251, 255 (Ct. App. 1987))).

78. DUKEMINIER ET AL., *supra* note 13, at 545.

79. *See Monterey S.P. P'ship*, 777 P.2d at 628 ("[T]he trustee under a deed of trust does not have a true trustee's interest in, and control over, the trust property. Nor is it bound by the fiduciary duties that characterize a true trustee.").

80. *See* Wansley v. First Nat'l Bank of Vicksburg, 566 So. 2d 1218, 1225 (Miss. 1990) (using a "commercially reasonable" standard); DUKEMINIER ET AL., *supra* note 13, at 545 ("In a deed of trust, the trustee is given the power to sell the land without going to court if the borrower defaults.").

81. *See* DUKEMINIER ET AL., *supra* note 13, at 546.

mortgagee may file this suit regardless of the method of foreclosure used.[82] However, the courts' reluctance to question the validity of foreclosure sales, coupled with the inability of foreclosure sales to generate fair market value for the mortgagor, provide room for abuse.[83] To prevent such abuse, many states have enacted anti-deficiency legislation, regulating or eliminating deficiency judgments.[84]

b. *Statutory Safeguards*

In addition to anti-deficiency legislation, many states have codified further protections for the mortgagor.[85] Before a foreclosure sale takes place, the mortgagor always has the equitable right of redemption.[86] However, because this right ends at the conclusion of the sale,[87] a majority of states have enacted legislation granting the mortgagor a *statutory* right of redemption for a specified period of time after the sale has taken place.[88] This period varies from state to state but always ends within six months to two years after the sale.[89]

While these procedural safeguards are designed to protect borrowers, their efficacy is hotly debated.[90] Critics argue that statutory redemption reforms merely reallocate the losses from irresponsible borrowing to later responsible borrowers, increasing costs for all.[91] Further, some argue that allowing for statutory redemption does not solve the problem, as almost no mortgagors are actually able to make use of such statutes.[92]

III. PROBLEMS IN CURRENT FORECLOSURE LAW

The foreclosure process seeks to balance the competing interests of mortgagees, mortgagors, and the borrowing public.[93] Mortgagees want quick, predictable procedures to expedite recovery and minimize loss on non-performing loans.[94] Because lenders pass increased costs on to the borrowing

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82. NELSON & WHITMAN, *supra* note 34, at 708.

83. *Id.* at 714-16.

84. *Id.*

85. *See id.* at 745.

86. SPRANKLING, *supra* note 16, at 349.

87. *Id.*; NELSON & WHITMAN, *supra* note 34, at 569.

88. NELSON & WHITMAN, *supra* note 34, at 745.

89. *Id.* at 745-46.

90. *See* SPRANKLING, *supra* note 16, at 353-54 (comparing the views of statutory redemption advocates and critics).

91. Mark Meador, *The Effects of Mortgage Laws on Home Mortgage Rates*, 34 J. ECON. & BUS. 143 (1982).

92. *See* Mattingly, *supra* note 3, at 108-09 (arguing that "statutory redemption laws further reduce the little incentive potential purchasers have to bid at foreclosure").

93. *See* Stark, *supra* note 2, at 652.

94. Mattingly, *supra* note 3, at 80.

public, borrowers in general also benefit from expeditious foreclosure proceedings.[95] The specific borrowers in foreclosure, on the other hand, want proceedings designed to protect homeowner equity.[96] The balance between these competing interests is difficult to strike, and mortgagors usually suffer the consequences.[97] Despite numerous proposals for reform,[98] inequities and inefficiencies within the foreclosure process remain.

A. *Existing Foreclosure Law Fails to Protect the Borrower's Equity*

Foreclosure sales are referred to as "distress sales" because the homeowner is never really made whole through the sale.[99] This can be attributed to several problems within the foreclosure process: buyers at foreclosure auctions often receive only a quitclaim deed;[100] sellers have no real incentive to either obtain (through buyers other than the mortgage company itself) or bid a fair price for the subject property at a foreclosure auction;[101] prospective buyers other than the mortgagee must bid in cash;[102] the sales are not well publicized;[103] and prospective buyers have no real opportunity to inspect the property.[104]

The combination of these defects artificially lowers sale prices at foreclosure auctions.[105] There is simply too much risk and too little incentive for any bidder to pay market price for the property.[106] Buyers cannot buy as easily or with the same confidence as they would in a non-foreclosure land sale.[107] This lowers the

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95. Stark, *supra* note 2, at 652 ("To the extent that the lender is not made whole through the foreclosure process, the lender will transfer those costs to *all* borrowers in the form of higher fees or interest rates.").

96. Mattingly, *supra* note 3, at 80.

97. *See* Johnson, *supra* note 55, at 966-72 (discussing the difficulty of realizing full value at a foreclosure sale); *see generally* Mattingly, *supra* note 3 (advocating an approach that increases competition among bidders at foreclosure sales); SPRANKLING, *supra* note 16 (citing several reform proposals).

98. *See* Johnson, *supra* note 55, at 963 (proposing that foreclosed property should be sold using "the same methods used in the retail real estate market"); Mattingly, *supra* note 3, at 120-22 (same); Stark, *supra* note 2, at 678 (proposing "commercially reasonable sale"); Steven 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, 880, 895 (1985) (proposing that a mortgagee could choose between "sell[ing] the property in a standard retail sale . . . or . . . tak[ing] title to the property upon paying the mortgagor the difference between the amount of the debt and the apprais[ed]" value).

99. Howard A. Elliott, *Mortgage Foreclosure Sales as Fraudulent Conveyances: Living Under* Durrett, 13 OHIO N.U. L. REV. 631, 633 (1986) (explaining that "[a] foreclosure sale is a distress sale; it occurs outside the normal marketplace!).

100. NELSON & WHITMAN, *supra* note 34, at 630-31.

101. *See* Wechsler, *supra* note 98, at 874 (noting that of ninety-one foreclosure sales at which the mortgagee was the successful high bidder, only one sale generated a surplus).

102. SPRANKLING, *supra* note 16, at 350.

103. *See* Stark, *supra* note 2, at 651 ("[N]o signs are posted on the property and the sale is advertised in the legal section of the newspaper, rather than in the real estate section.").

104. *Id.*

105. *See generally* Johnson, Jr., *supra* note 55 (discussing the effects of foreclosure on sale prices).

106 *See* Stark, *supra* note 2, at 651-52 (discussing the risks for bidders).

107. *See id.*

competitiveness of bidding at auctions.[108] As a result, the mortgage company is often the high bidder at a price well below the actual value of the property.[109]

The depressed values realized at foreclosure sales hit homeowners harder than any other party. Following a foreclosure auction, the money from the sale is distributed among persons holding an interest in the property.[110] However, all mortgage interests must be paid in full before the homeowner recovers any of her equity.[111] In effect, this often means that a homeowner will recover nothing, even when she holds substantial equity in her property.[112] In contrast, the purchasing lender can and usually does resell the foreclosure property, pocketing the homeowner's equity in the exchange.[113] This practice grants opportunistic mortgage companies a windfall at the expense of homeowner equity.

B. Existing Foreclosure Law Is Economically Inefficient

Both mortgagors and mortgagees feel the impact of inefficient foreclosure processes.[114] Unpaid interest, taxes, insurance bills, and legal costs associated with foreclosure can prevent mortgagees from recouping their full investment.[115] These costs are further compounded by the possibility of waste between the notice of foreclosure and the conclusion of the process.[116]

Additionally, the overwhelming majority of jurisdictions[117] require foreclosure properties to be sold at auction regardless of whether the remaining

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108. *See* Mattingly, *supra* note 3, at 95 (noting that often the only bidder, and thus the winner, at a foreclosure sale is the foreclosing lender).

109. *See id.* at 95.

110. *See* SPRANKLING, *supra* note 16, at 349-51 (noting that "any surplus sales proceeds are paid to junior lienholders or the mortgagor").

111. *See id.*

112. Johnson, Jr., *supra* note 55, at 959 ("In the vast majority of cases, the sale price realized at [a power of sale] foreclosure sale will be so inadequate that not only will the mortgagor lose her home but she will also lose any equity she owns in the property.").

113. *See* Wechsler, *supra* note 98, at 851 (giving an example from the public records where the mortgagee buys the property at auction, then resells to a third party for profit).

114. Mattingly, *supra* note 3, at 80-81. Professor Mattingly breaks down the competing interests as follows:

> Borrowers have an important interest in either protecting their property's equity or in reducing their post-sale liability exposure. Lenders have an important interest in expediting their recovery on non-performing loans, thereby reducing their losses and costs. Society, including the borrowing public, has an interest in a fair and efficient means of foreclosure, which theoretically reduces the costs of funds to prospective borrowers, preserves what equity is present for the benefit of the borrower, and minimizes the strategic use of foreclosure laws.

Id.

115. *See id.* (illustrating the potential effect of unprofitable mortgages on mortgagees in hypothetical form).

116. *Id.*

117. This includes all jurisdictions except for the two strict foreclosure jurisdictions: Connecticut and Vermont. NELSON & WHITMAN, *supra* note 34, at 596-600; SPRANKLING, *supra* note 16, at 349.

mortgage debt outweighs the fair market value of the property.[118] Because the mortgagee is often the high bidder at a foreclosure auction,[119] this requirement often forces the mortgagee to sell the property twice: once at auction and again through traditional means.[120] By requiring properties to be sold at auction without inquiry into the owner's equity interest, existing foreclosure law forces mortgagees to engage in expensive, time-consuming, and unnecessary public auctions despite the economic disadvantages to all parties involved.[121]

IV. PROPOSED REFORM

This Comment suggests a model in which the foreclosure process is bifurcated into two alternative procedures. Preliminarily, the homeowner's equity would be determined. If the homeowner does not hold sufficient equity,[122] the court would allow the mortgagee to take title pursuant to a judicial strict foreclosure. If, however, the homeowner holds sufficient equity, the property would be sold at a foreclosure auction. To protect the mortgagor's equity, this Comment suggests that state legislatures pass a fair value limitation (70% of appraised property value) for such auctions. If the fair value limitation is not met, the foreclosure sale would be invalid under state law. This proposal would work to the advantage of both mortgagees and mortgagors, reducing overall process costs while protecting homeowner equity.

A. *Determination of Fair Market Value*

As a preliminary matter, the court must determine the fair market value of the mortgaged property. Black's Law Dictionary defines "fair market value" as "[t]he price that a seller is willing to accept and a buyer is willing to pay on the open market and in an arm's-length transaction."[123] For properties sold at foreclosure, the "'sale price is not fair value though it may be used as evidence on the question of fair value.'"[124] The fair market value represents the "true value," or "worth" of a given piece of property.[125] In a typical home sale, the

118. NELSON & WHITMAN, *supra* note 34, at 596-600.

119. *See* Mattingly, *supra* note 3, at 95 (noting that often the only bidder, and thus the winner, at a foreclosure sale is the foreclosing lender).

120. *See* Wechsler, *supra* note 98, at 870-71 (discussing the results of a study in which "[m]ortgagees purchased in about three-quarters of the foreclosure sales . . . [and] resold the property within a year or less in seventy percent of the cases where they bought at foreclosure").

121. *Id.*

122. "Sufficient equity," as used in this Comment, means equity in excess of that needed to pay all foreclosure-related costs.

123. BLACK'S LAW DICTIONARY 1587 (8th ed. 2004).

124. DAVID G. EPSTEIN ET AL., BANKRUPTCY § 6-18 (1993) (quoting *In re* Joe Flynn Rare Coins, Inc., 81 B.R. 1009, 1017 (D. Kan. 1988)).

125. *See* Ring Surf, Property Appraisal and Market Value, http://www.ringsurf.com/online/2494-property_appraisal_and_market_value.html (last visited Mar. 21, 2009) (on file with the *McGeorge Law*

market value is determined by a variety of factors, including: the condition of the home, neighborhood environment, comparable local sales, sales performance and indices that forecast future value, location proximity to desirable schools and services, and appraiser experience.[126]

Several states have already adopted procedures for determining a property's fair market value. First, in the context of anti-deficiency legislation, states alternatively provide that the court, a jury, or appraiser may determine fair market value.[127] In some states, if a foreclosure property sells at auction for less than two-thirds of its appraised value, the mortgagor may either "upset" the sale[128] or limit the mortgagee's possible recovery in a deficiency judgment suit.[129]

Appraisal statutes may also provide guidance. Appraisal statutes facilitate the execution of judgment in favor of involuntary lienholders.[130] Appraisal statutes are often relevant in the context of fraudulent transfers and exist to ensure that property sold in execution of a judgment realizes a fair price at sale. Generally, such statutes permit interested parties to upset a sale if the property sells for less than two-thirds of the appraised cash value of the property.[131] All appraisal statutes, however, exclude real property from the "two-thirds" requirement. In the typical statute, a real property sale can only be set aside according to traditional common law standards.[132] To upset a foreclosure sale of real property, the proponent must show fraud, unfairness, or other irregularity in the sale.[133]

Although there is no guarantee that the appraised value of a property will in fact reflect its fair market value, the federal government and all state governments license and regulate appraisers to prevent conflicts of interest and to ensure accurate appraisals.[134] At the federal level, Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) established the Appraisal Subcommittee (ASC) of the Federal Financial Institutions Examination Council to monitor "the certification and licensing programs for real estate appraisers in each State to determine whether the State's policies, practices and procedures are consistent with Title XI and [to enforce]

Review) (discussing the determination of market value).

126. *Id.*

127. NELSON & WHITMAN, *supra* note 34, at 716-17.

128. Robert M. Zinman et al., *Fraudulent Transfers According to Alden, Gross and Borowitz: A Tale of Two Circuits*, 39 BUS. LAW. 977, 1005-06 (1984).

129. NELSON & WHITMAN, *supra* note 34, at 716-45.

130. A voluntary leinholder (like a mortgagee) refers to a creditor holding a secured interest on a particular item of property. *See* Zinman et al., *supra* note 128, at 1004-07 (providing statutory examples of such schemes).

131. *E.g.*, IND. CODE ANN. § 34-55-4-1 (West 1999).

132. *See, e.g.*, *id.*

133. NELSON & WHITMAN, *supra* note 34, at 640.

134. For a comprehensive analysis of Title XI, see Cal. Office of Real Estate Appraisers, Fed. Regulations, http://www.orea.ca.gov/html/fed_regs.shtml#Statement3 (last visited Mar. 21, 2009) (on file with the *McGeorge Law Review*) (providing an overview of Title XI).

the State's compliance with the requirements of Title XI."[135] Pursuant to FIRREA, states are responsible for implementing "procedures for certifying, licensing, supervising and disciplining individuals who are qualified to perform real estate appraisals" in specified transactions.[136] Appraisers must also comply with their state's code of professional responsibility.[137]

The reform proposed in this Comment could include the use of licensed appraisers to determine the fair market value of a foreclosure property. This approach could be modeled after the approaches already employed in the various jurisdictions that have adopted anti-deficiency and appraisal legislation. While some potential for abuse of the appraisal process would inevitably exist, the federal and state regulations discussed above would help to ensure that appraisals be conducted as fairly and accurately as possible.[138]

B. After the Appraisal: Assessing Equity and Bifurcating the Process

The mortgagor's equity in the foreclosure property could be determined following the fair market value determination. If the value of the foreclosure property exceeds the remaining mortgage debt, the difference represents the homeowner's equity in the property.[139] However, because the mortgagor is responsible for the costs of the foreclosure process,[140] the homeowner's equity should be reduced by an amount sufficient to cover such costs. This adjusted equity determination would reflect the defaulting mortgagor's true interest in his property.

Following this determination, the foreclosure would be conducted pursuant to a bifurcated process. Depending on the homeowner's equity, the foreclosure would follow one of two alternative procedures. Under the first option, if probable foreclosure costs exceed the homeowner's equity interest, the court would allow the mortgagee to take title through judicial strict foreclosure. This possibility is analyzed in Section C below. Alternatively, if the homeowner holds equity in excess of probable foreclosure costs, the property would be sold at auction with the imposition of a fair value limitation. This possibility is analyzed in Section D below.

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135. *Id.*

136. *Id.*

137. *Id.*

138. As a practical matter, the cost of appraisals could be incorporated into the costs of the foreclosure sale.

139. *See* Mattingly, *supra* note 3, at 91.

140. 59A C.J.S. Mortgages § 981 (2008) (explaining that a "mortgage ordinarily is a lien on the land not only for the debt secured but also for the costs of enforcing it").

C. The Property with No Equity: Strict Foreclosure

Ideally, foreclosure auctions are meant to protect the interests of homeowners and junior lienholders. "The theory fueling the public sale model was that mortgaged property would be sold at or near its fair market value and any proceeds received by the lender in excess of its indebtedness would be delivered to the mortgagor."[141] In this way, the mortgagor's equity is theoretically protected.

However, the policy justifications for foreclosure by auction do not apply when the mortgagor does not hold equity in his property. In such cases, the interest of the mortgagor is aligned with the interest of the mortgagee: satisfaction of the remaining debt. When a homeowner does not hold any equity, it is extremely unlikely that he would realize a surplus from a foreclosure sale.[142] However, the homeowner would still be liable for the costs of the foreclosure proceeding.[143] Accordingly, such foreclosure auctions provide no real benefit to the mortgagor.[144]

Similarly, forced sales in this context also waste the time and money of the mortgagee. As discussed above,[145] various defects in the foreclosure process artificially lower sale prices at foreclosure auctions.[146] Consequently, the mortgage company is often the high bidder at auction.[147] When this occurs, the mortgagee must sell the foreclosure property twice: once at auction and again through traditional means.[148]

In situations where the mortgagor holds no equity in the foreclosure property, strict foreclosure would avoid unnecessary and economically inefficient foreclosure auctions. All parties would benefit from this reform: homeowners would avoid unnecessary costs and lenders could sell the property through more effective, traditional means.

D. The Property with Equity: Imposing a Fair Value Limitation

If the homeowner holds equity in excess of probable foreclosure costs, the traditional justifications for foreclosure auctions remain valid.[149] Accordingly, this proposal does not suggest a drastic change in foreclosure law in these circumstances. However, to further protect the mortgagor's equity, state

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141. Mattingly, *supra* note 3, at 91.

142. *See* Wechsler, *supra* note 98, at 851 (giving an example from the public records).

143. *See* C.J.S., *supra* note 140.

144. *See* Mattingly, *supra* note 3, at 95.

145. *See supra* Part III.A.

146. *See* Johnson, *supra* note 55, at 959-60.

147. Mattingly, *supra* note 3, at 95.

148. *See* Wechsler, *supra* note 98, at 851 (giving an example from the public records where the mortgagee buys the property at auction, then resells to a third party for profit).

149. An auction would theoretically maximize the equity recovered by the mortgagor.

legislatures should impose a fair value limitation in foreclosure sales where the mortgagor holds sufficient equity in her property. To determine the ideal character of this proposed limitation, it is helpful to refer to similar limitations in fraudulent transfer law.

1. Fair Value Limitations in Fraudulent Transfer Law

a. Conceptual Overlap: Viewing the Mortgagor as an Unsecured Creditor

In many respects, the goals and norms of fraudulent transfer law aim to address the same concerns that exist in foreclosure law.[150] Both fraudulent transfer law and foreclosure law developed from early English common law.[151] More importantly, both address the same fundamental question: how should society prioritize and protect the conflicting interests of debtors and creditors?[152]

Although the two doctrines have developed separate and distinct bodies of law, a certain amount of overlap is unavoidable. Many mortgagors are effectively bankrupt by the time the mortgagee acts to foreclose the mortgaged property.[153] Professor Alex Johnson analogizes the mortgagor's interest during foreclosure to that of an unsecured creditor.[154] Although a mortgagor cannot technically have an interest in her own property,[155] a mortgagor's interest must be viewed differently after foreclosure occurs.[156] Under Johnson's model, the mortgagor's interest at foreclosure can be split into debt and equity interests.[157] When characterized accordingly, Johnson argues that the foreclosure process should function as a

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150. *See* Eric S. Palace, Note, In re BFP*: Just a Band-Aid?—Looking for a Stable Solution that Balances Creditors' and Debtors' Rights Under Bankruptcy Code Section 548(a)(2)*, 15 ANN. REV. BANKING L. 359, 369 (1996) (discussing the similarities between foreclosure law and law of fraudulent transfers).

151. *Id.*

152. *Id.*

153. *See* Johnson, *supra* note 55, at 1001-02 ("Recognizing the mortgagor's de facto bankruptcy status is the key to solving the puzzle that has intrigued the commentators who have examined and criticized the foreclosure process. If the mortgagor is functionally bankrupt, it should come as no surprise that the answer to the foreclosure puzzle also lies in bankruptcy law.").

154. *Id.* at 1006-07.

155. *See id.* at 1006 ("To the extent that the debtor owns property free of claims by creditors, either unsecured or secured, she is the absolute owner of that property, and it makes little sense to speak of her as having an unsecured interest in her own property.").

156. *See id.* at 1006-07.

> Although most commentators clearly view the mortgagor solely as an owner-debtor who has pledged her interest in the real property to secure repayment of the debt, they ignore the fact that her interest is pledged only to the extent of her debt. . . . When foreclosure occurs[,] . . . the mortgagor's interest, at least conceptually, is fractionated and defined by what is left after those with superior interests satisfy their interest in the property. In this situation, the mortgagor's interest looks like the prototypical junior unsecured creditor's interest.

Id.

157. *Id.* at 1006.

means towards ameliorating "a common pool problem . . . in a situation where the debtor does not have enough assets to pay all the creditors."[158] Although Professor Johnson's concerns mirror those already present in foreclosure law, his analogy serves as an important reminder that the foreclosure process must be designed to maximize the value of the foreclosure property. In pursuing this end, the traditional foreclosure auction often fails.

b. *Actual Overlap: Fraudulent Transfer Law and Foreclosure Proceedings*

In addition to the procedural and conceptual similarities between the two doctrines, the "de facto" bankruptcy status of the mortgagor often materializes when affected homeowners file for bankruptcy subsequent to a foreclosure proceeding. At bankruptcy, mortgagors and third-party creditors of the mortgagor may seek to upset the foreclosure sale as a fraudulent transfer of property under section 548 of the U.S. Bankruptcy Act.[159] Because section 548 covers involuntary, as well as voluntary, transfers of property, a mortgagor or other interested party may set aside a foreclosure sale within a year of bankruptcy if the mortgagor "received less than a reasonably equivalent value in exchange for [the foreclosed property] . . . and . . . was insolvent on the date" of the foreclosure sale.[160] In this situation, a court may scrutinize the foreclosure sale under both foreclosure and federal bankruptcy law. The close relationship and inherent

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158. *Id.* at 1002.

159. Section 548 states:

> (a)(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
>
> (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
>
> (B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
>
> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
>
> (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

11 U.S.C. § 548 (2006).

160. *Id.* § 548(a)(1)(B)(i)-(ii)(I).

tension between the two doctrines has sparked much scholarly debate and judicial attention.[161]

Courts first began invalidating foreclosure sales as fraudulent transfers under section 548 in 1980, following the Fifth Circuit's decision in *Durrett v. Washington National Insurance Co.*[162] However, *Durrett* quickly generated hostile responses from lending institutions,[163] prompting the Supreme Court to consider the issue. In *BFP v. Resolution Trust Corp.*, the Supreme Court overturned *Durrett* and prohibited the use of fraudulent transfers as a means of upsetting completed foreclosure sales.[164] Although *Durrett* and *BFP* focused primarily on bankruptcy issues, they may still provide important guidance in formulating effective foreclosure reform.

c. Durrett v. Washington National Insurance Co.

In the context of bankruptcy law, *Durrett* suggested in dicta that a foreclosure sale could be upset as a fraudulent transfer of property if the winning bid did not reach 70% of the appraised property value.[165] In *Durrett*, a trustee under a deed of trust foreclosed on the plaintiff mortgagor's property, subsequently selling the property pursuant to an otherwise valid foreclosure sale.[166] The foreclosure sale realized only $115,400, the exact amount remaining due on the deed of trust.[167] However, the court determined the fair value of the house to be approximately $200,000 at the time of sale.[168] Nine days later, the mortgagor filed for bankruptcy.[169]

At the bankruptcy proceeding, the mortgagor sought to set aside the sale of the foreclosed property as a fraudulent transfer under section 67(d) of the Bankruptcy Act, 11 U.S.C. section 107(d),[170] the predecessor to section 548 of the

161. *See e.g.*, Daniel W. Mitnik, *Foreclosures and Bankruptcy: The Mortgagee-Mortgagor Relationship*, 2 BANKR. DEV. J. 317 (1985) (discussing the tensions between real estate and bankruptcy law as pertaining to foreclosures).

162. 621 F.2d 201 (5th Cir. 1980).

163. Steven M. Alden, Steven R. Gross & Peter L. Borowitz, *Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the* Durrett *Problem*, 38 BUS. LAW. 1605, 1607 n.8 (1983) (listing "the American Land Title Association, the Mortgage Brokers Institute, the American Council of Life Insurance, the American College of Real Estate Lawyers, the California Bankers Association, and the California Bank Clearing House Association" as groups opposed to the *Durrett* approach).

164. 511 U.S. 531, 538-39 (1994).

165. *Durrett*, 621 F.2d at 203.

166. *Id.* at 202-03.

167. *Id.* at 203.

168. *Id.*

169. *Id.* at 202.

170. *Durrett* articulated the relevant portions of section 107(d):

"For the purposes of, and exclusively applicable to, this subdivision: . . . (e) consideration given for the property or obligation of a debtor is 'fair' (1) when, in good faith, in exchange and as a fair equivalent therefore, property is transferred . . . ." 67(d)(2) "Every transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition initiating a proceeding current Bankruptcy Code.[171] As a matter of law, the court held that a sale for 57.7% of fair market value could not constitute "'fair' consideration and a 'fair equivalent' within the meaning section 67(d)(1)."[172] The court stated in dicta that no "district or appellate court dealing only with a transfer of real property as the subject of attack under section 67(d) [of the Bankruptcy Act] . . . has approved the transfer for less than 70 percent of the market value of the property."[173] Accordingly, the court upset the foreclosure sale as a fraudulent transfer of property.[174]

Subsequent lower court decisions and several commentators viewed this language as effectively creating a fair value limitation on foreclosure sales within the context of fraudulent transfer law.[175] The approach adopted by the court can in some ways be explained by analogy to Professor Johnson's common pool problem.[176] The "fair equivalency" standard adopted in *Durrett* limits individual creditor remedies in favor of maximizing the value of the asset for all creditors. "Underlying the *Durrett* decision is the notion that it is fairer to distribute the debtor-mortgagor's equity in the property to general creditors than to allow the foreclosure sale purchaser to acquire the property at a bargain price and realize the equity upon resale."[177] Some scholars have even suggested that the limitation in *Durrett* does not go far enough.[178] After foreclosure and associated costs, the lender would still usually realize a windfall profit at resale.[179]

> under this title by or against him is fraudulent (a) as to creditors existing at the time of such transfer or obligation, if made or incurred without fair consideration by a debtor who is or will thereby be rendered insolvent, without regard to his actual intent; . . . ."

Durrett, 621 F.2d at 202 (quoting 11 U.S.C. § 107(d)).

171. The two codes are very similar in their treatment of fraudulent transfers 11 U.S.C. § 548 provides:

> The trustee may avoid any transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily . . . (B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; . . . .

11 U.S.C. § 548

172. *Durrett*, 621 F.2d at 203-04.

173. *Id.* at 203.

174. *Id.* at 204.

175. NELSON & WHITMAN, *supra* note 34, at 827-29 (explaining that *Durrett* would have created a *de facto* remedy similar to a one year statutory redemption system). For a comprehensive analysis of *Durrett*'s meaning and impact, see Alden, Gross & Borowitz, *supra* note 163. *But see* Zinman et al., *supra* note 128 (critiquing the Alden article and criticizing *Durrett*).

176. *See* Johnson, *supra* note 55, at 1002, 1006 (discussing the mortgagor as an unsecured creditor); *supra* Part III.D.1.a (same).

177. Mitnik, *supra* note 161, at 320.

178. *See* William H. Henning, *An Analysis of* Durrett *and its Impact on Real and Personal Property Foreclosures: Some Proposed Modifications*, 63 N.C. L. REV. 257, 284 (1985).

> Suppose real property with a fair market value of $300,000 is sold at foreclosure to the lender for seventy percent of the amount, $210,000. Under *Durrett*, the sale is final. The lender can resell the property for $300,000 and pocket a significant portion of the debtor's equity. If the property is placed with a broker who charges a 7 percent commission, the lender's profit is only reduced by $21,000. In addition, the lender will have $210,000 tied up in the property during the resale period. Assuming a 12 percent market rate of interest, he will be losing approximately $2,100 per month.

Although *Durrett* unquestionably improved the economic protection provided to mortgagors and unsecured creditors, the *Durrett* approach also subjected completed foreclosure sales to considerable uncertainty and instability.[180] Specifically, *Durrett* created a de facto one-year period following foreclosure throughout which title remained uncertain.[181] Until the expiration of this period, a mortgagor or other creditor of the mortgagor could seek to set aside the sale as a fraudulent transfer.[182] "This period is economically wasteful since it discourages development of the land until title is secure."[183] Critics argued that the increased instability of completed foreclosure sales under *Durrett* served to "chill bidding at foreclosure sales," lowering sale prices and effectively hurting most "those people and principles it was designed to protect."[184]

d. BFP v. Resolution Trust Corp.

Fourteen years after *Durrett*, the Supreme Court revisited the issue in *BFP v. Resolution Trust Corp.*[185] The facts of *BFP* are similar to those of *Durrett*. In *BFP*, the trustee under a deed of trust foreclosed on petitioner mortgagor's property, subsequently selling the property pursuant to an otherwise valid foreclosure sale.[186] The property sold at foreclosure for $433,000.[187] However, the mortgagor contended that the true value of the property was $725,000.[188] A court following the *Durrett* approach would have set the sale aside, as the foreclosure sale price represented just under 60% of the true value of the home.[189] Three months after foreclosure, the mortgagor filed for Chapter 11 bankruptcy.[190] At the bankruptcy proceeding, the mortgagor sought to set aside the foreclosure sale as a fraudulent transfer under section 548 of the Bankruptcy Code.[191] As in *Durrett*, the mortgagor argued that the

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> There also will be closing costs associated with the resale. Even with these costs, however, the lender or a subsequent purchaser will capture a significant profit. There is no reason why the profit should not be available to unsecured creditors.

Id.

179. *Id.*

180. Henning, *supra* note 178, at 276-77; Mitnik, *supra* note 161, at 329-31; Zinman et al., *supra* note 128, at 978.

181. *See* Henning, *supra* note 178, at 276-77 (discussing how *Durrett* creates a "de facto federal right of redemption" and a one year avoidance period).

182. *Id.*

183. *Id.*

184. Zinman et al., *supra* note 128, at 978, 1013.

185. 511 U.S. 531 (1994).

186. *Id.* at 533-34.

187. *Id.* at 534.

188. *Id.*

189. *See* Durrett v. Wash. Nat'l Ins. Co., 621 F.2d 201, 203 (5th Cir. 1980) (holding that any sale price under 70 % of the fair market value is the functional equivalent of a fraudulent transfer).

190. *BFP*, 511 U.S. at 534.

191. *Id.*

foreclosure sale price could not be considered "reasonably equivalent value" under section 548.[192]

In a 5-4 decision, the Court rejected the mortgagor's claim, overturning *Durrett* in the process.[193] Speaking for the majority, Justice Scalia held that "'reasonably equivalent value,' for foreclosed property, is the price in fact received at the foreclosure sale, so long as all requirements of the State's foreclosure law have been complied with."[194] Justice Scalia pointed out that foreclosed property is "simply *worth less*."[195] To justify this assertion, Scalia implicitly assumed that a foreclosure sale cannot realize a fair price at auction due to the "strictures of the foreclosure process."[196] While this argument clearly recognizes the inadequacy and inequity of the foreclosure process as a whole, its logic proves circular as applied to the determination of a property's "value." As Justice Souter's dissent points out, "[i]f a property's 'value' is conclusively presumed to be whatever it sold for, the 'less than reasonabl[e] equivalen[ce]' question will never be worth asking."[197]

Further, the logical extension of Justice Scalia's value presumption to deficiency judgments would seem to suggest that deficiency judgments could "be awarded simply by calculating the difference between the debt owed and the 'value,' as established by sale."[198] In reality, however, the opposite is true. "Instead, in those jurisdictions permitting creditors to seek deficiency judgments it is quite common to require them to show that the foreclosure price roughly approximated the property's (appraised) value."[199] The majority does not explain this apparent paradox.

In *BFP*, Justice Scalia based his interpretation of "reasonably equivalent value" on presumed congressional intent and principles of federalism. In interpreting the congressional intent of section 548, Scalia denounced both judicial activism and an overactive federal government.[200] Although he recognized the possible equitable appeal of the *Durrett* approach, Scalia stated that "such judgments represent policy determinations that the Bankruptcy Code gives [the Court] no apparent authority to make. . . . To specify a federal 'reasonable' foreclosure-sale price is to extend federal bankruptcy law well beyond the traditional field of fraudulent transfers, into realms of policy where it has not ventured before."[201]

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192. *Id.*
193. *Id.* at 545.
194. *Id.*
195. *Id.* at 539.
196. *Id.* at 538-39.
197. *Id.* at 555 (Souter, J., dissenting).
198. *Id.* at 555 n.7.
199. *Id.*
200. *Id.* at 540 (majority opinion).
201. *Id.*; *see also* Nickolai G. Levin, *Constitutional Statutory Synthesis*, 54 ALA. L. REV. 1281, 1367-69 (2003) (discussing the impact of *BFP* on the doctrine of federalism).

Because *BFP* gives dispositive weight to the states' treatment of the issue, the decision can be viewed as an invitation for states to step into the field of protecting mortgagors.[202] In this regard, the reform suggested in this Comment is the logical next step in responding to *BFP*.

2. *Application of Fraudulent Transfer Principles to Proposed Reform*

This Comment suggests a 70% fair value limitation similar to the one provided in *Durrett*. The key difference, however, is that instead of allowing the court to consider this limitation for the first time in a bankruptcy proceeding, the legislature should build the 70% limitation into the requirements for a valid foreclosure sale. If the fair value limitation is not met, the foreclosure sale would be invalid under state law. This characterization of invalidity would follow the sale through possible subsequent bankruptcy proceedings. The importance of this characterization is apparent when viewed in light of the fraudulent conveyance standard adopted by the court in *BFP*.[203] Under *BFP*, the court could overturn such foreclosure sales as fraudulent transfers.

By building the fair value limitation into the requirements for a valid foreclosure sale, this proposal would retain *Durrett*'s benefits while eliminating much of the confusion, uncertainty, and judicial overreaching concerns engendered by the same limitation in the context of fraudulent transfer law. For a foreclosure sale to be valid under the second prong of this proposal, the property must first be appraised. Accordingly, all buyers at the subsequent foreclosure sale would know the price which must be reached to validate the sale. The consequence of a low bid would be apparent at sale and would remain uncertain as in *Durrett*. This would provide a strong incentive for the mortgagee to bid or ensure that bidding reaches 70% of the appraised value of the foreclosed property. At a minimum, such a fair value limitation would protect the mortgagor from the mortgagee's most egregious abuses of the foreclosure process.

Equally important, the reform proposed in this Comment would not economically disadvantage lenders. Any additional costs to the mortgagee created by the fair value limitation would be minimal and would be offset by the process costs saved through the use of strict foreclosures when the mortgagor has no equity.[204] According to Professor William H. Henning, a 70% limitation is sufficient to allow mortgagees to recoup foreclosure and investment costs while

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202. *See* Palace, *supra* note 150, at 384, 391-92 (suggesting that the Legislature amend section 548 to define "reasonably equivalent value").

203. *See BFP*, 511 U.S. at 545 (indicating that a court may overturn a foreclosure sale as a fraudulent transfer if the foreclosure would be invalid under state law).

204. *See supra* Part III.D (proposing a strict foreclosure prong as a part of a bifurcated foreclosure process).

still allowing for a small windfall after resale of the property.[205] This proposal merely disallows the unjustifiably large windfalls realized by some mortgagees.

E. *Implementation of the Proposal*

In the context of foreclosure law, the fair value limitation merely clarifies the standard that a court may use to invalidate a foreclosure sale. By replacing current standards[206] with a bright-line (70%) rule, this proposal would increase the stability of completed foreclosure sales while furthering the principle of judicial economy.

In the context of fraudulent transfer law, the proposal could easily be implemented under the *BFP* framework. A foreclosure sale which does not reach the 70% fair value limitation would be invalid under state law. In a subsequent bankruptcy proceeding, the sale could thus be set aside as a fraudulent transfer under *BFP*. This proposal merely asks the legislature to make the policy determination that the *BFP* Court lacked the authority to make.

V. CONCLUSION

The current economic crisis has again brought the fairness and efficiency of the foreclosure process to the forefront of public debate. Under such scrutiny, it is apparent that the process unduly harms the parties it is meant to protect. Borrowers are unable to protect equity interests, lenders are forced to hold unnecessary and economically inefficient foreclosure auctions, and the general borrowing public absorbs the resulting cost through higher interest rates. The need for reform is both obvious and pressing.

The reform suggested in this Comment would benefit all parties involved in the foreclosure process. The proposal would protect homeowners' equity while reducing foreclosure costs for mortgagees. The saved costs could then be passed on to the borrowing public through lower interest rates. Finally, the reform proposed in this Comment would reduce litigation over inequitable foreclosures. If this proposal is adopted, all parties would benefit from the resulting improvements in the foreclosure process.

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205. Henning, *supra* note 178, at 284.

206. *See supra* Part II.B (discussing current standards).

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