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# Preventing Creditor Abuse of Deficiency Judgments: Some Good (and Not-so-Good) Approaches

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In his recent article, *Tools of Ignorance: An Appraisal of Deficiency Judgments*,[1] Professor Alan Weinberger accurately identifies both the benefits and detriments of statutory "fair value" limitations on deficiency judgments. The principal benefit of these statutes, of course, is that they stand in the way of a windfall double recovery by mortgage creditors. In many cases there is little or no competitive bidding at foreclosure sales, leaving the way clear for the creditor to bid at a level far below the property's market value and thus, gain both the full value of the property and the amount of a deficiency measured by the artificially low bid. This is simply an outrage, and the basic principles of fairness demand some means of preventing it.

On the other hand, determining what fair value is—indeed, defining what we mean by fair value—is often left ambiguous by fair value statutes. Even if the meaning is clear, determining value by a war of expert appraisal witnesses is a messy, complex, expensive, and often inaccurate process.

I find myself very much in sympathy with Weinberger's suggestions for an appraisal process, built into the statute, that will, in most cases, produce a fair-value figure at the cost of only one or two appraisals, and without the added expense of in-court testimony. His references to the South Carolina and Louisiana procedures, and his proposed modifications of them, are very helpful.

The Mortgages Restatement—of which Grant Nelson and I were co-reporters—takes an admittedly radical position on the

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1. Alan M. Weinberger, *Tools of Ignorance: An Appraisal of Deficiency Judgments*, 72 WASH. & LEE L. REV. 829 (2015), http://scholarlycommons.law.wlu.edu/wlulr/vol72/iss2/8.

fair value issue.[2] In essence, it invites courts to adopt a fair-value limitation on deficiency judgments, even if their legislatures have not done so by statute.[3] One might criticize this as "judicial legislation." But on the other hand, foreclosure in the Anglo-American legal system has always been an equitable proceeding, and courts of equity surely have inherent power to fashion fair remedies. I would argue that the Restatement is simply inviting courts to make foreclosure more fair and just by imposing a fair-value limitation on deficiencies.

Several recent cases suggest that courts have not been quite as unwilling to act on their own to adopt the Restatement's fair value approach, as Professor Weinberger suggests. Last year in *Sostaric v. Marshall*,[4] the West Virginia Supreme Court adopted the Restatement approach with no support whatsoever from West Virginia statutes.[5] Arizona already has a fair value statute, but a few months ago, the Arizona Supreme Court was faced with the need to decide whether it could be waived by language in the mortgage.[6] The court concluded that it could not and cited the Restatement's fair value section and its comments to support that conclusion.[7] It thus strengthened the fair value concept in its practical operation in Arizona.

Tennessee previously did not have fair value legislation, but in 2006, the Court of Appeals was invited to follow the

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2. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 8.4 (1997).

3. *See id.* cmt. a (adopting "the position of the substantial number of states that, by legislation or judicial decision, afford the deficiency defendant the right to insist that the greater of the fair market value of the real estate or the foreclosure sale price be used in calculating the deficiency").

4. 766 S.E.2d 396, 401 (W. Va. 2014).

5. *See id.* at 403 ("We conclude that the better and more legally sound approach is to follow section 8.4 of the *Restatement* . . . and allow a defendant to assert, as a defense in a deficiency judgment proceeding, that the fair market value of real property was not obtained at a trustee foreclosure sale."). Notably, in *Sostaric*, there was a stirring dissent based on the "judicial legislation" argument. *Id.* at 409–10 (Davis, J., dissenting).

6. CSA 13-101 Loop, LLC v. Loop 101, LLC, 341 P.3d 452, 453 (Ariz. 2014).

7. *See id.* at 454 ("Consistent with these principles, we have sometimes observed that waivers of statutory rights may "impliedly" be prohibited. Our past decisions have also stated that parties may waive statutory rights granted solely for the benefit of individuals, but rights enacted for the benefit of the public may not be waived." (internal citations omitted)).

Restatement and adopt that concept in *Lost Mountain Development Co. v. King*.[8] The court quoted the Restatement at length and with apparent enthusiasm.[9] It also quoted from, and appeared to readopt, a 1983 Tennessee Court of Appeals case, *Duke v. Daniels*.[10] That decision permitted a borrower to challenge the amount of a deficiency judgment, but only if the borrower could show that the price paid at the sale was "grossly inadequate."[11] Without explaining exactly how or why, the court concluded that this was the same as the Restatement approach:[12]

> Whatever procedural rules or burdens of proof apply, under both analyses the issue in deficiency actions is the fair market value of the property at the time it was sold. Thus, the fundamental principle is that the deficiency judgment should reflect the difference in the fair market value, if it is greater than the sales price, and the amount still owed. We think this principle is well-grounded and promotes the goal of fairness.[13]

This is a lovely summary of the Restatement principle, but it completely ignores *Duke*'s limitation of that principle to cases in which the sale price was "grossly inadequate."

The Tennessee court's opinion in *Lost Mountain*, like the West Virginia court's decision in *Sostaric v. Marshall*,[14] illustrates that a court can be influenced by the Restatement to impose limits on deficiency claims even when there is no statute directing it to do so. But *Lost Mountain* is fraught with uncertainty. Did the Tennessee court mean that even a small inadequacy in bid price would warrant the court's reduction of the deficiency judgment by the same amount, or did it mean that only a large inadequacy—a "gross inadequacy" of price—would

8. No. M2004-02663-COA-R3-CV, 2006 WL 3740791 (Tenn. Ct. App. Dec. 19, 2006).

9. *See id.* at *7–8 (quoting § 8.4 and comment (a) directly).

10. 660 S.W.2d 793 (Tenn. Ct. App. 1983).

11. *Id.* at 795.

12. The court conceded that there was one difference between the Restatement and *Duke v. Daniels*: the court in *Duke* used the sale price as the presumptive fair value, so that the borrower would have to overcome that presumption. The Restatement embodies no such presumption.

13. *Lost Mountain Dev. Co.*, 2006 WL 3740791, at *8.

14. 766 S.E.2d 396, 401 (W. Va. 2014).

justify the court stepping in and limiting the deficiency? The court's intent on this point is simply unclear.

In 2010, the Tennessee General Assembly, perhaps prompted by the *Lost Mountain* case, finally adopted a fair value statute.[15] The statute states that, in the absence of fraud, collusion, misconduct, or irregularity in the sale process, there is a rebuttable presumption that the sale price is the fair value.[16] The borrower can seek to overcome the presumption, however, by providing evidence "that the property sold for an amount materially less than the fair market value of property at the time of the foreclosure sale."[17] This language replaces the gross inadequacy standard of *Duke*—if indeed that was still the standard after *Lost Mountain*—with a "materially less" standard, but it does little to remove the uncertainty. How much is materially less? The term is just as vague as gross inadequacy, although it sounds somewhat more favorable to borrowers.

Since the statute's adoption, five Tennessee Court of Appeals cases have grappled with that question. In these cases, the bids were the following percentages of the highest available appraisal value: 85.7%,[18] 89%,[19] 78.1%,[20] 84.2%,[21] and 80%.[22] In each case, the Court of Appeals found that the bid at the sale was not sufficiently below the property's value to be materially less. It is still uncertain how much greater the gap must be in order to meet the statute's standard.

Surely this is a poor way to spend judicial resources. The Tennessee General Assembly presumably intended the materially less standard to address the fact that when seeking a deficiency, lenders will have—as yet undetermined—costs in marketing and

15. TENN. CODE ANN. § 35-5-118 (West 2010).

16. *Id.* § 35-5-118(b).

17. *Id.* § 35-5-118(c).

18. State of Franklin Bank v. Riggs, No. E2010–01505–COA–R3–CV, 2011 WL 5090888, at *1 (Tenn. Ct. App. Oct. 27, 2011).

19. GreenBank v. Sterling Ventures, L.L.C., No. M2012-01312-COA-R3-CV, 2012 WL 6115015, at *7 (Tenn. Ct. App. Dec. 7, 2012).

20. FirstBank v. Horizon Capital Partners, LLC, No. E2013-00686-COA-R3-CV, 2014 WL 407908, at *1 (Tenn. Ct. App. Feb. 3, 2014).

21. Capital Bank v. Brock, No. E2013-01140-COA-R3-CV, 2014 WL 2993844, at *7 (Tenn. Ct. App. June 30, 2014).

22. Halliman v. Heritage Bank, No. M2014-00244-COA-R3-CV, 2015 WL 1955448, at *1 (Tenn. Ct. App. Apr. 30, 2015).

carrying the property until it can be resold, and therefore are entitled in fairness to bid somewhat less than fair value to cover these costs. But the materially less test is an awkward and inefficient method of addressing this issue. As I will suggest in more detail below, it would have been far preferable for the General Assembly to simply fix a percentage of appraised value below which the bid would result in reduction of the deficiency judgment. Instead, the legislature "punted" the question back to the courts, which—despite having written five fairly detailed opinions on the subject—have yet to tell us the numerical answer.

Moreover, even a fixed percentage would not address all of the issues. Appraisals are notoriously contingent and approximate. For example, in one of the recent Tennessee cases, *FirstBank v. Horizon Capital Partners, LLC*,[23] the borrowers had entered into a lease-purchase agreement on one of the foreclosed parcels.[24] But the purchase option in the agreement was still unexercised at the time of the foreclosure and would not even vest in the prospective purchaser for another seven months.[25] One appraiser produced a valuation which was, by its terms, expressly dependent on the exercise of the option.[26]

Such variations reemphasize Professor Weinberger's point: the fair value concept is subtle and complex and cannot readily be encapsulated in a mere catch phrase. In defense of the Restatement, I would argue that it could hardly do more than that, for it is, after all, not a statute. A court that earnestly decides to adopt the Restatement would need to do a great deal of thinking about how to implement it, and I readily admit that the Restatement itself provides little guidance on this point. Indeed, that is the value of Professor Weinberger's article.

There is one issue on which I believe Weinberger's proposal requires amendment. His draft statute is based on "appraised value," which presumably means the current fair market value of the property. But if the lender is to be made whole, it is necessary

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23. No. E2013-00686-COA-R3-CV, 2014 WL 407908 (Tenn. Ct. App. Feb. 3, 2014).

24. *Id.* at *1.

25. *Id.* at *3.

26. *Id.* at *1.

to consider the lender's probable carrying costs and marketing costs as well. The marketing costs can perhaps be estimated with some reasonable accuracy; they consist of a brokerage commission and a variety of miscellaneous expenses for title work, perhaps some survey and engineering reports, and other minor expenses of sale. Carrying costs are another matter; such items as insurance, property taxes, and the expense of securing the property will depend almost entirely on how long it is held, and at the time the deficiency judgment is awarded, the holding period may be anyone's guess. Yet, these are real expenses and will simply come out the lender's pocket if the lender is forced to give credit against the deficiency for the full appraised value of the property.

One approach to this problem is to provide for an arbitrary percentage as a proxy for the total carrying and marketing costs by statute. The Uniform Nonjudicial Foreclosure Act—adopted by the Uniform Laws Commission in 2002 but not adopted by any jurisdiction—takes this approach.[27] Section 608 of the Act incorporates a fair value rule, but it employs ninety percent of the current fair market value—rather than the full value—as the base line from which the deficiency is computed.[28] In effect, it assumes that the lender's carrying and marketing costs will be ten percent of the appraised value. Obviously this is merely an approximation, and in many cases it will be somewhat inaccurate. But 90% is almost certainly closer to the lender's actual liquidation value of the collateral than 100%, and the 10% discount is easy to calculate and apply. In light of the fact that the actual costs will usually lie mainly in the future and cannot be accurately itemized at the time the deficiency judgment is rendered, this is a sensible and practical approach. It is far simpler and less wasteful of lawyers' and courts' time than the materially less standard adopted by the Tennessee General Assembly and described above.[29]

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27. UNIFORM NONJUDICIAL FORECLOSURE ACT (UNIF. LAW COMM'N 2002).

28. *See id.* § 608 ("If the court . . . finds that the foreclosure amount was less than 90 percent of the fair market value of the collateral, the court shall substitute 90 percent of the fair market value of the collateral for the foreclosure amount for the purpose of determining the deficiency . . . .").

29. *Supra* notes 15–16.

Overall, Professor Weinberger has provided a valuable service by highlighting the inadequacies of the present fair value statutes and proposing a rigorous, practical, and relatively inexpensive method for establishing fair value.