NOTE

A MARKET-BASED TOOL TO REDUCE SYSTEMATIC UNDERVALUATION OF COLLATERAL IN RESIDENTIAL MORTGAGE FORECLOSURES

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INTRODUCTION

THE collapse in residential real estate prices that began in 2006[1] resulted in a wave of foreclosures[2] that exposed a number of weaknesses in the mortgage foreclosure process. This resulted in the start of another in a long line of attempts by the National Conference of Commissioners on Uniform State Laws ("NCCUSL") to reform the mortgage foreclosure process.[3]

Like virtually all of the NCCUSL's prior efforts, this latest effort attempts to address the age-old problem of the systematic undervaluation of collateral in residential mortgage foreclosures.[4] Policymakers have

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[1] E.g., U.S. Gov't Accountability Office, GAO-13-180, Financial Regulatory Reform: Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act 21 figs.4 & 5 (2013); S&P/Case-Shiller U.S. National Home Price Index, S&P Dow Jones Indices (Feb. 25, 2014), http://us.spindices.com/indices/real-estate/sp-case-shiller-us-national-home-price-index (displaying the U.S. National Home Price Index from 1987 to 2012 and showing a gradual rise in prices until 2006, then a rapid collapse in prices followed by a slight recovery beginning in 2012).

[2] E.g., U.S. Gov't Accountability Office, supra note 1, at 25 fig.7; U.S. Foreclosure Starts Fall to Six-Year Low in January, RealtyTrac (Feb. 12, 2013), http://www.realtytrac.com/content/foreclosure-market-report/us-foreclosure-market-report-january-2013-7596 (including a chart on U.S. foreclosure starts, which shows a wave of residential mortgage foreclosures between April of 2005 and January of 2013 that peaked in April of 2009).

[3] See sources cited infra notes 55–56.

[4] See Home Foreclosure Procedures Act §§ 404–405 (Draft 2013) (outlining proposed NCCUSL provisions designed to improve valuations in foreclosure auctions by improving

wrestled with this problem for nearly a century.[5] The basic tool for valuing residential properties in foreclosure is the public auction.[6] Despite the potential for this tool to generate prices equal to fair market value ("FMV"), critics allege that it has long produced below-market prices.[7] Critics have asserted, at least since 1925, that the mortgage lender frequently ends up being the winning bidder in mortgage foreclosure auctions.[8] If the lender can acquire the collateral at a below-market price, it can capture the difference between the FMV and the lower auction price by reselling the property to a third party. If the auction price is below the outstanding obligation on the mortgage loan, the lender will also have an inflated deficiency claim against the borrower equivalent to the difference between the FMV and the auction price.[9] A deficiency claim is the difference between the remaining balance of a loan and the determined value of the collateral backing that loan.[10] Assuming the borrower is solvent, an inflated deficiency claim gives the lender the possibility of a double recovery and the borrower the risk of a double loss.[11]

As a result of the perceived flaws in the foreclosure auction, state governments and courts have tried to supplement auctions with rules in-

publicity of auctions and requiring better disclosure about property to potential bidders); see also sources cited infra notes 5, 54–56 (outlining proposed NCCUSL provisions designed to improve valuations in foreclosure auctions and documenting their eventual failure).

[5] See Restatement (Third) of Prop.: Mortgages § 8.3 reporters' note (1997); 1 Grant S. Nelson & Dale A. Whitman, Real Estate Finance Law § 7.16, at 837–40 (Practitioner Treatise Ser., 5th ed. 2007) [hereinafter Nelson & Whitman Treatise]; Edgar Noble Durfee & Delmar W. Doddridge, Redemption from Foreclosure Sale—The Uniform Mortgage Act, 23 Mich. L. Rev. 825, 833 (1925); see also sources cited infra notes 54–56.

[6] Grant S. Nelson & Dale A. Whitman, Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act, 53 Duke L.J. 1399, 1415 (2004) ("In the great majority of United States jurisdictions, foreclosure—both judicial and nonjudicial—is conducted by means of a public auction.").

[7] See sources cited infra notes 26, 38.

[8] E.g., Durfee & Doddridge, supra note 5, at 833.

[9] Nelson & Whitman Treatise, supra note 5, § 8.3, at 942; see also Durfee & Doddridge, supra note 5, at 840 (describing the incentive of a mortgagor to lower its auction bid in order to increase the size of its deficiency claim); Ronald Goldstein, Reforming the Residential Mortgage Foreclosure Process, 21 Real Est. L.J. 286, 286–87 (1993) (explaining the potential abuse from mortgagors who try to purchase collateral for below FMV, thereby increasing the size of deficiency claims); Robert M. Washburn, The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales, 53 S. Cal. L. Rev. 843, 849–50 (1980) ("A further consequence of a nominal bid by the mortgagee is that the mortgagee's double recovery is mirrored by a double loss to the mortgagor, who loses the property and is subject to a deficiency judgment.").

[10] See Black's Law Dictionary 487 (9th ed. 2009) (defining deficiency).

[11] Durfee & Doddridge, supra note 5, at 840; Washburn, supra note 9, at 849–50.

tended to protect against systematic undervaluation. These rules have included notice and disclosure requirements,[12] statutory redemption,[13] antideficiency statutes,[14] and doctrines that allow courts to set aside an auction price that is grossly inadequate or unconscionable.[15] While each of these rules has its merits, none of them have completely solved the undervaluation problem,[16] and some may ultimately be counterproductive.[17]

In deciding whether a new tool can be developed that would be more effective and efficient, it is useful to consider a tool used by secured lenders to protect themselves against undervaluation of collateral in bankruptcy proceedings. That tool is credit bidding.[18] Credit bidding al-

[12] See Nelson & Whitman, supra note 6, at 1430–39 (describing features in the proposed Uniform Nonjudicial Foreclosure Act that are designed to improve the mortgage auction process, such as requiring better public notice of auctions and information about property being auctioned).

[13] See generally Nelson & Whitman Treatise, supra note 5, §§ 8.4–8.8, at 977–1005 (describing the common form of statutory redemption). Certain states also enacted statutes during the Great Depression that imposed general moratoria on mortgage foreclosures. See id. § 8.3, at 940–42 & n.1. The U.S. Supreme Court upheld the constitutionality of mortgage foreclosure moratoria against a challenge under the Contracts Clause in *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 445–47 (1934).

[14] Nelson & Whitman Treatise, supra note 5, § 8.3, at 940–52.

[15] Restatement (Third) of Prop.: Mortgages § 8.3 (1997); Nelson & Whitman Treatise, supra note 5, § 7.16, at 837 & n.26.

[16] See, e.g., Nelson & Whitman, supra note 6, at 1438–40 (arguing that statutory redemption actually depresses mortgage auction prices because it undermines the finality of sales).

[17] E.g., Alex M. Johnson, Jr., Critiquing the Foreclosure Process: An Economic Approach Based on the Paradigmatic Norms of Bankruptcy, 79 Va. L. Rev. 959, 961 (1993) ("Although these attempts to protect the mortgagor's equity may be lauded from a fairness perspective, they are typically ill-conceived, short-sighted, and may ultimately hurt the very class of individuals—mortgagors—that they are designed to help.").

[18] For background information on credit bidding, see generally 11 U.S.C. §§ 363(k), 1129(b)(2)(A) (2012) (granting secured creditors the right to purchase collateral at a public sale by means of credit bidding or in a plan of reorganization guaranteeing them the "indubitable equivalent"); RadLAX Gateway Hotel v. Amalgamated Bank, 132 S. Ct. 2065, 2069–70, 2072–73 (2012) (holding that secured creditors have the right to credit bid for their collateral at a public sale as part of a plan of reorganization in a bankruptcy proceeding and that the right cannot be denied on the ground that only the "indubitable equivalent" is required); Vincent S. J. Buccola & Ashley C. Keller, Credit Bidding and the Design of Bankruptcy Auctions, 18 Geo. Mason L. Rev. 99, 100–02 (2010) (providing an overview of credit bidding in bankruptcy); Alan N. Resnick, Denying Secured Creditors the Right to Credit Bid in Chapter 11 Cases and the Risk of Undervaluation, 63 Hastings L.J. 323, 331–33 (2012) (providing an example of how credit bidding works); Charles J. Tabb, Credit Bidding, Security, and the Obsolescence of Chapter 11, 2013 U. Ill. L. Rev. 103, 106–07 (arguing that the *RadLAX* Court was correct to find that secured creditors hold a statutory right to credit bid); Donald S. Bernstein et al., Credit Bidding in Chapter 11 after *RadLAX* (Aug. 2, 2012) (un-

lows a secured creditor to purchase undervalued collateral in a non-cash transaction. The secured creditor is able to take possession of the collateral, thereby securing its claim against the bankruptcy estate in exchange for reducing its claim by the value attributed to the collateral. The secured creditor is then free to resell the collateral at the FMV and keep the difference. The creditor also has a deficiency claim against the bankruptcy estate for the difference between the total amount of its claim and the amount used to purchase the collateral.[19] Because credit bidding can result in a permanent transfer of wealth from the bankruptcy estate to the secured creditor, the very threat of credit bidding is often enough to deter any undervaluation of collateral.[20]

This Note will use credit bidding as a model for a new market-based tool that can deter undervaluation of collateral in residential mortgage foreclosure proceedings—we might call this new tool a "deficiency forfeiture sale option" ("DF sale option").[21] DF sale options would give borrowers a transferable call option for a relatively brief period of time—say ninety days—after a mortgage foreclosure auction. The option would have an exercise price equal to the winning auction bid. If a borrower sold or exercised the option in a bona fide transaction during the exercise period, the lender would receive the option exercise price. The deficiency claim would be determined by the DF sale price (or the sum of the exercise price and any premium received for the option) rather than the lower auction price.

This Note will proceed in four parts. Part I will define how residential properties would be valued if the mortgage foreclosure process were perfectly efficient. Part II will discuss actual foreclosure auctions and the supplemental rules designed to protect against undervaluation of collateral in these auctions. Part III will discuss credit bidding and how it protects against undervaluation of collateral in bankruptcy proceedings. Part IV will use credit bidding as a model for developing the DF sale op-

published manuscript), available at http://papers.ssrn.com/abstract=2243669 (arguing that the *RadLAX* Court was correct to find that secured creditors held a statutory right to credit bid).

[19] See Resnick, supra note 18, at 332.

[20] See, e.g., Brief for Bankruptcy Scholars as Amici Curiae Supporting Respondents at 13–14, *RadLAX*, 132 S. Ct. 2065 (No. 11-166).

[21] The term "deficiency forfeiture sale option" was crafted by the author to refer to the new tool described in this Note. The name indicates the key features of how the tool operates; namely, that it is an option that can be exercised or waived, and that, if exercised, it results in a forfeiture of all or a portion of a deficiency claim.

tion and will explain why this new market-based tool should be a more efficient and effective tool than any of the existing alternatives in reducing the systematic undervaluation of collateral in residential mortgage foreclosure auctions.

I. THE IDEAL: AN EFFICIENT MORTGAGE FORECLOSURE PROCESS

A perfectly efficient foreclosure process would give lenders and borrowers the benefit of their bargains—no more and no less. In the typical mortgage bargain, this would mean that, upon foreclosure, borrowers would receive full credit for the FMV of their mortgaged property.[22] Secured creditors would receive the lesser of the FMV and the outstanding amount of the secured obligation. If the FMV were greater than the outstanding obligation, the borrower would receive the surplus, absent any competing junior lien creditors.[23] If the FMV were less than the outstanding obligation, the secured lender would be entitled to an unsecured deficiency claim against the borrower for the difference.[24] These outcomes would be achieved at zero transaction costs.

II. VALUATION IN THE REAL WORLD

A principal goal of mortgage foreclosure law is to establish a process that results in sale prices that come as close as possible to the FMV. The principal means by which those laws attempt to achieve this goal is through a public auction.[25] Despite the potential for public auctions to generate prices equal to the FMV, critics allege that they have long produced below-market prices.[26] Therefore, various tools have been created by judicial or legislative action to protect against undervaluation.

[22] See Michael H. Schill, An Economic Analysis of Mortgagor Protection Laws, 77 Va. L. Rev. 489, 492–93 (1991).

[23] Nelson & Whitman Treatise, supra note 5, § 7.31, at 920–21.

[24] See Restatement (Third) of Prop.: Mortgages § 8.4(b) (1997).

[25] See generally Nelson & Whitman, supra note 6, at 1415–16 (asserting that the majority of states use public auctions to sell foreclosed property, and that one of the purposes of such auctions is to determine whether or not the lienholder has a deficiency claim—that is, to determine the property's FMV).

[26] Restatement (Third) of Prop.: Mortgages § 8.3 reporters' note (1997); Nelson & Whitman, supra note 6, at 1423; see also Nelson & Whitman Treatise, supra note 5, § 7.16, at 837–40 (describing how the adequacy of a sale price from a mortgagor foreclosure auction is reviewed).

A. The Mortgage Foreclosure Auction

The type of auction typically used in mortgage foreclosure proceedings is an English auction.[27] An English auction is an open auction, meaning that all potential bidders gather in a single place and they know whether there are other bidders, who those other bidders are, and the value of their bids.[28] The auction proceeds with the auctioneer calling out a minimum price and then progressively raising the price, "typically in small increments, as long as there are at least two interested bidders."[29] To win, a bidder is not required to offer its full private valuation of the property, but only a nominal amount above the last price offered by the second-highest bidder.[30] Thus, the second-highest bidder's valuation, rather than the winning bidder's private valuation, determines the sale price.[31]

Auctions are used when a seller is uncertain about the FMV of a property.[32] If the seller knew what the property was worth, it would simply sell the property at its FMV. Uncertainty about the value of the property in question is an inherent feature in a mortgage foreclosure proceeding.[33] In most situations, not only do sellers experience this uncertainty, but so do the bidders. Bidders do not value the property solely for the private value they attribute to it, but also for its resale value to third parties.[34] Signals about what the property is worth to third parties provide highly valuable information to bidders in this type of situation.[35]

An English auction should produce a winning bid reasonably close to the FMV if the auction is well publicized, attracts a large number of bidders with available financing, provides reliable information about the property's resale value, and provides bidders with all material information about the property's condition. The presence of at least one bidder who establishes a minimum resale price, such as a "stalking horse bidder" in a bankruptcy proceeding,[36] is critical. Fostering confidence in

[27] Nelson & Whitman, supra note 6, at 1416.
[28] See Vijay Krishna, Auction Theory 4 (2d ed. 2010).
[29] Id. at 2.
[30] Nelson & Whitman, supra note 6, at 1416.
[31] Id.
[32] Krishna, supra note 28, at 2.
[33] Id.
[34] Id. at 3.
[35] See id.
[36] In public auctions of property under § 363 of the Bankruptcy Code, the debtor-in-possession typically arranges for an initial bidder, or "stalking horse bidder," to enter into a

a property's minimum resale value encourages all bidders to submit higher bids because of the possibility for gains and the limited risk of loss. If a public auction does not satisfy these conditions, the sale price may be substantially below the FMV.

Although the empirical record is inconclusive,[37] critics have long asserted that public auctions for residential real estate in foreclosure systematically result in prices well below the FMV,[38] especially when they occur during a recession or depression.[39] This is probably even more likely to occur during a financial panic when the normal market has

binding sales contract to purchase the property at a specified sale price, "thereby setting a floor, or minimum bid," for the property. Elisa R. Lemmer, Unsuccessful Stalking Horse Bidder Entitled to Administrative Expense Claim for Costs Related to Aborted Closing, Bankr. Bull. (Weil, Gotshal & Manges LLP), Feb. 2006, at 5, available at http://www.weil.com/wgm/cwgmhomep.nsf/Files/BBFeb06/$file/BBFeb06.pdf. By setting a floor for the auction price, the stalking horse helps satisfy one of the conditions for an effective auction by providing other bidders with a fairly reliable signal that the resale value of the property is at least as high as the stalking horse's bid. See id.; Krishna, supra note 28, at 3.

[37] The record is inconclusive because the critics of the current foreclosure auction system appear to base their assertions as much on anecdotal evidence as on rigorous empirical data. Although the empirical studies cited by these critics support their assertions, these empirical studies were based on limited datasets. See, e.g., 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, 642, 656–57, 663 (1997) (concluding that the efficiency and fairness of foreclosure sales could be improved based on studies of one county in Illinois); 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, 853, 880 (1985) (concluding that foreclosure sales of real estate to mortgagees are consistently executed at lower prices than foreclosure sales to third parties based on a sample of only 118 sales). A more recent study also supports the assertion that foreclosure auctions are ineffective, but is also based on limited data. See John Y. Campbell et al., Forced Sales and Housing Prices 2–3, 5–6, 22 (Nat'l Bureau of Econ. Research, Working Paper No. 14866, 2009), available at http://www.nber.org/papers/w14866 (concluding that foreclosure auctions produce prices approximately twenty-eight percent below market based on residential mortgage transactions in Massachusetts over a twenty-year period). Thus, although the empirical record supports the critics, it is based on limited data and therefore is far from conclusive. It would be useful if economists could develop a national database that included market prices and foreclosure auction prices during both normal market conditions and financial crises and base further research on such a database.

[38] Restatement (Third) of Prop.: Mortgages § 8.3 cmt. a & reporters' note (1997); Durfee & Doddridge, supra note 5, at 831–32; Goldstein, supra note 9, at 286–87; Johnson, supra note 17, at 989; Nelson & Whitman, supra note 6, at 1423; Washburn, supra note 9, at 843; see also Nelson & Whitman Treatise, supra note 5, § 7.16, at 837–40 (describing how the adequacy of the sale price of a mortgagor foreclosure auction is reviewed).

[39] Nelson & Whitman Treatise, supra note 5, § 8.3, at 942.

failed to function properly and asset values are highly uncertain.[40] The following is a non-exhaustive list of reasons given for this systematic undervaluation of real estate collateral: real estate is not a fungible asset;[41] foreclosure auctions are typically poorly publicized;[42] the auctions attract few, if any, bidders other than the secured creditor;[43] potential bidders are not provided with reasonably complete or reliable information about the property's condition, a meaningful right to inspect the property,[44] or information about the quality of its title;[45] foreclosure auctions lack a mechanism like a stalking horse to provide potential bidders with confidence about the property's minimum resale value;[46] foreclosure auctions are forced sales;[47] and, if they occur during a financial crisis, foreclosure sales can even be fire sales.[48] Other reasons given for

[40] See Andrei Shleifer & Robert Vishny, Fire Sales in Finance and Macroeconomics, 25 J. Econ. Persp. 29, 30 (2011).

[41] Schill, supra note 22, at 493.

[42] See Restatement (Third) of Prop.: Mortgages § 8.3 cmt. a (1997); Washburn, supra note 9, at 848.

[43] Nelson & Whitman Treatise, supra note 5, § 8.8, at 995. For more on why there are few bidders other than secured creditors, see *Carteret Savings & Loan Ass'n v. Davis*, 521 A.2d 831, 835 (N.J. 1987) ("It is likely that the low turnout of third parties who actually buy property at foreclosure sales reflects a general conclusion that the risks of acquiring an imperfect title are often too high."); Goldstein, supra note 9, at 289; Johnson, supra note 17, at 969, 971; Washburn, supra note 9, at 848.

[44] Restatement (Third) of Prop.: Mortgages § 8.3 cmt. a (1997); Nelson & Whitman Treatise, supra note 5, § 8.8, at 996; Goldstein, supra note 9, at 289–90; Schill, supra note 22, at 493.

[45] Nelson & Whitman Treatise, supra note 5, § 8.8, at 995–96.

[46] See generally Krishna, supra note 28, at 3 (explaining that efficient auctions generally require bidders to have information about what the property may be worth to third parties, rather than merely their personal consumption value or private value); George A. Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q.J. Econ. 488, 488–90, 495 (1970) (discussing the detrimental effects of market elimination caused by the risk of overpaying for an asset because of a lack of sufficient information about its quality or resale value); Lemmer, supra note 36, at 5 (stating that in auctions conducted under § 363 of the Bankruptcy Code, a special bidder known as the "stalking horse bidder" establishes a minimum resale price). In the absence of some sort of signal about the minimum resale price of an asset being auctioned, bidders may discount their bids in order to avoid bidding more than the asset's resale value. See The Handbook of Experimental Economics 536–57 (John H. Kagel & Alvin E. Roth eds., 1995) (providing a detailed examination of the "winner's curse" in auctions—the curse of bidding more for an asset than its resale value); Ross M. Miller, Experimental Economics: How We Can Build Better Financial Markets 169–70 (2002) (discussing the "winner's curse"); Goldstein, supra note 9, at 290 (discussing the "winner's curse").

[47] Washburn, supra note 9, at 848.

[48] See Shleifer & Vishny, supra note 40, at 30.

this systematic undervaluation include the secured lender's asymmetrical funding advantage due to its ability to credit bid for the property[49] and the requirement that third-party bidders pay in cash.[50] According to the authors of the leading treatise on real estate finance law:

> [I]t would be difficult to design a sale procedure less apt to result in market prices than the usual foreclosure auction. The absence of so many features that buyers in negotiated sales have come to expect virtually ensures that below-market prices will prevail. . . . From the lender's viewpoint, the sale's function is, in the great bulk of cases, simply to place the property's title in the lender's hands. Such properties become "real-estate owned" ("REO" in industry parlance) to lenders, and they can then concentrate on liquidating the properties by conventional arms-length negotiated sales using such conventional methods as newspaper display advertisements and listings with real estate brokers.[51]

If secured lenders are the winning bidders in the vast majority of mortgage foreclosure auctions for residential properties, there may not be a material difference between the modern mortgage foreclosure process and strict foreclosure,[52] which has been formally banned in most states.[53]

B. Tools Designed to Improve the Foreclosure Valuation Process

As a result of these problems with mortgage foreclosure auctions, state legislatures and judges, and to a limited extent the federal government, have spent decades experimenting with supplemental provisions designed to either encourage higher sale prices or protect against gross

[49] See, e.g., Restatement (Third) of Prop.: Mortgages § 8.3 cmt. a (1997); Nelson & Whitman Treatise, supra note 5, § 8.8, at 995.

[50] Johnson, supra note 17, at 968–69; Washburn, supra note 9, at 849.

[51] Nelson & Whitman, supra note 6, at 1423.

[52] See Durfee & Doddridge, supra note 5, at 833 ("Thus foreclosure by sale is in practice strict foreclosure . . . ."); Washburn, supra note 9, at 848; Wechsler, supra note 37, at 896. Strict foreclosure refers to a secured creditor taking title to the collateral without a public sale. See Black's Law Dictionary 719 (9th ed. 2009) (defining strict foreclosure). Under strict foreclosure, the secured creditor is not liable for any surplus if the value of the foreclosed property is greater than the outstanding obligation—that is, the secured creditor is allowed to keep any windfall. See Dieffenbach v. Attorney Gen. of Vt., 604 F.2d 187, 195 (2d Cir. 1979).

[53] See Nelson & Whitman Treatise, supra note 5, § 7.10, at 801.

undervaluation.[54] In addition, since 1927, the NCCUSL has published four successive proposals to reform and unify state residential mortgage foreclosure laws,[55] and it is currently working on a fifth.[56] A central focus of those five proposals has been to provide rules designed to protect against systematic undervaluation of collateral in foreclosure proceedings. While most of these model laws have not been adopted by a single state,[57] they may have influenced state legislatures and judges in shaping or interpreting the tools designed to supplement foreclosure auction procedures.

While each of these supplemental devices has its merits, none has totally solved the undervaluation problem, and some may be counterproductive. The proceeding Subsections will describe these devices and explain why they have not been particularly effective or efficient.

1. Notice and Disclosure Requirements

The first set of rules was designed to improve notice about the auction and disclosure about the property for potential bidders. For example, the Uniform Nonjudicial Foreclosure Act of 2002 ("UNFA") contained minimum public notice and disclosure requirements.[58] It required notice to be published in a newspaper of general circulation.[59] It also required the

[54] See generally Multifamily Mortgage Foreclosure Act of 1981, 12 U.S.C. §§ 3701–3717 (2012) (stating that its purpose was to eliminate inefficiencies caused by state foreclosure laws that led to discounted foreclosure sale prices); Single Family Mortgage Foreclosure Act of 1994, 12 U.S.C. §§ 3751–3758 (2012) (stating that its purpose was to create a uniform federal remedy that eliminated inefficiencies caused by state foreclosure laws that led to discounted foreclosure sale prices); Federal Mortgage Foreclosure Act, S. 2507, 93d Cong. §§ 401–419 (1973) (attempting to encourage higher sale prices by eliminating state statutory redemption rights and mandating foreclosure by power of sale).

[55] See, e.g., 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, 1278–79 (1991); Unif. Real Estate Mortg. Act (1927); Model Power of Sale Foreclosure Act (1940); Unif. Land Sec. Interest Act (1985); Unif. Nonjudicial Foreclosure Act (2002).

[56] Nat'l Conference of Comm'rs on Unif. State Laws, Report of the January 13 Stakeholder Meeting and the January 14 Meeting of the Study Committee Regarding a Uniform Mortgage Foreclosure Procedures Act (2012), available at http://www.uniformlaws.org/shared/docs/mortgage%20foreclosure/2012may_RREMFPP_Report%20to%20Scope_FINAL.pdf.

[57] See Ann M. Burkhart, Real Estate Practice in the Twenty-First Century, 72 Mo. L. Rev. 1031, 1033 & n.8 (2007); Nelson & Whitman, supra note 6, at 1408–09; Schill, supra note 55, at 1262.

[58] Unif. Nonjudicial Foreclosure Act §§ 203, 303 (2002).

[59] Id. § 303.

lender to provide potential bidders with a title report[60] and access to the property.[61] The notice and disclosure requirements in the UNFA are largely reflective of existing state law—that is, the UNFA did not propose any material changes to common state law provisions in this area.[62]

These notice and disclosure rules are helpful to an extent, but experience shows that they have not been effective in attracting a large number of bidders at foreclosure auctions for residential real estate.[63] Secured lenders continue to be the sole bidders at many auctions or end up being one of only a small handful of professional and experienced amateur bidders.[64] Lenders are not required to prepare brochures, pictures, videos or other informational packets, or promotional material, or to use television, radio, the Internet, or any other media aside from newspapers to publicize mortgage auctions or disclose information about the property.[65] The asymmetric informational and financial advantages that secured lenders generally have over most third-party bidders are not erased. Nor is anything done to give bidders confidence about the minimum resale value of the property as is done in bankruptcy proceedings.[66]

Most importantly, these rules provide no incentive for the mortgage lender to solicit a large number of bidders or otherwise aggressively market the property. Instead, mortgage lenders have powerful incentives to do the bare minimum[67] because this gives them the opportunity to capture value at the expense of borrowers.

2. Statutory Redemption

Statutory redemption is an option to purchase a foreclosed property at an exercise price equal to the auction price, plus accrued interest, with an option exercise period between six months and two years *after* the foreclosure auction.[68] The exercise periods for many of these statutes were extended during the Great Depression.[69] Statutory redemption is

[60] Id. § 302.
[61] Id. § 304.
[62] For an example of a similar state law, see, e.g., Miss. Code Ann. § 89-1-55 (2011).
[63] See sources cited supra note 43.
[64] See sources cited supra note 43.
[65] See Johnson, supra note 17, at 970.
[66] For a description of how bidders in bankruptcy proceedings are provided with information about the minimum resale value, see Lemmer, supra note 36, at 5.
[67] See Johnson, supra note 17, at 993–94; Washburn, supra note 9, at 849.
[68] See Nelson & Whitman Treatise, supra note 5, § 8.4, at 977–78 & nn.4–5.
[69] See id. § 8.3, at 942.

different from equity of redemption, which is the right to redeem the mortgage at any time after default but *before* foreclosure by paying the full principal amount and accrued interest on the mortgage loan.[70] Statutory rights of redemption exist in about half of the states.[71] They are typically exercisable by both borrowers and any junior lien creditors.[72]

Advocates contend that statutory redemption rights help reduce the systematic undervaluation of residential property in foreclosure proceedings by creating an incentive for bidders to offer prices closer to the FMV, lest the borrower exercise its right to redeem the property at some point before the end of the statutory redemption period.[73] Critics argue that it has just the opposite effect: Bidders discount their bids to reflect their defeasible title—that is, the risk that the borrower or a junior lien creditor will at some point exercise its right of statutory redemption and take away the winning bidder's ownership rights.[74] Since borrowers often have the right to occupy the property during the statutory redemption period,[75] the bidder also bears the risk that the borrower will intentionally harm or neglect the property during the statutory redemption period.[76]

[70] Restatement (Third) of Prop.: Mortgages § 3.1 (1997); Nelson & Whitman Treatise, supra note 5, § 7.1, at 768–69.

[71] Nelson & Whitman Treatise, supra note 5, § 8.4, at 977 & n.2.

[72] Id. § 8.5, at 982.

[73] United States v. Ellis, 714 F.2d 953, 956 (9th Cir. 1983) ("Statutory rights of redemption give the mortgagor power to force the sale price closer to true market value."); Durfee & Doddridge, supra note 5, at 840 ("[T]he statutes also operate indirectly to the same end by encouraging, almost compelling, the mortgagee to bid up the property to its fair value."); Darryl A. Hart, The Statutory Right of Redemption in California, 52 Calif. L. Rev. 846, 848 (1964) (praising statutory redemption for "encouraging those who do bid at the sale to bid in at a fair price"); Schill, supra note 22, at 496 ("[A] statutory right of redemption should encourage purchasers at foreclosure sales to bid up the price to fair market value in order to avoid the risk of the property being redeemed at an artificially low foreclosure price several months later.").

[74] Nelson & Whitman Treatise, supra note 5, § 8.4, at 980–81, § 8.8, at 996; Goldstein, supra note 9, at 295; Nelson & Whitman, supra note 6, at 1404, 1439.

[75] See, e.g., Nelson & Whitman Treatise, supra note 5, § 8.4, at 978 & nn.6–7 (stating that continued possession is permitted in a vast majority of the states that recognize statutory redemption and that statutory redemption rights are conditioned on surrendering the property to others).

[76] See, e.g., United States v. Stadium Apartments, 425 F.2d 358, 365–66 (9th Cir. 1970) ("What third party would bid and pay the full market value, knowing that he cannot have the property to do with as he wishes until a set period has gone by, and that at the end of the period he may not get it, but instead may be forced to accept a payment which may or may not fully reimburse him for his outlays?"); Goldstein, supra note 9, at 295; Schill, supra note 22, at 534.

The behavioral impact of statutory redemption is mixed. On its own, it provides only a weak incentive for a secured lender to bid a price closer to the FMV. If a secured lender purchases the residential property securing its claim in a foreclosure proceeding at a price less than the FMV, and the borrower exercises its statutory right of redemption, a portion of the lender's claim will be converted from a secured claim to an unsecured claim. The portion of the lender's claim converted into an unsecured claim is equal to the difference between the FMV of the property and its auction price. The lender, however, can still go after the borrower for the inflated difference between the FMV and the below-market auction price by obtaining a judgment against the borrower and levying on the property. As a result, statutory redemption alone is not much of a threat to the secured creditor and therefore only has a weak impact on its incentives.

More likely, statutory redemption will, as its critics contend, actually decrease the number of third-party bidders in a foreclosure auction and depress their bids.[77] Given the right of redemption, potential third-party buyers have to be able to predict the future quality and value of the home on the expiration date of the exercise window. The longer the exercise period is, the greater the risk. Potential buyers will discount their bids to take account of this risk.

3. Anti-Deficiency Statutes

Anti-deficiency statutes limit or eliminate a secured creditor's deficiency claim.[78] They come in two principal varieties. The most common version, the FMV anti-deficiency statute, limits deficiency claims to the difference between the outstanding claim and the FMV of the property, rather than the auction price.[79] A less common version, the nonrecourse anti-deficiency statute, eliminates deficiency claims altogether, effectively making all mortgage loans nonrecourse to the borrower regardless of what the parties voluntarily agreed to at the outset of their contractual relationship.[80]

[77] Goldstein, supra note 9, at 295; Schill, supra note 22, at 534.
[78] See Nelson & Whitman Treatise, supra note 5, § 8.3, at 940–44.
[79] See id. at 942–44.
[80] See, e.g., id. at 946–47 & n.22 (showing that such statutes were enacted in Alaska, Arizona, California, Montana, and Washington).

a. FMV Anti-Deficiency Statutes

The FMV version of these statutes exists in numerous states.[81] Both the Restatement and the UNFA reflect this approach. The Restatement would limit deficiency claims to the difference between the outstanding claim on the mortgage loan and the FMV of the foreclosed property if the FMV is found to be more than the auction price.[82] The UNFA would limit deficiency claims to the difference between the outstanding claim and ninety percent of the judicially determined FMV of the property.[83] The purpose of the ten percent discount is to compensate the lender for its foreclosure costs.[84]

The purpose of FMV anti-deficiency statutes is to prevent a secured creditor from using the foreclosure process to recover more than the outstanding balance on the loan.[85] If the lender can acquire the collateral at a below-market price, it can capture the FMV of the property by reselling it to a third party, while increasing its deficiency claim against the borrower up to the difference between the FMV and the auction price.[86] Assuming the borrower is solvent, this gives the lender the possibility for a double recovery and the borrower a risk of a double loss.[87]

Although this type of anti-deficiency statute could provide an incentive for lenders to bid the FMV of the property in foreclosure auctions if the statute were coupled with an appropriate statutory right of redemption, a FMV anti-deficiency statute does not provide such an incentive on its own.[88] An anti-deficiency statute itself does not impose any meaningful penalty on a secured creditor's strategic behavior. To illustrate, consider a mortgage loan with an outstanding balance of $100. The

[81] See, e.g., Nelson & Whitman, supra note 6, at 1496 & n.365 (noting that twenty-three states have some sort of FMV anti-deficiency statute).

[82] Restatement (Third) of Prop.: Mortgages § 8.4(c)–(d) (1997).

[83] Unif. Nonjudicial Foreclosure Act § 606(b) (2002); Nelson & Whitman, supra note 6, at 1491–92. Otherwise, the UNFA defines a deficiency as the difference between the outstanding obligation and the auction price. See Unif. Nonjudicial Foreclosure Act § 606(a) (2002).

[84] See Unif. Nonjudicial Foreclosure Act § 606 cmt. (2002); Nelson & Whitman, supra note 6, at 1492.

[85] See, e.g., Restatement (Third) of Prop.: Mortgages § 8.4 cmt. a (1997).

[86] Id. § 8.4; Nelson & Whitman Treatise, supra note 5, § 8.3, at 942; Goldstein, supra note 9, at 286–87; Washburn, supra note 9, at 849.

[87] Washburn, supra note 9, at 849–50.

[88] See, e.g., Goldstein, supra note 9, at 294–95 ("[Anti-deficiency] legislation . . . does nothing to encourage higher bid prices in the first instance."); see also Johnson, supra note 17, at 983–84 ("At best, anti-deficiency legislation provides the mortgagee with the incentive to bid up to the amount of the debt at the time of foreclosure.").

FMV of the residential real estate securing the loan is $80. If the secured creditor bids $50 for the property, it will be able to realize the difference between $80 and $50 by selling the property to a third party. If its deficiency claim is reduced by the difference of $30, the lender is no worse off by bidding $50 than if it had bid the full $80 value. Assuming that the time and resources necessary to persuade a court to reduce a lender's deficiency claim deters most borrowers from asserting their rights, the lender might as well bid below-market prices whenever it can do so successfully because it faces no downside and the possibility of a significant upside.

Another weakness of this type of anti-deficiency statute is that judges are not particularly good at determining the FMV of a residential property. They are certainly not better than a properly conducted foreclosure auction—that is, one with proper notice, sufficient time to arrange financing, a large number of bidders, and so forth—that results in a precise market-based measure of the FMV. It is as if instead of using a precise tool to see if a picture frame is level, the legislature has asked a judge to step back and eyeball it. The judge may be able to get close to the FMV some of the time, but this type of anti-deficiency statute would be much more effective if a market-based tool, rather than a judicial estimate, could be developed to estimate the FMV.

b. Nonrecourse Anti-Deficiency Statutes

Some anti-deficiency statutes bar deficiency claims altogether; these are referred to as nonrecourse anti-deficiency statutes. Some of these statutes prohibit deficiency judgments for purchase money mortgage obligations.[89] Others prohibit deficiency judgments for nonjudicial foreclosures.[90] California has the most complex and pervasive anti-deficiency statute; it applies to almost all situations.[91] These types of statutes effectively convert certain mortgage loans with recourse to the borrower into nonrecourse mortgage loans as a matter of law. Such nonrecourse statutes eliminate the incentive for lenders to bid less than the FMV of the foreclosed property. If they did, a third party might bid a nominal amount more than them and win the bidding at a below-market price.

[89] See, e.g., Nelson & Whitman Treatise, supra note 5, § 8.3, at 947 & n.24 (listing such statutes in Arizona, California, North Carolina, Oregon, and South Dakota).

[90] See, e.g., id. at 946 & n.22 (listing such statutes in Arizona, Alaska, California, Montana, and Washington).

[91] See id. § 8.4, at 952.

The lender would then receive less than the FMV for the property and would lose the right to capture the difference between the FMV and the auction price because the third-party bidder would have possession of the property.

Although nonrecourse statutes are effective in eliminating a secured lender's incentive to make below-market bids in foreclosure auctions, they are inefficient and distort the market for mortgage loans because they do not respect the freedom of borrowers and lenders to choose what they believe to be the optimal terms of a lending agreement. Inefficiency and distortion arise from the fact that lenders will adjust to such restrictions by charging higher interest rates in jurisdictions that have nonrecourse statutes in order to compensate them for the risk of not being able to pursue deficiency claims against their borrowers after foreclosure.[92]

4. The Doctrines of Unconscionability and Gross Inadequacy

The doctrines of unconscionability and gross inadequacy were developed by courts during the Great Depression.[93] *Suring State Bank v. Giese* was the landmark case.[94] Among other things, that decision held that a foreclosure sale could be set aside if the auction price was "substantially inadequate."[95] Other courts adopted similar doctrines.[96] These

[92] Goldstein, supra note 9, at 294.

[93] See Nelson & Whitman Treatise, supra note 5, § 7.16, at 839.

[94] 246 N.W. 556, 557 (Wis. 1933). For information on how contemporary sources viewed the gross inadequacy and unconscionability doctrines and *Giese* at the time it was decided, see Sol Phillips Perlman, Mortgage Deficiency Judgments During an Economic Depression, 20 Va. L. Rev. 771, 807, 810 (1934); Recent Decision, 21 Calif. L. Rev. 522, 522–23 (1933); Recent Decision, 33 Colum. L. Rev. 744, 744–45 (1933); Norris E. Maloney, Recent Case, 8 Wis. L. Rev. 286, 286 (1933); Recent Case, 17 Minn. L. Rev. 821, 822 (1933); Note, Mortgage Relief During the Depression, 47 Harv. L. Rev. 299, 304–05 (1934); Note, Relief of Farm Mortgagors from Deficiency Judgments, 42 Yale L.J. 960, 961 (1933); C.J. Schloemer, Recent Decision, 17 Marq. L. Rev. 154, 154 (1933); George R. Sullivan, Recent Case, 27 Ill. L. Rev. 950, 951 (1933); Recent Case, 81 U. Pa. L. Rev. 883, 883 (1933); Annotation, Protection of Mortgagor or Owner of Mortgaged Property, on Foreclosure Sale, by Fixing Upset or Minimum Price, Requiring Credit of Specified Amount on Mortgage Debt, or Denying or Limiting Amount of Deficiency Judgment, 85 A.L.R. 1480, 1480–81, 1484–85 (1933).

[95] *Giese*, 246 N.W. at 557.

[96] For other examples of courts adopting similar rules to the "substantially inadequate" rule announced in *Giese*, see *Michigan Trust Co. v. Dutmers*, 252 N.W. 478, 478 (Mich. 1934), *Federal Title & Mortgage Guaranty Co. v. Lowenstein*, 166 A. 538, 540 (N.J. Ch. 1933), *Home Owners' Loan Corp. v. Wood*, 298 N.Y.S. 427, 432 (N.Y. App. Div. 1937), *Monaghan v. May*, 273 N.Y.S. 475, 480 (N.Y. App. Div. 1934), and *California Joint Stock Land*

early cases evolved into the modern rule that "a court will not refuse to confirm a sale or set it aside unless the price obtained was 'grossly inadequate' or the inadequacy was 'so gross as to shock the conscience or raise a presumption of fraud or unfairness.'"[97] The Restatement adopts the "grossly inadequate" standard.[98]

The purpose of these supplemental doctrines is to protect borrowers against auction prices that are so low that they cannot possibly be the FMV of the underlying property. These doctrines have been wholly ineffective, however, in achieving prices anywhere near the FMV. The reason that these doctrines are so ineffective is that courts have been extremely reluctant to override auction prices when there are no obvious defects in the auction process.[99] This is true even where an auction results in a price that is only a small fraction of the FMV. Thus, while some courts have found auction prices of less than twenty percent of the court-determined FMV to be unconscionable or grossly inadequate,[100] it has not been unusual for courts to uphold auction prices that were found to be only one-half or even one-third of the court-determined FMV.[101]

Reflecting these precedents, the Restatement explains that although gross inadequacy cannot be defined in terms of a percentage of the

Bank v. Gore, 55 P.2d 1118, 1120 (Or. 1936). See also D.R. Dimick, Recent Case, 15 Or. L. Rev. 385, 385 (1936) (presenting various jurisdictions' approaches to applying the "substantially inadequate" test to mortgage foreclosure sales); Recent Case, 51 Harv. L. Rev. 749, 749–50 (1938) (same); Charles Keating Rice, Note and Comment, 19 Cornell L.Q. 316, 317 (1934) (discussing courts' willingness to employ equitable powers to overturn foreclosure sales with grossly inadequate sale prices).

[97] Nelson & Whitman, supra note 6, § 7.16, at 837 (citation omitted).

[98] Restatement (Third) of Prop.: Mortgages § 8.3 (1997).

[99] See Goldstein, supra note 9, at 292; Washburn, supra note 9, at 860 (stating that courts may fear that voiding sales for only slight price inadequacies would discourage third-party bidders from participating in auctions).

[100] Restatement (Third) of Prop.: Mortgages § 8.3 reporters' note (1997); see also Nelson & Whitman Treatise, supra note 5, § 7.21, at 855 ("[I]t is extremely difficult to get a [foreclosure] sale set aside on mere price inadequacy."); sources cited supra note 26 (describing how the adequacy of the sale price of a mortgagor foreclosure auction is reviewed). Professor Washburn found that auction sale prices below ten percent of the FMV are typically struck down as grossly inadequate, whereas auction prices above forty percent of the FMV are typically upheld against a challenge for gross inadequacy. Washburn, supra note 9, at 866, *cited in* Restatement (Third) of Prop.: Mortgages § 8.3 reporters' note (1997). According to one student commentator, at least some Missouri courts have held that foreclosure auction prices as low as five percent of the FMV are not grossly inadequate. See Larry D. Dingus, Note, Mortgages—Redemption After Foreclosure Sale in Missouri, 25 Mo. L. Rev. 261, 262–64 & nn.4–5 (1960).

[101] See, e.g., Restatement (Third) of Prop.: Mortgages § 8.3 reporters' note (1997).

FMV, "a court is warranted in invalidating a sale where the price is less than 20 percent of fair market value and, absent other foreclosure defects, is usually not warranted in invalidating a sale that yields in excess of that amount."[102] This standard illustrates that these doctrines are blunt and ineffective tools. A doctrine that cannot police deviations from the FMV until an eighty, or similarly large, percent reduction has been reached is not likely to be very effective in encouraging auction prices to be as close to the FMV as possible.

These doctrines also suffer from three additional weaknesses. First, similar to the anti-deficiency statute process, judges are not particularly good at determining the FMV of a residential property or whether a particular auction price is unconscionably below the FMV or is otherwise "grossly inadequate." Second, it is costly for a borrower to obtain relief. The transaction costs of bringing an unconscionability challenge in court will deter many borrowers from ever bringing such challenges.[103] Finally, the terms "grossly inadequate" and "unconscionability" are so vague that no one, including secured lenders, borrowers, and even judges, can possibly have any idea what they mean or how they will be applied in practice. In other words, no one can reasonably expect that a winning auction price will be found grossly inadequate or unconscionable by a particular judge except in the most extreme case.

C. The Need for a New Market-Based Tool to Supplement Mortgage Auctions

Because of shortcomings in mortgage auctions and the current array of supplemental tools designed to encourage prices closer to the FMV, it is necessary to develop a new tool that is more effective and more efficient in supplementing the mortgage auction to produce sale prices closer to the FMV. In developing this new tool, it is useful to consider the features of a powerful tool that secured lenders use to protect themselves against undervaluation of collateral in a bankruptcy proceeding. That tool is the right to credit bid for undervalued collateral.[104]

[102] Restatement (Third) of Prop.: Mortgages § 8.3 cmt. b (1997).

[103] Goldstein, supra note 9, at 293.

[104] See, e.g., 11 U.S.C. §§ 363(k), 1129(b)(2)(A) (2012) (granting secured creditors the right to purchase collateral at a public sale by means of credit bidding or in a plan of reorganization guaranteeing the "indubitable equivalent"); RadLAX Gateway Hotel v. Amalgamated Bank, 132 S. Ct. 2065, 2072 (2012) (holding that secured creditors have the right to credit bid for their collateral at a public sale of the collateral as part of a plan of reorganiza-

III. CREDIT BIDDING IN BANKRUPTCY PROCEEDINGS

Undervaluation of collateral can be a serious problem in bankruptcy proceedings.[105] The assets of a bankruptcy estate are often sold in a manner similar to a foreclosure auction and are therefore subject to the same risk that they will be liquidated at prices below the FMV.[106] In the absence of credit bidding, the underlying collateral that secures a lender's claim may be undervalued and sold at a discount price, either purposefully or inadvertently. Debtors have strong incentives to sell collateral at discounted prices to insiders,[107] white knights,[108] and other third parties if they believe that such sales will lead to favorable treatment in the future by such buyers.[109] If the underlying collateral is valued and sold at a price less than its FMV, secured lenders will have an artificially large portion of their secured claim treated as an unsecured claim,[110] which may only be good for pennies on the dollar against the bankruptcy estate.

In order to protect secured creditors from undervaluation of their collateral, the Bankruptcy Code gives secured creditors the right to credit bid for undervalued collateral.[111] Credit bidding allows a secured creditor to purchase undervalued collateral by reducing its claim against the bankruptcy estate by the value attributed to the collateral. The secured creditor is free to resell the collateral at the FMV and keep the difference. It also has a deficiency claim against the bankruptcy estate for the difference between the total amount of its claim and the amount used to

tion in a bankruptcy proceeding and that the right cannot be denied on the ground that only the "indubitable equivalent" is required).

[105] See sources cited supra note 18.

[106] See *RadLAX*, 132 S. Ct. at 2065 n.2; Buccola & Keller, supra note 18, at 119–20; Bernstein et al., supra note 18, at 2.

[107] "Insider" is defined as officers, directors, major shareholders, and others with a special relationship with the debtor. See Black's Law Dictionary 866 (9th ed. 2009).

[108] "White knight" is defined as investors who are considered to be friendly rather than hostile to existing management. See Black's Law Dictionary 1734 (9th ed. 2009).

[109] See supra note 18 for additional sources describing debtors' incentives to sell property at discounted prices in the context of forced asset sales where credit bidding is used to offset those incentives.

[110] See 11 U.S.C. § 506(a)(1) (2012) (providing that if the value of the collateral underlying a secured claim is less than the amount of the secured claim, the portion of the claim equal to the value of the collateral is treated as a secured claim and the balance is treated as an unsecured claim).

[111] Id. §§ 363(k), 1129(b)(2)(A); *RadLAX*, 132 S. Ct. at 2072.

purchase the collateral.[112] Credit bidding can result in a permanent transfer of wealth from the bankruptcy estate to the secured creditor equal to the difference between the FMV of the collateral and the credit bid plus the value of the inflated deficiency claim against the bankruptcy estate. As a result, it provides a powerful incentive against the undervaluation of collateral in a bankruptcy proceeding.[113]

IV. A MARKET-BASED TOOL FOR REDUCING UNDERVALUATION OF COLLATERAL

The principles underlying credit bidding in bankruptcy proceedings can be used as a model for developing a new market-based tool that can effectively and efficiently deter the systematic undervaluation of collateral in residential mortgage foreclosure proceedings. Similar to credit bidding, the market-based tool described below—the DF sale option—attempts to impose a cost on mortgage lenders who bid or obtain third-party bids for less than the FMV of the property in a foreclosure auction in order to reduce the incentive to underbid. Although loosely based on the credit bidding model, DF sale options are more accurately described as a hybrid of the statutory right of redemption[114] and market-based FMV anti-deficiency statutes.[115]

A. The Ideal Revisited: An Efficient Mortgage Foreclosure Process

As noted in Part I, a perfectly efficient mortgage foreclosure process would give lenders and borrowers the benefit of their bargains—no more and no less. It would not favor borrowers over lenders or lenders over borrowers. If lenders receive windfalls in foreclosure, they may have an incentive to engage in lending that they expect, or in fact hope, will end in default and foreclosure. If borrowers receive windfalls, they may have an incentive to default on their debts even though they have the means to pay. If the law does more than ensure that both parties receive the benefit of their bargains, it will create perverse incentives that may encourage the parties to engage in behavior that results in inefficient outcomes.

[112] See Bernstein et al., supra note 18, at 2.
[113] See Brief for Bankruptcy Scholars as Amici Curiae Supporting Respondents, supra note 20, at 13–14.
[114] See discussion supra Subsection II.B.2.
[115] See discussion supra Subsection II.B.3.a.

In an efficient mortgage foreclosure process, borrowers would receive full credit for the FMV of their mortgaged property. Secured borrowers would receive the lesser of the FMV and the outstanding amount of the secured obligation. In the typical mortgage bargain in which the contract permits recourse against the borrower,[116] in the absence of any competing junior lien creditors, the borrower would receive any surplus of the FMV of the property over the outstanding obligation.[117] By contrast, if the FMV of the property were less than the outstanding obligation, the secured lender would be entitled to an unsecured deficiency claim for the difference against the borrower.[118] These outcomes would all be achieved at zero transaction costs.

Although the empirical record is inconclusive,[119] critics have long asserted that public auctions for residential real estate in foreclosure systematically result in prices well below the FMV.[120] They allege that lenders are typically able to bid for the collateral without any real competition from outside bidders.[121] The tools designed to prevent these outcomes—notice and disclosure requirements, statutory rights of redemption, anti-deficiency statutes, and judicial review of auction prices to guard against prices that are "grossly inadequate" or unconscionable—have been ineffective and inefficient.[122] Instead, lenders are frequently able to purchase the foreclosed collateral at discounted prices and flip the property for a profit, while at the same time generating a deficiency claim or an inflated deficiency claim against the borrower for a shortfall that does not really exist.[123] This creates an incentive for lenders to foster

[116] See Schill, supra note 22. This would not be true for a bargain in which the parties voluntarily agreed in advance that the loan would be made on a nonrecourse basis. Voluntary nonrecourse loans are rare in residential real estate financing, but anti-deficiency laws in some states override the intent of the parties and effectively make residential mortgage loans nonrecourse loans. See supra Subsection II.B.3.b for a discussion as to why such anti-deficiency statutes are not economically efficient.

[117] See Nelson & Whitman Treatise, supra note 5, § 7.31, at 920–21.

[118] Restatement (Third) of Prop.: Mortgages § 8.4(b) (1997).

[119] See supra note 37 and accompanying text.

[120] See, e.g., Restatement (Third) of Prop.: Mortgages § 8.3 cmt. a (1997); Nelson & Whitman Treatise, supra note 5, § 7.16, at 837–39; Durfee & Doddridge, supra note 5, at 831–32; Goldstein, supra note 9, at 286–87; Johnson, supra note 17, at 989 & n.105; Nelson & Whitman, supra note 6, at 1415, 1423; Washburn, supra note 9, at 843.

[121] See Durfee & Doddridge, supra note 5, at 833.

[122] See discussion supra Section II.B.

[123] Nelson & Whitman Treatise, supra note 5, § 8.3, at 942; Goldstein, supra 9, at 286–87; Washburn, supra note 9, at 849–50.

or at least tolerate an inefficient auction process in order to recover more than they are in fact owed under the lending agreements.

Under the typical mortgage contract, borrowers have a contractual right to receive credit for the full FMV of their property against the balance of the outstanding obligation and either walk away with whatever surplus remains or be liable for an unsecured deficiency claim equal to the amount of the outstanding mortgage less the FMV of their property.[124] Because current foreclosure laws often permit public sales at below-market prices,[125] borrowers frequently do not receive credit for the full FMV of their properties. As a result, they frequently walk away from foreclosure auctions with smaller surpluses or bigger deficiency obligations than a perfectly efficient mortgage foreclosure process would produce.

B. The Deficiency Forfeiture Sale Option

The DF sale option would give defaulting borrowers a transferable call option for a relatively brief period of time—say ninety days—after a mortgage foreclosure auction.[126] The DF sale option would be available whether or not the lender was the winning auction bidder. If a borrower was able to sell the underlying property for more than the exercise price to a third party in a bona fide sale during the option exercise period, the lender would lose the opportunity to resell the property at the FMV as well as its inflated deficiency claim against the borrower. Instead, the lender would receive only the option exercise price (which would be equal to the winning auction bid) and a reduced deficiency claim equal to the outstanding obligation less the higher purchase price paid by the third party in the DF sale. The same outcome would result if the borrower sold the option to a third party and the third party exercised the option before the end of the exercise period, except that the reduced deficiency claim would equal the outstanding obligation less the sum of the option exercise price and the premium paid by the third party for the option. Similar to the effect of credit bidding on the value of a bankruptcy estate,[127] the impact of a successful DF sale would be a permanent transfer

[124] See Schill, supra note 22, at 492–94.

[125] Restatement (Third) of Prop.: Mortgages § 8.3 reporters' note (1997); Nelson & Whitman Treatise, supra note 5, § 7.16, at 837–39.

[126] This would be much shorter than the typical period for exercising statutory redemption rights, which can be as long as two years. See supra note 68.

[127] See discussion supra Part III.

of value from the mortgage lender to the borrower equal to the amount of the undervaluation plus the reduction in the amount of the lender's deficiency claim against the borrower. Like the threat of credit bidding in a bankruptcy proceeding, the threat of a successful DF sale should be an effective and efficient deterrent of systematic undervaluation of collateral in residential mortgage foreclosures.

1. The Mechanics of Deficiency Forfeiture Sales

DF sale options should produce more efficient outcomes in mortgage foreclosure proceedings than existing tools by imposing costs on mortgage lenders that are designed to deter below-market auction prices. The costs imposed would perform the same function as the costs imposed by credit bidding in a bankruptcy proceeding if the debtor-in-possession or trustee-in-bankruptcy attempts to sell or otherwise values collateral at less than its FMV.[128]

Although DF sale options would perform a function similar to that of credit bidding, they are really a blend between the statutory right of redemption and FMV anti-deficiency statutes, without the weaknesses of those tools.[129] Like the statutory right of redemption, DF sale options would allow borrowers to redeem their property for the auction price. Borrowers could then convert any remaining portion of the secured creditor's claim into an unsecured deficiency claim, up to the difference between the FMV of the property and the auction price.[130] Like FMV anti-deficiency statutes, a DF sale option would also limit the lender's deficiency claim to the borrower's outstanding obligation on the mortgage loan less the higher DF sale price or, in the case of the sale of the option itself, less the sum of the exercise price and the premium paid for the option by the third party.[131] In effect, it would wipe out any portion of the deficiency claim equal to the difference between the auction price and the DF sale price (or the sum of the exercise price and the option premium).

The following sequence of events illustrates how a DF sale option would work:

[128] See discussion supra Part III.

[129] For a discussion of the statutory right of redemption and FMV anti-deficiency statutes, see supra Subsections II.B.2, II.B.3.a.

[130] See discussion supra Subsection II.B.2.

[131] See discussion supra Subsection II.B.3.a.

(1) A standard foreclosure auction would be held, and the winning bid would be recorded as the auction sale price.

(2) The borrower would automatically be deemed to have a transferable call option on the property at an option exercise price equal to the auction sale price and an exercise period of ninety days following the foreclosure auction.

(3) If the borrower is able to sell the underlying property to a third party for more than the exercise price in a bona fide sale during the option exercise period, the lender is paid the auction price and loses the opportunity to resell the property at the FMV. The lender's unsecured deficiency claim is thus limited to the outstanding obligation on the mortgage loan, less the DF sale price.[132]

An important feature of a DF sale option is that it would be available to the borrower whether or not the mortgage lender was the winning bidder at the foreclosure auction. This is an important feature because it should reduce the risk of fraud or collusion among lenders who might otherwise trade opportunities to buy one another's collateral outside of the protection of the DF sale tool. The DF sale option would be stripped of its teeth if lenders could avoid its application simply by arranging for a third party to submit the winning bid at a discounted value at the foreclosure auction. Otherwise, lenders might arrange for the third party to transfer the property to them at the discounted value or compensate them in some other way.

The DF sale option imposes a substantial cost on lenders who fail to bid or fail to make diligent efforts to find a third party who is willing to bid the FMV for the collateral sold at a public foreclosure action. The threat of this cost gives lenders a powerful incentive to bid or find a third party to make a bid at the FMV in order to protect the full value of their secured claim and maximize the amount of any unsecured deficiency claim.[133] The numerical examples in the next Subsection will help illustrate how a DF sale option can help ensure that both borrowers and

[132] The same result would occur if the borrower sold the option at a premium to a third party in a bona fide sale as long as the third party exercised the option during the option exercise period, except that the reduced deficiency claim would be limited to the outstanding obligation on the mortgage loan less the sum of the exercise price and the option premium.

[133] This incentive to bid or find bidders who will bid the FMV is similar to the incentive created by credit bidding in bankruptcy auctions. See Brief for Bankruptcy Scholars as Amici Curiae Supporting Respondents, supra note 20, at 13–14.

lenders receive the full benefit of their bargains through the new incentives that a DF sale option creates.

2. Numerical Examples

For purposes of these examples, assume the following: (1) the outstanding obligation on a particular mortgage loan is $100, and (2) the FMV of the property securing the mortgage loan is $70 at the time of a foreclosure proceeding.

Example 1. In a perfectly efficient market, the secured creditor would receive $70, the FMV of the collateral, leaving the secured creditor with an unsecured deficiency claim against the borrower for $30. Assuming the borrower had at least $30 in other assets, the secured creditor would recover $100, the full amount of the borrower's outstanding obligation under the mortgage loan.

In the real world, however, a public auction would be held and the property would be sold in a process that is less than perfectly efficient.[134] The next example assumes that the lender is the only bidder that participates in the auction. Without the threat of the DF sale option, the lender would have a strong incentive to bid as low as possible. This would allow it not only to obtain the benefit of its bargain by reselling the property at the FMV, but also to have a manufactured deficiency claim against the borrower if the FMV is higher than the outstanding obligation and an inflated deficiency claim against the borrower if the FMV is lower than the outstanding obligation.[135] If the borrower is solvent, this strategy would provide the lender with the opportunity for excessive or even double recovery of the difference between the outstanding obligation and the depressed auction price. The only constraints on how low the lender can bid are the possibilities that the sale could be overturned as unconscionable or grossly inadequate,[136] that the property could be redeemed by the borrower under statutory redemption rights,[137] or that the lender only benefits from an increased deficiency claim if the borrower is able to pay it. Example 2 illustrates what could happen under these circumstances if the borrower does not have a DF sale option.

[134] See Nelson & Whitman, supra note 6, at 1423.

[135] See Nelson & Whitman Treatise, supra note 5, § 8.3, at 942; Goldstein, supra note 9, at 286, 287 & n.4; Washburn, supra note 9, at 849–50.

[136] See discussion supra Subsection II.B.4.

[137] See discussion supra Subsection II.B.2.

Example 2. Suppose that the lender believes that the borrower has $40 in illiquid but valuable assets, that bidding only $60 for the underlying property will not result in a court setting it aside as grossly inadequate or unconscionable,[138] and that the borrower will not be willing or able to sell enough assets or borrow enough money to redeem the property under any applicable statutory redemption rights. The lender therefore bids $60, resells the property for $70, and successfully asserts a deficiency claim of $40 against the borrower. As a result, the lender recovers $110, which represents a windfall of $10 over the borrower's outstanding obligation on the mortgage loan of only $100. This windfall would be an inefficient transfer of value from the borrower to the lender compared to the outcome in a perfectly efficient market as illustrated by Example 1.

A DF sale option should reduce the likelihood of such an inefficient outcome by giving the borrower a transferable call option to the property with an exercise price equal to the auction price and an exercise period of ninety days. The winning auction price would provide valuable information to the market during the option exercise period that did not exist prior to the public auction by establishing a minimum resale value for the property. It would play the same role as the binding offer price of a stalking horse bidder in an auction conducted under Section 363 of the Bankruptcy Code.[139] It should increase the chance that the borrower is able to find a third party willing to pay a premium for the option during the option exercise period. Example 3 illustrates how a DF sale option could make the outcome more efficient.

Example 3. Assume that a borrower were able to sell the DF sale option to a third party for $10 in a bona fide sale and the third party exercises the option at the specified exercise price of $60 before the option exercise period expires. This would result in the lender receiving the auction price of $60, forfeiting the right to resell the property at the FMV, and having an unsecured deficiency claim against the borrower of only $30. In other words, the lender would receive a total of $90, which would amount to a permanent transfer of value from the lender to the borrower of $10. The potential for this outcome would create a powerful incentive for lenders to bid or find a third party to bid as close as possible to the FMV of the property, resulting in a more efficient outcome than Example 2.

[138] See supra notes 99–102 and accompanying text.
[139] See supra note 36.

The table below summarizes the results under each of the examples discussed above:

	Example 1: Perfectly Efficient Market	**Example 2: The Real World Without a DF Sale Option**	**Example 3: The Real World with a DF Sale Option**
Lender	$70 plus an unsecured deficiency claim of $30; total recovery of $100	Receive auction price of $60, resell property for $70, and inflate deficiency claim to $40 against the borrower; total recovery of $110	Receive auction price of $60 and reduced deficiency claim of $30 against the borrower; total recovery of $90
Borrower	Liable for an unsecured deficiency claim of $30	Liable for an unsecured deficiency claim of $40	Liable for an unsecured deficiency claim of $30

A criticism of the current foreclosure laws is that they produce inefficient outcomes by allowing mortgage lenders to recover more than the benefit of their bargains by systematically underbidding for the collateral in public foreclosure auctions.[140] This outcome is illustrated in Example 2, in which the lender's overall recovery was $110, resulting in a windfall of $10. At first glance, it would appear that DF sale options are vulnerable to similar criticism on efficiency grounds because they give borrowers the power to pay less than they are contractually obligated to pay under their mortgage loans. This outcome is illustrated in Example 3, in which the borrower's total payments to the lender were reduced to $90, producing a windfall to the borrower of $10.

The difference between the two scenarios, however, is that the lender has the power to neutralize the impact of the DF sale option in Example 3 and prevent the borrower's inefficient windfall. In contrast, in a world without the DF sale option, there is not much that the borrower can do to prevent the lender from reselling the property at its FMV while asserting a manufactured or inflated deficiency claim against the borrower. If the lender just bids or finds a third party to bid the FMV for the property,

[140] See sources cited supra note 38.

both the lender and the borrower will receive the full benefit of their respective bargains; neither will have the power to receive more or owe less than the contracted amounts at the expense of the other. This puts mortgage lenders in a position analogous to that of the bankruptcy estate in a bankruptcy proceeding where secured creditors have the right to credit bid for their collateral.[141] Just as debtors can avoid a transfer of value from the bankruptcy estate to the secured creditor by simply selling or otherwise valuing the collateral at the FMV, mortgage lenders can avoid a transfer of value to borrowers by simply bidding or finding a third party to bid for the collateral at the FMV.

3. The Impact of Deficiency Forfeiture Sale Options on the Behavior of Foreclosure Auction Actors

The existence of DF sale options will affect how both lenders and borrowers behave at foreclosure auctions. Like credit bidding in bankruptcy sales,[142] the ultimate goal of DF sale options is to alter the bidding incentives at foreclosure auctions so that lenders always bid or find a third party to bid the FMV and borrowers never exercise their DF sale options.

Faced with the possibility of losing significant portions of their secured claims if they bid or allow third parties to bid below the FMV, lenders have a strong incentive to bid or find third parties to bid as close to the FMV as possible at foreclosure auctions. The lower the winning bids are at foreclosure auctions, the easier and more attractive it will be for borrowers to exercise their DF sale options on the underlying properties and find third-party buyers. Ultimately, the behavioral effect of DF sale options on lenders will depend on each individual lender's perception of how easy it will be for the borrower to find a third-party buyer and the lender's individual level of risk aversion. The more a lender increases a below-market bid towards the FMV, the lower the potential deficiency claim will be. The more a lender moves its bid below the FMV, however, the greater the risk of a successful DF sale. If lenders are not particularly risk averse or do not believe that borrowers can find third-party buyers at higher prices, they will continue to bid highly discounted values at foreclosure auctions in the hope that they can capture large windfalls as described above. If, however, lenders are risk averse or be-

[141] See discussion supra Part III.
[142] See discussion supra Part III.

lieve that borrowers will be able to find third-party buyers, lenders should begin to increase their foreclosure auction bids. If a lender wanted to protect the full value of its secured claim and future unsecured deficiency claim, it could do so by bidding the FMV of the property. The lender could then rest assured that it would receive all that it was owed under the lending agreement. The DF sale option is unlikely to persuade all lenders to bid the full FMV in every auction because at some level the possibility of obtaining a windfall from a decreased bid will be more attractive than the certainty of losing a dollar on an increased bid. However, this tool should be successful in bringing auction prices much closer to the FMV because of the potential loss it imposes on lenders who bid highly discounted prices.

Borrowers are unlikely to change their behavior in any significantly negative way as a result of the availability of DF sale options. Critics may argue that borrowers will be more likely to default on their obligations given the availability of DF sale options and that this should be considered a material defect of the tool. First, borrowers may in fact default more often because the DF sale option does make default less costly to them. Default becomes less costly to them because they will face a lower risk of exploitation by lenders for costly inflated deficiency claims. However, ensuring that parties receive the benefit of their bargains and the natural results of the realization of that benefit should not be viewed as a defect arising from this tool. Second, there may be an initial surge in defaults because borrowers think they can capture the wealth transfer described above at the lenders' expense. Borrowers will soon learn, however, that lenders are able to protect themselves from this transfer of wealth by bidding the full FMV of the property. The incentive to default to capture a windfall at the lenders' expense should soon be chilled.

Critics may also argue that a DF sale option could create an incentive for borrowers to hide information about their property. Borrowers would do this to depress the auction value of their property in order to make a DF sale easier when they make more information about the property available to potential buyers. While this objection might appear to be a valid concern on its face, such a strategy is unlikely to result in a windfall for borrowers. First of all, mortgage lenders generally already have good information about the properties that secure their loans and can bargain for borrowers to be required to provide more detailed disclosure in their mortgage contracts. Second, borrowers are currently under very limited legal obligations to share information about their property with lenders or potential bidders.[143] As a result, the amount of information available to lenders and third-party bidders is unlikely to change in any significant way because of the introduction of DF sale options.

The availability of DF sale options will not only affect the behavior of lenders and borrowers, but will also affect the behavior of profit-seeking third parties. By reducing the lenders' deficiency claim by the difference between the DF sale price and the auction sale price, borrowers have the potential for gains that they can share with third-party intermediaries who can help them sell the underlying property for more than the auction sale price. Sophisticated borrowers who are able to find third-party buyers on their own will be free to do so, but unsophisticated borrowers with little hope of finding third-party buyers on their own during the ninety-day option exercise period may be able to turn to sophisticated intermediaries with the knowledge and experience necessary to sell a home quickly. By agreeing to pay a percentage of the potential gains from a successful DF sale to an intermediary, borrowers can provide incentives for expert intermediaries to help sell the underlying property to third-party purchasers in bona fide sales. Indeed, it would be in borrowers' interests to foster the creation of a robust and competitive market for intermediaries.

4. Expected Benefits of Deficiency Forfeiture Sale Options Compared to Existing Tools

By combining the best elements of statutory redemption and FMV anti-deficiency laws, and by avoiding their significant weaknesses, the DF sale option is a hybrid tool that efficiently and effectively takes advantage of market incentives to increase the likelihood that residential properties in foreclosure will be sold at their full FMV.

a. Advantages over Statutory Redemption and FMV Anti-Deficiency Statutes

The main criticism of FMV anti-deficiency statutes is that they do not themselves provide any meaningful incentives to lenders to bid the FMV at foreclosure auctions.[144] As noted in Subsection II.B.3, reducing a lender's deficiency claim to the difference between the FMV and a low-

[143] E.g., Nelson & Whitman, supra note 6, at 1421 & n.102.
[144] See, e.g., Goldstein, supra note 9, at 294–95; Johnson, supra note 17, at 983–84.

er auction bid provides no incentive to bid the higher value. If the lender's deficiency claim is reduced by the difference between these two prices, the lender is no worse off by bidding the lower price than if it had bid the higher price. Assuming that the time and resources necessary to persuade a court to reduce a lender's deficiency claim deters most borrowers from asserting their rights, lenders might as well bid below-market prices whenever they can do so successfully because they face no downside and the possibility of a significant upside.

A similar criticism has been leveled against statutory redemption rights: They do not by themselves provide a sufficient incentive to lenders to bid the FMV at foreclosure auctions.[145] Although the statutory right of redemption strips the lender of the property, it does not limit the inflated deficiency claim that results from bidding below-market prices. If the redeemed property is available to satisfy the lender's unsecured deficiency claim or the lender otherwise believes the borrower has enough assets to cover the shortfall, the lender is no worse by bidding the lower amount rather than the FMV. This limitation on statutory redemption rights essentially renders them toothless.

DF sale options combine statutory redemption and FMV anti-deficiency statutes into a single, hybrid tool to avoid these weaknesses. DF sale options both prevent the lenders from keeping the property and limit their subsequent deficiency claim; therefore, they should be successful in creating the proper incentives to push lenders towards bidding the full FMV of the underlying property at foreclosure auctions. By giving borrowers the option to resell the properties at the winning auction bid *and* limiting any deficiency claims to the difference between any remaining obligation on the mortgage loan and the DF sale price (or, in the case of a transfer of the DF sale option to a third party, the sum of the exercise price and the premium paid for the option), DF sale options create a powerful incentive for lenders to bid the full FMV at foreclosure auctions.

In addition to correcting auction bidding incentives for lenders, DF sale options also correct auction bidding incentives for third parties. Like the statutory right of redemption, DF sale options would not prevent borrowers from continuing to occupy their property during the option exercise period. Critics of statutory redemption claim that this leads to discounted bids from third parties because there are serious fears that

[145] See, e.g., Goldstein, supra note 9, at 295; Schill, supra note 22, at 534.

borrowers will intentionally harm or neglect the property during the option exercise period.[146] DF sales, however, are unlikely to suffer from the same type of neglect risks. The only way that DF sales are valuable to borrowers is if they maintain the property in good condition such that a third party would be willing to pay a price higher than the auction price for it. If the borrower does not take reasonable steps to keep the property in good condition, lenders will be able to engage in discount bidding and capture the windfalls described above. Because borrowers have a strong incentive to maintain the property, third parties should not feel as compelled to bid at discounted rates to cover the potential cost of intentional destruction or neglect.

By limiting the exercise window of the DF sale option to a relatively short period of time, the concern of fluctuating property values during the option exercise period also decreases. Lenders can take greater confidence in their valuations of the property because instead of having to guess what the property will be worth in six months to two years—a nearly impossible task—they only have to predict market behavior for a narrow period of time.[147] This Note has suggested an exercise window of ninety days, but ultimately each state legislature will have to choose the length of the exercise window.

When determining the appropriate length of the exercise window, state legislatures should consider: (1) the time necessary for the borrower to be able to find a new buyer; (2) whether a robust and competitive market for intermediaries exists or can be fostered to improve the efficiency of the DF sales process; (3) how much uncertainty the length of the window creates for auction bidders; and (4) how important it is to ensure that the borrower is able to credit the full FMV of the property against its outstanding obligation. If the exercise window is set too short and there is no robust market for expert intermediaries who can make the sales process more efficient, DF sale options will be less effective. If lenders know that borrowers are unlikely to have enough time to make effective use of their DF sale options, then this tool will have no impact on their auction bidding incentives and will not solve the systematic undervaluation problem. On the other hand, if the window is set too long, bidders will be in the same position as they are under the statutory right

[146] See, e.g., Goldstein, supra note 9, at 295; Johnson, supra note 17, at 984.

[147] For sources illustrating the negative effects of large redemption/exercise windows, see Nelson & Whitman Treatise, supra note 5, § 8.4, at 980–81; Goldstein, supra note 9, at 295; Nelson & Whitman, supra note 6, at 1404, 1439.

of redemption and DF sale options will lose a lot of their power to incentivize auction bids closer to the FMV.

Finally, if state legislatures are only concerned with preventing the most egregiously deficient sales, they can set very short option exercise windows. Borrowers will be able to find third parties for sales that are egregiously low much more easily, and it is the most egregious sales that provide borrowers with the greatest incentives to find third-party buyers because they have the most to gain in terms of reducing the risk of double losses. If state legislatures are concerned with protecting borrowers from even the most slightly deficient sale, they can set a longer option exercise window to give borrowers a greater chance of reselling the property at the FMV.

Another advantage of DF sale options over FMV anti-deficiency statutes is that DF sale options use the market, instead of judicial decisions, to measure the appropriate size of the reduced deficiency claim. The best a judge can do is listen to the evidence presented by each party about the valuation of a piece of property and then make an educated guess as to the property's FMV. The market, on the other hand, is able to measure the FMV in a much more efficient manner—through voluntary arm's length transactions.[148]

The final notable improvement of the hybrid DF sales tool over the FMV anti-deficiency statute is that its application does not require an expensive judicial proceeding. The application of the tool can be done completely between the lender and the borrower; there is no need to involve a judge. This will save time, reduce legal fees, and promote judicial economy. No longer will borrowers be prevented from exercising the tool intended to protect them from deficient sales because they cannot afford the judicial proceeding required to invoke that protection.

b. Advantages over Nonrecourse Anti-Deficiency Statutes

Nonrecourse anti-deficiency statutes reduce or eliminate the incentive of lenders to undervalue collateral in mortgage foreclosure auctions. But they do so at the cost of distorting the credit market by overriding the voluntary choices of borrowers and lenders. Lenders will respond by reducing the supply of credit or increasing the rates they charge for mortgage loans.

[148] "Arm's length transaction" is defined as a "transaction between two unrelated and unaffiliated parties." Black's Law Dictionary 1635 (9th ed. 2009).

DF sale options do not suffer from this defect. They reduce or eliminate the incentive of lenders to undervalue collateral without overriding the voluntary contractual choices of the parties. To the extent they result in a reduced supply of credit or higher interest rates by eliminating the potential for windfall gains by lenders, they correct rather than create a market distortion. Any windfalls were never rightfully the lenders' to begin with, and therefore lenders should not be making their lending decisions based on an ability to systematically undervalue collateral and capture more than the benefit of their bargains. The DF sale option will actually correct a market distortion that leads to lenders extending too much credit at inefficiently low interest rates, thereby benefitting credit markets instead of harming them in the way that nonrecourse anti-deficiency statutes do.

c. Advantages over the Doctrines of Unconscionability and Gross Inadequacy

When a judge is asked to decide whether an auction price is unconscionably low or grossly inadequate, an unacceptable amount of subjectivity and unpredictability is injected into the foreclosure process. The best a judge can do is listen to a borrower's or lender's expert witnesses testify on the FMV of the underlying property and make a judgment as to which one is more credible. This is largely guesswork. There is no reason to rely on the imprecise guesswork of a judge when we have a much better tool for measuring the FMV of underlying properties: the market itself.[149]

DF sale options would rely on the market to tell us a property's FMV. The FMV is defined by what a knowledgeable, willing, and unpressured buyer would pay to a knowledgeable, willing, and unpressured seller in the market. The market is more accurate in measuring the FMV than a judge sitting in court.

DF sale options would be superior to unconscionability and gross inadequacy price analysis because they would be more predictable and certain. Unlike unconscionability and gross inadequacy analysis, which seems to vary with every case, DF sales would have a very formulaic application that leads to more predictable outcomes. This is not to suggest that the DF sale option would be more predictable in the sense that

[149] See Brief for Bankruptcy Scholars as Amici Curiae Supporting Respondents, supra note 20, at 18.

it would allow parties to predict the final sale price of the underlying property in advance of a sale on the open market. The outcomes would be more predictable, however, in the sense that once the tool has been applied there is no cognizable claim that could be brought to challenge the sale price; the market has told us the value of the property, and the parties' individual entitlements have been determined. The tool will be the same every time: either (a) the DF sale option is exercised and the lender obtains the property for the auction price and has a deficiency claim equal to the outstanding obligation less the auction price; or (b) the option is exercised and the lender receives the auction price and a reduced deficiency claim equal to the outstanding obligation less the DF sale price (or, in the case of the transfer of the option itself, the sum of the exercise price and the premium paid for the option). By removing uncertainty, parties can invest time and money without fear of an unpredictable and unfavorable outcome in court.

Another advantage of DF sale options over unconscionability and gross inadequacy sale price analysis is that DF sale options do not require large deviations from the FMV to be activated. In contrast, some courts have required an auction price to be eighty percent or more below the FMV for unconscionability or gross inadequacy review to override the auction price.[150]

d. Finality of the Foreclosure Process

DF sale options are also superior to existing rules designed to improve the foreclosure auction process because they offer finality to the foreclosure process in a way that the other rules do not. The first way in which DF sales provide finality is by creating a bright line rule that is easy for lenders and borrowers to apply. There is no complicated set of facts or valuations to prove to a judge. DF sale options tell us exactly what the FMV of the underlying property is: It is either the lender's winning auction bid or it is the higher price received by the borrower in a subsequent DF sale. When a party comes to court challenging the sale price, it will no longer be necessary to hold a fact-intensive inquiry into what the proper value of the underlying property should have been. A judge can easily look to the auction price and any available DF sale price and decide the dispute over the price in the pleadings or summary judgment stage. DF sale options make clear that after the option exercise

[150] See supra notes 100–01.

window has expired, the foreclosure process is over and the rights and entitlements of lenders and borrowers will have been determined.

DF sale options also promote finality because, if they are functioning properly to correct the auction incentives of each party, they will never be used. All of the existing rules that supplement mortgage foreclosure auctions either suffer from an ambiguous and imprecise calculation of the FMV or fail to disincentivize, and in some cases actually incentivize, lenders to bid at values they know to be below the FMV. As such, they often require a subsequent round of litigation after the foreclosure auction to ensure that the auction was conducted properly and that it resulted in a sufficient sale price[151] for the underlying property. Like credit bidding in bankruptcy, DF sale options create incentives for lenders to bid the FMV of the underlying property at auctions; therefore, it is unlikely that borrowers would be able to sell the property for a higher price after the auction. DF sale options should make auctions the final stage of the foreclosure process because the FMV of the underlying property will have been established and credited against the outstanding mortgage.

DF sale options provide a sufficient, efficient, and productive foreclosure sale review tool for foreclosure auction sale prices. All of the existing state law provisions described above are insufficient to deal with the problem, deal with the problem in an inefficient manner, or are actually counterproductive in solving the issue of incentivizing lenders to bid the FMV of the underlying property at the foreclosure auction. DF sale options target the two main problems with current foreclosure auction practice—accurately determining the FMV of the underlying property and incentivizing lenders to bid that value at the auction—by using market transactions to measure the FMV and imposing costs on lenders who do not bid that amount at auction. DF sale options are efficient because they rely on market transactions of actual self-interested market actors as opposed to judges, who have nothing to gain or lose from proper valuation of the property.

[151] Note that a sufficient sale price is not necessarily the FMV of the underlying property and, given the position taken by the Third Restatement of Property, is likely to be up to eighty percent below the FMV. See Restatement (Third) of Prop.: Mortgages § 8.3 cmt. b (1997).

B. Addressing Potential Weaknesses of Deficiency Forfeiture Sale Options

DF sales, although a sufficient, efficient, and productive way of solving the valuation problem in foreclosure auctions, may be subject to certain potential weaknesses. Future critics may attack DF sale options for: (1) creating an unacceptably high risk of fraud; (2) being too protective of borrowers; (3) expecting too much out of lenders' valuation ability; and (4) lengthening an already long foreclosure process. This Section will analyze these potential weaknesses and suggest some possible solutions.

1. Increases the Risk of Fraud

The risk of fraud in DF sales is best illustrated through a numerical example. Assume that the value of the outstanding mortgage is $100 and the FMV of the underlying property is $70. In the face of a potential DF sale after the auction sale, the lender decides to bid $70, the full FMV, and therefore appears to be entitled to take possession of the underlying property and have an unsecured deficiency claim of $30. Despite the lender bidding the full FMV of the property, the borrower can potentially use a DF sale option to engage in fraud by setting up a sham transaction with a third party to capture more than the benefit of its bargain.

The sham transaction would involve a third party agreeing to purchase the property for the outstanding balance of the mortgage, in this case $100. The borrower would use $70 of the $100 received from the third party to pay the option exercise price to the lender. The borrower would return the remaining $30 to the third party as a kickback for agreeing to purchase the property at $100. The net effect of this transaction would be that the lender would receive $70 for the property, but have its deficiency claim completely wiped out since the DF sale price equaled the outstanding balance on the loan. The third party would receive an asset worth $70 for a net payment of $70. The borrower would receive a windfall of $30.

This type of fraud is a risk with DF sale options. Just as self-interested lenders systematically bid low at auctions to try to take advantage of the existing system, self-interested borrowers may engage in the type of sham transaction described above unless there is an offsetting penalty to discourage them and third-party buyers from doing so. The addition of two simple requirements, however, along with the jurisdiction's commercial anti-fraud statute, would likely provide a sufficient penalty to greatly reduce this risk of fraud.

First, the terms of the DF sale option should include a notification to borrowers that if they are found to have used their DF sale option to engage in a sham transaction to defraud the lender, borrowers will be prevented from exercising their DF sale option. This will mean that borrowers caught in fraud will only have the auction price credited against their outstanding mortgage and will be liable for a deficiency claim in the amount of the outstanding mortgage less the auction price. This will not provide a huge disincentive to borrowers from engaging in sham transactions when the lender bids the FMV because the borrower is now in a "heads I win, tails you lose" type of situation. If the borrower succeeds in the sham transaction, it obtains a windfall beyond its bargain because of the artificial reduction in the remaining deficiency claim. If the borrower engages in a sham transaction and is caught, it is stripped of the DF sale option, but still receives the full benefit of the bargain by receiving credit for the full FMV against any outstanding obligation. The threat of a DF sale option loss, however, will discourage sham transactions when the lender bids below the FMV because fraud that is detected will result in a transfer of wealth from the borrower to the lender in the amount of the difference between the FMV and the DF sale price. Depending on how highly discounted the below-market auction price was, this could be a powerful incentive to avoid engaging in sham transactions.

Second, DF sale options should include a provision that makes them conditional on borrowers and third-party buyers submitting to lenders notarized documents and bank records verifying the terms of the DF sale and the fact that money has in fact changed hands. Those documents should include representations and warranties by the borrowers and third-party buyers to the effect that a particular DF sale is a bona fide sale at a price specified in the document, with no kickback from the debtor to the buyer. Third-party buyers are unlikely to agree to engage in sham transactions with borrowers if they are required to provide such notarized documents and records, because if the fraud is detected it will be much easier to prove guilt, increasing the risk of fines and other serious penalties under the jurisdiction's commercial anti-fraud statute.

One final safeguard against this risk of fraud is that lenders tend to be sophisticated commercial entities capable of detecting fraudulent transactions. Legislatures must choose between subjecting borrowers to the risk that lenders bid below the FMV and extract windfalls through enlarged deficiency claims, and subjecting lenders to the risk that borrowers engage in sham transactions after the fact and reduce lenders' total recovery. Given that lenders will have the protection of commercial antifraud statutes and that they are likely to be more adept at detecting and challenging fraud, it seems reasonable to place the greater risk of harm on lenders than on less sophisticated borrowers who are less likely to be able to defend themselves from the potential harm of below-market auction prices.

2. Creates Windfall for Borrowers

A second attack on DF sale options is that they are too pro-borrower and therefore in the long run will result in unfair harm to lenders and a subsequent contraction of credit markets. The harm to lenders and benefit to borrowers is reflected by the windfalls borrowers can obtain by exercising their DF sale options. What this criticism fails to appreciate, however, is that borrowers cannot receive any of these windfalls unless lenders first choose to bid below the FMV at foreclosure auctions. The DF sale option is only pro-borrower and anti-lender to the extent that it ensures that borrowers receive credit for the full FMV of their property against their outstanding mortgage and that lenders do not receive a windfall from the market failures present in most, if not all, foreclosure auctions.

The DF sale option should not result in a contraction of the credit markets that public policy should be concerned with.[152] Rather than distort the market, DF sale options will help the market more nearly approximate the outcomes of the perfectly efficient market described in Part I. Over-lending is just as inefficient as under-lending.[153] If DF sale options have the effect of reducing the supply or increasing the price of credit compared to the amount or cost of credit when lenders have the

[152] For examples of issues in mortgage markets with which policymakers are concerned, see Editorial, Another Slap on the Wrist, N.Y. Times, Jan. 9, 2013, at A20; About Predatory Lending, Wash. State Dep't of Fin. Insts., http://www.dfi.wa.gov/consumers/predlendwp.htm (last visited Apr. 16, 2013); Predatory Lending, U.S. Dep't of Hous. & Urban Dev., http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/pred/predlend (last visited Apr. 16, 2013).

[153] See generally James R. Kearl, Economics and Public Policy: An Analytical Approach 53–54 (4th ed. 2007) (discussing the analysis involved in making an optimal choice and how over- and under-consumption of a certain activity can have similarly negative effects on overall social welfare).

potential for windfalls, then that is a benefit, not a defect, of the DF sale option. In other words, the DF sale option should only reduce the type of inefficient over-lending that has been condemned in public forums since the 2008 housing bubble burst.

3. Expects Too Much of Lenders' Ability to Value Property

Another critique of the DF sale option is that it expects too much of lenders' ability to accurately estimate the value of the underlying property in uncertain market conditions. This critique would argue that it is all well and good to say that lenders can protect the full benefit of their bargains by simply bidding the full FMV, but how are they to know the true FMV of a piece of property in a particularly turbulent market? While on its face this critique appears to have some merit, it fails to acknowledge several realities of foreclosure sales and the exercise of the DF sale option.

This critique, like the risk of fraud critique, involves the allocation of a risk that cannot be removed from the foreclosure sale process. Either lenders bear the risk that they will undervalue the property and forfeit a portion of both their collateral and the size of their deficiency claim, or borrowers bear the risk that lenders bid below the FMV of the property, lose a portion of the value of the collateral they have pledged, and are liable for an inflated deficiency claim. In a choice between two innocent actors, it seems more reasonable to place the risk on the actor who is in the best position to avoid the harm at the lowest cost. In this context, that is almost certainly the lender.

4. Creates an Additional Step to an Already Long Process

Finally, critics of this tool may complain that DF sale options make an already long process even longer. This attack is without merit. The average foreclosure process in New York, for example, lasts 1072 days, or almost three years—already a long period of time.[154] While it is true that a borrower choosing to exercise a DF sale option will extend the foreclosure process, as long as the legislature picks a reasonably narrow exercise window for the DF sale option, it is likely to be a shorter process than the average length of litigation challenging the sufficiency of the auction sale price. Litigation requires filing briefs, filing responses,

[154] Editorial, The States of Foreclosure, Wall St. J., Jan. 9, 2013, at A12.

scheduling court dates, performing discovery, finding expert witnesses, arguing before the court, filing appeals, and the list could go on. Given the unpredictable nature of litigation the exact length of a challenge to the sufficiency of the auction price is hard to forecast, but it is likely to take a long time. The DF sale option brings guaranteed finality to the foreclosure process after the narrow exercise windows established by state legislatures expire. The same cannot be said of the other foreclosure provisions. The DF sale option should, therefore, result in shorter foreclosures on average than the current alternatives.

CONCLUSION

Policymakers have been wrestling for nearly a century with the systematic undervaluation of collateral in residential mortgage foreclosure proceedings. Despite the potential for public auctions to generate prices equal to the FMV, critics have asserted at least since 1925 that public auctions have systematically produced prices that are far below the FMV. Existing supplemental rules designed to protect against systematic undervaluation in public auctions—notice and disclosure rules, statutory redemption, anti-deficiency statutes, and gross inadequacy or unconscionability doctrines—have failed to reduce or eliminate such undervaluation in an effective or efficient manner.

This Note has proposed a new market-based tool—the DF sale option—that should be more effective and efficient in reducing or eliminating systematic undervaluation of residential real estate collateral in foreclosure proceedings. It is modeled on the right of secured parties to credit bid for collateral in bankruptcy proceedings, which has been an effective tool in protecting secured creditors against systematic undervaluation of collateral in that setting. Like credit bidding, DF sale options rely on the threat of a permanent transfer of wealth from one party to another—in the case of DF sale options, from lenders to borrowers. This threat should be enough to provide a powerful incentive for lenders to bid or use reasonable efforts to find third parties to bid the FMV to avoid that transfer of wealth. If so, then providing borrowers with DF sale options should help foster outcomes in actual mortgage foreclosure auctions that more closely approach the outcomes that would be expected in a perfectly efficient market.

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