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Fair Value

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The history of foreclosure law is too often a story of well-meant attempts to protect debtors that generally turned out to do more harm than good. The common law provided for “strict foreclosure,” *i.e.*, if a mortgagor failed to redeem, the property was turned over to the mortgagee directly, without a sale, to satisfy the debt. During the last century, legislatures became convinced that strict foreclosure was wrongly eliminating mortgagors’ equities in their properties. As a result, state legislatures replaced it with foreclosure by sale: the idea was that the property would sell at foreclosure for its full value and the mortgagor would get the surplus, which would save the mortgagor’s equity in the property.

It didn’t turn out that way, however. Foreclosure sales generally produced less than the full value of the properties sold. Mortgagors were more commonly becoming subject to deficiency judgments rather than the recipients of surpluses. (Under strict foreclosure, an attempt to get a money judgment if the property was not equal to the debt was basically impossible; deficiency judgments arose only with sale foreclosures.)

Postsale Redemption

The California legislative response to “underbidding” was to attempt to coerce bidders into bidding more by adopting the statutory device of postsale redemption: give the mortgagor a year to buy the property back from the foreclosure purchaser by tendering what the purchaser paid at the foreclosure sale. CCP §§726(e), 729.010–729.090. That way—so the thinking went—potential bidders would be deterred from bidding too low because the lower the bid, the greater the likelihood that the debtor would redeem, thereby destroying the bidder’s bargain. Thus, Justice Traynor opined that the primary purpose of the postsale redemption right is to force the purchaser “to bid the property in at a price approximating its fair value.” *Salsbery v Ritter* (1957) 48 C2d 1, 11, 306 P2d 897.

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Like its predecessor idea of requiring a foreclosure sale instead of permitting strict foreclosure, however, this new right of redemption (commonly referred to as “statutory redemption”) rarely does what it is supposed to do. Rather, bidders find in statutory redemption a disincentive to bid more, because it robs them for the next year of both possession of the property and certainty of ownership. Our courts now recognize statutory redemption as an influence that, rather than increasing prices, reduces them.

Fair Market Value

This observation leads us to a discussion of the next legislative response to unfair “forfeitures”—fair market value. In many states, a deficiency judgment is not measured by the amount bid at the judicial foreclosure sale, but rather by the fair market value of the property. The new Restatement (Third) of Property (Mortgages) §8.4(d) (1997), thus provides:

If it is determined that the fair market value is greater than the foreclosure sale price, the persons against whom recovery of the deficiency is sought are entitled to an offset against the deficiency in the amount by which the fair market value . . . exceeds the sale price.

Accordingly, underbidding at the sale will not cause a double loss to the mortgagor.

California goes even further. Code of Civil Procedure §726 adopts as the limiting standard for deficiencies the phrase “fair value,” rather than fair market value. Fair value was plainly intended to mean something different from fair market value because the statute was amended in 1937 to replace “fair market value” with “fair value.”

San Paolo

The reason for all this background is to lead up to the recent case of *San Paolo U.S. Holding Co. v 816 S. Figueroa Co.* (1998) 62 CA4th 1010, 73 CR2d 272, reported at p 107. That decision adopts a workable definition of fair value while realistically recognizing that postsale redemption has an “adverse impact” on bidding. *San Paolo* holds that fair value is the same as fair market value—*i.e.*, what a willing buyer would pay a willing seller in an open market—except that fair value would not reflect the fact that the sale is a foreclosure sale subject to statutory redemption, with consequently lower bids. Thus, if the property would command $1 million on the open market, but foreclosure bidders are willing to bid only $900,000 (because of postsale redemption), the fair value of the property is $1 million, not $900,000.

Lenders can certainly complain about the math; it probably assures mortgagees that they will suffer noncompensable losses in their deficiency judgments. If a court is to assume that redemption reduces prices, then *any* price bid at a redeemable foreclosure sale by definition must be below fair market value. In other words, the fair value must be higher than what was bid at the sale (and the deficiency judgment accordingly smaller).

The mortgagee’s loss, however, may not be permanent. If the mortgagee is the winning bidder at the foreclosure sale, it can probably eliminate the loss by reselling (in a truly open market transaction) a year later. Recapture of the spread between fair value and fair market value should further induce mortgagees not to let third parties outbid them in this underbidding context.

San Paolo’s definition of fair value is also easy to work with: it is what a listing broker would say the property could be sold for, and appraisal testimony will be easy to produce. (“Fair market value on foreclosure,” on the other hand, would have been a much harder number to derive.)

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What Could Have Been

Most importantly, *San Paolo* rejected a rival concept of fair value that could have meant disaster. The court could have defined fair value—as the North Dakota Supreme Court did in *Schiele v First Nat’l Bank* (ND 1989) 436 NW2d 248, 249—as the number that produces “a fair and equitable result between the parties.” In California, *Rainer Mortgage v Silverwood, Ltd.* (1985) 163 CA3d 359, 209 CR 294, intimated such treatment by more or less equating fair value with intrinsic value. The consequences of that kind of interpretation were made obvious by the appraiser for the mortgagor in *San Paolo*, who, following *Rainer*’s line of reasoning, concluded that the security had a fair value of $5.1 million, even though the lender had acquired it for only $1.5 million at the foreclosure sale and had then resold it for $1 million to a third party. In the appraiser’s opinion, the current (1995) market value was irrelevant because the market was depressed, and the “intrinsic” or “inherent” value of the property was what it was worth during the years 1985–1989, when the market was not depressed, *i.e.*, was “normal.” How would you like to be up against appraisal testimony like that?

I recommend that lenders not be too upset that our existing fair-value test ignores the fact that postsale redemption hurts prices and charges lenders for it. Compared with what might have been, it is a small price to pay for the certainty of being able to use real values rather than impressions of what properties would be worth if only things were different from what they are.