CRITIQUING THE FORECLOSURE PROCESS: AN ECONOMIC APPROACH BASED ON THE PARADIGMATIC NORMS OF BANKRUPTCY

Alex M. Johnson, Jr.*

INTRODUCTION

THE greatest financial hardship faced by the typical mortgagor is the forced sale of her home. In most states, a mortgagor who cannot pay the debt secured by the mortgage must enter into the never-never land of an arcane real estate procedure known as "power of sale" foreclosure, which she "consented" to pursuant to the terms of the mortgage contract.¹ In the vast majority of cases, the sale price realized at such a foreclosure sale will be so inadequate that not only will the mortgagor lose her home but she will also lose any equity she owns in the property.² If the amount realized at the foreclosure sale does not cover the mortgagor's debt, the mortgagee may further com-

* Professor of Law, Harrison Foundation Research Professor, University of Virginia School of Law. I wish to thank Anil Adyanthaya and Vietta Parsons for their excellent research assistance.

¹ Unless otherwise stated, whenever the term "foreclosure" is used in this Article, it should be understood as referring to power of sale foreclosure and not strict or judicial foreclosure. Strict and judicial foreclosure are discussed infra notes 12-13 and accompanying text.

² In this Article, the term "equity" refers to the value of the mortgagor's property minus the outstanding value of any debt secured by a mortgage on the property. The mortgagor's equity in her property should not be confused with the mortgagor's equity of redemption, which is the mortgagor's right prior to a foreclosure sale to pay off the mortgage and retain her interest in the property.
pound the mortgagor’s financial distress by obtaining a deficiency judgment for the difference between the amount of the debt owed and the amount realized via the foreclosure sale. Finally, in many states, this emotionally charged situation may be exacerbated if the mortgagor is able to purchase the property at the foreclosure sale by making a ridiculously low bid that has no correlation to the fair market value of the property.

As one might expect, a hue and cry is often raised regarding the manner in which mortgagors lose their homes and the fact that their equity is not protected. If the deterioration of the mortgagor’s financial condition reflects larger economic or societal problems, the mortgagor presumably will not be alone in losing her home and her equity. Indeed, if recent events in the Southwest (particularly Texas) are any indication, many mortgagors will lose their jobs and be unable to make their mortgage payments through no fault of their own. Inevitably, in such times, published reports will circulate that a foreclosed home that sold for X thousand dollars at the foreclosure sale was resold by the foreclosing lender for X-plus thousand dollars shortly thereafter. The fact that none of the excess generated at the second sale of the property will benefit the mortgagor further hastens the cry for reform.

Politicians will seldom turn a deaf ear to such events, and they usually join the fray, castigating banks and financial institutions for profiting on the misery of poor, desperate homeowners. And who can blame them? Foreclosed mortgagors present a very sympathetic picture. And they vote. Those of us who own homes and are not in financial difficulty sympathize with those pathetic mortgagors facing the loss of their homes under the rubric of “there but for the grace of God go I.” And we vote. Banks, although they do undertake significant lobbying activities, do not vote. Hence, calls for reform of the foreclosure process are not that odd or unusual.

In fact, taking a historical approach, one can chart the economic health of this country by the dates of legislation passed by states and the federal government to protect mortgagors and their equity. Statutory redemption and antideficiency legislation, for example, are prod-

---

3 See infra notes 22-27 and accompanying text for a discussion of deficiency judgments.
ucts of the Great Depression of the 1930s. Given recent economic problems, it should therefore come as no surprise that attempts are currently being made to alter radically the manner in which property is foreclosed, with an eye toward further protecting the mortgagor’s equity of redemption. Many prominent commentators have joined in supporting such reforms. 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. This Article analyzes the economics of foreclosure and argues against a reformation of the process that does not attempt to maximize the interests of all of the parties involved. In doing so, it evaluates current attempts at reform of the foreclosure process and demonstrates that, at best, such attempts shift the costs of foreclosure to future mortgagors. As a result, current reform proposals do not rectify the real problem with foreclosure sales, which is that such sales do not reflect the economic realities and dynamics of the retail real estate marketplace.

Specifically, I argue that real property is typically sold to the residential consumer on a credit price basis. The mortgagor’s equity in the property is based on a subsequent purchase of the property at the same credit price. Unfortunately, due to the historical development of the foreclosure action and certain normative choices that have been made to protect the mortgagee’s interest in the property at the expense of the mortgagor’s equity, property is sold on a cash basis upon foreclosure. The result is a disparity in values between the perceived fair market value of the foreclosed premises prior to foreclosure and the amount actually realized upon foreclosure.

Part I of this Article describes the typical foreclosure proceeding, emphasizing the imperfections that occur due to the involuntary

---

6 See, e.g., Andrea Bloom, Foreclosure by Private Trustee: Now is the Time for Colorado, 65 Denv. U. L. Rev. 41 (1988) (examining Colorado statutory enactment modifying private power of sale by requiring a public trustee to conduct all sales); Cynthia A. Merten, California Foreclosure Statutes: Some Proposals for Reform, 26 Santa Clara L. Rev. 533 (discussing revisions made to California law in 1986 to provide extra protection to foreclosed residential mortgagors).
7 See, e.g., Nelson & Whitman, supra note 5, § 8.8 (arguing that fundamental reform of the foreclosure process is needed to bring a fair price for the mortgagor upon foreclosure).
8 See infra Part II.C.
nature of the sale. In particular, I discuss the most common critique of foreclosure sales, which is that the foreclosure sale does not realize the full value of the mortgagor's equity in the property, and explain why this occurs. I go on to explain why a mortgagor in default finds it difficult to use the equity she owns in the property to secure the financing needed to cure a default and why she also finds it difficult to realize the full value of the property by selling it herself. I conclude that the current foreclosure process is such that mortgagors will often lose any equity they own in the property whenever the mortgagee forecloses.

Part II critiques current efforts to reform the foreclosure process. It reviews both the substance of proposed changes and the extent of empirical evidence to support such changes, arguing that although some courts, academics, and legislatures have attempted to substitute something akin to a market-based foreclosure system, they have failed to take into account the benefits to mortgagees generated by the current foreclosure process. By and large, this failure reflects the shift in normative goals that underlie these efforts, normative goals that focus solely on protecting the mortgagor's interests while neglecting the interests of mortgagees. A more economic approach, by contrast, recognizes that any such shift in normative goals may simply result in financially healthy mortgagors subsidizing less well-off mortgagors. I find no principled basis to object to such a change in normative goals as long as the costs of doing so are recognized.

In Part III, I argue that the foreclosure process, if understood from the normative perspective that really underlies the current process, actually works quite well. The current foreclosure process reflects a hypothetical ex ante bargain between mortgagors and mortgagees as to the best way to control ex post opportunistic behavior. The fact that a mortgagor may not be fully protected at the point of a foreclosure sale can be understood from this perspective as reflecting the need of a mortgagee to protect itself from opportunistic behavior on the part of a mortgagor. Any reform proposal that fails to recognize this normative basis for the current system is likely to create more costs than benefits when measured from the perspective of the hypothetical mortgagor about to contract for a mortgage.

In Part IV, I suggest a foreclosure reform that both recognizes the ex ante bargain underlying current foreclosure norms and also better protects the mortgagor's equity in the property. My proposal draws
heavily upon the lessons learned from the Bankruptcy Code, arguing that the norms that guide the debtor-creditor relationship in bankruptcy have equal applicability to the debtor-creditor relationship with respect to foreclosure of real property. The problem faced by the mortgagor and mortgagee in the foreclosure setting can be likened to a common-pool problem, in which the goal should be to maximize the value of the asset for both. Consequently, examining the mortgagor’s interest in foreclosed property as bifurcated into the two dissimilar and opposite roles of debtor and unsecured creditor provides the key for unlocking and solving a common pool problem that has largely gone unnoticed. Viewing the mortgagor’s equity interest in the property as the equivalent of an interest held by an unsecured creditor is not only innovative, it provides a conceptual framework—bankruptcy—that protects the mortgagee as a secured creditor.

Specifically, I propose that a court appoint a trustee upon the commencement of any foreclosure proceeding. This trustee shall first decide if the mortgagor has any equity in the property. If not, the foreclosure can progress forward much as it does today. If the mortgagor does have equity in the property, however, the trustee will stay the foreclosure proceeding. The trustee will then have the duty to sell the property through the same methods used in the retail real estate market today.

Such a stay, all other things being equal, would subject the mortgagee to “price risk” from the time the property would have otherwise been sold at a foreclosure sale to the time the trustee actually sells the property. To compensate the mortgagee for this risk, the trustee would be obliged to estimate the fair market value of the property on the retail credit market upon requesting the stay and provide that the mortgagee be given a share of the upside in changes in the value of the property, with the mortgagee’s share set equal to the value of the debt as a percentage of the estimated fair market value of the property. This upside potential helps compensate the mortgagee for any down-

9 See infra notes 136-41 and accompanying text for a discussion of the common-pool problem faced by multiple creditors seeking to satisfy their claims from assets that are insufficient to pay all their claims.

10 See infra Part IV.C. for further explication of this innovative conceptual framework.

11 By “price risk,” I mean fluctuations in the market value of the property due to fluctuations in prices in the local real estate market. By delaying the foreclosure sale, the mortgagee faces the risk that the property will fall in value to a point at which the price realized upon sale will not cover the mortgage debt.
side price risk the mortgagee faces due to the delayed sale of the property. It also largely freezes in place the mortgagee’s and mortgagor’s relative priority claims upon the property, helping ensure that mortgagors will not use the new foreclosure process opportunistically.

The mortgagee, of course, still faces a slight risk that real estate prices will plummet in the interim. However, I conclude Part IV by arguing that these slight costs to mortgagees are outweighed by the benefits to mortgagors and therefore the two parties would, if they conducted a hypothetical ex ante bargain, agree to these new rules. The key societal question, which is more empirical than analytical, is whether any added cost justifies the change in norms from mortgagee protection to joint mortgagee-mortgagor protection. Part IV demonstrates that the increased cost of foreclosure necessitated by my model of foreclosure will be marginal at best because the goal of the model is collectivizational and not distributional. In essence, I argue for a collective rule that respects the relative values of the entitlements in the original ex ante bargain.

I. THE FORECLOSURE PROCESS

Although three types of foreclosure proceedings—strict,\(^1\) judicial,\(^2\) and power of sale\(^3\)—have been used historically to foreclose the mortgagor’s equity of redemption, the most prevalent and efficient

---

\(^1\) Strict foreclosure occurs when the mortgagee is declared the owner of property following default without any sale of the premises. Strict foreclosure is used in only two states: Connecticut and Vermont. See Nelson & Whitman, supra note 5, § 7.10. As a practice, it has been criticized for its lack of a foreclosure sale with which to determine the property’s value. As a result, the mortgagee can reap a windfall by utilizing this procedure if the mortgagor has significant equity in the premises. For a discussion of strict foreclosure, see Robert H. Skilton, Developments in Mortgage Law and Practice, 17 Temp. U. L.Q. 315, 318-20 (1943).

\(^2\) As its name implies, judicial foreclosure refers to a foreclosure accomplished by resort to the judicial process. Under this proceeding, a foreclosing mortgagee brings a lawsuit against the mortgagor to foreclose the mortgagor’s equity of redemption in the property. Most importantly for our purposes, a trier of fact must rule that the mortgagee has the right to foreclose before the court can order the sale of the property and determine the method by which the property is sold. Hence, the court is intimately involved in the foreclosure process and acts as a neutral third party, helping to some degree to achieve the maximum amount for the property at the foreclosure sale. Although judicial involvement when coupled with other benefits such as notice, due process, and adjudication of issues, might lead one to conclude that judicial foreclosure is the preferable method of foreclosing property, the costs associated with judicial foreclosure cause most mortgagees to avoid its use where legally permissible. For a discussion of judicial foreclosure, see Nelson & Whitman, supra note 5, § 7.11.

\(^3\) For an in-depth discussion of power of sale foreclosure, see Nelson & Whitman, supra note 5, § 7.19.
method of foreclosure is the private power of sale foreclosure. Because the power of sale foreclosure\textsuperscript{15} is also perceived as the method of foreclosure that most jeopardizes the mortgagor's equity, this Article will focus solely on this form of foreclosure, with judicial and strict foreclosure discussed only when differences warrant.

To demonstrate the problems created by the operation of the foreclosure process, this Article will use a hypothetical based on facts drawn from Murphy v. Financial Development Corp.,\textsuperscript{16} an oft-cited case that appears in many of the prominent casebooks.\textsuperscript{17} The \textit{Murphy} case aptly demonstrates the problem of foreclosure sales generating inadequate sales prices.

Let us assume that Karen Mortgagor purchases her house in 1980 for $111,000, paying $11,000 down and executing a promissory note and power of sale mortgage\textsuperscript{18} for the remaining $100,000 with First Bank as mortgagee, with a 20-year term and a 10% level-pay plan fully amortizable mortgage.\textsuperscript{19} Five years later, Karen is laid off from her job and is unable to make the monthly payments of $965.02. Eventually she finds herself seven months in arrears on the mortgage payment and receives a letter from First Bank notifying her, pursuant to her mortgage contract and perhaps an applicable state statute, that she is in default of the note and mortgage. The letter further states that unless the arrearage of $6755.14, plus the costs and expenses of the foreclosure, are paid within 90 days of receipt of notice, the prop-

\textsuperscript{15} For typical statutory language, see Cal. Civ. Proc. Code § 580(a), (d) (West Supp. 1993).

\textsuperscript{16} 495 A.2d 1245 (N.H. 1985).

\textsuperscript{17} For example, see Jesse Dukeminier & James E. Krier, Property 673 (3d. ed. 1993).

\textsuperscript{18} If Karen had legal counsel at the time she purchased her home, she might have been advised not to execute a mortgage with a power of sale provision but instead to execute a mortgage that requires judicial foreclosure upon default. Most home buyers, however, do not consult lawyers. See Allan Axelrod, Curtis J. Berger & Quintin Johnstone, Land Transfer and Finance 64-65 (3d ed. 1986). In any case, such advice would be worthless given the nature of the real estate finance market. In most residential real estate financing transactions, the mortgagor does not negotiate with the mortgagee over the important terms and conditions of the mortgage but instead must accept the mortgage pretty much on a take it or leave it basis. In other words, the mortgage is a standard adhesion contract. Alex M. Johnson, Jr., Correctly Interpreting Long-Term Leases Pursuant to Modern Contract Law: Toward a Theory of Relational Leases, 74 Va. L. Rev. 751, 796 n.142 (1988). Beyond the efficiencies generated by form contracts, a mortgagor will be offered a standard form contract in order to make it transferable on the national secondary mortgage market. For a discussion of the transferability of mortgages by mortgagees to third parties, see Roger A. Cunningham & Saul Tischler, Transfer of the Real Estate Mortgagor's Interest, 27 Rutgers L. Rev. 24 (1973).

\textsuperscript{19} For a discussion of this typical mortgage, see Nelson & Whitman, supra note 5, § 1.1.
erty will be sold 30 days after expiration of the ninety day period, with no opportunity to cure the default and reinstate the mortgage by simply paying the arrearage.\textsuperscript{20}

On the date she receives the notice of default and foreclosure, the balance due on the mortgage is $85,000. A year earlier, in better financial times, Karen had thought about refinancing her mortgage and had had her property appraised at $145,000, an appraisal that reflected the increase in real estate values in her area since she had purchased her home. As a result, Karen believes she has $60,000 in equity in the property—her reasonable expectation that the property is worth $145,000 minus the first and only mortgage of $85,000.

From these facts, one might expect that even if First Bank forecloses, Karen should still end up with roughly $60,000 (setting aside the question of transaction costs). For example, if the house is worth $145,000, presumably an auction of the property should realize that amount. Even if an auction would not sell the property for $145,000, Karen herself, like any homeowner, presumably could sell the property for that amount. Alternatively, Karen has $60,000 in equity to secure a loan that she presumably could use to cure her default on the first mortgage. Despite the theoretical basis for such assumptions, in reality Karen will have considerable difficulty realizing her $60,000 in equity in the property.

\textbf{A. The Difficulty of Realizing Full Value at a Foreclosure Sale}

Although the foreclosure sale in theory should allow Karen to realize full value on the sale of her property, an analysis of the realities of such sales and the incentives of the parties involved suggests that her realization of full value—effectuating a sale at the appraised price of $145,000—is extremely unlikely to take place. This Section discusses some of the difficulties Karen will face at the foreclosure sale.

Upon default, First Bank is entitled to accelerate the debt and receive payment in full. At the foreclosure sale, therefore, First Bank

\textsuperscript{20} Pursuant to the statutory scheme I have hypothesized applying to Karen's situation, Karen has a total of 90 days to reinstate the mortgage. Failure to cure within that 90 day period results in Karen's losing her right to reinstate. Following the expiration of the 90 day period, the loan is accelerated and Karen can prevent foreclosure only by paying off the entire balance owing on the mortgage. Of course, even after the expiration of the initial 90 day period, the mortgagor may voluntarily waive its acceleration right, accept the arrearage, and reinstate the mortgage, rather than foreclose.
will normally make an opening bid\textsuperscript{21} of the amount of the debt owed, in this case $85,000. That forces any purchaser to outbid First Bank at $85,001, with the first $85,000 going to First Bank to pay off the debt and cancel the mortgage securing the debt.

Of course, First Bank may bid less than $85,000, and if it is the sole and winning bidder at, say $50,000, it can pursue, if allowed by state law, Karen for a deficiency judgment of $35,000.\textsuperscript{22} Note that if the winning bid is $85,000 or less, Karen is out of luck and the property is sold free and clear of her interest because her equity of redemption in the property has been terminated.\textsuperscript{23} Typically, though, First Bank will make a bid of $85,000 at the foreclosure sale, largely because it is

\textsuperscript{21} In this Article, I refer to the ability of a lender to bid at a foreclosure sale by offering in essence to cancel its claim on the collateral as a "credit bid." A lender offering such a bid can be contrasted to other bidders at the sale who must offer cash; I shall refer to these bids as "cash bids."

My students are always indignant when they learn that the mortgagee is allowed to make a credit bid at the time of foreclosing, correctly sensing that it gives the mortgagee an incredible advantage at the foreclosure sale. I explain that the mortgagee invested those dollars represented by the credit bid in the property when it consummated the initial mortgage transaction, and at the foreclosure sale it is merely seeking to get those dollars out. Obviously, it would be ludicrous to require the lending bank to offer cash, and I explain that the advantage given to the mortgagee at the foreclosure sale stems from the methodology and norms inherent in the foreclosure proceeding.

\textsuperscript{22} If the jurisdiction in which Karen's property is located allows deficiency judgments, First Bank's ability to generate a deficiency judgment of sufficient size to satisfy its outstanding debt may only be limited by its own greed given the way property is foreclosed. Because First Bank can require any purchaser to pay cash at the termination of the foreclosure sale or shortly thereafter, First Bank is playing with "house money" in a competitive public bidding situation until it reaches the limits of its credit bid. Hence, if First Bank is aware of the following rule, it may open its bidding at $50,000 or even $25,000 for the property:

All jurisdictions adhere to the recognized rule that mere inadequacy of the foreclosure sale price will not invalidate a sale, absent fraud, unfairness or other irregularity. Stating the rule in a slightly different manner, courts sometimes say that inadequacy of the sale price is an insufficient ground unless it is so gross as to shock the conscience of the court, warranting an inference of fraud or imposition.

Nelson & Whitman, supra note 5, § 7.21, at 540 (footnotes omitted). If there are no other bidders, the property will be purchased for the opening bid. If there are other bidders, First Bank will simply outbid those other bids by one dollar until it reaches the figure of $85,000. At that point, First Bank will presumably stop bidding (unless it has some exogenous reason for owning Karen's property in fee instead of as mortgagee) because as soon as the $85,000 bid is entered by a third party, First Bank will be made whole—paid off—and will have no further interest in the property.

\textsuperscript{23} "When courts utilize [equity of redemption] they are referring to the mortgagor's right after default . . . to perform his obligation under the mortgage and have the title restored free and clear of the mortgage." Nelson & Whitman, supra note 5, § 7.1, at 478.
either in a jurisdiction with antideficiency legislation\textsuperscript{24} or one that provides the mortgagor with statutory redemption rights.\textsuperscript{25} In states that have enacted antideficiency legislation,\textsuperscript{26} there is little incentive for the bidder to enter a low-ball or below debt-owed bid.\textsuperscript{27} If, by contrast, Karen is given the right to statutorily redeem, an option available in approximately twenty states, she can repurchase the property from the purchaser at the foreclosure sale by paying the price realized at the foreclosure sale.\textsuperscript{28} The existence of statutory redemption will force the mortgagee to bid up to the amount of the debt in its bid because if it fails to do so by, for example, bidding and purchasing the foreclosed property at $50,000, the mortgagor can redeem it for $50,000 and not the $85,000 owed on the debt. Furthermore, in some jurisdictions in which statutory redemption is employed, First Bank will not be allowed to pursue Karen for a deficiency (i.e., the difference between the $50,000 redemption price and the $85,000 debt owed).\textsuperscript{29} If Karen is in such a jurisdiction, she can protect her equity interest because in most states she would have six months to a year to sell the property.\textsuperscript{30} Given all that, most mortgagees will bid up to the amount of the debt.

This analysis suggests that First Bank will bid $85,000. That fact, however, should not by itself preclude other potential buyers from bidding higher. Nevertheless, I argue that in many cases no one will bid above $85,000 because of the significant transaction costs buyers face in making an all-cash bid. Not many retail purchasers have access to $85,000 in cash to use at the foreclosure sale to outbid the credit bid made by First Bank. The purchase of real property simply

\textsuperscript{24} For an in-depth discussion of antideficiency legislation, including California's very pervasive and complex scheme, see id. § 8.3.

\textsuperscript{25} For a discussion of statutory redemption, see id. § 8.8.


\textsuperscript{27} I am ignoring for purposes of this discussion any incentive generated by the tax code to create a capital loss and thus assuming that, as with most things, the Internal Revenue Service would look askance at a taxpayer who enters a low-ball bid to create a tax loss.

\textsuperscript{28} For a discussion of statutory redemption, see Nelson & Whitman, supra note 5, § 8.4.

\textsuperscript{29} Id.

\textsuperscript{30} The fact that she has a significant period of time to redeem and that she also has the concomitant right to remain in possession until her redemption rights expire has the practical effect of chilling all outside bidding because any outside purchaser would take subject to her redemption rights. In effect, the purchaser would be purchasing a defeasible title in which possession would be delayed for an appreciable period of time. See id.
is not financed that way anymore in this country.\textsuperscript{31} Thus, many prospective purchasers will be eliminated from the market by the bidder’s requirement that a cash bid be tendered at the foreclosure sale or shortly thereafter.

The retail purchaser could try to replace a cash bid with a credit bid. But the retail purchaser will still find it difficult to arrange financing to purchase the property, even assuming possession of an excellent job, credit history, and a favorable appraisal by the retail purchaser’s lending institution. Most financial institutions will not lend $85,000 to someone like our typical retail purchaser, notwithstanding an excellent credit rating, unless the interest is secured by a mortgage or some other security interest that reduces the lending institution’s risk in the event of default.

Nor will a lender accept a putative bidder’s promise to later execute a mortgage on the property purchased. Such a promise does not rise to the level of a security interest and, if subsequently breached, may give the lender simply a cause of action for breach of contract or perhaps a claim that a constructive trust, rather than a mortgage, has been created by the lender.\textsuperscript{32} Even if the real property is purchased with the cash provided by the bank, the bank may not be able to foreclose a judgment lien against the property if the borrower qualifies for homestead protection or any of the other devices by which the typical purchaser protects his home and renders himself judgment-proof to unsecured lenders’ claims.\textsuperscript{33} As a result, not many institutional lenders are willing to make unsecured bridge loans to finance a retail purchaser’s acquisition of property.\textsuperscript{34}

\textsuperscript{31} Before the Great Depression, lenders typically required as much as 50\% down with the balance due as little as five years later in a lump sum (what we today would call a balloon payment). For a discussion of the historical development of the common mortgage, comparing the mortgage utilized today with its predecessor, see Paul Goldstein & Gerald Korngold, Real Estate Transactions: Cases and Materials on Land Transfer, Development, and Finance 376-77 (3d ed. 1993).

\textsuperscript{32} “Most American jurisdictions recognize the long-established rule that where one person pays the purchase price for land, but legal title is conveyed to another, a presumption is created that the grantee holds the land under a resulting trust for the person paying the purchase price.” Nelson & Whitman, supra note 5, § 3.20, at 76 (footnote omitted).

\textsuperscript{33} See, e.g., Tahoe National Bank v. Phillips, 480 P.2d 320 (Cal. 1971) (holding that debtor could use homestead exemption on property bought to be foreclosed to prevent creditor from treating its unsecured debt as a mortgage).

\textsuperscript{34} This is not to say that it does not happen. At my old law firm, a number of my colleagues were able to purchase their first homes by purchasing real property at foreclosure sales at which all cash bids were required as the method of payment within 48 hours of the foreclosure sale.
Even assuming that a lender would, as a general rule, provide a bridge loan to a retail purchaser, a number of factors will still discourage it in the foreclosure context. First, the prospect of statutory redemption in some states creates a defeasible security interest from the bank’s perspective. The relatively quick method of transferring title to the property generates another difficulty even in those states without statutory redemption. Most financial lenders will not look favorably upon a process that requires them to lend a significant amount of money to buy property within thirty days. The time pressures created by the deadline of the foreclosure date will affect many things, such as getting an appraisal, searching title, and obtaining title insurance. Indeed, foreclosure sales are notorious for generating defective titles and carry no guarantee that the purchaser will receive marketable title. Hence, the bank or the lending institution must ensure the validity of the title of its potential security interest, which is very difficult to do within thirty days.

The foregoing analysis also assumes that the retail purchaser will be aware of the foreclosure sale in a timely fashion. Many states, however, merely require posting of notice at the courthouse or county seat or publication of notice of foreclosure in a paper of general circulation in the county in which the property is located—which often means the most obscure publication in the county. Not many retail pur-

---

35 See infra notes 81-82 and accompanying text.

36 See, e.g., Rockafellor v. Gray, 191 N.W. 107 (Iowa 1922) (holding foreclosure sale and resulting deeds invalid 15 years after the fact because of a procedural irregularity with the sale).

37 For example, Cal. Civ. Code § 2924f (West 1993) requires, where possible, the publication of the foreclosure notice in a paper of general circulation published in the city or judicial district in which the property, or some part of it, is located. Cal. Gov’t. Code § 6004.5 (Deering 1980) requires that a newspaper of general circulation, “if either printed or published in a town or city, shall be both printed and published in one and the same town or city.” These types of requirements mean that the most widely read paper(s) in a given location may not qualify, while a relatively obscure paper “printed and published” in the location does. Perhaps more importantly, from the foreclosing mortgagee’s perspective, the most attractive “general
chaser regularly check the county courthouse or the notices of foreclosures appearing in the back of the county's newspaper.

Suffice it to say, it is relatively rare for a retail purchaser to purchase the property at a foreclosure sale. Nevertheless, one might ask, would not professionals such as real estate speculators or companies bid at the foreclosure sale? Often they do, expecting, of course, to make a profit on resale. But usually such parties can do better by dealing directly with the mortgagee—especially if such parties have the same sort of illiquidity problems attributable to retail purchasers. For example, if First Bank agrees to sell Karen's property to the real estate company upon receipt of ten percent down with the balance payable upon resale to a residential consumer, such an arrangement is perfectly legal and defensible. From the real estate company's perspective, an arrangement in which the company markets the property and keeps everything in excess of $125,000 if and when the property is sold (i.e., a net listing arrangement) may prove more profitable.

Given all these problems, competitive bidding rarely occurs at these types of sales. In our hypothetical, therefore, if a foreclosure sale takes place, Karen's equity of redemption and her equity interest in the property are likely to be terminated when the mortgagee properly forecloses her interest by making a winning credit bid of $85,000. Assuming that there is no statutory redemption period, First Bank becomes the fee simple absolute owner of Karen's residence. Consequently, if First Bank sells the property the next day to a real estate broker or a retail purchaser for $125,000, the bank pockets a quick $40,000 profit.

In such circumstances, First Bank has no obligation to turn over any of the profit to Karen. In addition, the fact that the property is sold to another entity for $40,000 more than the figure realized at the foreclosure sale two days after the foreclosure sale (the facts in Murphy) does not provide Karen with enough evidence to allege that the

38 Indeed, even if the real estate company is "liquid," it may be better off using its liquidity to sell as many foreclosed properties as possible by making partial payments on the purchase price.

39 Net listing agreements are discussed and defined in Goldstein & Korngold, supra note 31, at 44.

40 The actual numbers in Murphy were as follows: the amount bid or realized at the foreclosure sale was $27,000; two days following the sale the property was sold by the
foreclosure sale was improperly conducted or should be set aside, unless she can show chilled or collusive bidding. First Bank, in bidding for the property, is not attempting to protect Karen's interest in the property, but its own. It has no duty to maximize the price realized upon foreclosure. Its only real incentive is to make itself whole as a result of the foreclosure sale. Unfortunately, Karen's interest may be left out in the cold in the process.

B. The Difficulty in Obtaining Equity-Based Financing

During the ninety days she is given to cure the arrearage on her mortgage loan, Karen can attempt to obtain a loan, secured by a second mortgage against her equity in the property, in order to obtain the approximately $7,000 she needs to cure her default. But her efforts will almost certainly fail because she has no job and no job prospects. Furthermore, she has a poor credit rating because she is already in default on her mortgage to First Bank.

Why would a lender not offset this increased risk of default by charging a higher interest rate? Because if a bank lent Karen the money to cure her default, with no prospect of a stream of income to pay future payments to the first mortgagee, the only security would be a junior lien on property that will probably be sold pursuant to a foreclosure by the first mortgagee. As a junior lienholder on the property, its mortgage will be wiped out in any foreclosure action unless the sale price is enough to pay off the debt owed the First Mortgagee—in this case, $85,000. Alternatively, the lender can cure the defaults as they arise, add the new amounts to its debt, and subsequently foreclose on its second mortgage while keeping the first mort-

foreclosing lenders to a retail real estate company for $38,000, and the trial court determined that the property had a fair market value (presumably to a retail buyer) of $54,000. 495 A.2d at 1248.

Karen may complain that had she received the same generous treatment afforded the real estate company at the hands of First Bank she would have been able to salvage her equity interest in the property. First Bank's correct rejoinder to that grievance would be to point out that the real estate company possessed two essential attributes not possessed by Karen at the time of foreclosure: a good credit rating meriting the extension of credit and expertise to market the property in question.

For discussion and cases on junior or secondary financing, see Axelrod et al., supra note 18, at 214-32.

For a discussion of foreclosure and how it affects the redemption rights of a junior lienholder, see Nelson & Whitman, supra note 5, § 7.2.
gage current. Of course, even this alternative scenario assumes that the lender is given the right to cure Karen's default and that the default on the second mortgage does not cause an automatic acceleration of the debt pursuant to the terms of the first mortgage. The point is that eventually the first mortgage held by First Bank will have to be paid off.

Of course, second and even third mortgages are made on residential property all the time. Indeed, an entire industry has developed to serve junior mortgages, and the recent explosion of home equity loans, which are simply junior mortgages in most instances, attests to the spread and use of secondary or junior financing. But Karen, unlike the borrowers in this market, has no job or job prospects, and therefore does not present an adequate risk for traditional junior creditors interested in securing a stream of payments with a junior mort-

44 See id.
45 For a discussion of the circumstances under which the mortgagee is allowed to accelerate, see id. §§ 7.6-7.8.
46 Nor will a rational individual investor loan money to Karen under these circumstances when he can wait until Karen's interest in the property is foreclosed at the foreclosure sale. The investor will act rationally by bidding in at the foreclosure sale with a bid higher than that of the First Bank. Alternatively, the outside investor can wait until after the foreclosure sale and deal with the purchaser at the foreclosure sale if he wishes, assuming that neither Karen nor anyone else has statutory redemption rights which may be exercised after the foreclosure sale to purchase the property for the price realized at the sale. Of course, this probably is not a desirable alternative because the purchaser at the foreclosure sale, be it First Bank or anyone else, is not forced by an artificial time deadline to accept the best offer for the property as it is when the property is foreclosed at auction. Hence, I hypothesize that most interested parties or investors in this situation will not loan Karen any money against her equity interest in the property; they will attempt to capture that excess value at the foreclosure sale by outbidding First Bank for the property.

The only situation in which it makes sense for a rational investor to deal with Karen prior to foreclosure is when the investor is aware that there are multiple bidders for the property and the investor wishes to purchase the certainty that it will be the winning bidder by purchasing Karen's equity of redemption prior to the foreclosure sale. If this is accomplished, the investor purchasing Karen's interest "steps into Karen's shoes" and is able to pay off the foreclosing mortgagee up to the instant that the foreclosure sale becomes final—at the conclusion of the sale "cried" on the courthouse steps. In other words, Karen can market her equity interest to the highest bidder. However, this possibility is of little practical import to someone in Karen's position. First, it assumes that there are many bidders out there with the $85,000 in cash to invest in the property. Second, it assumes that the bidders have equal access to information and will be aware of the threat of other bidders. Third, it ignores the fact that even if there are other active bidders out there in the market and they are aware of each other, they are all individually and collectively better off if they wait until the mortgagor's interest in the property is eliminated in order to deal solely with the mortgagee who, in most instances, is interested in getting the amount of the debt—$85,000—returned to it.
gage on real property, albeit at a higher interest rate than first mortgagees.47

C. The Difficulty of the Mortgagor Selling Prior to the Foreclosure Sale

Karen has one other option to protect her equity interest in the property: sell the property to a buyer during the ninety day period. After all, half a loaf is better than none, and Karen can presumably strike a deal with a purchaser at some price between $85,001 and $145,000.48 Karen, however, faces considerable transaction costs in locating a buyer interested in purchasing this unique, immobile asset in such a short period of time.49

A buyer interested in purchasing the property can deal directly with Karen and purchase her interest in the property. This purchase can be financed by the purchaser's assuming or taking subject to the existing mortgage.50 Typically, however, the mortgage contract prevents Karen's transfer of the premises without First Bank's consent. The prospective purchaser can, of course, seek First Bank's consent and the bank should have no objection if the purchaser presents a reasonable risk and is willing, if necessary, to have the interest rate on the loan adjusted upward to reflect current interest rates. If the parties cannot reach such an agreement about the transfer of the mortga-

47 For an in-depth discussion of the mortgagor-debtor's value as a capitalized stream of payments, see infra notes 149-54 and accompanying text.
48 The $85,001 figure represents the minimum sales price because that is the price that must be paid in order to free the property from the foreclosing mortgagee's action. The retail price is $145,000. Assuming the parties are rational economic actors, the only real question is how the bargaining will split the $60,000 in equity between the two parties.
49 For a discussion of real property's status as "unique" and therefore entitling the injured party to specific performance upon breach of contract, see, e.g., Anthony T. Kronman, Specific Performance, 45 U. Chi. L. Rev. 351, 355-58 & n.20 (1978).
50 A mortgage is "assumed" by executing an instrument stating that the assuming party—the transferee—will be personally liable to the mortgagor on the underlying debt. By contrast, if the property is transferred "subject to" the mortgage, the transferee is not personally liable to the mortgagor. If the mortgage is assumed, the land remains as primary security for the underlying debt, but the mortgagee can only go after the original mortgagor as a surety for the payment of the debt if the mortgage is subsequently foreclosed and there is a deficiency realized upon the foreclosure sale. For a discussion of the transferee's taking subject to or assuming the mortgage, see Nelson & Whitman, supra note 5, §§ 5.3-5.4. Most mortgages effectively prohibit the transfer of the mortgage by including due-on sale clauses, meaning that the mortgagee's consent is required. See id. §§ 5.21-5.26. Although some courts require that mortgagees withhold consent only when reasonable, many courts allow a mortgagee to unreasonably withhold consent. Id.
gor's interest, the purchaser can arrange for his own financing, and he would presumably do this as a matter of course if interest rates have fallen. In this latter scenario, First Bank will get what it was due—the $85,000—and Karen would receive some portion of her equity interest in the premises between $1 and $60,000.

No doubt, a few "Karens" are lucky enough to obtain a portion of their "equity interest" in the property by selling to individuals like our hypothetical purchaser. But the vast majority of "Karens" are unable to do so. The reason is that the prospective purchaser is usually better served by waiting until Karen's interest is foreclosed and then dealing with First Bank or the purchaser at the foreclosure sale. Why deal with Karen when the market provides a mechanism for eliminating her interest in the property in thirty days? Indeed, the prospective purchaser, if he chooses to, can try to extort a deal from Karen by threatening to or actually purchasing the property at the foreclosure sale. Karen is already in a precarious situation and from the retail purchaser's perspective there is already a perfect market mechanism for establishing the price of the property that incorporates Karen's weak bargaining position: the foreclosure sale.

The only reasonable scenario that could force a deal between Karen and a retail purchaser is if the purchaser is not certain that he will be the successful bidder at the foreclosure sale. The retail purchaser, fearful of other bidders at the foreclosure sale, may be willing to pay for the certainty of owning the property by directly purchasing Karen's interest, rather than risk bypassing Karen's interest by purchasing at the foreclosure sale. Realistically, however, the retail purchaser, unless he is extremely risk averse, will not negotiate directly with Karen unless he expects other interested bidders for Karen's property.

Karen could bluff and state that others are interested in the property. However, the retail purchaser will likely demand proof. At this point Karen will face a dilemma: Unless she reveals the identity of other interested parties, assuming there are any, the retail purchaser will assume she is bluffing and discount her threat to sell to another party. But if she reveals the identities of other interested parties, these parties may collude by purchasing Karen's interest and split any resulting surplus or profit. This collusion possibility, from slight to very good depending on the positions of the parties and their negotiating skills, is that the two parties may cooperate to transfer the value of
Karen's equity interest in the property to themselves. Thus, if the retail purchaser places the highest value on the property, he will purchase the property from whomever offers him the best price. If the only credible bidder is the interested party, and he is willing to forego bidding on the property in exchange for $5,000, the retail party will strike a deal with the interested party pursuant to which the interested party agrees not to bid for the property in exchange for $5,000, payable if the retail purchaser is the highest bidder at the foreclosure sale.

Of course, if Karen can prove that this agreement occurred and affected the bidding—a big assumption—she would have a prima facie case for chilled bidding that would allow her to set aside the sale to the retail purchaser and set up another sale. As of yet, though, no court has found chilled bidding in such a circumstance and set aside the sale. Part of the problem lies in determining what is collusive behavior in this situation. If the retail purchaser and the interested party bump into each other at an open house and decide to form a joint venture to purchase the property, splitting the profits between themselves instead of independently bidding for the property, is that collusion resulting in chilled bidding?

More importantly, even if chilled bidding is proven, what does Karen obtain as a result? Another foreclosure proceeding at which the mortgage is revived for the purpose of foreclosing it properly. And unless Karen has improved her financial situation in the interim, she will find herself in the same position as before, except that the purchaser at the first sale will expend five thousand additional dollars to protect its interest at the subsequent foreclosure sale.

51 A more difficult problem is raised when there is collusion among third parties alone. This could involve an agreement among several third parties that they will discourage others from attending the sale and that they will only bid the property up to a specified price. They might further agree that if one of them actually purchases at the sale, he will, upon resale, split the profits with the others. . . . If one of the third parties is a successful bidder, it would seem that the mortgagor should be able to get the sale set aside against the third party purchaser. The collusion, after all, probably kept the price down and setting aside the sale would foster a public policy that encourages open and honest bidding.

Nelson & Whitman, supra note 5, § 7.21.

52 An entirely different situation is presented when the mortgagee engages in irregular conduct that suppresses bidding. Because the mortgagee or its trustee is conducting the sale and owes certain contractual and fiduciary duties to Karen, any conduct undertaken to suppress bidding will result in the sale being set aside. See id.
Thus concludes our lengthy saga involving Karen. Karen will bitterly complain about the loss of her equity in the premises. Similarly, given the facts in this hypothetical, those complaints will be aggravated by the fact that the foreclosing mortgagee stands to make a significant (up to $40,000) profit upon the resale of the property and that the middleman—the real estate company—will make a substantial profit on the property if the property sells at or near its previously appraised value of $145,000 within a year of foreclosure. The only person who will definitely not make any money on the transaction will be Karen, the party whose initial investment, and perhaps sweat equity, caused the appreciation in the property. In effect, Karen loses her equity interest in the property when she loses the ability to continue to make payments on the property. When Karen loses her job, she loses her ability to pay the mortgage and her home.

II. EXAMINING THE CRITIQUES OF THE CURRENT PROCESS: EXPOSING THE LACK OF A NORMATIVE BASIS

In this Part, I survey the conventional critiques of the real estate foreclosure process. Most of the critiques focus on the failure of the typical foreclosure procedure to approximate the retail market and, as a result, attempt to reform the procedure in a manner that mimics the retail market. I also review the rather limited available statistics on

---

53 A similar scenario, presented in a condensed version that does not explicate the many reasons why Karen cannot transfer or sell her equity in the premises, was presented in 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, 851 (1985):

In September 1976, Thomas and Allison Wilson acquired their single-family home in Marcellus, New York for $54,250. They put $9,250 down and borrowed the balance of $45,000 from Old Line Savings Bank at eight and one half percent interest, giving the bank a conventional mortgage on the property. Two years later, in September 1978, the Wilsons defaulted on their loan and in early 1979 the Bank began a foreclosure action, obtaining a judgment of foreclosure in July 1979. The Bank posted notices of the foreclosure sale in three public places in Marcellus and published the notices for four successive weeks in the legal notices of the local newspaper. In August 1979 when the foreclosure sale was held, the Bank was owed $52,000 (which included accrued interest, unpaid real estate taxes, the costs of the foreclosure action, and attorney’s fees). The Bank bid $51,800 for the property, leaving a deficiency amount of $200. In early April 1980 the Bank sold the home to an unrelated third party for $60,000. Seven months after acquiring the property at the foreclosure sale, the Bank thus recovered its entire investment of $52,000 and made a profit of about $8,000. Under the current state of the law, the Bank was entitled to retain this profit.
foreclosure, which surprisingly demonstrate that the premise upon which most criticisms of the foreclosure process is based may be false. Following my review of the numbers, I analyze what is actually accomplished by the foreclosure process, concluding that the current foreclosure proceeding protects the creditor's interest in the premises at the expense of the debtor. This rather simple yet oft-ignored conclusion suggests that current efforts at reform do not address the root of the problem. The key question is: Who will pay for the change in the foreclosure process, the mortgagor or the mortgagee?

A. Critiques of the Current Foreclosure Process

1. The Judicial Approach

The fact that homeowners have been adversely affected by the foreclosure process has not gone unnoticed by the courts. In Murphy v. Financial Development Corp., the court took an atypical approach to a problem that many courts resolve by simply determining whether the price realized at the foreclosure sale was so inadequate as to shock the conscience of the court, and if so vacating the sale and ordering a new sale. In Murphy, the court held that the lenders in that case:

had a fiduciary duty to take more reasonable steps than they did to protect the plaintiff's equity by attempting to obtain a fair price for the property. They could have established an appropriate upset price to assure a minimum bid. They could also have postponed the auc-

54 As discussed below, see infra notes 86-101 and accompanying text, there are a few studies that support the proposition that "full value" or "market value" is realized upon the foreclosure sale. Although such studies may seemingly call into question the need for reforming the foreclosure process, they are of limited utility in responding to the critics of the foreclosure process, given the limited number of such studies, the pervasiveness of the critiques of the process, and the visceral reactions generated by—if the studies are to be believed—possibly atypical cases such as Murphy.

55 Phrasing the question in this fashion is somewhat disingenuous because, as I will discuss, see infra notes 106-09 and accompanying text, mortgagees will pass increased costs through to future mortgagors. Therefore, mortgagors will bear the cost in any event. The better question is whether financially solvent mortgagors should subsidize those mortgagors whose mortgages are foreclosed through the payment of higher interest rates, offsetting the cost to the mortgagee of protecting the mortgagor's equity interest in foreclosed property.

56 495 A.2d 1245 (N.H. 1985).

tion and advertised commercially by display advertising in order to assure that bidders other than themselves would be present. 58

Implicit in the court's holding is both a substantive and procedural condemnation of the foreclosure process for its willingness to sacrifice the mortgagor's equity interest in exchange for a quick, efficient foreclosure process. At a substantive level, the court found that the mortgagee, whose interest in a foreclosure process differs from that of the mortgagor, is in a quasi-fiduciary relationship with the mortgagor. The mortgagee, according to the court, must take reasonable steps to preserve the mortgagor's equity interest in the foreclosed premises by obtaining a fair price. 59 This quasi-fiduciary relationship imposes the additional duties of good faith and due diligence on the foreclosing mortgagee to protect the interest of the mortgagor. Thus, strict compliance with the foreclosure statute will not act as a safe harbor for any foreclosing lender; more is required of the lender when foreclosing the interest of the mortgagor.

The duties of good faith and due diligence imposed on the mortgagee also reflect the court's dissatisfaction with the procedural requirements of the typical foreclosure proceeding. The court in Murphy determined that the efforts of the foreclosing mortgagee—publication and posting as required by the statute—were inadequate when no other bidders attend the foreclosure sale to bid on the property. 60 The court then came very close to suggesting that the mortgagee should not conduct the foreclosure sale pursuant to the statute, but rather that it should conduct the sale as any reasonable retail seller would: by advertising commercially, displaying advertising, and not holding

58 Murphy, 495 A.2d at 1251.
59 Id. at 1249-50. One of the many weaknesses of this opinion, and there are many, is that the court never defines "fair price." The court, in computing damages, awards the mortgagor "the difference between a fair price for the property and the price obtained at the foreclosure sale." Id. at 1252. The court emphasized the fact that no bad faith was found in this case, simply the absence of good faith, and therefore the lender was not required to pay damages based on the difference between the higher fair market value of the premises and the price realized upon foreclosure. Id.

Given the facts of the case, one can only infer that a fair price is the price realized upon subsequent resale—in Karen's case, $125,000—because that is the amount that the bank realizes when it finally exercises due diligence. Fair market value, by contrast, would no doubt be the appraised value of the property to a retail purchaser—in Karen's case, $145,000.

The fallacy of this artificial dichotomy between a fair price and the fair market value of the property is discussed infra in Part III.B.
60 Murphy, 495 A.2d at 1250-51.
the sale until more bidders (buyers) were found.\(^6\) Thus, like many of the academic commentators who have criticized the foreclosure process,\(^6\) the Murphy court intimated that a foreclosure process modeled on the retail market is required of the foreclosing mortgagee in order to satisfy its "fiduciary duties" to the mortgagor.

Although the court's novel approach in Murphy has received widespread attention,\(^6\) this opinion is deeply disturbing for its characterization of the mortgagor-mortgagee relationship as one based on a fiduciary relationship. The court, in essence, concludes that it is the mortgagee's duty to protect the mortgagor's interest. Of course, the logical person to protect the mortgagor's interest is the mortgagor herself, because she has the best economic incentive to protect her interests.

The Murphy court attempted to characterize the mortgagor-mortgagee relationship in a fashion that superseded the statutory requirements and apparently called for the court's use of its inherent equitable powers (although the court nowhere expressly states this) to determine if the "relationship" had been abused by the mortgagee.\(^6\) Yet one should not lose sight of the fact that it is the process that generated the inadequate price upon foreclosure that spawned the court's misbegotten characterization of the mortgagor-mortgagee relationship as one based on fiduciary duties and obligations.

2. The Academic Approach

Numerous commentators have addressed the issues raised by the foreclosure process, focusing on the mortgagor's loss of her equity.

\(^{61}\) Id. at 1251.
\(^{62}\) See infra notes 66-76 and accompanying text.
\(^{64}\) In a limited sense, the court's opinion in Murphy is eerily reminiscent of the 17th-century intervention by the English chancery courts to protect the mortgagor's equity by allowing late redemption when the mortgagor failed to promptly pay the mortgage as required in the agreement. The law courts were concerned only with ensuring that the process called for by the mortgage agreement was properly complied with by the parties. The chancery courts were not similarly limited. This process of tardy or equitable redemption by courts of equity led to the enactment of foreclosure statutes, which allowed the the mortgagee's equity of redemption to be terminated. For a discussion of this historical development and the bifurcated roles of the equity and law courts, see Nelson & Whitman, supra note 5, § 1.3. For a discussion of the historically equitable nature of the concept of fiduciary obligation, see Deborah A. DeMott, Beyond Metaphor: An Analysis of Fiduciary Obligation, 1988 Duke L.J. 879, 880-82 (1988).
interest in the foreclosed property. One of the most prominent and vociferous critics of the current procedure is Professor Grant S. Nelson. Professor Nelson, citing the usual problems that lead to the inadequate price realized upon foreclosure, such as the mortgagee's credit bid, the requirement that any third-party bidder pay cash, the inadequate publication of the notice of foreclosure, potential quality of title problems that scare off potential purchasers, and the lack of opportunity for adequate inspection of the property by potential third-party purchasers due to the mortgagor's uncooperativeness produced by the foreclosure process adopts a market-based approach to the problems generated by the current foreclosure process.

Professors Dale A. Whitman and Nelson adopt a similar market-based approach in their highly regarded treatise on real estate finance. Their proposal is unique and visionary in that they advocate that a truly independent "trustee" conduct the sale in order to protect the equity interest of the mortgagor. Further, they correctly perceive that if the independent trustee is given a sufficient monetary incentive to obtain the highest price possible on the sale of the property, the foreclosed property has a better chance of being sold above the amount of the debt, thereby generating some surplus for the mortgagor.

---


67 Id. at 248.

68 "First, the sale should be conducted by customary commercial methods used in the sale of real estate in a nonforeclosure setting, including the use of real estate brokers and normal commercial descriptive and pictorial advertising." Nelson & Whitman, supra note 5, § 8.8, at 628.

69 "The person who conducts the sale should be a truly independent public official and should be given a strong incentive to achieve the highest possible foreclosure price. He should have substantial experience and expertise in real estate matters. While the title for this person is not particularly important, the one who now conducts foreclosure sales is often called a "trustee," and that title is probably as appropriate as any other.

70 The method of compensating the trustee should encourage him to obtain the highest possible sale price. For example, if the sale price does not exceed the mortgage debt, the trustee's fee should be relatively low, perhaps a fixed amount. If the foreclosure sale
In his excellent, although statistically limited, empirical study of the foreclosure process, Professor Steven Wechsler also provides a proposal for reforming the process. Although his suggestions for reform are multifaceted and include some of the reforms suggested by Nelson and Whitman, it is his suggestions that differ I find the most intriguing.

Professor Wechsler believes that “[t]here is no reason to distinguish between profits realized on a resale and a surplus produced at a foreclosure sale.” Hence, when a mortgagee who purchases at the foreclosure sale resells to a third party for a profit within a certain time period, the mortgagee must disgorge the profit and return it to the mortgagor because that profit represents the mortgagor’s equity interest in the premises. This could be accomplished on a case-by-case basis or as a matter of statute. Although this approach has many fatal problems, interestingly it would shift the focus of inquiry to a situation in which it is presumed that the market works. In other words, Wechsler would ignore the price realized upon the foreclosure sale unless the price exceeds the mortgage debt, the trustee should receive a percentage of the excess that increases as the excess increases. The trustee should be permitted to employ brokers, pay for advertising and incur other normal expenses of sale. He would be subject to ordinary fiduciary duties of good faith and fair dealing.

Id. at 629.

See Wechsler, supra note 53.

Id. at 892-93.

Id. at 887.

Id. at 887-89.

For example, Professor Wechsler’s proposal would only operate when the mortgagee purchases at the foreclosure sale, begging the question of who is a third party. In other words, is a subsidiary a third party if the subsidiary is the independent real estate selling arm of the lender? This type of agency question arises in statutory redemption cases in which third party purchasers are not subject to statutory redemption rights but mortgagee-purchasers are, thereby creating a strong incentive to create third-party purchasers where none might otherwise might exist. See Blades v. Ossenfort, 481 S.W.2d 531 (Mo. Ct. App. 1972).

In addition, the time requirement can easily be manipulated by the foreclosing party to avoid disgorging profits to a mortgagor. Will courts allow mortgagees to evade the mortgage protection aspect of the act by selling the property 367 days after the foreclosure sale, but not 364 days after?

Finally and most importantly, what sort of perverse incentives are created for the mortgagee when it must disgorge its profits on the resale of the property? Without any incentive to make a profit on the resale of the property, I predict that the mortgagee will sell the property at the foreclosure price, and it is the third party who will reap a windfall profit by subsequently reselling it to yet another purchaser. Hence, Wechsler’s scheme operates merely to shift the profits from the mortgagee who at least had some interest and risk in the property to a third party who is given a windfall as a result of the statute.
and instead focus upon the first “true” sale of the property, the mortgagee’s resale, to determine the mortgagor’s equity interest in the premises.

Intuitively, Professors Nelson, Whitman, and Wechsler zero in on the fact that the current foreclosure sale process does not mirror the retail marketplace. The hope of these “free marketeers” is that if the foreclosure process closely approximates the market, it can protect the homeowner’s equity interest. The problem with such a market-based approach is that it presupposes that the normative basis supporting the foreclosure process is solely the protection of the mortgagor’s equity interest.

3. The Statutory Approach

The two traditional methods of forcing bidders at the foreclosure sale to make accurate and fair bids on the property are antideficiency legislation barring the mortgagor from pursuing a deficiency judgment following foreclosure, thereby eliminating any incentive on the mortgagee’s part to make a low-ball bid to create an artificial deficiency judgment, and the right of statutory redemption by the mortgagor following foreclosure. Although one can debate whether antideficiency legislation accomplishes its goals of discouraging the mortgagee from overvaluing the security when making a mortgage loan and preventing a further decline in local real estate values, there is no assertion that antideficiency legislation assists the mortgagor in protecting her equity interest in the premises.

At best, antideficiency legislation provides the mortgagee with the incentive to bid up to the amount of the debt at the time of foreclosure. These statutes operate as debt cancellation or forgiveness stat-
uates: once the mortgagee begins the foreclosure process, the debt that secures the mortgage is cancelled and the mortgagee protects its own interests. The statutes do nothing to address the case where the mortgagor alleges that she has a significant equity interest unrealized at the foreclosure sale.

Statutory redemption schemes also tend to guarantee only that the mortgagee will bid up to the amount of the debt at the time of the foreclosure sale in order to protect its interest in the property. Failure to bid up to the amount of the debt at the foreclosure sale will in most states establish a redemption price at the foreclosure sale price and prohibit the mortgagee, if otherwise allowed, from seeking a deficiency judgment if the property is subsequently redeemed.81 As a result, the mortgagee has a strong incentive to bid up to the amount of the debt being foreclosed if the property equals or exceeds the amount of the foreclosed debt.

On the other hand, the mortgagee or third parties have little incentive to bid in excess of the debt. That is because statutory redemption creates a defeasible title in the purchaser at the foreclosure sale. Moreover, because in a number of jurisdictions the defaulting mortgagor is allowed to remain in possession of the premises (rent free!), any purchaser runs the risk that the property purchased at the time of sale may be neglected by the mortgagor during the redemption period and therefore be worth less if and when possession is actually realized by the purchaser.82 Consequently, statutory redemption has the countervailing effect of practically guaranteeing that no one will bid significantly higher than the mortgagee's debt interest in the premises.

One final statutory proposal is worth mentioning. Some courts83 and commentators84 have referred to and analyzed the Uniform Land Transactions Act (ULTA) sections 3-507 to 3-51085 as an appropriate vehicle to govern the foreclosure process and protect the mortgagor's equity interest. The ULTA's provisions incorporate many of the provisions suggested by Nelson and Whitman to transform the tradi-

81 Id. § 8.4.
82 Id.
83 See, e.g., Murphy, 495 A.2d at 1251.
84 For an excellent article analyzing the foreclosure process in general and the Uniform Land Transactions Act in particular, see Robert M. Washburn, The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales, 53 S. Cal. L. Rev. 843, 936-938 (1980).
tional foreclosure proceeding into one that more closely approximates the market proceeding and therefore need not be repeated here.

B. An Examination of the Numbers

Commentators on the foreclosure process assume that foreclosure sales create inadequate sales prices. They also assume that the problem is exacerbated by the rapacious actions of greedy institutional mortgagees who manipulate the procedure to extract exorbitant returns at the expense of the debtor-mortgagor's equity interest in the premises. The few and limited statistical studies to date, however, do not support all of these premises. Only the conclusion that foreclosure may not protect the mortgagor's equity draws any support.

Consider the empirical study conducted by Professor Steven Wechsler of all completed foreclosures that took place in a rural county in New York state in 1979. The study overwhelmingly indicates that the mortgagor's equity interest, assuming it exists, is not being protected by the current foreclosure process. Wechsler concludes that 99% of all sales to mortgagees resulted in either no surplus (7%) or a deficiency (92%) even though the mortgagees realized profits in approximately half the resales within one year after foreclosure.

However, every other conclusion supporting the condemnation of the current procedure was unsupported by his data. For example, Wechsler admits that significantly more third party purchasers purchased at the foreclosure sale than had previously been assumed or

---

86 This Article will focus on Steven Wechsler's study. See Wechsler, supra note 53. Several other statistical analyses of the foreclosure process have been done. See, e.g., John P. Herzog & James S. Earley, Home Mortgage Delinquency and Foreclosure (1970); Robert J. Aalberts & Douglas S. Bible, Mortgage Default in Louisiana: An Empirical Study of Recent Foreclosures on Residential Property in Caddo Parish, 15 S.U. L. Rev. 215 (1988).
87 Wechsler, supra note 53.
88 Id. at 851-52.
89 Id. at 877.
90 As Wechsler admits, given the nature of the foreclosure process, it is impossible to evaluate the fairness of the bids at the foreclosure sale when made either by the mortgagee or anyone else. Id. at 874-75. Thus, the fact that 99% of the winning bids made by foreclosing mortgagees are at or below the amount of the debt does not necessarily prove that the mortgagee is bidding below the market value of the foreclosed premises. Indeed, as demonstrated infra, how to exactly determine the fair market value of the property when it is foreclosed is the subject of some debate.
In his study, approximately one quarter of all the winning bids were made by third-party purchasers. This finding calls into question the criticisms of the foreclosure process that argue that the lack of “market-type” advertisements or marketing techniques leads to a lack of third-party bidders at the foreclosure sale.

Wechsler’s study also casts doubt on the criticism that foreclosure sales generate inadequate prices due to a lack of adequate notice. Based on the limited nature of his study, perhaps the strongest statement that can be made to reconcile the conflict between the criticisms of the foreclosure process and the reality as presented by Wechsler’s study is that even though the data is not widely or “publicly” disseminated when compared to the retail market, the better the bargain, the better the market. In other words, information, and hence bidding, is disseminated with respect to those properties with greatest profit potential for putative investors. Analyzed from the view of putative investors, inadequate dissemination of information is more costly for the foreclosure of marginal or less profitable property.

Moreover, Wechsler’s study reveals that mortgagees may not be taking advantage of the mortgagor’s plight or exploiting any “advantage” generated by the foreclosure process. As indicated, 99% of sales to the mortgagee did not produce a surplus for the mortgagor’s benefit. If mortgagees were profiting by manipulating the foreclosure process to generate a deficiency upon foreclosure, they would do so by subsequently selling the premises at a price in excess of the price realized or bid at the foreclosure sale. What Wechsler discovered in his study is quite illuminating. Approximately 80% of the mortgagees who purchased at the foreclosure sale sold the property within one year of purchase. Of the 72 sales that the author was able to calculate profit and loss, 35 resales were profitable and 37 were not.

91 Id. at 870 n.129.
92 See supra text accompanying notes 67-70.
93 Deficiencies or surpluses are calculated by subtracting the balance of the debt, the accrued interest, and the additional amount due to the lender on account of the foreclosure from the successful bid at the foreclosure sale. If the sale price exceeds these deductions, a surplus remains and is distributed to junior lienors or paid to the mortgagor. If the deductions exceed the price, a deficiency amount results. If the amount bid at foreclosure equals the amount due the lender, neither a surplus nor a deficiency results.
94 Id. at 879.
Moreover, their total loss on resale exceeded their gains on the profitable resales by slightly more than an average of $13,000.

By comparison, of the 27 homes sold to third parties, 26 were sold to 26 different third parties, generating a surplus in 54% of the cases and no deficiency in 7% of the cases. Of the 26 different buyers, 11 retained their interest in the premises beyond a year following purchase, indicating that they purchased the property as a principal residence. Fourteen of the fifteen resales generated profits, and in twelve of those resales the profit ranged from $7,000 to $23,000. This caused the author to conclude quite reasonably that "third-party buyers were snapping up the most attractive properties at foreclosure, leaving the depreciated and neglected parcels for the mortgagees to buy in order to protect their investments."

More importantly, for our purposes, the author was able to conclude that mortgagees will be made whole, and that includes the funds generated upon resale, in only 35% to 53% of all foreclosures and that mortgagees lose more money than they gain in foreclosures. This dismal picture understates the mortgagee's plight because the study excluded eighteen foreclosed properties from its results, each of which more than likely created a loss for the lending institution.

---

95 Id. at 875-76.
96 Id. at 878-79.
97 Id. at 883 (footnotes omitted).
98 This conclusion was within a 95 percent confidence interval, a confidence interval being a statistical tool for predicting the characteristics of a universe based on a sample drawn from that universe. It is expressed as a range within which the true mean of the value in the universe is likely to fall, together with a statement of the likelihood that the true mean does fall within that range. Id. at 869 n.126 (citing David Barnes, Statistics as Proof: Fundamentals of Quantitative Evidence 235-36 (1983)).
99 Id. at 883.
100 If we consider all foreclosure transactions, rather than only those involving nonexempt resales, the mortgagees in the sample sustained even greater losses. Three reasons explain these losses. First, the exempt resales, in which the purchase price could not be determined, were more likely to produce losses than profits. These sales were usually tax-exempt because local government units or charities purchased the properties, and neither were likely to pay much for foreclosed properties. Second, because no mortgagee collected a deficiency judgment, the deficiency amounts remaining in eleven of the cases involving third-party buyers also represented losses to the mortgagees involved. When these deficiency amounts are combined with the profits and losses on resale, the average mortgagee sustained an overall loss of almost $14,000. Finally, the nine properties which mortgagees purchased at foreclosure and were still holding four
The reader can draw her own conclusion from this brief review of Wechsler's statistical data. I believe it calls into question many of the assumptions and charges that have been leveled against mortgagees by those wishing to reform the process. It is hard to support a reformation of the foreclosure procedure postulated on an assumption that the mortgagor's equity interest in the foreclosed premises is being destroyed by actions of the mortgagee when the mortgagee, if anything, will lose more than the mortgagor with respect to their interests in the property.101

C. Sacrificing the Mortgagor's Equity in the Premises by Protecting the Mortgagee's Interest in the Premises: A Normative Approach

A review of recent scholarship analyzing the foreclosure process would lead any reasonably intelligent reader to conclude that the primary and perhaps sole purpose of the process is to provide competitive bidding in order to protect the mortgagor's equity interest.102 Little if any attention is given103 to the protection of the mortgagee's interest.104 I contend that failure to address the mortgagee's interest in the foreclosure procedure has led commentators to incorrectly conclude that the real estate foreclosure procedure is inefficiently accomplishing its objective.

---

101 Wechsler, of course, recognizes that he cannot base his call for reform of the foreclosure procedure solely on the perception that the foreclosure procedure generates an inadequate price:

The results of the empirical study suggest that foreclosure by sale is not achieving its objectives of providing competitive bidding and fair prices, while preserving mortgagees' rights to collect deficiencies. . . . None of these results is desirable. On the one hand, the mortgagee who keeps the surplus [provided by resale] deprives the mortgagor of a benefit that belongs to him and that our system clearly intends him to have. On the other hand, the failure of the mortgagee to collect deficiencies, or his absorption of losses on unprofitable resales, may increase the cost of credit.

---

102 For an example of such an argument, see id. at 858-60.
103 See supra text accompanying notes 66-84.
104 The one exception is Professor Wechsler who asserts that mortgagees are being harmed by the current foreclosure process because they are often stuck with unprofitable properties as a result of the inadequate price produced at the foreclosure sale. Wechsler, supra note 53, at 883. Of course, Wechsler then concludes that the major reform that should take place in the foreclosure process is the mortgagee's disgorgement of any profits it receives on resale. See supra text accompanying note 74.
If maximizing the sale price is the normative goal of the foreclosure proceeding, the current procedure admittedly fails to achieve that goal. Indeed, it is ill-designed to do so. Not surprisingly, most of the suggested reforms attempt to mimic the operation of the retail market, where commentators perceive a higher price will be realized. The problem with that approach, however, is that it ignores the primary purpose of the foreclosure procedure, which is to terminate the debtor-mortgagor's equity of redemption. The current procedure attempts to ensure that the creditor-mortgagee has some relatively inexpensive and expeditious way of realizing on the land and structures that secure the debt.

To understand the true purpose and normative goals of the foreclosure procedure, attention must be focused on the initial contract between the debtor and the creditor. By examining the foreclosure procedure as an isolated event separate and distinct from all that preceded it, commentators have oversimplified a complicated and interactive process.

The ability of a lender to foreclose on a mortgage in an inexpensive and expeditious manner is a key element of the ex ante bargain struck between creditor and debtor, a bargain that allows the debtor to obtain a loan at a very attractive interest rate, at least compared with other forms of debt such as personal loans. It is a standard axiom that the higher the risk on a loan, the higher the interest rate. The converse is true as well. One significant, if not predominant factor, that makes the typical real estate mortgage relatively riskless is the value of the asset that the debtor pledges as security. For several reasons, real property serves as an almost perfect security interest when compared with other types of collateral that the debtor might pledge.

What is very interesting, however, is that these same commentators never address the crucial issues raised by their own critiques and suggestions for reform: Why does the property bring a higher price in the retail market than at the foreclosure and if so, what does that mean for their contemplated reformation of the process? See infra text accompanying notes 115-24.

See, e.g., John Waggoner, 15 Ways to Straighten Up Your Financial House, USA Today, June 28, 1993, at B3 (noting that average 30-year fixed rate on mortgages was at 7.34% while rate for personal loans averaged 15.6%).

For an in-depth discussion of the contrasts and similarities between personal and real property secured debt and the effect that each may have on the other, see Alex M. Johnson, Jr., Adding Another Piece to the Financing Puzzle: The Role of Real Property Secured Debt, 24 Loy. L.A. L. Rev. 335 (1991).
First, land and the structures thereon are very easy to monitor because they are immobile. Second, due to its permanence and visibility, it is very difficult for the debtor to engage in opportunistic behavior with respect to the collateral by secreting it away or consuming it. Third, other than active or permissive waste created or allowed to be created by the mortgagor,\(^{108}\) which itself can be effectively monitored by the lender through periodic visual inspection and which is deterred in any event by the debtor’s own interest in the premises, most risks that affect the value of the property are exogenous to the particular debtor and therefore not affected by the particular debtor’s activities and behavior.\(^{109}\) For all these reasons, the debtor will receive a lower interest rate on a mortgage loan.

The value of the security, however, is premised on the lender’s ability to “realize” the security upon default. The security interest would be relatively worthless, irrespective of its other values as a security interest, if the creditor could not efficaciously take possession of the property and apply its value upon sale or transfer to the underlying debt. My point is not that the current foreclosure process is not without its flaws. Rather, my point is simply that the more efficient the process, the lower the interest rate on the original loan, all other factors being equal. Any attempt to change the foreclosure procedure begs the question: What impact will such changes have on the ex ante position of the parties?

This conceptual model of real estate financing is based primarily on the norm of efficiency. My assumption is that mortgagees and mortgagors would prefer a system that maximizes their respective economic interests in the aggregate and sacrifices, to a degree, idiosyncratic individual interests. Such a norm helps explain the use of standardized forms, routinized transactions, and the operation of the secondary financing market in the typical real estate purchase and


\(^{109}\) In other words, most if not all of the serious foreseeable risks undertaken by the creditor at the time of contracting, such as a large fall in local real estate prices or massive unemployment, are not controlled or seriously affected by the debtor’s behavior. Elsewhere I have argued that the lender can more efficiently undertake these risks. See Alex M. Johnson, Correctly Interpreting Long-Term Leases Pursuant to Modern Contract Law: Toward A Theory of Relational Leases, 74 Va. L. Rev. 751, 754 (1988).
Critiquing Foreclosure

A component of that efficiency norm is the protection of the creditor's interest in the security. Consequently, the normative perspective that I employ to analyze and describe the foreclosure procedure is not based solely or predominantly on whether a fair price that protects the mortgagor's equity interest in the premises is realized upon the foreclosure sale. Instead, my evaluation is based on the following question: Is the current foreclosure procedure the most efficient method of allowing the creditor to reach or realize its security interest in the premises following default in light of the entire relationship between the debtor and the creditor, particularly the competing claims of the mortgagor and mortgagee at the time of default?

I believe it is, if it is assumed that mortgagors and mortgagees enter into many such transactions and any change in the nature of the security interest and the manner in which it is realized by the creditor will have an impact on future bargains between mortgagees and mortgagors. The problem to date with criticisms of the foreclosure process is that they have focused almost exclusively on the foreclosure stage of the relationship as paradigmatic of the entire relationship. These criticisms have also ignored the changes in future relationships that will occur as a result of any shift in entitlement from the mortgagor to the mortgagee. In their attempts to increase the price upon foreclosure and protect the debtor's equity interest, critics of the current foreclosure procedure have substituted a normative base or perception at odds with the current operational structure of real estate finance.

III. SHIFTING THE NORMATIVE GOAL: EMPLOYING A DISTRIBUTIONAL PREFERENCE

In this Part, I further develop my arguments on three issues. First, I question whether the foreclosure process has failed, arguing that the market works quite efficiently if one presumes that the primary objective is protection of the mortgagee's security interest in the mortgagor's property. Second, I establish that the reason foreclosure does
not protect the mortgagor's equity is that the sale price generated at foreclosure is a wholesale price while the valuation underlying estimates of the mortgagor's equity is a retail price. Third, I suggest that although a shift in the normative paradigm underlying foreclosure may be necessary, the required shift is one quite different than that typically proposed by critics of the foreclosure process.

A. Defending the Foreclosure Process

Critics of the foreclosure process tend to make two distinct arguments as to why it does not protect the mortgagor's equity interest. The first type of argument is predictive. \(^{111}\) Under this approach, critics argue that the foreclosure procedure fails because of improper design. In other words, the foreclosure procedure's flaws ensure that it does not produce the most efficient outcome and therefore, to obtain the right outcome, the rules governing the foreclosure process must change.

Aside from allegations that mortgagees conspire with others to extinguish the mortgagor's equity interest, an act that all would agree is actionable, \(^{112}\) the predictive view has two primary objections to the current foreclosure procedure: a lack of publicity that leads to a lack of bidders at the foreclosure sale, and a lack of credit bidding at the foreclosure sale that eliminates a large number of buyers from bidding at the foreclosure sale.

I. Lack of Publicity

Those urging reform of the current foreclosure procedure have focused on the manner in which the foreclosure sale is advertised as a major factor in destroying the mortgagor's "equity interest" in the premises. \(^{113}\) Without realizing it, all the critics of the foreclosure procedure have zeroed in on one of the classic sources of market failure and have been using it as the primary predictive rationale for their

---

\(^{111}\) The second type of argument, which is less explicit, is normative and is discussed in the text, supra, at Part II.C.

\(^{112}\) See supra text accompanying notes 51-52 for a discussion of collusive bidding behavior.

\(^{113}\) See supra text accompanying notes 58-62 & 67.
reform efforts.\textsuperscript{114} These lack of publicity arguments can be reduced to a claim that information asymmetries create a market failure.\textsuperscript{115}

It is argued that very few buyers (bidders) are aware of the availability of the property at the time of foreclosure due to the way the property is advertised.\textsuperscript{116} Thus, if the foreclosing bank is analogized to a seller and the bidders at the foreclosure sale are likened to buyers, one can make a credible theory that there is a market failure in that the sellers have much more information about the property being sold, such as the quality of title and the quality of the property, and most importantly, the fact that the property is available for sale. The resulting market failure allegedly creates a lesser price for the property at the time of foreclosure, leading to a diminution of the mortgagor's equity interest.

The mortgagee is analogized to a seller because the mortgagee controls and implements the sale of the asset. Moreover, the mortgagee's position can be analogized to that of an agent of the selling party, the mortgagor. However, due to the ex ante bargain struck between the mortgagor and mortgagee upon executing the mortgage, the mortgagor's agent, the mortgagee, may purchase the asset from the principal as long as it abides by the process's procedural requirements. Because the agent can capture any excess gains realized from the subsequent sale of the property to a third party following effective foreclosure, contrary to normal agent-principal rules,\textsuperscript{117} one can argue that the agent has an incentive to produce a sale negating the principal's interest at the lowest price which discharges the debt. Such a result, some may argue, is a breach of the agent's fiduciary duty to the principal.

\textsuperscript{114} For example, see Robert Cooter & Thomas Ulen, Law and Economics 48 (1988):

The fourth source of market failure is a lack of information, for example, about who is selling the desired good or about the quality of goods offered for sale. It is often the case that sellers know more about the quality of goods than do buyers. . . . When sellers know more about a product than do buyers, or vice versa, information is said to be distributed asymmetrically in the market. . . . [S]evere asymmetries can disrupt markets so much that a social optimum cannot be achieved by voluntary exchange.

\textsuperscript{115} See Susan Rose-Ackerman, Inalienability and the Theory of Property Rights, 85 Colum. L. Rev. 931, 939 (1985) (noting that information asymmetries are a common source of market failure). In a related vein, Professor Schill supports the implementation of mortgage protection laws because the private market allegedly cannot be relied on to supply an optimal level of mortgage protection. See Michael H. Schill, An Economic Analysis of Mortgagor Protection Laws, 77 Va. L. Rev. 489 (1991)

\textsuperscript{116} See supra text accompanying notes 58-62.

\textsuperscript{117} The court in \textit{Murphy} expressed similar thoughts. See \textit{Murphy v. Financial Development Corp.}, 495 A.2d 1245, 1250-51 (N.H. 1985).
The contention that information asymmetries result in lower prices is enhanced because there is a third party whose interest is most affected by the information asymmetry—the mortgagor. Thus, it can be argued that unlike typical situations involving buyers and sellers, where either the buyer or seller can demand more information to induce optimal exchanges, the affected party in this transaction is unable to protect its interest in the transaction. The mortgagee, by contrast, has no incentive to correct the information asymmetry because it would not benefit from doing so. Consequently, proposals to replace the foreclosure process with mechanisms that approximate the retail real estate market should be viewed as attempts to protect the mortgagor's interest by correcting information asymmetries in the market.\footnote{118 See Cooter & Ulen, supra note 114, at 48-49 for a discussion of governmental intervention in the market to correct information asymmetries.}

There is one major problem, however, with this approach. It presumes a market failure when none has been proven. Indeed, the evidence tends to indicate that the relevant information is being distributed and received by appropriate parties and that the market is working quite well. A review of the empirical data reveals that somehow buyers are aware of foreclosure sales of residences that they are interested in purchasing for residential use.\footnote{119 See supra text accompanying note 97.}

Moreover, this is not the classic case of information asymmetry in which one party has knowledge of certain facts and refuses to disclose those facts to the other party.\footnote{120 For an example of this sort of asymmetric information, see Obde v. Schlemeyer, 353 P.2d 672 (Wash. 1960) (holding seller of building liable for withholding fact that building was infested with termites).}

The information is distributed and available to anyone diligent enough to ferret it out, as certain buyers have. Further, the fact that lawyers, who have never been shy in passing up a business opportunity, realtors, and others involved in the real estate industry are aware of the mechanics of foreclosure sales and the potential profits from purchasing at them leads me to conclude that the market works relatively well with respect to the dissemination of information. The fact that the foreclosure market can be characterized as a wholesale market does not mean information asymmetries necessarily create serious market imperfections.

At best, the fact that information may be more difficult to obtain in this context, because signs are not posted in the yards of the fore-
closed homes or advertisements are not placed in the real estate portion of the local newspaper, may simply mean that the cost of obtaining the information is higher than in the comparable retail transaction. But that is the most that can be said. The claim that the current foreclosure procedure creates asymmetric information that results in market failure may be rejected as unproven and unsupported by the evidence.121

2. Lack of Credit Bidding

The second predictive objection to the foreclosure process is based on transaction costs. Foreclosure proceedings are said to entail higher transaction costs, both because of higher search costs and because, unlike the mortgagee who can make a credit bid at the foreclosure sale, a third party bidder must essentially make an all-cash purchase. With respect to this claim, there is a factual basis to support it if one compares the price of property realized upon foreclosure to that realized upon resale to third parties.122

To determine, however, whether the transaction costs generated by the foreclosure procedure are acceptable, the entire relationship must be examined. One cannot simply look at the end of a procedure in isolation from what came before and what transpires after. Looking at it from an overall perspective, the mortgagee’s credit bid makes perfect sense because it has already put its money into the premises. Requiring the mortgagee to make something other than a credit bid would make little sense because, in effect, it would be requiring the mortgagee to pay twice. The primary goal of the foreclosure proceeding is for the mortgagee to get back the money that it already lent, not to require the mortgagee to further invest in the property.

Moreover, the requirement that buyers make an all-cash bid at the foreclosure sale can be traced to the original relationship between the mortgagor and mortgagee and recognition that, at the foreclosure stage of the relationship, the mortgagee is entitled to get as much cash

---

121 As the Wechsler study indicates, when it is cost-efficient for buyers of foreclosed properties to become more informed about properties being sold, they apparently do so, thus resolving the information asymmetry problem. See Wechsler, supra note 53, at 883. On the margin, though, costly information gathering may still create limited information asymmetry problems.

122 For a discussion of the difference between the retail price and the price realized upon foreclosure, see infra Part III.B.
as possible out of its security interest. At this stage of the relationship, the mortgagee is attempting to terminate its relationship with the debtor. Any requirement that the creditor-mortgagee finance the purchase of land by accepting a credit bid at the foreclosure sale would work a substantial alteration in the parties' ex ante relationship. Further, it would create a situation in which the debtor-mortgagor could manipulate default in a manner inconsistent with current federal law with respect to due-on-sale clauses. In other words, to require the lender to accept a credit bid or a buyer on the same terms and conditions as the foreclosed mortgagor would essentially require it to accept an assignment of the mortgage.

Most commercial lenders would likely welcome the appearance of a solvent buyer willing to purchase the property and finance the purchase through the same commercial lender who made the original mortgage. Not only would the bank have the advantage of having the illiquid asset or property removed from its portfolio, it would also have a solvent debtor making payments on a mortgage at presumably market interest rates, thereby removing a noninterest-bearing asset from its balance sheet. This sort of "refinancing" no doubt happens all the time.

Consequently, contrary to its critics' assertions, the foreclosure process works quite well and quite efficiently when the entire relationship between the mortgagor and mortgagee is examined. By contrast,

123 For a discussion of the benefit of using a relational approach that focuses on the entire relationship between the parties, see supra Part II.C.
124 See id.
125 For example, assume that a mortgagor wished to transfer its mortgage, along with the property, to a prospective purchaser. Pursuant to the Garn-St. Germain Depositary Institutions Act of 1982, 12 U.S.C. § 1701j-3 (1989), the lender can legally restrict the alienation of the property with the mortgage by exercising the due-on clause in the mortgage. For a discussion of the Act and the exercise of due-on clauses, see Johnson, supra note 109, at 772-774, 801-03. If, on the contrary, the mortgagee must accept a credit bid that incorporates the same term and conditions as the original mortgage, the debtor can manufacture a default and force the mortgagee to accept the proposed assignee, assuming he is the highest bidder, at the foreclosure sale. If, alternatively, the credit bid must be made at market rates to avoid this problem, another question arises: What exactly is market rate on this foreclosed piece of property and who will determine it? Will the mortgagee be forced to lend on the same terms and conditions of the average mortgage transaction (however that will be computed?) or will it be able to charge a higher rate of interest (how high?) because the property has already been foreclosed once and represents a higher degree of risk? In any event, the resolution of these latter questions is immaterial because the bidder at the foreclosure sale can always go to the mortgagee in advance of the sale and arrange to make a credit bid. See infra text accompanying notes 31-34.
looking at discrete pieces of the relationship in isolation results in a distorted picture of the procedure.

B. Defining the Mortgagor's Equity Interest

Throughout this Article, I have referred to the mortgagor's interest in the premises as her equity interest. At this point, I consider whether the term is properly used in conjunction with foreclosure proceedings. Critics typically compute the mortgagor's equity interest based on the property's value on the retail market and then unfairly compare this price to the price realized at the foreclosure sale. The foreclosure procedure in no way approximates the dynamics of the retail market and was designed and implemented by statutes at a time when all or substantially all-cash sales were the norm. In the interim, the current credit method, i.e., the level-pay plan fully amortizable mortgage, has developed as the prototypical vehicle to finance the purchase of real property. The foreclosure process does not adequately incorporate the changing fare of the real estate market and, as a result, the method of foreclosure employed is subject to the criticism that although it was not designed to generate a lower cash price, it results in a lower cash price realized at the foreclosure sale than the price that would be realized if the dynamics of the retail market are employed to effectuate a sale upon foreclosure.

Hence, critics of the current foreclosure procedure are comparing apples and lemons and finding that apples are sweeter than lemons and demanding that apples somehow be grown from the seeds of lemons. What these champions have failed to address and learn from is why the current foreclosure procedure fails to produce that same price. What creates the differential in prices and what, if anything, is accomplished by the differential? Put another way, what facts or factors are represented by the differential in prices and what do the proposed changes in foreclosure procedures, such as moving from a wholesale market to a retail market, portend for real estate financing other than the protection of the mortgagor's equity interest in the premises?

I posit that the mortgagor's equity interest in the premises in this situation is chimerical. Given the way the market is structured and the manner in which the sale of real property is financed, the mortgagor's equity interest exists if, and only if, the property is being trans-
ferred to a mortgagor who finances the purchase of the property with a traditional mortgage.

The divergence between the cash price for property and what I term the credit price of the property represents the mortgagor’s equity interest in the premises if the process, as designed and implemented, typically only produces a credit bid by the mortgagee that equals the outstanding debt (plus costs) owed to the mortgagee. Moreover, there is a legitimate, reasonable explanation as to why such a divergence exists. The differential in price is created by the search, transaction, and opportunity costs (remember the bank has its $85,000 sunk into the property), in locating that solvent, creditworthy mortgagor who can finance the purchase of the property.

C. Changing the Norms Inherent in the Foreclosure Process: Protecting the Mortgagee’s Interest

Advocates of reform of the foreclosure process essentially seek to change the normative basis underlying foreclosure in order to protect the mortgagor’s equity interest. By elevating the protection of the mortgagor’s equity interest as the appropriate normative goal of the reformed foreclosure procedure, critics propose a framework that limits what they perceive as potential opportunistic behavior by the mortgagee against the mortgagor’s equity interest.

Opportunistic behavior, not to be confused with conduct that constitutes a breach of contract, is defined as behavior of a performing party to an agreement “contrary to the other party’s understanding of their contract, but not necessarily contrary to the agreement’s explicit terms, leading to a transfer of wealth from the other party to the performer.” Thus, opportunistic behavior is behavior that, although permissible under the contract, results in a wealth transfer. In this context it is the transfer of the mortgagor’s equity interest from the mortgagor to the mortgagee.

126 See supra notes 77-82 and accompanying text.
128 Id. at 521.
The reforms suggested by commentators critical of the current foreclosure process take the form of limitations on the creditor-mortgagee's right to negate the mortgagor's interest in the property through an involuntary transfer of the mortgagor's interest in the foreclosed property. In other words, under current foreclosure practices, the creditor-mortgagee is given a very effective and powerful right to negate the mortgagor's interest in the premises through a forced transfer of that interest at a foreclosure sale. The interests of the mortgagee in the proceeding are paramount; action taken by the mortgagee to protect its security interest in the premises not only outweighs any interest in the mortgagor's equity in the premises, such action is deemed to be opportunistic because it ultimately leads to a transfer of that equity to the mortgagee, contrary to the expectations of the mortgagor.

Professor Nelson's suggestion that a trustee be appointed to sell the property pursuant to normal commercial measures is indicative of calls for reform.130 His proposal limits the creditor-mortgagee's right to sell the property until a trustee is given adequate time to attempt to sell the property through the suggested commercial methods. The trustee, of course, is charged with not only protecting the mortgagee's interest in the premises but the mortgagor's as well. The problem with Professor Nelson's analysis is the assumption that the creditor-mortgagee is acting in an opportunistic fashion. Opportunism is present when the wealth transfer was not bargained for ex ante by the parties.131 In the typical foreclosure proceeding, however, the ex ante bargain expressly allows for just such a wealth transfer upon foreclosure.

At best, the mortgagor can claim surprise at the operation of the foreclosure process because of ignorance ("I didn't read the document") or lack of sophistication ("I read the document, but I didn't understand it"). But if that is the problem the remedy is quite different, such as using simpler language, using bold type language, or requiring a separate document signed by the mortgagor stating that she understood the foreclosure process. Indeed, more likely, the

130 Nelson, supra note 66, at 249.
131 "In one sense, [opportunistic behavior] represents a party's strategic response to a situation that was not contemplated by or anticipated by the parties ex ante and which was therefore not addressed in the agreement between the parties." Johnson, supra note 129, at 75 (citation omitted).
mortgagor-debtor is aware of the risks of the foreclosure process, but she is unable to internalize that risk either due to imperfect information (she cannot accurately predict the odds of her falling on hard times and losing her home), or lack of bargaining power (the contract is an adhesion contract), or both.\footnote{132}{See supra note 18.}

What these commentators critical of the current foreclosure process fail to expressly acknowledge is that they have employed a distributional preference that results in a substantive change in the way proceeds are distributed upon default and foreclosure. They have changed the ex ante bargain that awards the creditor-mortgagee most of the benefits at the foreclosure by incorporating norms of debtor-mortgagor protection. The key questions are what costs are engendered by the shift in the normative basis and who will pay for the increased costs?

IV. REDESIGNING FORECLOSURE TO INCORPORATE THE NORMS OF BANKRUPTCY

In this Part, I assume that protecting the mortgagor's equity interest in the premises should be one of the intrinsic goals in an effective and efficient foreclosure process. The cost of achieving that goal will be addressed later.\footnote{133}{See infra notes 171-77 and accompanying text.} However, even assuming the ideal foreclosure process protects the mortgagor's interest in the premises, that does not answer the question of how that goal should be realized. Moreover, any such goal must consider the effects upon the mortgagee's interest. For example, it is quite easy to devise a procedure that totally protects the debtor's equity interest but has the objectionable effect of destroying or greatly reducing the protections provided to secured creditors. Such a procedure might require some third party arbiter to hear evidence on the foreclosed property's fair market value on the date of foreclosure. That value could be based explicitly on an appraisal of what the property would bring on the retail market. If that adjudicated value exceeds the amount of the debt, as it often will, the foreclosing mortgagee could be ordered to pay the excess value to the mortgagor as a precondition of foreclosure.\footnote{134}{Thus, if our hypothetical mortgagor Karen was forced into foreclosure, she would be entitled to $60,000 from the mortgagee ($145,000 equity minus $85,000 debt on the date of foreclosure).} In effect, the credi-
tor would have to purchase the mortgagor's equity interest in the premises.

Notwithstanding the almost complete debtor protection afforded to the mortgagor by such a plan (the only risk borne by the mortgagor would be the possibility of an inaccurate below-market appraisal), most would reject such a plan as unthinkable and unworkable. Such a significant reduction in the value of the creditor's security interest would cause a concomitant rise in the cost of obtaining the loan. Many lenders would likely refuse to lend money on a substantial portion of residential real estate if such a foreclosure scheme were put into effect, and those that continued to lend would, I predict, charge much higher interest rates.

Hence, any foreclosure scheme intended to protect the mortgagor's equity interest must, by necessity, prioritize the conflicting norms inherent in such a scheme. In order to preserve mortgage lending at its existing level and as close as possible to its current cost, any scheme that incorporates debtor protection features should also attempt to preserve as closely as possible the mortgagee-creditor's security interest in the premises. That will minimize the cost of any such scheme, a cost ultimately borne by future mortgagors.

A. Looking to Bankruptcy Law for the Answer

In this Part, I introduce an innovative way of analyzing the foreclosure process that represents a paradigm shift with respect to the normative goals usually applied to the problem. My analysis emphasizes protection of the mortgagor's equity of redemption while minimizing the costs of that protection to the mortgagee. Because my proposal emphasizes maximizing the interests of all parties, neither mortgagees, who will bear little if any costs, nor that class of mortgagors sophisticated enough to recognize that any costs borne by the mortgagee will eventually be passed on to the mortgagor, should object.

The key factor that has distorted prior proposals to apply market mechanisms to the foreclosure process is that these proposals presuppose solvent parties able to protect their interests in arms-length transactions. The problem is that in the typical foreclosure proceeding the party with the least ability to protect its interest in the premises—the mortgagor—is given rights that it cannot exercise as a practical matter. That is because the mortgagor is, in effect, bankrupt. Recognizing the mortgagor's de facto bankruptcy status is the
key to solving the puzzle that has intrigued the commentators who have examined and criticized the foreclosure process.

If the mortgagor is functionally bankrupt, it should come as no surprise that the answer to the foreclosure puzzle also lies in bankruptcy law. In order to illustrate the answer without needlessly confusing two very different situations (bankruptcy proceedings and foreclosure proceedings), I assume that the defaulting mortgagor has not formally filed for bankruptcy, even though her interest is being foreclosed. I also assume the mortgagor has only one secured creditor, the mortgagor, who has properly noticed the foreclosure.

Even though we will be operating pursuant to state law, the norms of bankruptcy will provide us with a viable solution to our problem. The focus is not on the procedures employed under bankruptcy law to collect and disperse assets of the debtor to her various creditors but on the norms that support the use of bankruptcy rules when the courts are faced with an insolvent debtor. Those norms have best been expressed in the pioneering work of Professor Thomas H. Jackson.135

Professor Jackson argues that bankruptcy rules should be viewed as ameliorating a common pool problem engendered by a system of individual creditor remedies in a situation where the debtor does not have enough assets to pay all the creditors.136 Often times a collection of assets is more valuable when held together than if divided and distributed. This is often referred to as the surplus or going-concern value versus the liquidation value.137 In this context, the decisions of individual creditors to pursue individual creditor remedies such as attachment, levy, and garnishment may be the wrong decision for the group of creditors as a whole.138 Even though the debtor is insolvent, the creditors as a group may be better off if the assets of the debtor are held together or if individual creditor actions are postponed in an attempt to maximize the value of the assets for the purpose of satisfy-

137 Id. at 14.
138 Id. at 12.
ing creditor claims.\textsuperscript{139} By imposing a collective and compulsory proceeding on the creditors that supplants the individual debt-collection rules of state law, bankruptcy provides a way to make the diverse claimant-creditors act as one and, more importantly, act as one would to maximize the value of the assets if only one individual owned all of the assets.

This collectivization norm is limited by one caveat: bankruptcy law should not alter the prebankruptcy relative entitlements among creditors. In other words, a secured creditor that has priority over other creditors should always maintain that priority irrespective of bankruptcy's collectivization procedure. Although the collectivization norm may require a stay in the secured creditor's attempt to realize on its security because it is in the best interests of all the creditors that the item that serves as security remain with the debtor during reorganization, the secured creditor is entitled to exercise its priority interest by the time the case is completed.\textsuperscript{140} A different rule would create inefficient incentives for particular holders of rights in assets to resort to bankruptcy proceedings in order to gain for themselves the advantages of those changes, even when the bankruptcy proceeding would not be in the collective interest of the creditors.\textsuperscript{141}

It may appear that my proposal turns the Jackson paradigm of bankruptcy on its head, because I propose to alter the substantive rules that currently exist under state law. I am not arguing, however, that one set of substantive rules should regulate the protection of the mortgagor's equity interest under state law and another set of rules should regulate the protection of that interest under federal bankruptcy law. If state law does not adequately protect the mortgagor's equity interest in the foreclosed property, I agree that the same lack of protection should apply in bankruptcy.\textsuperscript{142} What I am arguing, on the

\textsuperscript{139} Id. at 14.

\textsuperscript{140} For further discussion of equivalent value and how that is attained when a stay is imposed on the secured creditor, see infra notes 158-63 and accompanying text.

\textsuperscript{141} Jackson, supra note 136, at 21.

\textsuperscript{142} Indeed, this is exactly what happens today when the foreclosed mortgagor resorts to bankruptcy court for protection from the mortgagee-initiated foreclosure proceeding in state court. A stay is normally granted and then lifted once the mortgagee proves its security interest and the right to foreclose its interest in the subject real property. This leaves the mortgagor at the mercy of state law, which provides no protection for the mortgagor's equity interest in the foreclosed real property.
contrary, is that state foreclosure law is viewed as inefficient because of its cavalier sacrifice of the mortgagor's equity interest.

A more efficient method of foreclosure is suggested if the mortgagor-mortgagee relationship is viewed as one involving a common pool problem once the mortgagor defaults. The same substantive norms that support the use of bankruptcy in personal and business failures, such as collectivization of the debtor's assets, expanding the pie to be shared by the creditors, and limiting the grab and run tactics of creditors,\footnote{In the typical bankruptcy situation, two or more creditors may engage in a race to grab the debtor's assets—this represents the sort of “grab and run” tactics limited by the operation of bankruptcy proceedings. In the hypothetical foreclosure setting addressed here, there is but one formal creditor—the mortgagee. However, the mortgagor's equity interest is best likened to that interest held by an unsecured creditor. See infra Part IV.C. The “grab and run” tactic sought to be limited by applying bankruptcy norms to foreclosure is the mortgagor's right to grab the asset and cause its forced sale, notwithstanding its harmful effect on the mortgagor's equity interest even where an alternative procedure would not harm the mortgagee but simply benefit the mortgagor. Technically speaking, however, there is no race to “grab and run” because that entitlement has been awarded ex ante to the mortgagee.} should be equally applicable with respect to foreclosure of the mortgagor's equity of redemption. There is no justifiable reason why an individual's personal assets or a businesses' assets should be protected under bankruptcy while the individual's or business' interest in real property is not.

B. Applying Bankruptcy Norms to Real Estate Foreclosures

Bankruptcy norms are applicable to the foreclosure proceeding because a foreclosure proceeding can be likened to a liquidation or Chapter 7 proceeding in bankruptcy. The debtor has reached a point where she can no longer pay her bills and the creditor has the right under the mortgage agreement to require liquidation of the asset that is the subject of the foreclosure proceeding.

Employing a Chapter 7-type proceeding as the model to mimic in the foreclosure setting,\footnote{One can envision a system pursuant to which the debtor-mortgagor's default requires a determination of whether the debtor should be able to file the equivalent of a “wage-earner's plan” under Chapter 13 of the Bankruptcy Code. See 11 U.S.C. §§ 1301-1330 (1988). But Chapter 13-like rules seem inappropriate in the context of foreclosure for a couple of reasons. First, the most frequent cause of debtor delinquency is when the debtor loses her job, yet Chapter 13 envisions a debtor with a job earning a stream of income. Second, it would be too costly, because a foreclosure modelled on Chapter 13 would require the debtor to pay less than the outstanding amount on the debt while retaining the asset. Creditors would take this loss into account in setting interest rates, causing the cost of such loans to rise significantly.} the mortgaged property must be sold to pay
Critiquing Foreclosure

The goal of such a process is to maximize the collective pie to distribute to creditors while at the same time recognizing that any distribution should not thwart the preexisting priorities of the parties.\textsuperscript{145} Thus, the secured creditor-mortgagee is entitled to any proceeds from the sale before any other creditor is paid.

Under such a "bankruptcy foreclosure proceeding,"\textsuperscript{146} therefore, the mortgagee-creditor must internalize the collectivization goal inherent in bankruptcy proceedings. What the typical foreclosure procedure lacks is the notion that the foreclosing secured mortgagee must refrain from acting when acting would hurt other creditors and the delay has no detrimental effect on the foreclosing secured mortgagor.\textsuperscript{147} In other words, the typical foreclosure proceeding rewards the foreclosing mortgagee for taking actions that in the bankruptcy setting would be regarded as grab and rim tactics harmful to other creditors.\textsuperscript{148}

No one can reasonably object to a procedure that has little, if any, cost and provides benefits that far outweigh those costs. I contend that my proposed bankruptcy foreclosure proceeding meets this goal by imposing minimal costs on the mortgagee. Conversely, it provides a tremendous benefit to the mortgagor and any junior lienholder because the collectivization norm employed in the bankruptcy foreclosure proceeding requires that the property's value be maximized.

\textsuperscript{145} See Jackson, supra note 136, at 58.

\textsuperscript{146} Henceforth, I refer to my proposal as the "bankruptcy foreclosure proceeding." It is so designated because it employs the norms inherent in bankruptcy law, not because the foreclosure takes place within a bankruptcy proceeding.

\textsuperscript{147} In some respects, the reform procedure suggested herein mimics the automatic stay applicable to secured creditors in Chapter 7 proceedings, in that secured creditors can demand "adequate protection" to ensure that they do not suffer harmful effects from the stay. See 11 U.S.C. § 362(d) (1988). For the definition of adequate protection in the Code, see 11 U.S.C. § 361 (1988).

\textsuperscript{148} Pursuant to the typical foreclosure proceeding, the secured creditor does not have to consider (internalize) what is in the best interest of all the creditors as long as its relative priority and rights are maintained in the secured assets. Thus, even though the foreclosed property may bring a higher price on what I term the retail market, thereby benefitting junior lienholders and perhaps the mortgagor, the senior secured creditor is allowed to foreclose those other interests in the premises even though it might not be harmed in any way by being forced to delay the sale of the real property in order to bring about a higher price. As currently structured, the typical foreclosure proceeding pursuant to state law is designed to sacrifice the interests of junior lienholders and the mortgagor's equity interest under the guise of efficiency without an examination of whether it would be more efficient and (I hate to use the word) fairer to all concerned if other methods of realizing on the security were employed by the foreclosing mortgagee.
C. Characterizing the Mortgagor's Interest as an Unsecured Creditor's Interest

Before describing the bankruptcy foreclosure proceeding, two matters must be addressed: an accurate characterization of the mortgagor's interest in the property and a closer examination of the inefficiencies contained in the typical foreclosure proceeding. Foreclosure presents a common-pool situation if the foreclosed property is worth more than the mortgagor's debt because if the mortgagor has equity in the foreclosed property there is always a secured and an unsecured creditor who each have interests in the property that must be maximized pursuant to collectivization norms. Who is the unsecured creditor? The mortgagor. Irrespective of the presence of any junior lienholders, a common pool problem is presented in any real estate foreclosure proceeding when the mortgagor has an equity interest in the premises.

In other words, I bifurcate the mortgagor's interest in the premises into debt and equity interests. The mortgagor's claim to any proceeds after the secured creditor has been paid is comparable to an unsecured creditor's interest in the property and should be treated comparably. Although most commentators clearly view the mortgagor solely as an owner-debtor who has pledged her interest in the real property to secure repayment of the debt, they ignore the fact that her interest is pledged only to the extent of her debt. The secured creditor's claim does not extend to any interest of the mortgagor that exceeds the amount of the debt for which the security is given.

Of course, the debtor technically cannot have a secured or unsecured interest in her own property. To the extent that the debtor owns property free of claims by creditors, either unsecured or secured, she is the absolute owner of that property, and it makes little sense to speak of her as having an unsecured interest in her own property. Her absolute ownership interest in the property—part of her bundle of rights that comprise her ownership interest—is much broader than her interest in the property as "unsecured creditor" and can be said to be subsumed by it.

When foreclosure occurs, however, the mortgagor's interest, at least conceptually, is fractionated and defined by what is left after those with superior interests satisfy their interest in the property. In this situation, the mortgagor's interest looks like the prototypical junior unsecured creditor's interest. Thus, the mortgagor can be viewed
as not the absolute owner but the owner of a residual claim on the property—a claim that is junior and subordinate to all other creditor claims on the property. It can only be defined and valued by reference to those interests superior to it at that stage, and the mortgagor’s interest can ripen into absolute ownership only when those senior interests are removed from the property.

D. The True Costs of Foreclosure: Cash Versus Credit

One might quibble with my analysis by noting that in many cases the mortgagor has no equity in the foreclosed property, at least as measured by the amount realized at the foreclosure sale. Thus, notwithstanding my attempt to characterize the mortgagor’s interest as akin to an unsecured creditor’s interest, if the mortgagor has no equity in the property upon foreclosure, she has no interest to protect. Such an argument presumes that if a valid foreclosure results in a bid at or below the amount of the debt, that price represents the fair market value of the property. This is an erroneous presumption because the foreclosure price typically represents the cash price, although the fair market value of the foreclosed property, as I use the term, is the credit price. Indeed, one of the keys to comprehending why the mortgagor’s equity is not realized in the typical foreclosure proceeding is recognizing that two different values are being used for two very different markets: cash upon foreclosure versus credit in the retail or resale market. What the typical foreclosure process accomplishes is the preclusion of obtaining the latter price to the detriment of the mortgagor.

Differentiating between cash and credit price for foreclosed property also resolves another objection to the use of bankruptcy norms in this context. An argument can be made that employing bankruptcy norms in this setting is inappropriate because, technically speaking, the mortgagor-debtor is not bankrupt. At first glance, that appears correct if the assumption is made that property values are flat or increasing in value. Thus, if Blackacre has a cost of $110,000 and the purchaser makes a $10,000 downpayment, financing the remainder of the purchase price with a first mortgage of $100,000 at 10%, she owns an asset worth a minimum of $110,000 with an encumbrance of $100,000, leaving her with a net value of $10,000. Hence, technically she is not insolvent.
However, what is missing is the realization that in order to protect that $10,000 in equity or value in the property, the debtor's human capital must be at a level to support the monthly payments on the debt. The debtor's equity is protected only if the property is sold on the retail or credit market and not on the cash market. If the debtor's human capital is insufficient to support the monthly payments on the debt, the debtor is indeed insolvent as a practical matter and unable, due to that insolvency, to exploit her equity in the premises by resort to the retail market. The lack of human capital forces the debtor to the cash market with a concomitant loss of value. The net result is a loss in her equity in the premises because that equity is premised on the debtor's financial ability to exploit the retail market.

Perhaps an example will clarify my thesis. Continuing with our hypothetical purchaser who purchases Blackacre for $110,000 with a $10,000 downpayment, the lender who makes the loan of $100,000 will be most interested in the amount and source of the debtor's annual income before approving the loan. Similarly, for tax and other reasons (primarily the transaction costs associated with purchasing a house) most home purchasers want to purchase as much house as they can qualify for or afford. And because lenders finance 80-90% of the purchase price, qualifying for a loan is as important, if not more so, than accumulating the downpayment. To qualify for a loan, most lenders examine the income of the putative mortgagor and establish the amount that they will lend based on the putative mortgagor's income. The simplest way to explain it is that lender will only loan an amount that will yield a monthly payment over the term of the loan that will not exceed a certain percentage of the putative mortgagor's monthly income.

---

149 The putative mortgagee will, of course, look at other factors such as the credit history of the putative mortgagor. But we will assume, as is truly the case, that the most important attribute for qualification of a loan is the amount and source of the debtor's income.


151 Thus, if the debtor earns $4,000 a month, and if the lender qualifies the debtor for a loan that does not require repayment in excess of 30% of the debtor's gross income, the debtor, all other things being equal, can qualify for a loan that requires a payment of up to $1,200 a month. To determine the maximum amount of the loan that the debtor qualifies for you also need to know the term or amortization rate of the mortgage and the interest rate charged on the loan. For example, assuming a 20-year term and an 8% interest rate, the debtor would qualify for a loan in the principal amount of $143,000, yielding a monthly payment of principal...
Critiquing Foreclosure

For the sake of discussion, I will assume that our putative debtor-mortgagor earns $48,000 a year or $4,000 per month. Using a conservative payment to gross monthly income ratio (the percentage of the debtor's monthly payment that comprises the monthly payment for housing), most lenders would easily qualify the debtor for 25% of her gross income or $1,000 a month. Ignoring property taxes and insurance, and using an interest rate of 10% and a 20-year term, the debtor will qualify easily for a mortgage loan in the amount of $100,000, which results in a monthly payment of $965.02 for a 20-year conventional or fixed fully amortizing mortgage on Blackacre. The loan, coupled with the $10,000 downpayment, allows her to purchase Blackacre for $110,000.

The payment to gross monthly income ratio masks the true nature of the transaction. The real reason why this ratio is utilized is because it measures the present value of the debtor's wealth (her income stream) versus the present value of the mortgage (the payment stream computed to present value), and if the present value of the mortgage is some fraction or less (say 25%) of the present value of the debtor's wealth, the loan is an acceptable risk. But, and this is crucial, the risk is based upon and the loan is approved with the assumption that the debtor will have an income stream that matches or exceeds the ex ante income stream the debtor possesses at the time the debtor applies for the mortgage.

Consequently, the mortgage loan should be characterized as follows: the present value of the right to receive $965.02 for the next 20 years as required by the mortgage that the mortgagor signed is $98,589 using an interest rate at 10%. Thus, if the interest rate remains the same, it is assumed that following the execution of the mortgage, the lender can sell the mortgage on the secondary market for $98,589.152 The present value of the right to receive $4,000 a month over the same 20-year period at the same interest rate of 10% is $408,652. Twenty-five percent of that present value is $102,163. In

and interest of $1,196.10. If this were a 30-year term mortgage, the debtor would qualify for a $163,000 mortgage loan, yielding a monthly payment of $1,196.02. To demonstrate the effect that interest has on these numbers and qualifying for mortgages, if the interest rate rises to 12%, the debtor only qualifies for a loan of $108,000 for the 20-year term, or $35,000 less than at 8%. Using a 30-year term and a 12% interest rate, the debtor qualifies for a maximum mortgage of $116,000, or $47,000 less than at 8%.

152 For a discussion of the secondary market and the securitization of mortgages, see infra note 176.
other words, 25% of the present value of the debtor's stream of income slightly exceeds the present value of the mortgage if the same time period and interest rate are used to compute present value. Thus, what the lender is banking on is the debtor having a net worth in human capital equaling four times or more the present value of the amount being lent. The security for the note, above and beyond the land secured by the mortgage, is the debtor's net worth, which, if it includes the present value of the debtor's income stream, is four times greater than the amount of the debt.

Thus, if the debtor constructed a balance sheet immediately after the loan was executed, the debtor would have a net worth far in excess of the amount of the debt. Indeed, the debtor would have a net worth of $420,063, which represents $310,063 as the net present value of her human capital ($408,652 minus 98,589) and the value of the land ($110,000). The debtor is clearly solvent and has the income stream to support the payments made on the mortgage, which in turn gives the land its value of $110,000.

The point is that once the debtor's stream of income drops below that present value, the loan is imperiled. Moreover, if the debtor loses her job and has no income (excepting perhaps an unemployment check), and hence no present value, the present value of the debt ($98,589) exceeds the present value of the human capital, which is zero when she is jobless and has no prospect of obtaining a job in the immediate future. Looking at it another way, we can assume that the debtor will not be jobless for the next 20 years, but what we are unable to assess is exactly what the present value of her human capital when she is unemployed because we do not know when she will get a job and how much it will pay. Thus, the present value of the debtor's income stream should more accurately be characterized as somewhere between zero and $408,652. However, until the debtor can establish a certain stream of income, the present value of the debtor's income stream (her human capital) has to be measured at either zero or the marginal rate of employment at the time of termination, assuming there are jobs available at that rate and the cost of procuring the job is nominal.

In the foreclosure setting, the debtor has a period of time—typically 90 to 180 days when she is in default but the foreclosure has not
taken place\textsuperscript{153}—to reestablish a stream of income that will support making payments on the debt. Failure to do so within the appropriate time period results in termination of the mortgagor's interest and the loss of her equity in the premises because, even though the debtor owns an asset in which she believes she has equity worth at least $10,000 (her original downpayment), when the value of that asset is measured against the present value of the debt ($98,589), the debtor's net worth is a liability of $88,589, because the value of her human capital is still zero. The debtor is indeed bankrupt because she has a long-term liability (the mortgage) and no long-term asset (a job) that represents the value of her human capital.

Moreover, the debtor cannot use the value of the foreclosed property to claim that she is solvent. The value of the foreclosed property, $110,000, is dependent on her maintenance of a job that provides her with a stream of income (her human capital) to make the payments necessary to maintain her ownership interest in the premises. In other words, and this is the oddity that causes the loss of the mortgagor's equity interest in the foreclosed premises, the mortgagor's equity interest depends on the existence of a solvent debtor (herself) with a stream of income that can support the weight of the debt that is the mortgage.

What I have characterized as the credit price for the real estate is simply a reflection of the fact that when real estate is sold to consumers on the retail market the asset that they are using to purchase their interest in Blackacre is the capitalized value of their future income stream. Thus, the market of potential bidders/buyers for Blackacre is very large. The potential market consists of anyone with $10,000 (the downpayment) and a minimum income of $4,000 a month produced from a steady job that a lender can assume will continue in the future indefinitely. Furthermore, if the debtor-mortgagor is selling Blackacre, time may be less of a factor with respect to forcing a sale because if the debtor-mortgagor is solvent, her income will provide for the monthly payments that are due on the property while the property is on the market.

When, however, the debtor's interest is foreclosed and cash is required at the foreclosure sale, a different market is created, one that I have characterized as generating a cash price for the property. The

\textsuperscript{153} See, e.g., Nelson & Whitman, supra note 5, § 7.4.
Virginia Law Review

Cash price will be significantly less than the credit price for two reasons. First, the number of potential bidders/buyers for the property is much smaller. Bidders/buyers can no longer use the present value of their human capital to purchase the asset. They have to come up with cash in order to compete with the mortgagee whose liquidity enabled it to pour $100,000 into the property at the time of purchase. The second factor is the lack of time. Finding the right buyer for the right piece of property can be time consuming. The search costs associated with finding a buyer is why brokers are paid what may appear to be an exorbitant amount. When the seller is the debtor, the debtor finances that search cost through employment and payment of the broker. More importantly, the debtor’s income stream provides the debtor with sufficient resources to enable the debtor to keep the property on the market (by paying the current mortgage) until a suitable purchaser is discovered. Once the debtor’s income stream disappears, however, so does her ability to market the property patiently. A separate market thus develops for distressed or foreclosed property that generates a lower price when compared to the retail market.

Consequently, it is easy to appreciate why the truncated foreclosure process creates a different market than the retail market for the sale of real property. The only true mystery is why others have not recognized that the foreclosure sale represents the equivalent of a wholesale market in which those with expertise in marketing, sufficient liquidity, and risk tolerance can shop for bargains that can be marketed later on the retail market with concomitant risks and profit margins.

E. Is Bankruptcy Law a Sufficient Alternative for the Mortgagor?

At this point, some questions arise. If my proposed foreclosure proceeding is modeled on the procedures and principles employed in the Bankruptcy Code, why is there a need for an alternative system when the debtor-mortgagor can simply resort to bankruptcy? Indeed, some mortgagors clearly do take advantage of bankruptcy in an

---

154 Indeed, anecdotal evidence suggests that some retail shoppers purchase at wholesale prices at foreclosure sales. See supra note 34. However, the major impediment to greater accessibility is the cash requirement that must be complied with in most foreclosure sales. One way to get around that hurdle is to borrow money from the bank, proceed to the foreclosure sale, bid and purchase the property, and then secure the loan.
attempt to protect their equity interest in the premises. Given that, why reform foreclosure? Why not simply allow mortgagors to resort to bankruptcy when they wish to use the collectivization norm of bankruptcy?

My answer is threefold. First, the fact that an existing procedure (bankruptcy) provides similar relief should not preclude the development of an alternative procedure (foreclosure premised on state law) that employs the same normative basis if the existing superior procedure is not completely appropriate in all circumstances. The debtor, for example, may not have other creditors, or at least creditors claiming the debtor is in default, and the debtor may not technically be bankrupt.

Second, the collectivization norm inherent in bankruptcy is premised on the existence of multiple creditors with incentives to engage in grab and run tactics. In the foreclosure setting, however, there is typically only one creditor—the secured-creditor mortgagee. By recharacterizing the debtor-mortgagor’s interest as akin to that of an unsecured creditor, I have gone beyond traditional bankruptcy rules to create a new creditor. In one sense, I am proposing to create a new entitlement in the foreclosure proceeding—viewing the interest of the debtor-mortgagor as that of an unsecured creditor—that turns the traditional theory of bankruptcy on its head. I am expressly creating a substantive entitlement that exists only in the foreclosure proceeding and not outside of it, thereby creating incentives for debtor-mortgagors to use foreclosure to protect their equity interest in the premises.

Third, as long as a separate foreclosure option is maintained in which the parties are not forced to utilize bankruptcy, it makes little sense to employ one norm in one system and a totally different norm in the other system. Such differentiation leads secured creditors foreclosing mortgagors to resort to state law foreclosure proceedings to maximize their interests, whereas debtor-mortgagors are forced to file for bankruptcy as a strategic vehicle in order to gain the temporary advantages afforded by the automatic stay. This strategic manipulation of the differences in the two systems results in the inefficient

employment of resources because secured creditor mortgagees have to respond to the strategic behavior of mortgagors who flee to bankruptcy for protection when that protection can and should be provided in state courts as part of normal debtor-creditor relations.  

F. A Brief Description of the Bankruptcy Foreclosure Proceeding: Nuts and Bolts

My model foreclosure proceeding begins once the secured creditor mortgagee properly notices a foreclosure. At that point, the debtor-mortgagor can proceed to state court and request a stay of the foreclosure proceeding. As part of that request, the debtor-mortgagor would agree to relinquish title and perhaps possession of the foreclosed property to the trustee. From that point forward the trustee will be regarded as the record owner of the premises.

The trustee in my bankruptcy foreclosure proceeding will perform a role similar to that of the trustee in bankruptcy. The trustee's role, however, will be limited to two discrete functions. First, the trustee will estimate, as part of a judicial proceeding if a party requests, the liquidation or cash value of the property (the value that could be realized upon a relatively quick foreclosure) and the retail or credit value of the premises (the price obtainable if the property is sold pursuant to normal real estate practices). If the retail or credit price exceeds the amount of the debt owed the mortgagee, taking into account the time-value of money, then the trustee should stay the foreclosure proceeding.

The rationale for the automatic stay is straightforward. The collectivization norm requires that the creditor-mortgagor be prevented from taking action that has a detrimental effect on the value of the

---

156 For an example of mortgagor manipulation of bankruptcy proceedings to extract a benefit not obtainable under state law, see Durrette v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980) (holding that a foreclosure sale that produces a price less than 70% of the property's fair market value is a fraudulent conveyance that can be avoided under § 548(a)(2) of the Bankruptcy Code). For an argument critical of Durrette, see Douglas G. Baird & Thomas H. Jackson, Fraudulent Conveyance and its Proper Domain, 38 Vand. L. Rev. 829 (1985).

157 The logic of whether to grant or deny the stay largely parallels the decision under the Bankruptcy Code to grant an undersecured creditor relief from the automatic stay. See 11 U.S.C. § 362(d) (1988). One difference is that the Bankruptcy Code also conditions an undersecured creditor's relief from the stay upon whether the property is "necessary to an effective reorganization." 11 U.S.C. § 362(d)(2)(B) (1988). This consideration, however, is not relevant in the foreclosure setting.
mortgagor-debtor's assets. As a result, the process must determine whether the debtor-mortgagor's asset, in this case the property being foreclosed, is worth more than the amount of the creditor's debt on the retail or credit market. If it is, then the foreclosure should be stayed in order to attain that higher value on the retail or credit market with the concomitant benefit to the debtor-mortgagor, who receives the excess value over the amount of the debt—her equity interest in the foreclosed premises. If the property is worth less than the amount of the debt being foreclosed on the retail market—technically, “the collateral in question is worth no more than the amount of the secured party's claim”—no stay should be granted, or, if a provisional stay has been granted, it should be lifted immediately upon the adverse determination of value. Professor Jackson elaborates:

Application of the automatic stay to fully secured creditors makes sense in the first instance. To permit a secured creditor the full exercise of its rights may hinder efforts to preserve the value of the debtor's assets. It may be in the interest of the owners as a group to stay the repossessing rights of a secured creditor and to substitute a requirement that the secured creditor instead accept the asset's liquidation value. Because of the costs repossessing and subsequent repurchase may bring, it is consistent with the collectivization norm to substitute for a secured creditor's actual substantive rights under nonbankruptcy law a requirement that the secured creditor accept the equivalent value of those rights. Thus, application of the automatic stay to the secured creditor, with a substitution of the relative value of rights in place of the rights themselves, is consistent with bankruptcy's role as a collective debt-collection device.

The second function of the trustee is that she will have the power to sell the property on the retail market. Consequently, the trustee must be given the authority to contract with realtors in order to list the property for retail sale, to spend funds necessary to effectuate a sale of the property, to sign contracts of sale, and finally to execute special or limited warranty deeds conveying title to the property to a purchaser.

---

158 Jackson, supra note 136, at 181-82.
159 Id. at 182.
160 Id. at 181-82 (footnotes omitted).
161 For example, the trustee will have to obtain a title report, appraisals, surveys, and so forth. The costs of doing so will be charged as a lien against the property and repaid from the sales proceeds before paying any creditor's claim, including the claim of the mortgagee.
The trustee will have sole discretion with respect to negotiating and accepting a sale price for the property.\textsuperscript{162} Of course, if the property is not worth more on the retail market than the secured debt being foreclosed, the request for stay will be denied and the property will be foreclosed pursuant to the traditional method.

This process will protect the secured creditor's interest in the property because the trustee will have a duty to preserve the relative values of the parties' rights.\textsuperscript{163} The trustee must attempt to give the secured creditor the same value it would have received if it had been allowed to foreclose the premises pursuant to the cash method of foreclosure. If this is accomplished, the trustee will have succeeded in preserving distributional entitlements while at the same time maximizing the amount of capital distributed to the claimants—a deployment question. By contrast, a distributional change would occur if, for example, the property were sold on the retail market for $25,000 more than that at a hypothetical foreclosure sale that might have taken place six months previously. In such a case, although the trustee would have correctly stayed the foreclosure sale, the mortgagor would earn a windfall profit of $25,000 while the mortgagee gains nothing.\textsuperscript{164} This result is contrary to the preservation of relative values because one class of creditors, debtor-mortgagors, gain from any upswing in value while avoiding the downside risks. Unless relative values are preserved, the debtor-mortgagor has a tremendous incentive to resort to the bankruptcy foreclosure proceeding in order to gain for itself the advantage of those changes, even when the bankruptcy foreclosure

\textsuperscript{162} At this point, trustee error can affect the process. In other words, the trustee can sincerely, but erroneously, believe that the property has a value in excess of the amount of the secured debt. As a result, no acceptable offers may be forthcoming. Thus, my proposal includes a one-year time limit on the trustee's right to sell the property; otherwise, it would be sold through a typical foreclosure auction. Of course, if real estate values decline over the course of the year, it is possible that the secured creditor mortgagee will not only lose the use of the money, but it also may find itself in the unfortunate position of receiving less money for the foreclosed property than it otherwise would have. This is, indeed, a potential cost of my alternative system that I address in the next Section. However, part of the reward given to the mortgagee if the property sells at its fair market value—the upside scenario—is given to compensate the mortgagee for the risk that this downside scenario occurs.

\textsuperscript{163} The concept of preserving relative rights in bankruptcy is fully explored in Jackson, supra note 136, at 183-85.

\textsuperscript{164} I can envision a court doing something slightly less objectionable: giving the foreclosing secured creditor mortgagee legal interest in the amount it is owed. For the reasons stated in the text having to do with the preservation of relative value, this result is not entirely satisfying.
proceeding would not be in the collective interest of the parties if the parties acted as an efficient sole owner.

My proposal preserves relative values by first estimating what the foreclosing secured creditor would have received at a foreclosure sale. I use the earliest date at which the property could be foreclosed pursuant to state law as the determination date for establishing when the foreclosing creditor is entitled to receive its interest in the property. The amount the foreclosing secured creditor is entitled to receive is established by the amount of the debt owed on the date of foreclosure, plus costs. In our hypothetical, the foreclosing mortgagee is owed $85,000 on the date that foreclosure is scheduled to take place, so that in order to protect the secured creditor’s relative rights, it will be given a “secured” claim for $85,000.165

This right given the mortgagee in the bankruptcy foreclosure proceeding is equivalent to an allowed secured claim given a secured creditor in a bankruptcy proceeding.166 Under § 506(a) of the Bankruptcy Code, a creditor’s claim is a secured claim to the extent of the value of such creditor’s interest in the collateral upon the filing for bankruptcy.167 The value of the collateral, and hence the secured creditor’s allowed secured claim, is determined by estimating its value in a manner analogous to that used under my proposal.

In order to provide the foreclosing secured creditor with the relative value of its asset at the time of foreclosure, the creditor must be granted an additional claim. To do so, the trustee must make an additional value determination. As part of her resolution of whether the property should be foreclosed immediately for its cash value or marketed on the retail market, the trustee must ascertain the present value of the foreclosed property based on it being sold on the retail market. Assume for purposes of illustration in this Section that the trustee estimates that the expected present value equals $125,000.168

165 Jackson, supra note 136, at 185.
167 Id.
168 The expected present value of the property would equal the probability that the property would sell for a certain amount multiplied by that amount, discounted by the length of time it takes the trustee to sell the property, and then summed across all possible amounts for which the property might sell. For example, suppose the trustee estimated that the property has a 75% chance of being sold in one year, for an amount that after being discounted equals $145,000. Conversely, suppose there is a 25% chance the property will not sell on the retail market for an amount above the outstanding debt, and the property is then foreclosed
This valuation of $125,000 would form the basis for distributing any surplus above the cash price generated by the trustee's sale of the property to the mortgagor and mortgagee. In this case, our foreclosing mortgagee already had a claim for $85,000, or 68% of $125,000, the expected present value of the property. Under my proposal, the mortgagee would have an additional (unsecured) first priority claim for 68% of the sale value of the property less any amount realized under its priority $85,000 secured claim. The mortgagor, in turn, would have a second priority claim for 32% (or $40,000) of the expected present value of the property, less any amount needed to pay the mortgagee's unsecured claim (in this case zero). Note that both the latter unsecured claim of the mortgagee and the claim of the mortgagor are subordinated claims in the sense that they come after the secured claim of the mortgagee discussed below.

Some hypothetical distributions may clarify the operation of this proposal. Suppose the property actually ended up selling for $125,000. In that case, the mortgagee would first have its priority secured claim for $85,000. It would also have an unsecured claim for 68% of the $125,000 sale price (or $85,000), less the $85,000 already received, meaning the additional claim would pay the mortgagee zero. This result is as it should be, because if the actual sale price matches the expected present value, then the mortgagee would receive its relative priority at the time of foreclosure, which was $85,000. The mortgagor, of course, would receive 32% of the sale price (or $40,000) less the mortgagor's unsecured claim (zero), leaving $40,000.

Suppose instead that the property eventually sells for $145,000. The foreclosing mortgagee is entitled to his priority claim of $85,000 and then its claim for 68% of the sale price (or $96,600), less its secured claim of $85,000, equalling $11,600 for what I have characterized as its unsecured claim. Added together, the two claims total $96,600, the sale price of the property. The mortgagee will always receive 68% of the sales price under these calculations whenever the sale price is above the expected present value of the property. The

pursuant to the cash method of foreclosure for an amount that, after being discounted, equals only $80,000. Given these numbers the property has a current fair market value of $125,000, because $75($140,000) + .25($80,000) = $125,000.
mortgagor would receive the remaining 32% of the sale price, or $46,400.\textsuperscript{169}

Consider now an example where the property sells for less than the expected value but more than the cash price at a liquidation sale, say $100,000. The mortgagee gets its priority secured claim for $85,000. The mortgagee's unsecured claim would total 68% of the sale price (or $68,000) less $85,000, which is a negative number and means that the mortgagee collects zero on its unsecured claim. The mortgagor would receive what is left over, or $15,000. One should note in this example that the although the sale price was less than the expected present value, the mortgagee's priority claim of $85,000 remains unchanged. In other words, the mortgagor bears the shortfall for the fact that the sale price is less than expected present value.

Finally, consider the possibility that the property will not sell at all during the upcoming year and will bring $70,000 at the end of the year. The mortgagee has the priority claim for $85,000, but in this case there is an insufficient amount to pay even that claim. The mortgagee would therefore receive $70,000 towards its claim, and that would be the only distribution. Note that, as in the last example, the mortgagor does not receive 32% of the sale price.

Another way of looking at my proposal is to ask what the parties would have agreed to ex ante. I contend that the parties would reach an agreement, after assessing all the relevant factors, that mirrors that discussed above, because it protects their relative interests in the property. In other words, the parties would enter into a type of "best efforts agreement" to sell the property for the best obtainable price within the next year. Furthermore, upon sale of the property the parties would agree to divide the proceeds in a way consistent with the distribution outlined under my proposal.

\section{G. An Economic Analysis of the Hypothetical Bankruptcy Foreclosure: The Benefits Outweigh the Costs}

At bottom, the outstanding question is whether the increased costs occasioned by my bankruptcy foreclosure proceeding outweighs its

\textsuperscript{169} I am charging all the administrative and transaction costs against the mortgagor's share of the spoils because this will minimize the costs imposed on the mortgagee in our shift from a mortgagee protection paradigm of foreclosure to a joint mortgagor-mortgagee protection paradigm of foreclosure. For a discussion of the benefits achieved by minimizing costs, see infra notes 171-77 and accompanying text.
benefits. That is an exceedingly difficult question to answer without empirical data. Theoretically, however, such a system should impose minimal, if any, additional costs over the current regime.

What are the possible costs of the hypothetical bankruptcy foreclosure proceeding? First, the mortgagee faces the risk that the property will decline in value due to exogenous movements of prices in the local real estate market. The risk is that the price of the property would fall below the value of the outstanding debt. In such a situation, the mortgagee’s priority claim would do little good because the price realized from the sale of the property would be insufficient to cover the debt.

This potential cost may be overstated, however. In the foreclosure setting, the mortgagee purchases the property at the foreclosure sale for the amount of the debt and then later, through middlemen or directly, sells the property to others. In the case of a declining market, the foreclosing mortgagee will suffer a loss in any event. That loss would be limited based on how quickly it can transfer the property to a third party. The trustee’s role is to determine ex ante whether the property has any excess value above the amount of the debt. If the answer is no, then no harm will be caused to the mortgagee’s interest because the property will be sold as it would have been under the foreclosure process. The only risk the mortgagee runs is that the market will turn sour between the time the trustee makes his ex ante determination and the actual sale. However, this is a risk for which the mortgagee is adequately compensated. Of course, third party purchasers in a declining market will internalize the fact that the market is bottoming and will attempt to purchase at the bottom. Hence, the mortgagee’s action in selling the property may not occur quickly unless the prospective purchaser and the mortgagee agree on a price that approximates the bottom.

Second, perhaps there are information and error costs associated with the trustee’s role in the bankruptcy process. The two go hand-in-hand. Notwithstanding the theory underlying my proposal, in practice it will work perfectly only if the trustee has perfect information concerning a number of factors. First, she needs to distinguish those properties worth foreclosing (liquidating with no stay), from those worth selling as going concerns (utilizing the stay and selling on

170 See supra Part IV.F.
the retail market). Second, she must determine which offer to accept when the property is sold as a going concern on the retail market. Errors in judgment by the trustee will be borne more heavily by the creditor-mortgagee in this system compared to the current system simply because in the current system no error costs are borne by the creditor-mortgagee—at least, no "external" error-costs are imposed on it. Under existing law, the creditor-mortgagee calls the shots and any errors made (such as not bidding or bidding above the amount of the debt owed at the time of the foreclosure sale) are internalized by the mortgagee.

The potential informational deficiencies are twofold. First, as a practical matter, in a market as imperfect as the real estate market, the trustee will not get it right one hundred percent of the time, or even come close to that. Moreover, given the normative basis of this new regime, on the margin the trustee may decide to protect the interests of the debtor-mortgagor instead of the creditor-mortgagee. The trustee may do this even in the face of overwhelming evidence that none of the mortgagor's equity interest is salvageable and that in the long run such a decision to attempt to salvage the mortgagor's interest harms the mortgagee.¹⁷¹

The second type of information cost has to do with the uncertainty generated by my proposal. There will be some costs incurred as a result of a shift from a creditor protection regime to a joint creditor-debtor protection regime. Unfortunately, it is impossible to predict these costs. I assume that most creditors are risk averse and that they will overestimate the cost of complying with the new regime to ensure their survival. Eventually, as creditors move up the learning curve, they, like everyone else, will be able to ascertain how much the new system costs and accurately spread those costs among their customers. Initially, however, creditors will likely overinsure by charging higher than necessary interest rates in order to protect their profitability.

¹⁷¹ Frankly, I am not sure that this would be such a bad thing given the fact that the mortgagee can spread the risk of that loss over his other loans. I would rather force individuals into a regime in which that equity is protected with the cost being borne by the mortgagors obtaining the protection. More importantly, because I am wearing my paternalistic hat, I would force them to internalize the cost of this protection by making this scheme of foreclosure a mandatory default rule that the parties could not waive or alter.
Having said that, I do not believe that the costs of implementing the proposal would be inordinately high for two reasons, one theoretical and one practical. Theoretically, I think this alternative scheme will impose little cost for the same reasons that bankruptcy is a viable creditor allocation mechanism. The trustee should be able to quickly ascertain whether there is any value in the property above the value of the secured debt. If there is not, the property is sold via the traditional foreclosure route, with the mortgagee likely being the highest bidder and with no equity accruing to the mortgagor. However, if a contrary determination is made, the secured creditor's interest is protected as it is in bankruptcy. By "protected" I also mean protecting the mortgagee's interest by giving it post-foreclosure interest while the trustee sells the property—even if that means giving the mortgagee a return higher than that provided in the note. The mortgagee, after all, has this right currently once it cashes out its investment by having the property sold at a foreclosure sale.

The practical reason for predicting that the implementation of the alternative system will impose little additional cost lies in my analysis of work done in this area by Professor Michael H. Schill.\textsuperscript{172} Schill notes that other mortgagor protection laws such as prohibitions on deficiency judgments and statutory rights of redemption have been criticized because they allegedly "increase the cost of home credit without any corresponding benefit to borrowers."\textsuperscript{173} Schill examines the issue of whether mortgagor protection laws can be justified as promoting economic efficiency. He then reconceptualizes mortgagor protection laws as a form of insurance against the adverse effects of default and foreclosure.

Contrary to earlier empirical studies which concluded that the costs of mortgagor protection rules are substantial, Schill presents a net present value simulation of mortgage lending whose results indicate "that home mortgage loan interest rates are relatively insensitive to the existence of mortgagor protection laws and that the incremental costs of these laws is likely to be quite modest."\textsuperscript{174} He concludes that the effect of state mortgagor law on interest rates is much smaller than previous studies had indicated. Thus, Schill supports the implementation of mortgagor protection laws because the private market,

\begin{footnotesize}
\begin{enumerate}
\item See Schill, supra note 115.
\item Id. at 489.
\item Id. at 491.
\end{enumerate}
\end{footnotesize}
due to imperfect information (what I have characterized as information asymmetries), cannot be relied upon to supply an optimal level of mortgagor protection, a conclusion with which I wholeheartedly agree.\textsuperscript{175}

I take solace from Schill's study and believe that the shift in the normative basis to joint creditor-debtor protection is the type of mortgagor protection legislation that will have little effect on the interest rates charged by mortgagees. Moreover, I, like Schill, argue that the cost incurred is acceptable given the protection it affords to mortgagors unable or unwilling to bargain for such protection in an arms-length transaction.\textsuperscript{176}

Finally, and this is perhaps the best argument in favor of a change, the normative value of such protection is worth the cost incurred. The hue and cry raised concerning the inadequacy of the current foreclosure process reflects dissatisfaction with that process on a normative level.\textsuperscript{177} The minimal cost occasioned by the change from the old to the new must be viewed as an acceptable component in the change from an unacceptable state of affairs to a better one.

\textbf{CONCLUSION}

The current foreclosure process is a very simple procedure designed to yield a certain result: the protection of the mortgagee's interest in the foreclosed premises at the expense of the mortgagor's equity interest. In that respect, it is like a crystalline rule or doctrine that yields fixed consequences.\textsuperscript{178} The mortgagor's failure to pay her debt promptly leads to the loss of the mortgagor's equity in the premises. It's that simple. That crystal rule, however, results in a forfeiture, a forfeiture of the debtor's equity in the premises. In essence, I believe

\textsuperscript{175} See supra notes 115-14 and accompanying text.

\textsuperscript{176} Indeed, because the mortgage market has been "nationalized" by the development of a federally created and subsidized secondary market that trades mortgages as securities, see Axelrod et al., supra note 18, at 111-27; Nelson & Whitman, supra note 5, at 814-16, uniform instruments are used by mortgagees in their dealings with mortgagors. As a result, it is almost impossible to customize a mortgage instrument to fit an idiosyncratic transaction because doing so destroys the ability of the mortgagee to trade the instrument or debt on the secondary market.

\textsuperscript{177} For a discussion of the many commentators who have decried the lack of mortgagor protection provided by the current foreclosure scheme, see supra notes 65-76 and accompanying text.

that those who criticize the current foreclosure process do so because of their "deep antipathy to what is . . . the debtor's 'forfeiture.'" \footnote{Id. at 597 (footnote omitted).}

Thus, it is not surprising that there are calls to reform the process, to employ what Professor Carol M. Rose would call "mud rules," to make the process more equitable. No one likes to see someone kicked when they are down. However, courts, legislatures, and commentators must not lose sight of the fact that the crystal rules that result in the loss of the mortgagor's equity interest in the premises also serve a valid purpose. Those crystal rules provide the mortgagee with easy access to its security, resulting in less risk to the creditor, which translates into lower interest rates for the average mortgagor. The alternative foreclosure system proposed herein, modeled on the norms of bankruptcy, respects that valid purpose while at the same time better protecting the mortgagor's equity interest in the property.