

NATIONAL

JURISDICTIONAL IMPACT ON RECOVERY OF DEFICIENCY

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As the overall volume of new foreclosures finally decreases, default servicers and investors are looking for ways to recover their losses from the recent foreclosure boom. Prior to the economic downturn of 2008, investors could expect to recover the full amount of a borrower's outstanding debt at foreclosure sale in a substantial number of cases. In more recent years, however, the outstanding debt (including principal, interest, escrow advances, property preservation, and other foreclosure costs) often exceeds the deflated market value of the collateral real property. The high volume of disparities between amounts owed and property values has required investors to consider various factors in determining whether they can, or should, pursue a deficiency in any given foreclosure case.

According to their 2012 report, the Federal Housing Finance Agency (FHFA) found that in 2011, Fannie Mae and Freddie Mac recovered less than \$5 million of the \$2.1 billion in deficiency judgment amounts that they sought to collect.¹ Based on this low percentage of recovery, the FHFA established a list of relevant factors to consider when deciding whether or not to pursue a deficiency: jurisdiction of foreclosure, federal and other superseding law, mortgage insurance terms, loss mitigation efforts, likelihood of recovery based on loan and borrower-related factors, bad faith acts by borrower, and business judgment based upon cost of collection, amount of deficiency, reason for default, and other risk-based factors.²

Complexity of using Jurisdiction as a Determining Factor

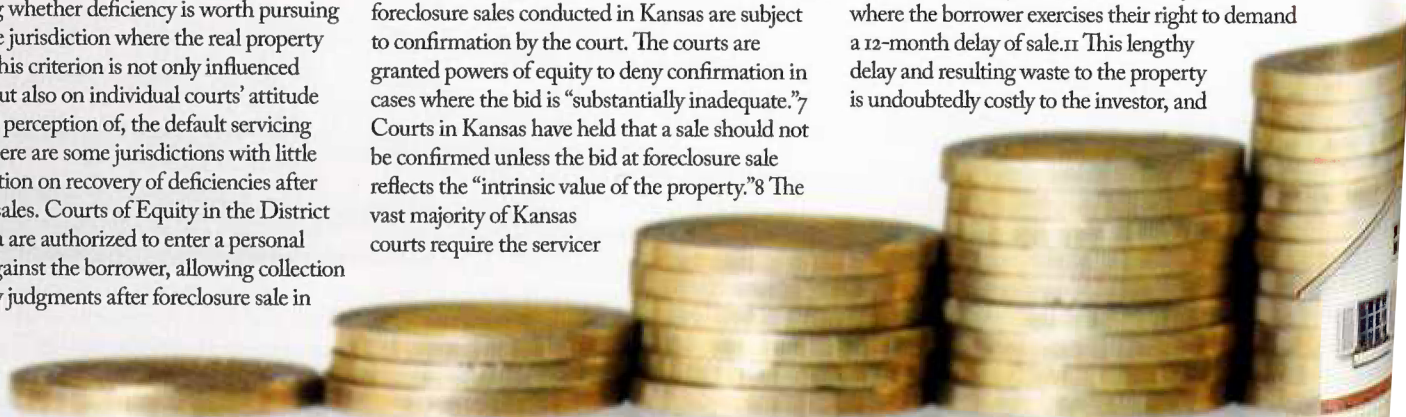
One of the more complicated issues is determining whether deficiency is worth pursuing based on the jurisdiction where the real property is located. This criterion is not only influenced by statute, but also on individual courts' attitude toward, and perception of, the default servicing industry. There are some jurisdictions with little to no restriction on recovery of deficiencies after foreclosure sales. Courts of Equity in the District of Columbia are authorized to enter a personal judgment against the borrower, allowing collection of deficiency judgments after foreclosure sale in

cases where sale proceeds are not sufficient to pay the remaining debt.³ Illinois statute does not restrict a servicer's right to recover a deficiency judgment upon confirmation of the foreclosure sale.⁴ Missouri law does not contain any anti-deficiency provisions. A foreclosure sale may be voided if the winning bid is so inadequate that it is shocking to the conscience,⁵ but there is no mechanism by which a borrower can directly challenge the deficiency amount.

Several jurisdictions allow for pursuit of deficiency judgments, but the recoverable amount of the deficiency is limited by state law. In Florida, when the foreclosed property is residential and owner-occupied, the deficiency amount is restricted to the difference between the total judgment debt amount and the fair market value of the property when the sale occurs.⁶ Similarly, there is no anti-deficiency statute in Kansas, but all foreclosure sales conducted in Kansas are subject to confirmation by the court. The courts are granted powers of equity to deny confirmation in cases where the bid is "substantially inadequate."⁷ Courts in Kansas have held that a sale should not be confirmed unless the bid at foreclosure sale reflects the "intrinsic value of the property."⁸ The vast majority of Kansas courts require the servicer

to provide proof of the property's value, such as an appraisal or broker's price opinion at the confirmation hearing. Some Kansas trial courts have denied confirmation of sales and required bids to be set at a total debt "upset price" in cases where the sale has been delayed for a significant amount of time by the servicer. These courts have reasoned that interest, property preservation fees, and escrow advances that continue to accrue during the delay unfairly increase the amount of the potential deficiency against the borrower.

Several states have anti-deficiency laws that result in situations where the cost of preserving the right to deficiency far outweighs the potential benefit of doing so. Arizona statute prohibits execution on a personal judgment against the borrower on purchase money loans for property consisting of 2.5 acres or less and used as either a single one or two-family dwelling.⁹ Servicers and investors in California may not recover a deficiency judgment in a foreclosure action pertaining to a defaulted contract of sale, a purchase money mortgage, or a loan that refinances a purchase money mortgage.¹⁰ In Iowa, it has become customary practice to waive the deficiency at the outset of a foreclosure filing. If electing to foreclose without the 12-month redemption period, when the property is the principal residence of the borrower, a servicer may only recover a deficiency in cases where the borrower exercises their right to demand a 12-month delay of sale.¹¹ This lengthy delay and resulting waste to the property is undoubtedly costly to the investor, and



the outstanding debt on a property in Iowa is rarely sufficient to justify preserving the right to a deficiency. Further, trial courts in Iowa are quick to admonish servicers and their counsel if deficiency rights are preserved, particularly since the economic downturn. Servicers and investors should work with local foreclosure counsel in such jurisdictions to determine whether waiving deficiency is required or recommended as a best course of action.

Future Considerations Regarding Pursuit of Deficiencies

Jurisdiction is just one of the factors to consider in concluding whether or not to seek a deficiency judgment against a borrower. In order to further minimize losses, investors would benefit from considering additional factors and creating clear policies so that the appropriate course of action is determined from the outset of the foreclosure. For instance, investors could set a threshold unpaid principal balance amount in order to avoid the cost of preserving a deficiency in cases where the deficiency is bound to be a negligible amount. Another factor to consider might be whether or not the property is confirmed to be vacant or abandoned. In order to ensure best practices in each jurisdiction, servicers are encouraged to consult with their local foreclosure counsel and to heed counsel's advice as to whether deficiency rights should be preserved or pursued in that particular jurisdiction.

¹ FHFA's Oversight of the Enterprises' Efforts to Recover Losses from Foreclosure Sales. <http://origin.www.fhfaog.gov/Content/Files/AUD-2013-001.pdf> (October 17, 2012).

² Management of Deficiency Balances, AB 2013-05. http://www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/AdvisoryBulletinDocuments/20130916_AB_2013-05_Management-of-Deficiency-Balances_508.pdf (September 16, 2013).

³ DC ST § 42-816.4 735 I.L.C.S. 5/15-1508(b)(2).⁵ Roberts v. Murray, 232 S.W.2d 540, 546 (Mo. 1950); Cockrell v. Taylor, 145 S.W.2d 416, 422 (Mo. 1940).⁶ F.S.A. § 702.06.7 K.S.A. 60-2415.8 Olathe Bank v. Mann, 252 Kan. 351, 357 (1993).⁹ A.R.S. § 33-729.10 Cal.C.C.P. § 580(b). ¹¹ I.C.A. § 654-6.

