Real Property

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Adviser Foreclosure

Case Resolves Unsettled Definition of 'Fair Value'

By Jeffrey Huron

In *San Paolo U.S. Holding Co. v. 816 South Figueroa Co. Inc.*, 98 Daily Journal D.A.R. 3287 (2nd Dist. March 31, 1998), the California Court of Appeal interpreted "fair value" for purposes of determining the amount of any deficiency following a judicial foreclosure. The two cases interpreting the term prior to *San Paola* were not entirely clear as to its meaning. Because *San Paolo* clearly defines fair value, the case should resolve the unsettled differences between lenders and mortgagors in determining the amount of deficiency judgments.

California Code of Civil Procedure Section 726(b) provides that a deficiency judgment is limited to "the amount by which the amount of the indebtedness . . . exceeds the fair value of the property . . . as of the date of sale." The California Legislature enacted the fair value limitation as a result of the Great Depression to protect mortgagors.

As originally enacted, the statute limited deficiency judgments to "the amount by which the entire amount of the indebtedness due at the time of sale exceeded the fair market value of the real property." However, during the Depression, the shortage of money and depressed land values meant little or no market value for foreclosed properties. Consequently, mortgagees were able to acquire foreclosed properties for a fraction of their intrinsic value and obtain large deficiencies against mortgagors.

To prevent lenders from defeating the purpose of the anti-deficiency laws, the Legislature addressed the loophole created by the term "fair market value" in Section 726. The Legislature first considered an amendment that would have removed the term and provided for the appointment of an appraiser who would determine the "intrinsic value" of the property. But the Legislature instead amended Section 726 to refer only to the fair value – as opposed to the fair market value – of the foreclosed property.

Nelson v. Orosco, 117 Cal.App.3d 73 (1981), was the first case to interpret the term "fair value" in amended Section 726. Orosco had purchased a piece of property from Nelson in exchange for a promissory note secured by a second deed of trust on another piece of property Orosco owned. Afterwards, Orosco sold his encumbered property to a third party, Woodburn, who assumed a note secured by a first trust deed on the property. Orosco did not disclose to Woodburn the second trust deed in favor of Nelson. Orosco then defaulted on his note to Nelson, who thereafter obtained a judgment for foreclosure. Prior to the ordered sale, Woodburn filed suit against Nelson and Orosco and recorded a lis pendens.

At the foreclosure sale, Nelson purchased the property and thereafter sought a deficiency. In determining the amount of the deficiency, the trial court refused to consider either the affect of Woodburn's lis pendens or his possession of the property. The Court of Appeal

reversed, holding that "'fair value' is determined by all of the circumstances attending the property at a foreclosure sale, including the state of its title and merchantability."

The next case to interpret fair value, *Rainer Mortgage v. Silverwood Ltd.,* 163 Cal.App.3d 359 (1985), parted company with *Nelson*. *Rainer* involved an appeal from a deficiency judgment that took into account the impact of the foreclosure proceedings on the property's value. The lender, relying on *Nelson,* argued that a judicial foreclosure affects title and merchantability because the borrower may redeem the property within one year after the sale. C.C.P. Sections 729.010(a) and 729.030(b).

The *Rainer* court distinguished *Nelson*. It observed that the lis pendens in *Nelson* was unrelated to the foreclosure itself. It also found that the *Nelson* court "did not hold that any circumstance arising from the foreclosure sale must necessarily be considered." The *Rainer* court therefore concluded *Nelson* did not define fair value to include the price-reducing circumstances of the foreclosure.

Having distinguished *Nelson*, the *Rainer* court went on to interpret fair value. It considered the legislative history of the fair value limitation, including the Legislature's proposal to replace fair value with intrinsic value. Although the *Rainer* court recognized the Legislature ultimately dropped this proposal, it nevertheless held that the Legislature, in amending Section 726, intended to limit the amount of deficiency judgments, and thereby protect mortgagors, by taking into account the intrinsic value of the foreclosed property. *Rainer* thus equated fair value with intrinsic value.

The *Rainer* court remarked that in many instances, the intrinsic value of foreclosed property will coincide with its fair market value. But, the court observed, market value is only one factor the court should consider in determining fair value. It held that the intrinsic value of foreclosed property is determined by "taking into consideration all the circumstances affecting the underlying worth of the property at the time of the sale, without consideration of the impact of foreclosure proceedings on this value."

The court reasoned that lenders cannot complain about the price-reducing affect of the redemption period because they may obtain clear title through private foreclosures instead of electing to seek deficiency judgments through judicial foreclosures. The court also reasoned that the mortgagor's right of redemption is limited to one year and thereafter no longer adversely affects the marketability of the foreclosed property.

By defining fair value using intrinsic value, *Rainer* created ambiguity. Lenders focused on the court's remarks that intrinsic value coincided with market value and thus argued that fair value meant the property's fair market value without consideration of the diminutive affects of foreclosure. Mortgagors, on the other hand, argued that intrinsic value as used in *Rainer* meant something other than the fair market value of foreclosed property. According to mortgagors, intrinsic value referred to the value of the property prior to the economic conditions that conspired to depress its value. Trial courts were therefore left to interpret what the *Rainer* court meant by intrinsic value. As a result, the determination of deficiency judgments became uncertain, unpredictable and unfair.

San Paolo addressed that ambiguity and attempted to resolve it. The trial court relied on the mortgagor's appraisal in determining the fair value of the foreclosed property. On the basis of *Rainer*, the mortgagor's appraisal concluded that the property's fair value was its intrinsic value. Its intrinsic value, according to the appraisal, was best represented by pre-recession market conditions – that is, the "normal" market conditions that existed between 1985 and 1989.

Because the depressed market conditions existing at the time of the foreclosure sale were temporary in nature, the mortgagor's appraisal did not consider the market conditions at the time of sale. Instead, it relied upon comparable sales during normal market conditions and adjusted existing rents to comparable rents in 1989. Consequently, the mortgagor's appraisal valued the foreclosed property substantially

higher than its fair market value.

The lender's appraisal also relied on *Rainer*. It did not make any downward adjustments in valuing the property because of the foreclosure sale or the mortgagor's right of redemption. The lender's appraisal also noted that the lender had received purchase offers and thus established that the property was marketable. Subject to these considerations, the lender's appraisal concluded, on the basis of traditional market valuation principles, that the fair value of the property equaled its market value.

The lender appealed the trial court's determination of fair value, which served to significantly limit the amount of the deficiency. The lender argued that the trial court, in relying upon the mortgagor's appraisal, misinterpreted *Rainer's* definition of fair value. The *San Paolo* court agreed.

San Paolo defined "fair value, within the context of [Section 726(b)], as the fair market value of the real property, as of the date of the foreclosure sale, without any reductions for the adverse impact of the foreclosure and the one-year right of redemption that would temporarily lower the market value of the real property." The *San Paolo* court interpreted *Rainer's* use of the term intrinsic value as meaning nothing more than the fair market value without taking into account the price-reducing affects of the foreclosure. To the extent there is any doubt about its conclusion, the *San Paolo* court construed *Rainer's* reference to intrinsic value as dicta and declined to follow it.

Applying its definition of fair value, the *San Paolo* court rejected the mortgagor's appraisal as flawed. The appraisal failed to evaluate the property's actual value as opposed to some hypothetical value at any point in time. The plain language of Section 726 requires valuation as of the date of sale. Nevertheless, to minimize any deficiency, the mortgagor's appraisal did not take into account the market conditions existing when the property was sold. The *San Paolo* court therefore held that the mortgagor's appraisal was improper, and reversed the trial court's judgment.

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