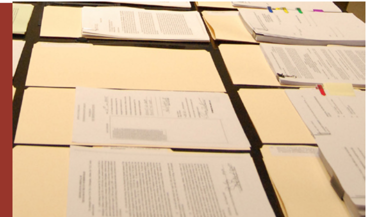
Real Estate Finance Alert



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Tennessee Adopts New Deficiency Legislation

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Executive Summary

On June 2, 2010, Governor Bredesen signed the recently enacted new legislation formally establishing limits on the ability of lenders to obtain deficiency judgments against debtors after real property foreclosure sales. The new legislation contains two key provisions. The first sets specific standards for determining the amount of or contesting the amount of a deficiency judgment. The second, and arguably more important, provision shortens the statute of limitations for filing deficiency actions.

Background

The recent economic downturn has resulted in a large number of real estate foreclosures. At a real estate foreclosure sale, the shortfall between the amount of the lender's debt and the sales price is termed a "deficiency." The debtors, absent an agreement to the contrary, remain liable to the lenders for repayment of the deficiency. Certain debtors have contended that lenders bid unfairly low prices at foreclosure sales. These debtors also argue that the lenders will then sell the property to third parties at higher prices resulting in a windfall to the lenders.

In some instances this argument has become intertwined with a contention that the Tennessee foreclosure process benefits certain predatory lenders who take advantage of a relatively expeditious foreclosure process. The Tennessee Legislature recently addressed this concern by providing residential debtors with the right to receive certain notices which extend the foreclosure process by at least an additional 60 days. We addressed this parallel legislation in a separate news alert. (Click here to read the Alert.)

The new deficiency legislation addressed by this news alert will apply to both commercial and residential foreclosures and will be codified at Tennessee Code Annotated. 35-5-117 in the same chapter that contains the other provisions addressing trust sales. The legislation represents an attempt to balance a perceived need to protect debtors from the unjust enrichment of lenders with an attempt not to radically alter the bargains lenders believed previously existed with their debtors.

To elaborate, on December 19, 2006, the Tennessee Court of Appeals rendered its opinion in Lost Mountain Development Company v. King (Tenn. Ct. App 2006 WL 3740791). This case, relying heavily on Duke v. Daniels, 660 S.W.2d 793 (Tenn. Ct. App. 1983) and the Restatement of the Law (Third) Property allowed a debtor to challenge the presumption that the sales price at a foreclosure sale is fair. The Court indicated that a lender may only pursue a deficiency for the difference between the amount owed and the "fair value" of the foreclosed real estate. But the Court placed the burden of proof on the debtor in any such challenge. The first prong of the new law essentially codifies most of the Lost Mountain decision.

Summary of New Legislation

The new legislation creates a rebuttable presumption in favor of the lender that the foreclosure sales price is fair and inserts a formula for establishing the deficiency. A lender is now expressly entitled to a deficiency amount which equals the total debt (plus costs) minus the sales price. The debtor must prove by a preponderance of the evidence that the

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foreclosure price is materially less than the fair market value of the property.

If the debtor meets this burden, the court will determine the fair market value of the property. The legislation provides little guidance on this process. The legislation does specify that the foreclosure sale date is the measuring stick for the determination of the "fair market value."

The more important provision of the new legislation shortens the statute of limitations for filing deficiency actions. Beginning with foreclosures initiated after September 1, 2010, a lender will have two (2) years to file an action seeking a deficiency (unless existing law would have established a shorter statute of limitations). This is a substantial shortening of the current period which allows a lender six (6) years from the date of default under a loan obligation to sue.

Conclusion

The new legislation contains a tradeoff. The debtor is given the protection of a shortened statute of limitations, while the lender is given the protection of a clarified process for establishing a deficiency. We suggest lenders take two concrete steps in response to this legislation. First, clearly document the rationale for the foreclosure sales price. If a lender cannot state objective reasons for the bid price which it is willing to defend in court, it should reconsider the foreclosure bid strategy. Second, the lender should clearly document expenses it incurs in improving and repairing the property during its term of ownership. While the statute calls for measuring the fair market value of the property "at the time of sale" in determining the deficiency, we have no doubt that a sale to a third party for a sum greatly in excess of the foreclosure price will be used as evidence by a debtor. The lender, in its deficiency action, should be prepared to defend this discrepancy.

Foreclosure Moratorium and Application of Insurance Proceeds

By Emily Bowman

On May 4, 2010, President Obama issued a Presidential Major Disaster Declaration for Cheatham, Davidson, Hickman and Williamson Counties. Since that time, many counties in Tennessee that were affected by the flooding and tornadoes have been added to the list of designated disaster areas (a complete list can be found on FEMA's website at www.fema.gov).

As a result, holders of mortgages insured by the Federal Housing Administration (FHA) are subject to an automatic 90-day moratorium on foreclosures for properties directly affected by the disaster. The moratorium applies to new foreclosures and the suspension of foreclosures already in process for the duration of the 90 day period. The moratorium expires on August 2, 2010.

Holders of FHA-insured mortgages must make insurance proceeds from hazard insurance claims available to the mortgagor. Such lenders may not retain such proceeds to apply to the existing debt without the mortgagor's written consent.

The Department of Housing and Urban Development strongly encourage lenders to work with borrowers whose properties were affected by the disaster, by extending payment terms, forbearance, mortgage modification, waiver of late charges and acceptance of deeds in lieu of foreclosure after the moratorium.

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