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CREDIT BIDDING IN CALIFORNIA FORECLOSURE SALE

By Richard A. Rogan, 01/01/09

Under California's foreclosure law, three months must pass after recording a Notice of Default before the creditor can instruct the Trustee to sell the property. While California law requires only 20 days notice before the foreclosure sale, lenders typically instruct the foreclosure company to give 25 days notice, as this is what IRS requires for a foreclosure to cut off any junior lien rights that IRS might have.

If the Bank chooses to go forward with a nonjudicial foreclosure sale, the trustee will conduct an auction and sell the property to the highest bidder. The fall of the auctioneer's hammer will cut off the Bank's right to obtain a deficiency against the borrower.

The Bank is entitled to credit bid, and typically opens by bidding the sum of its outstanding principal balance (customer balance), plus all out of pocket expenses, such as appraisals, foreclosure fees, property taxes and insurance premiums advanced, attorney's fees, etc. However, the Bank's opening bid should not exceed the appraised value of the property. The main reason is that the Bank does not want to create taxable income by bidding unpaid interest unless there is a good chance that the property will be sold to another bidder and there will be cash available to pay the taxes on the interest income.

In the happy event that there are other bidders at the sale, the Bank can continue to credit bid up to the amount of accrued but unpaid interest, with the appraised value being a ceiling. If it is expected that other bidders will be present, it is a good idea for the Bank to have its own representative present at the sale, rather than relying on the foreclosure company to bid for the Bank. Most foreclosure companies will present an opening bid on behalf of the lender, although some will make one additional bid. I have never seen any agree to make any further bids, as they do not want to accept responsibility for making a decision on behalf of the lender.

Where the appraised value is less than the outstanding customer principal balance, typical bidding strategy would be to open with a bid of the appraised value, but this is a matter that the Bank needs to determine internally before the sale. Obviously, the idea is to encourage a third party bidder to buy the property for the highest possible price, and bidding strategy must consider that possibility.

Because the property may be worth less than the outstanding debt, it is possible that there will be a deficiency. If the Bank chooses to go forward with the nonjudicial foreclosure sale by the trustee, it will be waiving its rights to collect a deficiency against the borrower. As a practical matter, the borrower's assets must be analyzed to determine whether it has any other assets that could be liquidated to pay a deficiency owed to the Bank. If not, then the nonjudicial foreclosure sale, even if it results in a deficiency, is probably the choice to make. If assets do exist, then the Bank should analyze whether it makes sense from a cost-benefit perspective, to try to preserve the deficiency.

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In California, there are two ways to preserve the deficiency. First, the Bank can foreclose judicially. This means that the Bank would file a lawsuit against the borrower and ask the Court to order foreclosure. After the property is sold, the Bank returns to Court and asks the Court for a money judgment against the borrower in the sum that is the difference between the amount of the indebtedness (principal, interest, fees and costs) and the "fair value" of the property at the time of the sale. "Fair value" is not the sale price at the foreclosure sale. Instead, "fair value" is the amount that the Court finds after taking evidence of the value of the property at the date of sale. The Bank will then obtain a judgment against the borrower and will try to collect the judgment against other assets of the borrower.

The process of judicial foreclosure is rare, slow and costly. It requires expert testimony and multiple court hearings. It should not be used unless the lender is reasonably certain that the borrower is capable of paying the deficiency and the likely amount of the deficiency is substantial.

The second way to preserve the deficiency is to collect it from the guarantors. Again, before making a decision, it is advisable to determine whether it is likely that the guarantors are capable of satisfying a deficiency judgment.

In the event the Bank chooses to foreclose by trustee's sale, there is case law authority that if the Bank tenders the debt to the guarantors before the foreclosure sale, the Bank's rights to collect the deficiency are preserved. This is done by sending a letter to the guarantors before the Notice of Trustee's Sale is given and recorded.

It is likely that the guarantors will vigorously defend. Once the foreclosure sale happens, the Bank would send a demand letter to the guarantors, and then would have to follow up with a lawsuit against the guarantors.

In the event the Bank chooses to foreclose by judicial foreclosure, the guarantors are typically named as parties to the foreclosure lawsuit.

This article is not intended to be a complete explanation of California foreclosure law and the various strategies to be employed by a foreclosing lender, but rather a summary of relevant options typically available to secured creditors. Depending upon the Bank's internal policies and credit decisions, other considerations may well be relevant in choosing the best course of action.

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