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CHAIRMAN'S CORNER

Season of Change Returns

BY CHRISTOPHER M. GEORGE, CMG FINANCIAL, CMBA CHAIRMAN

Change! Again! With the return of Fall comes the return of election season, and this year's was quite the game-changer. Again. It seems a two-year cycle these days that each party gets swept in a 'wave' only to get rejected two years later. Unless you've been under a rock for the past few weeks, you know that the Republicans have captured control of the U.S. Senate and several additional state governorships. That's certainly the main headline, but there are several other results that you may not be as aware of, but could shake up our industry even more than swapping out Harry Reid for Mitch McConnell will.

In my backyard, in Richmond, industry (including the CMBA) has been diligently fighting a dangerous eminent domain scheme designed to help underwater borrowers by seizing the mortgage notes from investors. If you've heard this before, bear with me! Just over a year ago, the city seemed poised to put the plan into action, giving mortgage investors a hard deadline to either sell the targeted loans to the city or face eminent domain proceedings. That deadline came and went with no action, in large part due to the makeup of the city council. Proponents of the plan were just short (a single vote at times) of having enough support to move

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The Full Credit Bid

Avoiding (Expensive) Unintended Consequences

BY SCOTT D. ROGERS, PARTNER, & THEODORE K. KLAASSEN, SENIOR COUNSEL, RUTAN & TUCKER

Foreclosing real estate lenders are often surprised to learn that their "full credit bid" at a trustee's foreclosure sale has had expensive unintended consequences. In the recent California case of *Najah v. Scottsdale Insurance Company,* 230 Cal.App.4th 125 (2014), a full credit bid prevented the lender from recovering insurance proceeds for pre-foreclosure damage to the security property. To avoid this and other unintended consequences, lenders are well-advised to understand the legal import of a full credit bid and to develop a comprehensive bid strategy in advance of the trustee's sale.

Under California law, a foreclosing lender is permitted to credit bid at the foreclosure sale any amount due to the lender with respect to the defaulted loan. This avoids the inconvenience of a foreclosing lender having to pay cash at the foreclosure sale only to have the money delivered back to the lender. The amount credit bid is treated the same as if the lender had bid and paid cash. A "full credit bid" occurs when a lender credit bids the sum of all amounts owed to the lender at the time of sale, typically including all unpaid principal, accrued interest, late charges, advances, foreclosure costs, legal fees and other sums due. As the amount credit bid is treated the same as cash, when a foreclosing lender obtains title as the result of a full credit bid, the indebtedness to the lender is generally deemed to have been paid in full—the "full credit bid rule."

In the *Najah* case, Najah and Akhavain (together, Najah) sold a commercial property to Orange Crest Realty Corporation (Orange Crest) taking back a second deed of trust to secure $2,550,000 of the purchase price. After Orange Crest defaulted under both deeds of trust, Najah purchased the senior debt and deed of trust, presumably to avoid having their second deed of trust wiped out if the first lienholder foreclosed. Najah then instituted foreclosure proceedings under the second deed of trust and reacquired title to the property by making a full credit bid of the amounts owed under the second deed of trust ($2,878,000) at the trustee's sale.

After getting the property back through the trustee's sale, Najah brought suit against Scottsdale Insurance Company (Scottsdale) to collect under a commercial general liability insurance policy issued to Orange Crest covering the property and naming both the senior lender and Najah as insured mortgage holders. Prior to the foreclosure sale, the property had been vandalized and many of its fixtures removed by the principal owner of Orange Crest. The estimated cost to repair the property exceeded $500,000, which Najah hoped to recover from Scottsdale.

When Scottsdale would not pay Najah's claim, Najah sued, and the trial court ruled in favor of Scottsdale and denied Najah any recovery. Najah appealed, and the appellate court affirmed the trial court's judgment in favor of Scottsdale. The appellate court held that Najah's full credit bid at the foreclosure sale under the second deed of trust precluded Najah from making a claim on the proceeds of the Scottsdale insurance policy. The appellate court found that the amount payable to Najah under the insurance policy was limited to the amount necessary to satisfy the debt and that because the debt was fully satisfied through the full credit bid, Najah had no further claim on any insurance proceeds.

According to the appellate court, the purpose of requiring the trustee's sale to be a public auction is to resolve the question of value of the foreclosed property through competitive bidding at a public sale. This gives any member of the public an opportunity to participate in setting the value for the property. This public value setting provides some degree of market protection (and transparency) for those

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FULL CREDIT BID CONTINUES FROM PAGE 18

who may be financially impacted by the value of the foreclosed property. As the appellate court stated: "A lender who intends to later claim that the value of the property was impaired due to waste, fraud, or insured damage, but nonetheless makes a full credit bid, interferes with that [public value setting] process by impeding bids from third parties willing to pay some amount between the value the lender places on the property and the amount of its full credit bid." The appeals court noted that a lienholder could readily preserve its right to insurance proceeds by bidding less than the total of all of secured amounts.

Lenders must understand when credit bidding that, although they are not paying cash, they are taking part in a market to establish property value, and full credit bids are seen by the courts as potentially impeding that market. In this case, the appeals court stated that "the effect of appellants' [Najah's] bidding the full amount of their second lien, notwithstanding their belief that the property was worth less than the combined amount of their first and second liens, was to block other interested parties from participating in setting the price for the property, and preventing the property from going to the party that placed the highest actual value on it." The appellate court summarized its approach saying "a lender who makes a full credit bid despite believing the value of the property to be impaired subverts the integrity of the foreclosure auction at the expense of the insurer or any other party whom the lender intends to pursue through legal action post-foreclosure." In the court's view, having deprived Scottsdale of the benefit of a true public auction, Najah should not be entitled to pursue insurance proceeds in an amount between what Najah freely paid to obtain the property and the amount Najah now claims the property to be worth.

Giving effect to the full credit bid made by the lender, the appellate court concluded that the value of the property established by Najah's credit bid was $4,627,000 (the $2,878,000 bid by Najah at the trustee's sale and the $1,749,000 paid by Najah to buy the senior lien). Consequently, as the value of the property obtained by Najah at the trustee's sale was equal to the sum of all amounts owed to Najah, the court determined that the indebtedness owed to Najah had been fully satisfied and that Najah had no claim to any potential insurance proceeds because such proceeds would be a double recovery for Najah.

No doubt Najah was surprised and dismayed with the outcome of this case. At the time of the trustee's sale, Najah believed the property to be worth far less than the combined amount of both loans due, at least in part, to the property damage caused by Orange Crest. Had Najah thought through his foreclosure bid strategy, he could easily have credit bid a much lower amount to leave outstanding sufficient indebtedness to allow for recovery under the Scottsdale insurance policy.

Although the facts in *Najah v. Scottsdale* are relatively uncommon, the application of the full credit bid rule has very broad implications for lenders in planning their foreclosure bid strategies. The full credit bid rule has also been applied to prevent foreclosing lenders from later pursuing claims for foreclosure of additional collateral, bad faith waste, rents held by a receiver, fraud, mortgage bond proceeds and negligence.

A full credit bid can also be risky to the lender should the computation of the full credit bid amount be erroneously high for any reason. This can easily occur where there is uncertainty in the calculation of variable and/or default rate interest due, imposition of late charges, recovery of attorneys fees and other enforcement costs, reimbursement of protective advances, etc. In the event that the credit bid made by the lender is subsequently determined to have exceeded the full amount of the indebtedness, the lender runs the risk of being required to come out of pocket to pay the excess to junior lienholders or even to the borrower.

Due to the potential loss of additional recovery rights and exposure for payment of overbid amounts, lenders should very carefully plan the amount of their bid(s) at trustee's sales. Even in circumstances where the value of the security property is thought to equal or exceed the unpaid obligations, it is generally advisable to avoid a full credit bid to preserve potential claims against other security, to allow for recovery under insurance policies or against third parties and to avoid exposure from an inadvertent overbid. Once again our mothers had it right, an ounce of prevention is worth a pound of cure.