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Lender Alert

July 2014

The Full Credit Bid at a Foreclosure Sale: Don't Make One Without the Advice of Knowledgeable Counsel

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While the Great Recession appears to be slowly receding, rising oil costs and other price increases threaten to choke off what had appeared to be an economic recovery. Accordingly, foreclosures may become more frequent in the future. Therefore, this is an excellent time to review a lender's strategy for bidding at its foreclosure sale.

It is assumed that the lender has already done the appropriate due diligence to make an informed decision as to whether it is willing to become an owner of the encumbered real property. Obviously, this due diligence would include, but not be limited to, a determination of the environmental condition of the property.

Since the entry of a credit bid at a foreclosure sale reduces, if not eliminates, many of the lender's rights, extreme caution should be taken to see that the lender does not needlessly reduce its rights. Assuming that the lender is the beneficiary of a valid and enforceable Deed of Trust which is a first priority lien on the subject real property, the opening bid at the foreclosure sale is frequently recommended to be between 20% and 30% of the lender's equity in the property. See, Restatement of the Law Third, Property (Mortgages), § 8.3 Adequacy of Foreclosure Sale Price: Bernhardt and Hansen, California Mortgages, Deeds of Trust and Foreclosure Litigation § 2.87 (Calif. Cont. Ed. Bar, Fourth Ed.) and Hansen: "The Full Credit Bid 'Rule' and Occam's Razor," 30 Cal. Real Prop. J. 32 (No. 4, 2012). If the lender is not the beneficiary of a valid and enforceable first priority lien on the property, then a figure a credit bid of materially less than 20% of the equity in the property may be appropriate.

The determination of the lender's equity in the property is not always the easiest task to accomplish. Frequently, appraisals tend to over value the property because they are typically "looking backwards" at transactions which closed, but fail to take into consideration the current trend in prices. Therefore, consideration should be given to obtaining one or more broker's price opinions as being more reflective of the market today for the property.

There are two principal exceptions to the 20/30% credit bid rule. First, if there are junior Internal Revenue Service tax liens where the IRS has a right after the foreclosure sale to redeem property from the successful bidder consideration should be given to increasing the bid to a level which is commensurate with the whole of the equity in the property.

The second situation where the 20/30% rule should be disregarded is where there is competitive bidding and it is in the foreclosing lender's interest to increase the bid to approximate the fair market value of the property. Of course, appropriate consideration should be given to the anticipated expense and cost in marketing the property. Therefore, it may be appropriate for the foreclosing lender to allow itself to be outbid once the price passes the estimated market value of the property because of the anticipated expense and delay in disposing of the property.

The principal disadvantage of a full credit bid by lender at its foreclosure sale is that it may have a eliminated its right to recover from guarantors, foreclosure on additional security, retain rents collected by a receiver, collect insurance proceeds, collect damages claims, etc. There is a substantial body of case law dealing with these issues, and the outcomes are not always what might be expected and many of the decisions have some conflicts between them. However, the problems created by a full credit bid can be avoided if the foreclosing lender, as its initial bid, only credit bids 20/30% of the apparent equity in the property (assuming that it has a valid and enforceable first priority lien on the property).

One of the more comprehensive discussions of the full credit bid by the California Supreme Court is found in *Alliance Mortgage Co. v. Rothwell* (1995) 10 Cal.4th 1226, where the Court held as follows:

> "At a nonjudicial foreclosure sale, if the lender chooses to bid, it does so in the capacity of a purchaser. [Citation.] The only distinction between the lender and any other bidder is that the lender is not required to pay cash, but is entitled to make a credit bid up to the amount of the outstanding indebtedness. [Citation.] The purpose of this entitlement is to avoid the inefficiency of requiring the lender to tender cash which would only be immediately returned to it. [Citation.] A 'full credit bid' is a bid 'in an amount equal to the unpaid principal and interest of the mortgage debt, together with the costs, fees and other expenses of the foreclosure.' [Citation.] If the full credit bid is

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successful, i.e., results in the acquisition of the property, the lender pays the full outstanding balance of the debt and costs of foreclosure to itself and takes title to the security property, releasing the borrower from further obligations under the defaulted note. [Citation.]" (*Alliance Mortgage Co. v. Rothwell* (1995) 10 Cal.4th 1226, 1238.)[1]

Under the " 'full credit bid rule,' when a lender makes such a bid, it is precluded for purposes of collecting its debt from later claiming that the property was actually worth less than the bid. [Citations.] Thus, the lender is not entitled to insurance proceeds payable for prepurchase damage to the property, prepurchase net rent proceeds, or damages for waste, because the lender's only interest in the property, the repayment of its debt, has been satisfied, and any further payment would result in a double recovery. [Citation.]" (*Alliance Mortgage Co. v. Rothwell*, *supra*, 10 Cal.4th at pp. 1238-1239.

In conclusion, the credit bid is a very useful "tool in the foreclosing lender's toolbox." However, it is a "tool" which needs to be knowingly used, otherwise there can be potential adverse consequences.



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1 The lender "is not required to open the bidding with a full credit bid, but may bid whatever amount [it] thinks the property worth. [Citation.]" (*Commonwealth Mortgage Assurance Co. v. Superior Court* (1989) 211 Cal.App.3d 508, 520.)

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