

# **FORECLOSURE OVERVIEW**

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## **1. CHOOSING METHOD OF FORECLOSURE – JUDICIAL OR NON-JUDICIAL**

### **A. THE “ONE ACTION RULE”**

The “one action rule”, better characterized as the “security first rule”, as set forth in California Code of Civil Procedure Section 726, requires that when an obligation is secured by real property, the lender must proceed against the real property first before pursuing the borrower personally. This rule does not apply to actions against Guarantors or, in most cases to actions against the borrower by “Sold Out Junior Lienholders” (see below).

### **B. JUDICIAL FORECLOSURE**

Judicial Foreclosure is a court proceeding. It is rarely used but...it is the only method of foreclosure in which the lender can obtain a deficiency judgment (a money judgment against the borrower after foreclosure). Judicial Foreclosure should be used when: the borrower has significant assets other than the real property security and the real property security’s value is insufficient to satisfy the debt OR when there are problems with the transaction’s documentation, for example, incorrect legal description or the security instrument is a “mortgage” with no “power of sale”. Additionally, Judicial Foreclosure supports a request for appointment of a receiver to collect rents from tenants during the foreclosure process. However, the same result can be obtained by a lawsuit for Specific Performance to enforce the rent and profits clause of the security instrument. In almost all other cases, Judicial Foreclosure should be avoided due to excessive legal expenses and judicial delays.

### **C. APPOINTMENT OF A RECEIVER**

As stated above, a receiver can be appointed in a Judicial Foreclosure or in an action for Specific Performance of the rents and profits clause of the security instrument. Rarely, a perfected assignment of rents clause can be enforced by a letter to the tenants without judicial action but this course of action is not recommended. Due to the amount of attorney fees and receiver fees involved in having a receiver appointed, the monthly rents accruing from the security should be substantial (\$5,000+ per month(?)).

### **D. NON-JUDICIAL FORECLOSURE**

99% of foreclosures in California are Non-Judicial Foreclosures. This method of foreclosure is, as the name implies, done without court supervision. For this reason, case law requires strict compliance with the statutory scheme for Non-Judicial Foreclosure and such foreclosures are generally done by professional foreclosure trustee companies. The main advantages of the Non-Judicial Foreclosure are lower fees and costs and a much faster time to sale (approximately four months as opposed to a year or more in Judicial Foreclosure). Thus, most lenders avoid Judicial Foreclosure even when the value of the security is insufficient to satisfy the debt. The main disadvantage of Non-Judicial Foreclosure is that there can be no monetary judgment against the borrower after the Non-Judicial Foreclosure sale.

## 2. NON-JUDICIAL FORECLOSURE PROCEDURE

The Non-Judicial Foreclosure procedure is fairly simple and commences with the recordation and mailing of a Notice of Default. After a three month waiting period, a Notice of Sale is prepared setting the actual foreclosure sale on a date about 20-30 days in the future. Thus, the entire procedure takes about four months (not including debtor actions to delay the process like bankruptcy or lawsuit to enjoin). A professional foreclosure trustee handles the details of the necessary postings, recordations, mailings and publications as required by law. Upon sale of the real property security, the successful bidder at the sale receives a special foreclosure deed from the trustee known as a Trustee's Deed Upon Sale.

## 3. SPECIAL CONSIDERATIONS IN NON-JUDICIAL FORECLOSURES

### **A. MULTIPLE NOTES AND TRUST DEEDS ON THE SAME PROPERTY**

When the lender has more than one promissory note secured by more than one deed of trust on the same property, care must be taken in deciding how to foreclose. California law provides that a foreclosure on a senior lien extinguishes (wipes-out) junior liens on the same property. Thus, a lender could wipe-out its own junior lien by completing a foreclosure on its senior lien. Note: absent a Subordination Agreement, all liens take their priority or position based upon their date of recording. As a rule, the lender will complete the foreclosure on its most junior lien first to avoid the "wipe-out" issue described above. However, when the value of the security is less than even the senior lien, the lender may decide for strategic reasons to complete the foreclosure on its senior lien and "wipe out" its own junior lien. Note: A lender that wipes out its own junior lien generally cannot proceed against the borrower as a "sold out junior" Simon v. Superior Court.

### **B. ONE NOTE SECURED BY TWO OR MORE TRUST DEEDS**

This is a common occurrence when the lender requires multiple parcels of real property as security for an obligation. California law permits multiple foreclosures contemporaneously or consecutively on the real properties. The critical concern for the lender is to remember to apportion the debt, and, therefore, the bid, among the several properties. At any point that the lender bids an amount equaling the total debt, or receives proceeds of sale equaling the total debt, all additional security must be released.

### **C. ONE NOTE SECURED BY ONE TRUST DEED LISTING MULTIPLE PROPERTIES**

As a rule, when possible, placing several different parcels of property on the same trust deed to serve as security for a note should be avoided. The reason is that the lender may wish to complete foreclosure on only one of the parcels and reserve its right to foreclose on the others later. The proper method of exercising the power of sale on only one of several parcels listed as security in the same trust deed is unclear. The problem can be wholly avoided by drafting and recording separate trust deeds for each piece of the security and then proceeding as in paragraph 3B above

### **D. MULTIPLE NOTES SECURED BY ONE TRUST DEED**

This is a rare occurrence and should be avoided unless the notes are cross-defaulted. Absent cross-defaulting, a foreclosure against the property due a default on one of the notes results in the second note becoming unsecured.

### **E. LENDER BIDDING AT FORECLOSURE SALES**

A lender is entitled to make a “credit bid” at its own foreclosure sale (and not at the sale of another lien holder). The highest credit bid the lender can make is the total amount due to the lender including all principal, interest, late charges, attorney fees and trustee’s fees and costs. The lender, also known as the beneficiary, can bid above its full credit bid with cash or cashier’s checks. Caution: under California law, a full credit bid is equivalent to receiving full payment on the debt and all additional security or liable parties (guarantors) must be released. For this reason, most lenders start their bidding at less than a full credit bid. There is no clear bar to bidding just \$1.00 if no other bidders are at the sale but the better practice is to bid an amount that is rationally related to the wholesale value of the property. If the lender starts with less than a full credit bid, the lender’s bid can be raised incrementally during the sale up to a full credit bid. Bidding less than a full credit bid permits the lender, among other remedies, to: pursue guarantors, foreclose on additional security, retain rents collected by a receiver and claim fire insurance proceeds from pending claims. A full credit bid should never be made without advice from the legal department.

#### **F. INVESTOR BIDDING AT FORECLOSURE SALES**

An investor must bring cash or cashier’s checks in excess of the lender’s opening credit bid in order to bid at the foreclosure sale. The auctioneer “qualifies” the bidders by privately recording on paper how much money the bidder has brought to the sale. The bidder cannot bid in excess of the amount shown to the trustee unless the bidder shows the trustee additional funds. As stated above, the lender can start with a low credit bid and raise its bid incrementally towards a full credit bid if there are outside bidders up to whatever amount the lender is willing to accept for the property.

#### **G. DISPOSITION OF PROCEEDS FROM THE FORECLOSURE SALE.**

If there are no bidders at the sale, or if no bid exceeds the lender’s credit bid, then there will be no proceeds from the sale. The lender will receive a foreclosure deed, a Trustee’s Deed Upon Sale, from the trustee. However, if the property is sold to a third party investor, the proceeds of the sale will be distributed as required by California Civil Code Section 2924k. Thus, the foreclosure trustee will be paid first, followed by the lender, then the “wiped-out” junior liens and then, if surplus funds still remain, they will be paid to the former owner of the property. Note: if the lender makes less than a full credit bid but the bidding continues between two or more outside bidders, the lender will still be entitled to collect the full amount due to it, not just the amount of its partial credit bid.

#### **H. JUNIOR IRS LIENS NOT WIPED OUT IMMEDIATELY**

An exception to the proposition that a senior foreclosure sale wipes out all junior liens occurs when the Internal Revenue Service has a junior IRS tax lien. In such cases, the IRS has a 120 day right after the sale to take the property from the successful bidder (whether lender or investor) by paying the lender its full debt or paying the investor the amount bid at the sale. In 24 years of practice, although the IRS tracks all sales, we have never had a redemption by the IRS. The lender or investor who acquires a property subject to the IRS right of redemption should refrain from making costly improvements to the property until the 120 day right of redemption expires.

#### **4. THE ANTI-DEFICIENCY LAWS (CCP SECTIONS 580b, 580d AND NEW 580e)**

California law provides protections for borrowers who lose their property through foreclosure or short sales. One of the purposes of these laws is to avoid saddling a person who has already lost their property with personal debt as well. The three anti-deficiency laws are described below.

**A. CODE OF CIVIL PROCEDURE (CCP) SECTION 580b**

CCP Section 580b bars deficiency judgments after foreclosures based upon all seller carryback loans and on acquisition loans from lenders for one to four unit owner occupied dwellings.

**B. CODE OF CIVIL PROCEDURE SECTION 580d**

CCP Section 580d bars deficiency judgments after Non-Judicial Foreclosure sales.

**C. CODE OF CIVIL PROCEDURE SECTION 580e (NEW)**

CCP Section 580e bars deficiency judgments after lender approved short sales on one-to four unit first trust deeds where the property is owner by an individual and not a corporation (the legislature forgot to mention whether LLCs are covered).

**5. LENDER'S RIGHTS AGAINST GUARANTORS**

Although this area of the law is a bit unsettled, the general rule is that the lender who makes less than a full credit bid may proceed against the third party guarantors of the obligation so long as the guarantors have executed well written guaranties that waive various suretyship (guarantor) rights otherwise existing under California law.

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If you have any questions or comments regarding these materials, please call Richard G. Witkin, Esq. of Witkin & Eisinger, LLC at (818) 845-4000.