

Avoiding the \$475,000 Mistake – Entering the Credit Bid

By John L. Hosack and Joffrey Long

Finally! The delays are over and your foreclosure is going to sale. The trustee asks for bidding instructions. The grand total owing on your loan (a first trust deed) is \$575,000. The value of the property is \$500,000. Would you open the bidding at \$575,000? It could be a big mistake. Surprisingly, many otherwise sophisticated lenders and servicers, including large banks, are completely unaware of this problem.

At the opposite extreme, there's another challenge. It occurs when a lender/servicer who is owed \$575,000 opens the bidding at a minimal sum, such as \$2,000, that has no relationship to the equity being auctioned.

There are serious problems with either approach. The good news – either set of problems can be avoided with some relatively simple procedures.

Full Credit Bids – The Problem:

If \$575,000 is the total of your principal and accrued interest, late charges and other fees and costs, and the property reverts to you as beneficiary after you credit bid that amount, you're deemed to have been "paid in full." Having just acquired a \$500,000 house in exchange for a \$575,000 debt, you (and especially your investors) won't want to consider this arrangement as "payment in full."

There may be other ways to collect on your note, such as insurance proceeds, proceeds from title insurance claims, rents, personal property, or payments from a guarantor, if there is one. But if the property has reverted to you under a full credit bid scenario, providers of title or hazard insurance, guarantors, and anyone else you intend to pursue for your losses will point to the fact that you were already "paid in full," when you acquired the property in exchange for a full credit bid. Any amount that you credit bid at the trustee's sale is deducted from the total amount owing. Acquiring the property for a lower credit bid, (\$100,000, for example) preserves the right to pursue other parties for the remaining unpaid portion of the debt.

The Other Problem – "Minimal Opening Bids"

The term "minimal opening bids," refers to opening bids that have no relation to the value of the property or the equity being sold at the trustee's sale, such as an opening bid of \$2,000 on our \$500,000 property. Many lenders start with minimal opening bids, then instruct the trustee to increase their credit bid in the event there are other bidders at the sale. The problem with a dramatically low opening bid is that the "Re-statement of the

Law-Property Mortgages” (Fn1) states that if it is determined there were any irregularities with the sale, and the opening bid was for less than 20% of the equity being auctioned, a court may invalidate the foreclosure sale. Opening your bidding at a minimum of 20% of the equity being auctioned creates some protection for a beneficiary in the event an irregularity with the sale is later discovered.

How to proceed with your trustee’s sale:

In the case we referenced above, the total balance of all amounts due on the note was \$575,000 and the property value was \$500,000. You would open the bidding at \$100,000. Instructions would then be issued to the trustee that should there be other bids at the sale, the trustee is to increase your credit bid in increments of \$2,000, until either 1) the bidding reaches an amount acceptable to you or 2) you acquire the property. With no other bidders, the property reverts to you in exchange for your “giving up” only \$100,000 or your debt. The other \$475,000 has not been paid. Through this one simple maneuver, you’ve preserved the ability to pursue the collection of the remaining \$475,000 of your debt from insurers, guarantors, or other parties to the transaction.

If there are other bidders, your bid is increased in increments of \$2,000 until you receive an acceptable price or acquire the property. If other bidder(s) stop bidding and you acquire the property at a \$325,000 credit bid, you’re still better off than with a full credit bid. You’ve now been “paid” only \$325,000, leaving \$250,000 (\$575,000 less \$325,000) that you can attempt to collect from others.

There’s another possible benefit in starting with a lower bid. Although unlikely in this market, a third party bidder could bid an amount that benefits you more than taking title to the property does. Prepare for this by carefully thinking through the amount at which you’re willing to allow a third party bidder to acquire the property.

A procedure for setting your credit bids might look like this:

- 1) Take the market value (Fn2) of the secured property and subtract any senior liens.
- 2) Determine the equity being transferred at the foreclosure auction.
- 3) Calculate 20% of the equity being transferred as a possible opening bid.
- 4) Instruct the trustee (in writing) as to your opening bid, increments in which you wish the bid increased in the event there are other bidders, and your maximum credit bid.

Also critical, any manner in which you instruct the trustee to bid on your behalf could be challenged by your investors. You should have provisions in your loan servicing agreement that cover this, or obtain their later authorization to proceed. Even with prior authorization, they should be informed in writing as to the manner in which the bidding will proceed.

Fn 1: The “Restatement of the Law-Property Mortgages is a scholarly treatise published by The American Law Institute that is highly regarded and often followed by the courts. (American Law Institute Publishers, 1997)

Fn 2: In determining the market value of the property, remember that any appraisals you order could be discoverable in litigation with the borrower, an investor, or other parties to the transaction. Having your attorney order the appraisal and then sharing information with you keeps the appraisal under the “attorney-client” privilege, making it generally non-discoverable by other parties.

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