Commentary

Foreclosure Bidding Strategies and the Risks of a Full Credit Bid

by John H. Kuhl and Douglas P. Snyder

With the volume of foreclosures taking place in today's market, the foreclosure process is something which lenders should carefully analyze before embarking on a program of "taking back" properties. The typical foreclosure sale involves a single bidder, the foreclosing lender, who acquires the property by credit bidding its debt. It is tempting to believe that the foreclosure process is one in which the foreclosing lender simply takes the necessary steps to convert its deed of trust into ownership of the property. While this reflects the result in many situations, the lender's strategy in foreclosing is significant in preserving other remedies that may be available.

By law, a foreclosure sale is a public auction of the property. The rights of the foreclosing lender prior to, during and following the foreclosure sale are governed by this concept of a public auction which is designed to bring the highest price for the property to satisfy the lender's debt. The public auction approach should be used by lenders in adopting bidding strategies which will most likely produce cash from foreclosure sales and will not impair the lender's other rights against other collateral, the borrower and other parties.

Bidding Procedures

The foreclosing lender has the right to credit bid up to the full amount of its debt, including permitted foreclosure costs and attorney's fees. All other bidders must bid in cash or a cash equivalent, such as cashier's checks or checks drawn by a financial institution. The trustee holding the foreclosure may require each bidder to be "qualified" by showing the trustee his or her funds.

When bidding commences, each bid is deemed to be an irrevocable offer to purchase the property. Each higher bid cancels all prior bids. If the bidding is postponed for any reason, all bids are canceled and bidding starts over when the sale is reconvened.

The foreclosure sale is complete when bidding has stopped and the trustee announces completion of the sale by fall of the gavel or in another customary manner. At this time, the deeds of trust of the foreclosing lender and any junior lienholders are extinguished by operation of law, and the successful bidder is entitled to a trustee's deed to the property. If the successful bidder is any party other than the foreclosing lender, the cash proceeds of the sale are paid first to the foreclosing lender up to the amount of its debt, including the costs of the sale, next to any junior lienholders to the extent of their debts, and any excess amounts to the borrower.

Bidding Strategies

Many foreclosing lenders simply bid the full amount of their debt - a "full credit bid" - without analyzing the value of the property or potential claims it may have against other collateral, the borrower or other parties relating to the loan. This procedure can be hazardous to a lender who may want to pursue a deficiency claim against the borrower or its general partners (following judicial foreclosure) or against separate guarantors. Claims relating to the loan or the property which otherwise could be pursued against these parties may be barred if the lender has acquired the property with a full credit bid at foreclosure. The lender also must be careful to protect its rights to rents which may be held by a receiver, or to other security such as a letter of credit, by "under bidding" at least to the extent of such rents or other additional security.

Careful analysis must be given to foreclosure bidding strategy. The foreclosing lender should know what it believes the fair market value of the property to be, based on the value which could be realized at resale following foreclosure. Even if there are no other bidders at the foreclosure sale, the foreclosing lender should not bid more than the property's fair market value. If other bidders appear, the foreclosing lender may want to start bidding at a lower level in order to encourage cash bidders to make bids. If a cash bid is made, the lender must consider the alternatives of receiving the net proceeds of the cash bid versus making a higher credit bid and taking the property into ownership. In most instances, a full credit bid should not be made unless competitive bidding has driven the price up to this level and the lender believes it is supported by value in the property.

Of course, these recommendations assume that the foreclosing lender will send a representative to the foreclosure sale who is in a position to implement a bidding strategy. If active bidding is anticipated, it is generally preferable for the lender to send a representative to the sale, rather than rely on the alternative of asking the trustee to enter the lender's bids.

Full Credit Bid Illustration

A recent case illustrated the danger of purchasing at foreclosure with a full credit bid. In *Western Federal Savings & Loan Association v. Sawyer,* 10 Cal.App.4th 1615 (1992), the lender made a loan to a purchaser of real property. After the borrower defaulted on the loan, the lender foreclosed and acquired the property by making a full credit bid at the trustee's sale. The lender, having discovered that the loan application and appraisal contained several misrepresentations, brought suit against the borrower. At trial the jury ruled that the borrower was part of a conspiracy to fraudulently induce the lender to make the loan and awarded damages to the lender.

The appellate court, relying on the California Supreme Court case of *Cornelison v. Kornbluth,* 15 Cal.3d 590 (1975), reversed the trial court's decision. In *Cornelison*, a lender sought recovery for waste. The Supreme Court refused to decide whether waste had occurred, holding that even if liability existed, the plaintiff could not recover damages because it had made a full credit bid at the trustee's sale. Specifically, the Supreme Court ruled that the measure of the lender's damages would be equal to the amount of the impairment of the security, which is the excess of the indebtedness over the value of the security. By entering a full credit bid, the Supreme Court concluded that the lender established the value of the security as being equal to the outstanding indebtedness and, therefore, no impairment of the security (and no damages) existed.

The court in *Western Federal* followed *Cornelison,* ruling that the lender could not recover damages for the alleged fraud since its full credit bid established the value of the security as equal to the outstanding indebtedness.

The *Western Federal* case illustrates the risks of making a full credit bid at foreclosure. This result emphasizes the need to treat the foreclosure process as a public auction in which the proceeds will be used to satisfy the foreclosing lender's debt. The debt will be deemed satisfied to the extent of the successful bid.

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