

Strategic Defense Program Article: Understanding the Foreclosure Process

Introduction

This article on the foreclosure process is the second in a series of articles to be presented by the C.A.R. Strategic Defense Counsel and Panel members.

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By now most REALTORS® have experienced the impact of the declining housing market within their own businesses. Of paramount concern for real estate professionals is the need to most effectively represent buyers and sellers in a declining real estate market. An understanding of the principles of foreclosure is important in providing the proper representation to a client who is the owner of a diminishing real property asset. It is also critical in assisting buyers in finding a home. Regardless of whether one is the listing agent, the selling agent or the buying agent, a basic understanding of the mechanisms of real estate foreclosures is important to providing competent real estate services in the present real estate economy.

A number of factors have led to the present crisis in the housing market. One of the initial factors was the overextension of credit. In the last few years prior to the present housing slump 35% of homeowners nationwide had loans in excess of 95% of the value of the home. In California 45% of the homeowners had loans in excess of 95% of the value of the home. Many people purchased homes with adjustable rate mortgages planning to refinance into a fixed rate mortgage before the loan adjusted to the point that it would become unaffordable. The initial low payments made these loans particularly attractive and their popularity began to exceed the popularity of the fixed rate mortgage. However, when the homeowners attempted to refinance they found that the equity in the home had decreased to the extent that lenders would not refinance. As a result many homeowners found themselves in foreclosure. Mortgage fraud has also increased the number of foreclosures through Ponzi schemes and pyramid holdings not unlike those in the securities industry in the 1920's prior to the Great Depression. Moreover, as a result of the continuing slow down in the housing market buyers have hesitated in purchasing real estate. Thus, buyer caution has exacerbated the housing decline.

According to data from the National Association of REALTORS®, nationwide existing home sales were at 4.89 million in January 2008, compared to 6.38 million in January of 2007. This is a decrease of over 23.4%. The glut of existing homes on the market in the United States in January 2008 reached 4.19 million which is a 10.3 month supply. In contrast, in January of 2007 the existing home inventory was 3.52 million which was a 6.7 month supply. PropertyShark.com reports that foreclosures in Los Angeles in the third quarter of 2007 were up 247% over the third quarter of 2006. There were 5320 foreclosure filings in Los Angeles in the third quarter which was a 40% change over the filings in the second quarter of 2007. Stockton, Riverside/San Bernardino, Sacramento, Bakersfield and Fresno are five of the top 20 foreclosure-filing areas in the nation according to the Department of Housing and Community Development.

Types of Foreclosure

In California there are two types of foreclosure with which a home owner might be faced. These are the "judicial foreclosure" and the "trustee sale" sometimes called the "power of sale" foreclosure. In a judicial foreclosure, where the amount recovered in the sale is less than the amount owed on a loan, the difference is called a "deficiency." A "deficiency judgment" is a judgment against the borrower for the difference between the unpaid balance on the loan and the amount generated by the foreclosure sale or the fair market value, whichever is greater. Where the foreclosure is accomplished by judicial action, the lender may be able to obtain a deficiency judgment against the borrower. However, the recovery of the deficiency amount is only available in a judicial foreclosure and is not permitted after a "trustee's sale." In other words if the lender utilizes the non-judicial method of a trustee sale, a deficiency cannot be collected. Additionally, the recovery of a deficiency is not possible on a "purchase money" loan, including seller-carried financing, on any real property or loans on property consisting of 1-4 family units of owner occupied residential property. Recovery of the deficiency amount is possible, however, on a refinanced property loan (non purchase money) or on 1-4 family non owner occupied residential property loans.

Judicial Foreclosure

Fewer than 5% of residential foreclosures in the state of California are judicial foreclosures. A judicial foreclosure is initiated by the lender filing a lawsuit against the defaulting borrower in Superior Court. Upon sufficient proof at trial, the court enters judgment of foreclosure and orders the sale of the property. After the sale the lender files an application for fair value deficiency after which there is a hearing on the deficiency. Upon approval the court issues a fair value finding on the deficiency and enters a conventional money judgment called a "deficiency judgment." A judicial foreclosure generally takes much longer than a trustee sale. Subsequent to the issuance of the judgment there is a time period during which the borrower can exercise his right of redemption and repurchase the property by paying the full amount of the defaulted loan. Where the proceeds from the sale are sufficient to pay the debts on the property the redemption period is three months. Where the proceeds are not sufficient to pay the debts on the property the redemption period is twelve months.

Attorneys are often asked by real estate professionals what the "One Action Rule" means in real estate foreclosures. The One Action

Rule was designed to limit the number of lawsuits that would be required in order to foreclose on a piece of real estate. In California, the One Action Rule has been codified as CCP§ section 726(a). That section requires a mortgagee (the party who lends money to the property owner [mortgagor] and takes a security interest in the property) to seek all of its relief in one legal proceeding. While most foreclosures in the state of California occur without judicial intervention by way of a trustee sale, the One Action Rule applies in situations where the party utilizes the courts to achieve a judicial foreclosure. Judicial foreclosures are most commonly utilized when the lender is seeking to recover the deficiency between the unpaid balance on the loan and the amount raised at the foreclosure sale or the fair market value of the property, whichever is greater.

At common law, in order for a lender to recover its property and a money judgment on the deficiency, the lender had to file three separate actions. They were (1) a suit in equity to foreclose on the property; (2) an action at law on the debt to obtain a money judgment; and (3) an action for ejectment to remove the borrower from the property. This requirement of filing three separate actions was a significant burden to lenders who desired to foreclose on real estate. In 1851 California adopted a version of a proposed New York law and codified it in Section 246 of the Civil Practice Act. In 1872 it was recast as CCP §726(a), which remains in effect today.

CCP §726(a) is most commonly thought of as debtor protection, because it allows the debtor to avoid a multiplicity of lawsuits. In reality, it was originally intended to protect the lender from the necessity of prosecuting numerous actions to recover different forms of relief under three different forms of action. As mentioned above, the vast majority of foreclosures on residential real property occur by way of trustee sale. However, in situations where the foreclosing lender seeks to recover a deficiency on the sale of real property, the judicial foreclosure process must be utilized and the lender must comply with the One Action Rule.

Foreclosure by Trustee Sale

In contrast to the judicial foreclosure, in a trustee sale there is no court filing. Instead the lender elects to accelerate the loan under the "power of sale" clause contained in the deed of trust and the property is sold at a trustee sale. In actual practice, when the borrower is approximately 45 to 60 days in default, the lender sends a letter advising that the loan is in foreclosure and that the lender is going to exercise the option to accelerate the loan. The borrower is also provided information about how to reinstate the loan. If the borrower does not cure the default, the lender then records a "notice of default" against the property. The soonest the actual foreclosure sale can occur once the notice of default is recorded is three months and twenty one days.

If the property sells at foreclosure for more than the amount due plus costs of foreclosure, the "excess proceeds" are distributed to junior lien holders whose loans or liens were "wiped out" by the foreclosure and any remaining excess is returned to the property owner. Where the junior lien holder's security is wiped out by the foreclosure of the primary lender, the junior lien holder may choose to sue on the note under a breach of contract claim. While this was rarely done in the past, some lenders are now pursuing this course of action to recover the lost security on their loans.

Options for a Borrower Facing Foreclosure

Workout Plans:

The first option a borrower should consider when attempting to keep a home is a workout. Under a workout scenario the lender will assist the borrower in keeping the property. One of the plans usually offered to the borrower is "forbearance." Under a forbearance plan the lender will allow the borrower to continue for a certain period of time, such as six months, without making a payment. When the borrower is able to catch up, the borrower resumes making payments plus an additional amount to bring the loan current. Loan modification can also involve rewriting the terms of the loan to make the loan affordable for the borrower. This might consist of changing an adjustable rate mortgage to a fixed rate mortgage, for example. The objective is to work out the default with the borrower to allow the borrower to remain in the home and avoid foreclosure.

Short Sales:

"Short sales" may occur once a home is in foreclosure or prior, but before the property goes to sale. In a short sale, the lender accepts an offer from a third party buyer for less than the outstanding loan on the property and forgives the deficiency owed by the borrower. This arrangement may be appealing to lenders because it saves time and money by stopping the legal foreclosure process and by taking the property off the lender's books. However, recently it has come to light that some lenders agreeing to short sales are including language in the release which allows them to sue on the note even though they are releasing the security in the property.

Until December 21, 2007, if the lender accepted less than the balance owed and cancelled the debt, that amount would be considered debt forgiveness, and tax would be due on the amount forgiven. This forgiven amount was called "phantom income." According to the IRS it is the same as if you received that amount of income. On December 21, 2007 President Bush signed H.R.3648: Mortgage Forgiveness Debt Relief Act of 2007 which provides relief to homeowners facing foreclosure from the phantom income realized from debt forgiveness or foreclosure. The benefit to the borrower of a short sale is that the credit report will show that the loan settled for less than full value as opposed to a foreclosure. Those who are most interested in the short sale opportunity are those who would like to preserve their credit by avoiding the foreclosure.

Deed in Lieu of Foreclosure:

In a "deed in lieu of foreclosure" plan the borrower returns the deed on the property to the lender in exchange for a release of the security interest and a cancellation of the note. As in the case of foreclosures and short sales, the borrower may be able to claim relief under the Mortgage Forgiveness Debt Relief Act.

Caution: A number of lenders have been offering a deed in lieu of foreclosure. However, when the borrower reads the fine print on the release of claims, he discovers that the lender is reserving the right to proceed against the borrower for breach of contract on the loan. REALTORS® are strongly recommended to advise their clients to request an attorney to review the documents received from a lender before entering into a deed in lieu of foreclosure transaction to assure that the documents express the true intent and understanding of the borrower.

Bankruptcy:

Bankruptcy is another option that defaulting borrowers may sometimes consider. Generally, bankruptcy will be attractive where the borrower is in debt with no feasible way of recovering. The most common scenario is where the borrower is in default on a loan where the lender is seeking judicial foreclosure or where the lender is suing on a note where the underlying security has been "wiped out" by a senior creditor. Again, whenever a borrower is facing possible foreclosure it is prudent to refer them to an attorney who is qualified to address all of the available options.

Conclusion

This brief article is intended to provide an overview of some of the more salient issues that might be encountered by REALTORS® in the present economy. The importance of addressing these issues competently cannot be overstated. A client may have many options that are not apparent to one unfamiliar with real estate law. While the foregoing is intended to provide an understanding of some of the basic issues that arise in foreclosure context, in all situations where a client is facing a possible foreclosure, it would be prudent to refer the client to several attorneys familiar with real estate law and the foreclosure process and to document the referral in writing.

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