

## **Is There a Foreclosure in Your Future?** **by Dale S. Alberstone, Esq.**

Sales of apartment buildings in Southern California continue to be strong, even though the market has softened somewhat from last year's historically high prices. Apartment complexes, in stark contrast to depressed single-family residential sale prices, are still fetching at high gross multipliers and low CAP rates.

Fueling high prices for multi-residential income property is the low vacancy rate in Los Angeles and Orange Counties. In many cities, the vacancy factor is below 5%. Relatively few new units are being constructed. That, in turn, leads to significant rent increases under the established economic rule of "supply and demand."

Similar economics were present in the late 1980s, namely: high prices, low vacancies, strong rental market and limited supply.

About the mid-1990s, the bottom fell out from the market. Vacancies increased, tenants moved out of state, others moved back home with their parents or other relatives, positive cash flows turned to monthly losses and foreclosures began. Each time a property was lost at foreclosure, the new buyer was able to acquire the property at a fantastic savings, thereby allowing him or her to lower the rent below market to attract new tenants. That induced tenants to vacate their existing units in favor of finding lower rent elsewhere, if not right next door.

The end result was that many apartment owners experienced substantial negative cash flows. More and more buildings went into foreclosure during the mid-90s, creating a snowball effect of bank repossessions and lower rents.

Not only are the current national economic woes of the country leading to a high number of foreclosures of single-family residences, we are also seeing a significant increase in foreclosures of duplexes, which perhaps could be defined as the smallest example of an apartment building. Typically, the smaller the number of units, the higher the purchase price per door, all of the things being equal.

As a real estate attorney it is not my place to advise AOA members of the wisdom of purchasing a building at a high gross multiplier, but only to caution readers that they should carefully analyze each transaction for its economic soundness prior to purchase. Positive cash flows which do not soon occur after the close of escrow are the predominant cause of foreclosures. And as you know, a foreclosure can have dire consequences on one's economic well being. For starters, if a bank pursues the appointment of a receiver coupled with a judicial foreclosure, the owner's personal assets (that is, his bank accounts and other properties) may be subject to the lender's levy following the completion of the foreclosure. With a judicial foreclosure, the owner is liable to the lender for the entire amount of the indebtedness less the market value of the property. That indebtedness not only includes unpaid principal, but also accrued interest, attorney's fees, court costs, appraisal costs, receiver fees (in some cases), and other expenses

incurred by the lender. The difference between the total indebtedness minus the property's valuation is the deficiency which may be awarded by the Superior Court against the property owner.

Often there are legal procedures and strategies available (other than bankruptcy) for the owner to avoid personal liability to the bank for the deficiency. The most important of these is for the owner (usually through the owner's attorney) to persuade the lender to complete a trustee's sale, rather than a judicial foreclosure. In that event, the owner will lose the building, but not any of his other assets.

Incidentally, the most critical mistake that many owners, as well as inexperienced counsel who may represent them, make when negotiating with the bank is providing the bank with a copy of the owner's financial statement or tax returns. Such financial data provides the lender with a road map of where to execute on the owner's other assets and places the bank in an extremely strong bargaining position when it seeks to collect the entire indebtedness.

For those owners who find themselves in judicial foreclosure or under circumstances where a receiver has been appointed, generally they should implement the following procedures:

1. File an answer to the Superior Court Complaint within 30 days after receiving the Summons,
2. Assert the four affirmative defenses specifically applicable to judicial foreclosures,
3. Immediately propound discovery on the lender, including Requests for Document Production (requiring production of the lender's entire file), Form Interrogatories and Interrogatories specially drafted for the case at hand,
4. Correspond with the lender's attorney explaining the seven reasons why the lender should abandon the judicial foreclosure in favor of a trustee's sale (i.e. time duration, attorney's fees, appraisal costs, uncertainty of the amount of the deficiency judgment, uncertainty of collectability, the one-year equity of redemption rule and the lender-landlord liability exposure issue) and
5. Obtain a credible valuation of the property for negotiation purposes with the lender.

Conclusion:

The best way to avoid foreclosure is to acquire property which is unlikely to have a negative cash flow, or which can soon be turned into a positive cash flow. That, of course, is easier said than done. Buildings purchased at high gross multipliers or low income capitalization rates are handsome candidates for judicial foreclosure.

Despite an owner's best valuation and intentions, if he or she finds himself the target of a judicial foreclosure, competent real estate counsel should be immediately sought. Personal liability can usually be avoided with proper planning.

*Dale Alberstone is a prominent real estate attorney who has practiced real property and business law in Century City for the past 31 years. He has been appointed to periodically serve as a judge pro tem of the Los Angeles Superior Court and is a former arbitrator for the American Arbitration Association. He also testifies as an expert witness for and against other*

*attorneys who have been accused of legal malpractice.*

*Mr. Alberstone has been awarded an AV rating from Mardindale-Hubbell. An AV rating, registered through Reed Elsevier, reflects an attorney who has reached the heights of professional excellence and is recognized for the highest levels of skill and integrity. The foregoing discussion is intended as a general overview of the law and may not apply to the reader's particular case. Readers are cautioned to consult an advisor of their own selection with respect to any particular situation.*

*Address correspondence to Dale S. Alberstone, Esq., ALBERSTONE & ALBERSTONE, 1801 Avenue of the Stars, Suite 600, Los Angeles, California 90067. Phone: (310) 277-7300.*