

**Is There a Foreclosure in Your Future?
(Chapter 2)
by Dale S. Albertstone, Esq.**

A year ago last May, I asked readers of this magazine the same above question. For that reason, this month's column is designated as "Chapter 2." Although the advice and strategies I offered in my 2008 discussion have not changed during the past 12 months, the probability of any given apartment building in California now being a candidate for foreclosure has increased significantly.

THE PROBLEM

With tens of thousands of tenants losing their jobs and becoming unable to pay their rent, more and more of them are vacating and moving elsewhere, often out-of-state. Vacancy rates have dramatically increased in the past year and it is not uncommon to see a plethora of "For Rent" signs up and down streets.

Landlords are reducing rents to attract new tenants, thereby competing with other landlords who are vying for the same fixed and curtailed pool of potential applicants.

Sale prices for multiple-family residential income property in California have softened in the past 12 months, but are still strong relative to most other parts of the country.

Indeed, our current economic paradigm in the apartment arena has many similarities to that existing a decade ago when REOs seemed omnipresent.

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

As numerous 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 even lower rents.

Not only are the current national economic woes of our country allowing for a high number of foreclosures of single-family residences, we are now beginning to see the foreclosure of apartment buildings.

From a lender's perspective, one important difference between foreclosures of owner occupied single-family homes (including condominiums) and multi-family dwellings is that people generally do not allow their personal residence to go into foreclosure unless they are insolvent, or nearly so, whereas owners of apartment buildings treat their property as a business. As such, if the enterprise is losing money month after month and the mortgage indebtedness exceeds the

market value, the bank knows that an apartment owner may elect to cut his losses and walk away from the property, much like a local retail store which posts a “Going Out of Business” sign.

Because owning and operating an apartment complex is essentially a business venture, the fact that the owner stops making mortgage payments (thereby leaving the lender with no choice but to foreclose) does not necessarily mean, unlike the owner of a home, that the owner of the apartment building is broke. Instead, the owner might simply be making a (prudent) business decision to allow the bank to repossess the property. Thus, while the homeowner may be close to bankruptcy with no money for the lender to later levy upon and no wages to garnish, the apartment owner may have solid cash reserves.

It is precisely for that reason that lenders frequently pursue the full recovery of the mortgage they are holding from an apartment owner, while not pursuing the personal indebtedness of a homeowner.

And as you know, a foreclosure can have dire consequences on one’s economic well being. For starters, if a bank pursues a judicial foreclosure, the owner’s personal assets (that is, his bank accounts and other real and personal property) 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 fair value of the property at the time of the judicial sale. That indebtedness not only includes unpaid principal, but also accrued interest, attorney’s fees, court costs, appraisal costs, receiver fees, and other expenses incurred by the lender. The difference between the total indebtedness minus the property’s valuation is the deficiency which the Superior Court is empowered award against the property owner.

SOLUTIONS

There are legal procedures and strategies available (other than bankruptcy) to the apartment 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 induce the lender to complete a trustee’s sale, rather than a judicial foreclosure. In that event, the owner will forfeit the building, but not lose any of his other assets.

Usually a lender will file both judicial and non-judicial foreclosures which proceed concurrently, although in different forums. During the proceedings, if the lender elects to complete the trustee’s sale through the non-judicial foreclosure, it will then dismiss the judicial action. Thus, the owner needs to induce the bank to complete the non-judicial foreclosure (i.e. the trustee’s sale) rather than the judicial foreclosure.

The most critical mistake many owners and inexperienced counsel make when negotiating with a lender is providing it with a copy of the owner’s financial statement and/or tax returns. Disclosure of such financial data provides the lender with an invaluable 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 court-ordered receiver has been appointed, generally they should implement the following procedures:

- (1) File an Answer or Demurrer to the Superior Court Complaint within 30 days after receiving the Summons;
- (2) Assert the four affirmative defenses specifically applicable to judicial foreclosures (e.g., the “Security First Rule”);
- (3) Immediately propound discovery on the lender, including Requests for Document Production (requiring production of the lender’s entire file), Form Interrogatories and Specially Prepared Interrogatories 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 consumption, 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 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 even if rents decline, 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.

For buildings which are already owned by the individual, workouts through negotiation are sometimes possible, but use caution as the bank’s goals are to usually ascertain the whereabouts of the borrower’s assets, not to provide him with a write-down of the mortgage.

Despite an owner’s best intentions, if he or she finds himself the target of a judicial foreclosure, competent real estate counsel should be immediately sought. Personal liability can frequently 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 32 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.

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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.

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