

## **How to Fight a Judicial Foreclosure**

**by Dale S. Alberstone**

There is a significant difference in a lender's mindset between the foreclosure of a single-family residence (which is typically occupied by the owner), and a multi-family residential dwelling (in which the owner customarily lives elsewhere). With a home, a borrower is not likely to allow his residence to be lost to a foreclosure sale unless he/she is truly insolvent, or nearly so. Lenders know that if they were to pursue the borrower under the promissory note after repossessing ownership of the house, they are likely not to recover the deficiency owing simply because the debtor is broke. A solvent homeowner generally does not give up his home to a bank.

The lender's mindset is dramatically different when it comes to the foreclosure of an apartment building. There, a solvent owner, employing sound business judgment, may decide to walk away from a property just because the cash flow is hugely negative. That is not to say that he couldn't make the mortgage payments from a personal account, but only that it is not worth it to him to do so.

Once an apartment owner has made the final decision to abandon the property, his every objective (when defending a foreclosure) is to induce the lender to abandon the judicial foreclosure (which is almost always filed so that the lender can have a receiver appointed to take charge of the monthly rents, and thereafter pursue a deficiency judgment), in favor of a trustee's sale. Unlike a judicial foreclosure, the lender may not recover the balance owed on the mortgage indebtedness following a trustee's sale. For that reason, apartment owners need to cause the lender to dismiss the judicial foreclosure and pursue the non-judicial procedure of a trustee's sale.

Unfortunately, in 1998, the California Court of Appeal gave lenders an important round of ammunition if they pursue judicial foreclosures. In San Paolo vs. 816 South Figueroa Co. (62 C.A. 4<sup>th</sup> 1010), the appellate court ruled that for purposes of determining the amount of a deficiency judgment, the "fair value" of the property is synonymous with the "market value." Let me explain the significance of that.

As previously stated, unlike a non-judicial foreclosure (where the borrower is not liable for the balance of the loan following a trustee's sale), the completion of a judicial foreclosure results in the court assessing monetary damages against the borrower equal to the total indebtedness minus the "fair value" of the property. Until 1998, trial courts routinely acknowledged that "fair value" was different than "market value."

Market value is commonly defined as the price that a willing buyer and seller agree upon, each under no compulsion to buy or sell, in an arms-length transaction. Fair value, on the other hand, was thought to be the "intrinsic" value of the property, which, during a recession would be higher than market value.

For example, in one case which litigated for a borrower during the recession of the 1990s, I was able to establish to the trial court that the fair value of the property was \$2,000,000, even though the market value was \$1,000,000. Because the indebtedness on the loan was \$2,000,000, my client did not owe the balance, i.e., any deficiency judgment.

Under the said 1998 Court of Appeal decision, trial courts will now ignore the temporary impact of the recession when ascertaining fair value. Instead, the lower court must determine the market value of the property without regard to temporary economic conditions.

In view of the 1998 decision, borrowers should assiduously follow the following rules when opposing a judicial foreclosure:

- 1. Do not Provide the Bank with Financial Data:** A lender will always request the owner to provide financial statements and tax returns. Unless the loan documents specifically state that the debt is non-recourse, or unless the owner is unemployed and practically insolvent, he or she should not give the lender any financial data. That is because if the lender determines that the owner has financial wherewithal, it is likely that the lender will complete the judicial foreclosure so as to recoup its losses from the owner's personal assets.
- 2. Promptly Defend the Judicial Foreclosure Lawsuit:** Once served with the Summons and Complaint, the borrower has 30 days during which to file his Answer, Affirmative Defenses and any Cross-Complaint. If he does not timely respond to the Complaint, the lender will be allowed to take a default, followed by a judgment of personal liability against the borrower.
- 3. Raise Affirmative Defenses:** The Answer should allege Affirmative Defenses including: (a) the lender must exhaust the security before the defendant can be personally liable; (b) the lender can only recover the deficiency if the debt exceeds the fair value of the property, and (c) the "one form of action" rule may be violated. Additionally, if the lender engaged in improper conduct or breached any enforceable agreement, the doctrines of estoppel, unclean hands, waiver, release and laches should be considered as Affirmative Defenses.
- 4. Aggressively Pursue Discovery During the First Four Months of Litigation.** The first four months of the litigation are the most critical. That is generally the period during which the lender determines whether it will complete the judicial foreclosure. By aggressively propounding and pursuing discovery on the lender, the owner may be able to induce the lender to abandon the judicial foreclosure in favor of the less acrimonious and more expeditious process of a trustee's sale. Such discovery includes serving interrogatories and demanding production of documents, including all the lender's files. Of course, be sure to demand production of the original promissory note and deed of trust.
- 5. If All Else Fails:** In roughly 95% of all judicial foreclosures, competent counsel will be able to induce the lender to complete the trustee's sale, rather than the judicial foreclosure. There are a limited number of cases, however, where no amount of defensive efforts will cause the lender to abandon the litigation. In that event, the best strategy is for the borrower's counsel, with the informed consent of his client, to stipulate with the lender that the court may order an immediate sale of the property without

additional litigation or delay. The reason for this is that once it is apparent that the lender intends to complete the judicial foreclosure, the proper strategy is to expedite the matter to a conclusion. That is because the total indebtedness increases each month as interest continues to accrue, late charges continue to be assessed and the lender's attorney's fees (which ultimately are paid by the borrower) continue to be incurred. Since the amount of the deficiency will be the difference between the total debt minus the value of the property, an owner will want to at least limit these additional increases by shortening the time it takes to schedule the foreclosure trial and subsequent fair value hearing. Conversely, the longer it takes for the matter to come to trial, the more debt that accrues and the greater the ensuing personal liability to the owner.

## **CONCLUSION**

While the number of foreclosures of single-family homes in California may be high, fortunately foreclosures of apartment buildings are not. Nevertheless, we continue to see an increase in those proceedings, largely due to increased vacancy factors in virtually all multi-family buildings.

Owners of apartment complexes who find their property subject to foreclosure, should implement the preceding suggestions in order to maximize their chances of avoiding personal liability under their loans.

*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.*

*Mr. Alberstone has been awarded an AV rating from Martindale-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.*