Advanced Issues in Foreclosure

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Advanced Issues in Foreclosure

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Loss Mitigation Solutions

Submitted by Steven M. Morger

LOSS MITIGATION SOLUTIONS

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I. INTRODUCTION

Foreclosure is generally an unfortunate end result from both a borrower's and lender's perspective. From the borrower's perspective, it means the loss of property and all time and money previously invested in that property as well as a potential deficiency. From a lender's perspective, it discloses potentially bad underwriting standards, potential regulatory considerations (if a regulated lender), delay in payment receipt, additional costs of collection, potential headaches of owning and marketing property and unknown prospects for ever collecting the full amount of the debt.

One thing that is a given which the parties need to get past, is the fact that the lender has advanced the monies and has a valid contract which has been breached by the borrower by non-payment. This is frequently an insurmountable emotional issue for many parties, particularly lenders, to overcome. However, when the full panoply of facts and issues is discussed, it is a rare situation where some alternative to foreclosure is not the best option.

This section of the presentation will be broken up into three general areas of discussion–(1) background facts and issues for all parties to consider; (2) general options which can be alternatives to foreclosure; and (3) some specific plans that are in place or under consideration to assist in the avoidance of foreclosure.

II. PRELIMINARY CONSIDERATIONS

For both the lender and borrower (and respective counsel), it is necessary to understand not only the foreclosure process but also the respective considerations of the parties to determine whether some alternative to foreclosure is called for. In some circumstances, foreclosure may be an acceptable alternative to both borrower and lender. In others, foreclosure will be beneficial only to one or the other or neither. This section will discuss some of the issues underlying the decision to explore alternatives to foreclosure.

A. Understand The Consequences of Foreclosure.

1. Time. Foreclosure may be a time consuming process, ranging from 3-4 months to many years depending on the jurisdiction and method of foreclosure. During this time, significant changes may occur in the economy, the value of the security, the condition of the property and the resources of the borrower.

2. Cost—Including Out Of Pocket, Internal Resources And Opportunity Cost. Costs of nonjudicial foreclosure may range from 1-2% of the unpaid principal of the loan in a nonjudicial foreclosure context to $100,000 or more in a judicial foreclosure context. The costs of either type of foreclosure are not insignificant sums considering it might be questionable whether the lender will ever recoup those costs from the already defaulting borrower.

3. Redemption Rights. Some foreclosure schemes may allow for post-sale redemption by the borrower or other junior lienholders. Other schemes may not. In California, there is no right of post-sale redemption after nonjudicial foreclosure. There may be up to a one year post-sale right of redemption following judicial foreclosure but only for the borrower.

4. Constraints on Resale—Will a Quiet Title Action Be Required? While the validity of foreclosures is established, any foreclosing creditor should confirm that it can obtain title insurance or any assurance which will be necessary to establish marketable title.

5. Post-Sale Collections Rights Against Debtor. Can the borrower be held responsible for any shortfall received after the sale of the property?

a. Purchase Money/Non-Recourse. Whether by statute or contract, certain loans may be determined to be non-recourse obligations of the borrower. As such it is irrelevant what the property may be worth or sell for. The lender will not be able to look to the borrower for more than the property.

b. Fair value collection limitations. In many states like California, a borrower enjoys statutory protection from an excess deficiency through a credit for the "fair value" or "fair market value" of the property irrespective of what it might actually sell for at foreclosure. Besides leaving the amount of a deficiency to later determination by the court after the fact, it creates an additional level of cost to any foreclosing lender.

6. Impact on guarantors. Surprisingly, while California is very pro-borrower (as it relates to deficiencies), it is almost at the other end of the spectrum where it concerns guarantors. As such, while guarantors are (in theory only) "secondarily liable" parties, more often they are the true first source of repayment along with the property. As such, the impact of any creditor action must be evaluated against its impact on collection prospects against any guarantor.

7. What are foreclosure options? Normally, this is a simple answer since the lender will have the option of proceeding with either or both of judicial and nonjudicial foreclosure. However, in the event that any of the security instruments are defective or fail to include a "power of sale," a lender might be limited to proceeding judicially. This result may dramatically alter the respective bargaining party of the parties due to the cost and requirements of judicial foreclosure.

B. Understand The Lender's Considerations.

1. Regulatory issues. Does the bank need to create loss reserves? Is it in regulatory compliance? What are the bank's capital needs? Would it prefer a discounted payoff to secure present cash infusion rather than engage in a long and expensive battle to maximize its recovery?

2. Cost of collection v. potential recovery. Given the impediments to a deficiency in many jurisdictions, many lenders require a significant potential deficiency before they will commit to proceeding for a deficiency. This is, as it frequently should be, a simple cost/benefit analysis. While "simple," it is frequently the most important consideration facing any lender.

3. Value of security v. amount owed. Does the lender even need to concern itself with deficiency procedures? If the property is worth more than the debt, the lender is usually best served by simple resort to its consensual security. While California places great impediments on the collection of a deficiency, its processes for resort to security when no deficiency is requested is relatively quick, cheap and easy.

4. Condition of security when recovered. Given that it may be many months or years before the creditor may obtain title to and possession of the security property, its condition (and value) today may not accurately reflect those same issues when the property is recovered. While a receiver might help maintain a property, such may be costly and be unavailable if the property is a single family occupied residence.

C. Understand the Borrower's Concerns.

1. Credit. How problematic is the negative credit considerations from foreclosure? Would the credit consequences of other options be less harmful?

2. Potential for "free rent" during foreclosure period. As a practical matter, the borrower will not be divested of the property until after sale. During this period, it might be able to avoid paying its mortgage or rent payment but continued with unfettered occupancy.

3. Potential for collectible deficiency. Practically, a deficiency judgment is only as good as the actual money collected to satisfy the judgment. With the time necessary to complete the sale and secure a deficiency, a borrower may have opportunities to asset plan. Whether attachment might be available is a question for individual jurisdictions.

D. Are There Other Parties Who Are Impacted?

1. Guarantors. Will a foreclosure impact rights which the lender might have against guarantors?

2. Municipalities. Primarily as a result of the foreclosure blight or ordinances, municipalities might impose special duties on foreclosing lenders.

III. GENERAL ALTERNATIVES TO FORECLOSURE

While California theoretically requires a creditor to foreclose as its "one action," custom, practice and the courts themselves recognize that there are options available to the parties short of foreclosure which may be in the mutual interest of both the creditor and debtor. This section will raise certain options and some of the issues related to each. We will, of course, discuss these options in more depth during the actual seminar.

A. Reinstatement

1. Reinstatement is the right to bring the loan current by performing all past due obligations and paying any fees incurred by the lender.

2. Reinstatement would invalidate (rescind) any pending foreclosure and would prevent any unfiled foreclosure from commencing.

B. Forbearance Agreements

1. Under a forbearance agreement, the outstanding default is not cured but the lender agrees not to proceed further with foreclosure so long as terms of forbearance are complied with.

2. Post-default waivers—real property and UCC.

3. Consequences of default—immediate resumption of enforcement proceedings at the stage where the forbearance commenced.

C. Loan Modifications

1. Under modification, the terms of the loan are formally changed.

a. Waivers of debtor protections or rights?

2. Priority issues with junior lienholders—i.e., does the modification result in a "new" loan with attendant reprioritization?

D. Deeds-In-Lieu

1. Formal conveyance of the property to lender.

2. Is unsatisfied portion of debt satisfied?

3. Can lender get title insurance; is the property marketable?

E. Injunctive Relief

1. Formal court action to limit or preclude lender's right to foreclose.

2. Bond and payment conditions?

3. Is cost of litigation warranted?

F. Bankruptcy

1. Automatic stay prevents foreclosure.

2. Can borrower accomplish a restructuring of the loan in bankruptcy? Or is bankruptcy only a short term, and potentially costly, respite?

G. Short Sale

1. Seller releases its lien for less than full payment.

2. Will borrower be held responsible for the shortfall?

3. Borrower potential liability as "seller" to new buyer.

4. Who really benefits from short sale?

5. Tax Consequences.

H. Non-Short Sale–Assumption or Subject To by New Buyer

1. At any time prior to foreclosure, borrower has right to sell its property.

2. If full payoff, then no foreclosure.

3. If not full payoff, lender may allow new borrower to step into the loan.

   a. Will the old borrower be released from liability?

4. If lender won't allow assumption, would buyer take "subject to?"

   a. Reinstatement and threat of invocation of due on sale clause.

I. Court Ordered Mediation

J. Municipal Blight Claims

IV. FORECLOSURE OPTIONS

Since a creditor must foreclose to enforce its debt, it has two options—nonjudicial and judicial foreclosure. This section will discuss the general procedures and certain concerns with each type of foreclosure.

A. Nonjudicial Foreclosure

By far the most common type of foreclosure practiced in California is nonjudicial foreclosure. To utilize this option, the security instrument must contain a "power of sale" which is little more than a statement to the effect that the debtor has granted to the creditor the right to foreclose nonjudicially. Commonly known as a "trustee's sale," this process is commenced by recording a Notice of Default in the official records of the county where the real property is located. The Notice of Default must describe at least one existing default. Within the statutory period (of 10 or 30 days), the Notice of Default will be served on the interested parties. At the expiration of three months, the trustee may record a Notice of Trustee's Sale, which formally sets forth the date and time of the trustee's sale and a good faith estimate of the amount of the debt, with interest and fees, on the noticed date of sale. The Notice of Trustee's Sale will also be served on the interested parties, published in a newspaper of general circulation and posted on the property and at a public location in the county where the property is located. The trustee's sale can be scheduled at any date on or after twenty (20) days of the Notice of Trustee's Sale. On the date of the scheduled trustee's sale, the sale can be postponed for up to one year (and, thereafter, continued so long as the total continuances do not exceed one year, in which case the Notice of Trustee's Sale will need to be prepared anew).

At any point up to five (5) business days before the date scheduled for the trustee's sale, the trustor or any junior lienor may reinstate the obligation by curing all outstanding defaults specified in the Notice of Default or which occur subsequent to its recordation. If the date for the trustee's sale is continued for more than five (5) business days, the right to reinstate will be resurrected. The trustor and junior lienholders retain the right to pay off the loan in full at any time up to the time of the trustee's sale.

The costs of a nonjudicial foreclosure proceeding normally run approximately two to three percent (2%-3%) of the unpaid balance of the obligation. The process can also be completed in approximately four (4) months. The cost and time will be contrasted with those associated with judicial foreclosure in the next section.

At the trustee's sale, the creditor will be allowed to credit bid the amount of its debt, with interest and fees. Other parties will be required to produce cash or cash equivalent (like a cashier's check) at the time of the sale unless other arrangements have been made with the trustee. A junior creditor will have no right to credit bid its debt if the bidding gets that high.

Upon completion of the sale, the trustor has no right to redeem (undo) the trustee's sale as a matter of right. While the trustor may attack the validity of the sale in certain circumstances, the trustee's sale will presumed to be valid as to any buyer and conclusively presumed to be valid as to bona fide purchasers. The trustee's sale will wipe out any liens or encumbrances which are junior in priority to the underlying deed of trust. The trustee's sale will have no impact whatsoever on any liens or encumbrances senior in priority to the underlying deed of trust.

The trade off for the creditor for completing the (relatively) cheap and quick nonjudicial foreclosure process is that the creditor will be barred from any further recovery against the debtor non-pledged assets on any promissory note obligation. On any other type of obligation (such as a guaranty), the recovery will be limited to the difference between the debt and the higher of the winning bid at the trustee's sale or

the fair value of the property. However, if the creditor has other security, a trustee's sale of one property will not preclude resort to other security so long as the debt has not been satisfied by a full credit bid or bids at the prior proceedings. Upon receipt of bids sufficient to pay off the debt, the debt will be satisfied and all remaining security (including rents held by a receiver) will be automatically released.

A trustee's sale will have no impact on any senior liens (except to the extent that a due on sale clause might be present in the senior instruments). The trustee's sale will wipe out all junior liens or encumbrances (such as easements). To the extent that a junior lien is wiped out, since its security is now gone, the junior lienor will not be subject to the proscriptions of Section 726 although it still may be barred from recovery if the obligation was a purchase money obligation. One exception to this rule exists where the foreclosing creditor holds both the foreclosing senior lien and a junior lien. A creditor which wipes itself out will be barred from recovery of the lien it caused to be wiped out.

B. Judicial Foreclosure

As the name implies, judicial foreclosure contemplates judicial action in the form of one (or two) judicial proceedings. A judicial foreclosure is initiated by filing a complaint in the county where the property is located. This lawsuit proceeds as any other lawsuit with responsive pleadings, discovery, motions for summary judgment, etc. At trial, the creditor will be called upon to prove the validity of its security interest and the amount of its debt. Of significant importance, the creditor will also be required to either reserve or waive the right to a potential deficiency against the borrower. Upon completion of this initial trial, the plaintiff (creditor) will recover a decree of foreclosure finding the amount of the debt, that the security secures the debt and whether a potential deficiency is reserved. The decree will also order the lien of the property foreclosed by sale overseen by the sheriff or other court officer.

The next step of the process is to arrange the sale of the property by the sheriff. The method of levy and sale by the sheriff will vary depending on whether a deficiency is reserved but it would likely take a minimum of five months before the actual sale occurs from the time that the decree of foreclosure is issued.

In the event that a potential deficiency is reserved, a further proceeding—the fair value proceeding—will be required. Within three months of the sheriff's sale, the creditor must request a fair value hearing (actually a mini-trial) where the court will determine the "fair value" of the property on the date of sale. This "fair value" is the value of the property without the constraints of foreclosure (in essence, the willing buyer, and willing seller appraised value scenario). Upon the court's determination of the fair value of the property, the creditor can finally determine if it will receive a deficiency. Its deficiency will be calculated by comparing the debt on the date of the sheriff's sale to the higher of the winning bid or the fair value of the property on that same date. Under this formula, unless the creditor can match the winning bid to the fair value which will be determined by the court well after the sale (which is unlikely), its ultimate deficiency will be lessened by any difference between the winning bid and the court determined fair value of the property.

In the event that the creditor reserved the potential right to a deficiency, when the property is "sold" by the sheriff, the sale will not be final. Rather, the property will be sold subject to a post-sale right of redemption of three months if the bid was sufficient to pay the debt in full and one year if it was not. During this period, the debtor retains the

right of possession of the property. The debtor's right to redeem the property will be based on the final bid. The redemption figure should be contrasted with the figures used to calculate any deficiency that might be awarded.

This process will likely take a minimum of 18 months and could take 3-4 years. Further, the cost of process from the creditor's perspective could easily cost $100,000 or more in legal fees and costs. A final consideration from the creditor's perspective is the possibility that the debtor might not have sufficient assets to answer for any deficiency when the process is finally complete. It is not difficult to see why a creditor might elect to proceed with nonjudicial foreclosure even when it might otherwise be entitled to some deficiency.

V. MORTGAGE ELECTRONIC REGISTRATION SYSTEM (MERS)

MERS is a private company owned by various of the major loan originators as well as Fannie Mae and other interested parties. The idea behind MERS was to create a private system to document the current holder of deeds of trust, thus avoiding the necessity of recording assignments in county records and the attendant cost thereof. Each deed of trust is assigned a unique mortgage identification number which would "theoretically" allow the borrower and others to track the current holder of its deed of trust.

Under this system, MERS would appear as the beneficiary, either directly or as nominee for the original lender, in the deed of trust recorded in the Official Records. MERS would enter the "true" owner of the deed of trust in its private ledger and subsequent transfers of the beneficial interest in the deed of trust would be entered only in its ledger, and not in the Official Records of the county where the property is located. MERS may also be used to register "eNotes," electronic versions of promissory notes. It does not appear that it has the capacity to hold the original promissory notes or deeds of trust.

Commentators have suggested that MERS helped make mortgage-backed securities possible, thereby contributing to the housing bubble. The author is not one who entirely endorses this conclusion.

Upon satisfaction of the loan obligation, MERS will reconvey the deed of trust held in its name. Similarly, if it is notified of a default, it may institute nonjudicial foreclosure proceedings. Various borrowers have been successful in enjoining foreclosure proceedings instituted by MERS on the grounds that it is not an interested party and, thus, has no standing to institute such proceedings. There is some merit to this argument.

While the discussion about streamlining the assignment process has some theoretical and maybe actual benefits, it fails to adequately address in the author's opinion various issues. First, it suggests that borrowers have the sophistication necessary to understand the MERS process. It is not a stretch to assume that a borrower may not understand who or what MERS is or why it is listed on its loan documents. The prospect for confusion is rife.

Second, with MERS based on "eDocuments" while California law is focused on the paper originals, the prospects for confusion permeates any MERS transaction. As in other jurisdictions, will California courts require possession of the original promissory note

to commence foreclosure? More succinctly, can any party safely act for a lender without possession of the original documents?

Third, MERS purports to disclose the current holder of the deed of trust without regard for possession of the promissory note. Under California law, irrespective of the apparent holder of the deed of trust, the beneficial holder of deed of trust will ALWAYS be the holder of the promissory note.

The idea of streamlining any process to make it more efficient and less costly can be an admirable goal. However, when such a process ignores applicable law and does little to reach out to a substantial portion of the parties affected by the process, problems will arise. In any transaction involving MERS or any similar entity, it is strongly recommended that any result mandated by the entity be confirmed with California law and that the original loan documents be required for any transaction contemplating payoff or foreclosure of that loan.

Income Tax Consequences Of Foreclosure

Submitted by Walter R. Turner

INCOME TAX CONSEQUENCES OF FORECLOSURE

Walter R. Turner, Esq.

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I. INTRODUCTION

The California real estate industry has been inundated with foreclosures, abandonments, deed-in-lieu transactions and short sales as it muddles through one of the most challenging cycles in its history. Numerous factors have contributed to the current industry conditions, including tightening credit, plummeting property values and the consequences of ill-conceived and in some cases rapacious lending practices.

Making matters worse, property owners facing foreclosure may experience unexpected tax consequences with the precise impact depending on the type of debt involved; state law; the type of real property involved; and whether the property is transferred via foreclosure, a deed-in-lieu of foreclosure or a short sale. Foreclosure can also have unexpected tax consequences to the lender.

This section of the presentation focuses primarily on the federal income tax consequences to the borrower in the event of foreclosure, including deed-in-lieu and "short sale transactions" . In general, California income tax consequences with respect to foreclosure transactions are consistent with the federal rules, subject to certain exceptions, some of which are noted herein.

References to the "Code" and the "Regulations" herein mean, respectively, the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

II. VOCABULARY AND TERMINOLOGY.

As the ensuing discussion will illustrate, the income tax consequences to a borrower who loses his property in foreclosure may vary in certain respects depending on (i) the classification of the indebtedness as recourse or non-recourse, and (ii) whether the property is transferred pursuant to a foreclosure proceeding, a deed-in-lieu

transaction, or a "short-sale" transaction. As a preliminary matter, it will, therefore, be useful to consider certain definitional aspects of these concepts.

A. Distinguishing a Foreclosure from a Deed-in-Lieu of Foreclosure. A foreclosure refers either to a trustee's sale under a deed of trust (i.e., not a judicial proceeding) or to a judicial foreclosure. A deed in lieu of foreclosure refers to a transaction in which the lender agrees to accept title to the property, and the borrower formally conveys the property to the lender rather than waiting for the lender to foreclose on the property.

B. Short-Sale Transactions. A "short-sale" refers to a transaction in which the borrower sells the property to a third party for less than the existing mortgage balance with the cooperation of the lender. In connection with a short sale, the borrower will endeavor to obtain the lender's agreement to accept less than the balance due on the mortgage as payment in full.

C. Recourse Debt. In general, indebtedness is recourse if the lender can hold the borrower personally liable for any deficiency when the foreclosure sale price is less than the amount of the indebtedness.[1]

D. Non-Recourse Debt. Indebtedness is non-recourse if the lender is restricted to recovering the property securing the debt and does not have the right to go after the borrower personally for any deficiency in the event the value/sales price of the property is less than the loan balance. While indebtedness may be non-recourse by virtue of express terms of the loan documents negotiated by the parties, non-recourse indebtedness is more typically a function of applicable state law.

Under California law, a debt is considered "non-recourse" if it is subject to the anti-deficiency rules set forth in § 580 of the California Code of Civil Procedure. § 580b provides that a loan is non-recourse if is made under either one of the following circumstances:

> (i) the loan is made to finance all or part of the purchase price of a one-to-four unit dwelling, and the borrower occupies at least one of the units; or
>
> (ii) the seller carries back financing for all or a portion of the purchase price of any real property.

[1] As covered in more detail in other presentation segments of this program, California's "One Action Rule" under Code of Civil Procedure § 580d might bar a subsequent action for deficiency even in the context of recourse indebtedness.

Under California law, indebtedness which does not fall under either of the two categories of non-recourse debt referenced above is "recourse" debt. Accordingly, in many instances debt secured by real property will be recourse debt, including loans other than seller financing, used to purchase property that is not an owner-occupied one-to-four unit property; home improvement loans; refinances of existing mortgages, equity lines of credit.

III. TAX CONSEQUENCES TO BORROWER

A. Cancellation of Indebtedness Income. Understanding the income tax consequences to a borrower who loses property as a result of foreclosure or the threat of foreclosure requires a basic understanding of the tax treatment associated with the forgiveness or cancellation of indebtedness. Generally, gross income includes the amount of any indebtedness that is cancelled or forgiven by a lender.[2] This general rule is in the nature of the symmetrical imperative generally imposed under the tax law and stems from the fact that a taxpayer does not realize income upon the receipt of loan proceeds due to the offsetting obligation to pay it back. Should that repayment obligation be eliminated through forgiveness or cancellation of the indebtedness, the taxpayer experiences an increase in his/her net worth – and that increase in net worth is treated as income for tax purposes.

The general rule that a taxpayer recognizes cancellation of indebtedness income (CODI) upon the discharge or forgiveness of debt, is subject to several potential exceptions in the context of mortgage foreclosures, including (i) a Title 11 bankruptcy case[3], (ii) insolvency[4], (iii) qualified farm indebtedness,[5] (iv) qualified real property business indebtedness (for taxpayers other than C corporations),[6] or (v) qualified principal residence indebtedness discharged before the end of 2012.[7]

The insolvency exclusion is limited to the amount by which the taxpayer is insolvent. [8] The exclusion for qualified farm indebtedness is basically limited to the adjusted basis of the taxpayer's qualified farm

[2] See § 61(a)(12) of the Code and Regulations. § 1.61-12(a).
[3] See § 108(a)1)(A) of the Code.
[4] See § 108(a)(1)(B) of the Code.
[5] See § 108(a)(1)(C) of the Code.
[6] See § 108(a)(1)(D) of the Code.
[7] See § 108(a)(1)(E) of the Code.
[8] See § 108(a)(3) of the Code.

property.[9] The qualified real property debt exclusion is limited to the taxpayer's basis in depreciable real property.[10]

Any amounts excluded from gross income pursuant to any of the foregoing exclusions must reduce adjusted basis or other tax attributes, such as net operating loss carryovers, by the amount of the exclusion.[11]

B. Foreclosure of Recourse Debt.

A sale of mortgaged property to a third party pursuant to a foreclosure is treated for federal income tax purpose as a sale or exchange of the property.[12] If the mortgage debt is recourse, the amount realized is calculated in a two-step process. First, the difference between the fair market value (FMV) of the property and the taxpayer's adjusted basis is gain or loss. [13] Second, if the balance of the mortgage exceeds the FMV of the property and the taxpayer is discharged from liability for that excess, the difference is CODI.[14] Consequently, the foreclosure of a recourse mortgage (as well as a transfer as a result of an agreement between the parties (e.g., a deed-in-lieu transaction)) is treated as a sale up to the point of the FMV of the property. The taxpayer will recognize gain or loss on this first component of the transaction, measured by the difference between the FMV and the taxpayer's basis in the property. If the balance of the mortgage exceeds the FMV of the property and such excess is forgiven by lender, that amount will be CODI and will be taxed at ordinary income rates.

Example One: The taxpayer purchased nondepreciable investment real property for $500,000, paying $100,000 in cash and financing the balance of the purchase price with a recourse mortgage loan of $400,000. After making principal payments of $40,000 (and thereby reducing the principal balance of the mortgage to $360,000), the taxpayer defaults and the property is acquired by the lender via foreclosure and in connection with the transaction, the lender agrees to forgive any shortfall between the FMV of the property and the balance of the mortgage. Assume further that the FMV of the property at the time of the foreclosure was $340,000. On the foregoing facts, the taxpayer would have a capital loss of $160,000 (measured by the FMV of $340,000 less the taxpayer's adjusted basis of $500,000). The taxpayer would also have $20,000 of CODI that would be taxed as ordinary income.

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[9] See § 108(g)(3)(A) of the Code
[10] See § 108©(2)(B) of the Code.
[11] See § 108(b), (h) of the Code and Regulations §§ 1.108-4, 1.1017-1.
[12] See Revenue Ruling 73-76.
[13] See, e.g., Emmons v. Comr. T.C Memo, 1998-173.
[14] See Regulation § 1.1001-2(a)(1).

The tax results can change somewhat – primarily with reference to the character of the gains or losses recognized – if the encumbered property is depreciable § 1231(b) property rather than a capital asset. In that situation, the indicated losses – which are ultimately dependent upon the results of the other 1231 gains and losses of the taxpayer during the year – could be ordinary rather than capital.

Example Two: Assume the taxpayer purchases depreciable real property for use in her trade or business for $500,000, paying $100,000 in cash and securing a recourse mortgage loan of $400,000 for the balance. Assume further that when the mortgage has been reduced to $380,000 through debt service payments and the property's basis has been depreciated to $400,000 (using straight line depreciation), the taxpayer defaults and the property is sold at foreclosure for $410,000. The taxpayer has 1231 gain of $10,000.

Example Three: Assume the same facts as Example Two except that the property is sold at foreclosure for $370,000, and the lender initiates legal proceedings against the taxpayer to collect the $10,000 deficiency. The taxpayer has a § 1231 loss of $30,000.

Example Four: Assume the same facts as in Example Three except that the lender fails to perfect his rights against the taxpayer and is, therefore, unable to collect the $10,000 deficiency from the taxpayer. The taxpayer has a § 1231 loss of $30,000 and cancellation of indebtedness income of $10,000, or, if the debt is qualified real property debt and the taxpayer elects under § 108(c), the taxpayer would have § 1231 gain of $20,000.

As noted, for recourse debt, the tax consequences of mortgage foreclosure are heavily dependent on a determination of the property's fair market value. This is not always an easy task. If the taxpayer surrenders the property to the lender as in Example One above in exchange for cancellation of the debt in a foreclosure sale, absent clear and convincing proof to the contrary, the FMV will be presumed to be the sale price at the foreclosure sale.[15]

Unless the taxpayer rebuts this presumption, the amount bid at the foreclosure sale will be deemed to be the property's FMV. Lenders frequently bid an amount higher than the property's FMV. If appropriate, the taxpayer should obtain appraisal evidence at the time of sale if the value of the property is less than the amount bid at foreclosure.[16] If the

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[15] See Community Bank v. Comr. 819 F. 2d 940 (9th Circuit 1987, affirming 79 T.C. 789 (1982)

[16] See Frazier v. Comr. 111 T.C. 243 (1998).

transfer is a deed-in-lieu transaction and the lender sells the property shortly thereafter, the taxpayer will have to determine the selling price of the property.

A lender is generally obligated to issue a Form 1099-C, Cancellation of Debt, to report any debt cancellation income realized by a borrower as a result of a foreclosure. The amount of debt forgiven or cancelled should be reflected in box 2. The IRS has advised taxpayers who do not agree with the amount of CODI reported in box 2 to contact their lender to work out any discrepancies and have the lender issue a corrected Form 1099-C.[17]

C. Federal Mortgage Forgiveness Debt Relief Act of 2007.

Prior to 2007, the foregoing tax consequences in the context of a foreclosure of a taxpayer's residence produced inequitable results in that the taxpayer had to recognize CODI, subject to the insolvency exception, but could not deduct the loss because it was personal.[18]

This outcome has been alleviated to a substantial degree under the Mortgage Forgiveness Debt Relief Act of 2007 (MFDRA). That legislation provides that a taxpayer will not be taxed on the CODI component for a foreclosure transaction if the indebtedness is "qualified residence indebtedness" that is discharged after 2007 and before 2013. To ensure that the borrower technically recognizes the amount so discharged, the MFDRA further provides that the basis of the principal residence must be reduced by the amount excluded from income – which will typically have the effect of reducing the amount of the nondeductible personal loss.

Example Five: Taxpayer purchased qualified principal residence property for $500,000 paying $100,000 cash and securing a recourse mortgage loan of $400,000 for the balance. After paying only $20,000 in principal payments on the mortgage and at a time when the property has dropped in value to $275,000, the taxpayer defaults and the property is transferred to the lender in a deed-in-lieu transaction in which the lender agrees to forgive the $105,000 deficiency. Shortly thereafter, the lender sells the property to a third party for $275,000.

It is useful to note that the taxpayer's actual economic loss on the foregoing facts is basically $120,000 – the sum of the amount of the down payment of $100,000 plus the additional $20,000 in principal payments

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[17] See the IRS Web page, The Mortgage Forgiveness Debt Relief Act and Debt Cancellation at http://www.irs.gov/.

[18] See § 165(c) of the Code (limitation on losses of individuals).

made by the taxpayer prior to surrendering the property to the lender in a deed-in-lieu transaction. For tax purposes, however, if the foregoing occurred before 2007, the taxpayer's net economic loss of $120,000 would be reflected in : (i) a nondeductible personal loss of $225,000 - measured by the FMV/sales proceeds of the property less the taxpayer's adjusted basis of $500,000, and (ii) $105,000 of taxable CODI – measured by the difference between the balance of the mortgage ($380,000) and the FMV of the property.

On the other hand, if the foregoing occurred after 2006 but before 2013, under the MFDRA, the taxpayer would first reduce her basis in the principal residence by $105,000 – to $395,000. Then, the foreclosure sale of the property at an FMV of $275,000 would generate a nondeductible loss of $120,000 and no CODI.

Qualified principal residence indebtedness means acquisition indebtedness (except that the limit on the amount of debt that can be relieved tax-free is $2 million, or $1 million if married filing separately) for the taxpayer's principal residence. Acquisition indebtedness generally means debt that is incurred in the acquisition, construction or substantial improvement of the principal residence of the individual and is secured by the residence. It also includes refinancing of such debt to the extent the refinancing does not exceed the amount of the refinanced indebtedness.[19]

D. California Mortgage Debt Forgiveness Relief.

California law, SB 401, conforms California Revenue and Taxation Code § 17144.5 to federal law, but with the following changes:

1. The maximum amount of qualified principal residence indebtedness is $800,000 for married taxpayers filing jointly, registered domestic partners filing jointly and single persons; and $400,000 for married couples or registered domestic partners filing separately.

2. The maximum amount of debt relief that can be forgiven is $500,000 for married couples filing jointly, registered domestic partners filing jointly and single persons; and $250,000 for married couples or domestic partners filing separately.

3. California's debt relief statute applies to property sold after January 1, 2009 and before January 1, 2013.

[19] See § 108(h)(2) of the Code referencing § 163(h)(3)(B) of the Code.

E. Nonrecourse Debt.

When a nonrecourse mortgage is foreclosed, a straight forward single-step process is deployed. The property is treated as being sold for the balance of the mortgage.[20] Thus, the entire difference between the taxpayer's adjusted basis in the property and the amount of the mortgage is gain (or loss) and there is no CODI component.

Example Three: The taxpayer purchased for investment commercial real property for $500,000, paying $100,000 in cash and incurring a nonrecourse mortgage loan of $400,000. After taking $50,000 in depreciation deductions with respect to the property and reducing the principal balance of the mortgage to $360,000 through debt service payments, the taxpayer defaults and the property is sold at foreclosure for $290,000. For tax purposes, the taxpayer has a loss of $90,000 (measured by the remaining balance of the mortgage less the taxpayer's adjusted basis of $450,000). The lender has a loss of $70,000.

F. Timing of Gain or Loss.

A taxpayer whose property is sold through foreclosure or threat of foreclosure will realize the taxable gain or loss in the year that the sale becomes final. In the case of a judicial foreclosure, the sale is considered not to have "closed" until the debtor's right of redemption expires.[21] As discussed in other sections of this program, under California law, the post-sale right of redemption is three months if the bid was sufficient to pay the debt in full and one year if it was not. If the debtor redeems the property before the period for exercising such right expires, then no loss is allowable.[22]

G. The Qualified Real Property Business Indebtedness Exclusion.

Taxpayers other than C corporations may elect to exclude from CODI income realized from the discharge of "qualified real property business indebtedness" (QRPBI).[23] QRPBI is generally debt that the taxpayer incurred or assumed before January 1, 1993, in connection with real property used in a trade or business (or if incurred or assumed after that date, is "qualified acquisition indebtedness")[24] and that is secured by

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[20] See Comr. v. Tufts, 461 U.S. 300 (1983).
[21] See Revenue Ruling 70-63.
[22] See Hotz v. Comr., 42 B.T.A. 432 (1940).
[23] See § 108(c) of the Code.
[24] See § 108(c)(3) of the Code.

the real property.[25]

The exclusion is limited to the excess of the principal amount of the qualified debt over the FMV of the property. The amount excluded also may not exceed the basis of the taxpayer's depreciable real property, and it reduces the basis of the property.[26]

The election to exclude discharged indebtedness under this exclusion must be made by attaching a completed Form 982 to the taxpayer's timely filed income tax return for the year in which the taxpayer has discharge of indebtedness income that is excludible under § 108(a).[27]

As noted, to qualify for this exclusion, the real property must be used in a trade or business. In Technical Advice Memorandum 8350008, the IRS took the position that the mere rental of real property does not constitute a trade or business for purposes of § 1231. Ultimately, the issue depends upon the facts and circumstances and will require an analysis as to whether the services performed by the taxpayer with respect to the property as well as all other activities conducted by the taxpayer with respect to the rental operations rise to the level of a trade or business for tax purposes.

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[25] See § 108©(3)(A) of the Code.
[26] See § 108(c) (2) and § 1017 of the Code.
[27] See Regulation § 1.108-5

A Review of Complicated Priority Disputes And Lien Issues Under California Law

Submitted by Terrance J. Evans

A Review of Complicated Priority Disputes And Lien Issues Under California Law

By Terrance J. Evans, Esq.

For nearly a decade, I have represented numerous banks, private lenders, and financial services companies in a wide range of secured transactions and complex commercial litigation in federal and state courts throughout the United States. During that time, I have become well acquainted with complicated priority disputes and lien issues. This article will provide a brief overview of California law with respect to priority disputes and lien issues involving real property collateral, and will also provide some helpful tips for lenders seeking to minimize their exposure from priority disputes and lien issues on loans that they make in California.

I. A Review of California Priority Rules

Before delving into some of the more complicated aspects of priority disputes and lien issues in California, it is important to have a firm grasp of the applicable rules. In particular, California has a first in time rule and a race notice recordation statute, which together provide the framework for resolving and avoiding priority disputes in California. *See* Cal. Civ. Code §2897, and Cal. Civ. Code § 1214.

A. California's First In Time Rule

California Civil Code §2897 provides as follows:

> PRIORITY OF LIENS. Other things being equal, different liens upon the same property have priority according to the time of their creation.

Cal. Civ. Code §2897.

California Civil Code §2897 creates a first in time rule that prioritizes liens based on their time of creation. *See* Roger Bernhardt, *California Mortgages, Deeds of Trust, and Foreclosure Litigation* §9.43 (4th ed. 2011); *see also Thaler v Household Fin. Corp.*, (2000) 80 Cal. App. 4th 1093. Pursuant to this standard, a deed of trust executed and delivered on June 1, 2011, will have priority over a deed of trust executed and delivered on July 1, 2011. *See*, Bernhardt, *supra*; *see also Boye v Boerner,* (1940) 38 Cal. App. 2d 567; and *20th Century Plumbing Co. v Sfregola,* (1981) 126 Cal. App. 3d 851, 853, (presumption that deed of trust delivered on date of execution). Please note that different events may trigger the creation of involuntary or special liens, such as mechanics' liens or vendor's liens, but Civil Code §2897 relates solely to consensual liens, such as mortgages and deeds of trust. Bernhardt, *supra*.

The first-in-time rule is not perfect, and does not address situations where a subsequent lender may be unaware of an unrecorded prior deed of trust. Consequently, California has enacted a race notice recording statute that rewards lien holders who first record their security interests in real property, and punishes those who fail to do so. *See* Bernhardt, *supra* ; and Cal. Civ. Code § 1214.

B. California Is A Race-Notice Jurisdiction

California Civil Code §1214 provides as follows:

> Every conveyance of real property or an estate for years therein, other than a lease for a term not exceeding one year, is void as against any subsequent purchaser or mortgagee of the same property, or any part thereof, in good faith and for a valuable consideration, whose conveyance is first duly recorded, and as

> against any judgment affecting the title, unless the conveyance shall have been duly recorded prior to the record of notice of action.

Cal. Civ. Code § 1214.

California Civil Code §1214 establishes a race-notice jurisdiction in California that allows a subsequently created lien to take priority over an earlier created lien provided that <u>all</u> four following circumstances apply:

1. The earlier lien was not recorded;
2. The later lien holder was without notice of the earlier lien;
3. The later lien holder gave value for the lien; and
4. The later lien was recorded first.

See Bernhardt, *supra* at §9.44 2.

If any of the four above noted circumstances are absent, the earlier lien has priority over the subsequent lien under California law. *See* Bernhardt, *supra* at §9.44 2; *Citizens for Covenant Compliance v Anderson*, (1995) 12 Cal. 4th 345; *First Fid. Thrift & Loan Ass'n v Alliance Bank*, (1998) 60 Cal App. 4th 1433, 71 CR2d 295; *In re Pavich*, (Bankr ED Cal 1996) 191 BR 838.

As a general rule, under California's race notice recording statute, a bona fide purchaser for value without notice who first records wins a priority dispute. A helpful mnemonic device is a BFP4V wins a priority dispute under California's race notice recording statute.

1. The Security Instrument Must Be Properly Recorded

To qualify as a bona fide purchaser for value who first records within in the meaning of California's race notice recording statute, the subject lien must be properly recorded. *See* Bernhardt, *supra* at §9.45. A lien may be deemed unrecorded for purposes of California's race notice recording statute even when the creating instrument has been given to the county recorder, copied into the official records, and entered into the appropriate indexes if the lien is (1) outside the chain of title, (2) improperly indexed, or (3) not properly recordable. *See* Bernhardt, *supra* at §9.45.

It is well established in California that deeds that are indexed incorrectly by the county recorder are deemed unrecorded because they cannot be discovered by a search of the records. *Id.; Hochstein v Romero*, (1990) 219 Cal. App. 3d 447.

Title insurers maintain real property records by parcels and will likely list an instrument affecting title to the real property as an exception to title on the preliminary report regardless of when it was recorded, thus imparting actual notice even if the recorder did not properly index it. However, the principles of constructive notice are premised on the grantor-grantee index maintained by the recorder. *See* Bernhardt, *supra* at §9.45.

Instruments that are not properly recordable, such as those that lack acknowledgment or statutory authorization for recordation, are nonetheless sometimes recorded. These documents are generally treated as not giving constructive notice, but they may be regarded as creating enough of a cloud on title to give rise to liability for slander of title. *See* Bernhardt, *supra* at §9.45; *see also* e.g., *Seeley v Seymour ,* (1987) 190 Cal. App. 3d 844.

Helpful Tip Regarding Title Insurance Policies For Lenders: A lender can reduce its exposure with respect to recordation issues by purchasing title insurance for every loan that it makes, and having the title insurer assume responsibility and liability for the recordation of the deed of trust and other loan documents. A lender should also request that the title insurer provide a preliminary title report listing any and all encumbrances on the title to the real property collateral before the loan is made, and also a final title report after the loan is made. This will allow a lender to confirm the priority of its security interest in the real property collateral, and confirm that there have been no intervening security interests recorded against the real property collateral.

Additional Helpful Tip For Lenders: In addition to purchasing a title insurance policy for every loan that a lender makes, a lender should also purchase a loan modification endorsement to its title insurance policy. This endorsement will ensure that the lender's title insurance coverage remains intact in the event that the loan is modified in the future. It is better for a lender to obtain loan modification coverage when the loan is first made because the lender or its servicer may forget to obtain this coverage in the future during the modification of the loan.

2. Actual Knowledge of a Prior Lien Defeats A Priority Claim, Even if the Prior Lien Was Not Recorded

A party with actual knowledge of a prior lien cannot claim priority over it even if it was not recorded. *See* Bernhardt, *supra* at §9.46. California Civil Code §1217 addresses this issue and provides as follows:

> An unrecorded instrument is valid as between the parties thereto and those who have notice thereof.

Cal. Civ. Code §1217.

The statutory requirement of good faith requires the absence of actual or constructive notice of the prior interest. *See* Bernhardt, *supra* at §9.46.; *see also Gribble v Mauerhan* (1961) 188 Cal. App. 2d 221, 227, (notice precludes good faith). Even where a party is without actual knowledge, suspicious circumstances (e.g., a reference in a recorded instrument to an unrecorded instrument or the presence of persons on the property whose possession is inconsistent with record title) may impose an obligation to make inquiries, which, if undertaken, would lead to knowledge of the prior lien. *See* Bernhardt, *supra* at §9.46; s*ee also Randall v Allen* (1919) 180 Cal. 298, (constructive notice); *Slaker v McCormick-Saeltzer Co.* (1918) 179 Cal. 387, 388, (actual notice); *Gates Rubber Co. v Ulman,* (1989) 214 Cal. App. 3d 356, (constructive notice).

It is important to note that a party without actual or inquiry notice may still lose its status as a bona fide encumbrancer without notice based on the imputation of constructive knowledge of an agent. *See* Bernhardt, *supra* at §9.46; *see also Zeller v Klein* (Apr. 16, 2004, A102248; not certified for publication) 2004 Cal App Unpub Lexis 3728, 2004 WL 823489 (knowledge of mortgage broker who was aware of unrecorded reconveyance imputed to client and assignee of note, who was otherwise innocent and without knowledge).

3. A Party Must Give Value To Assert Priority Over a Prior Unrecorded Lien

Under California law, a party who does not give value is not injured by losing priority to a prior unrecorded claim, because there is no substantial reliance to protect. *See* Bernhardt, *supra* at §9.47. However, when a party has given value for the subject property, complying with California's race notice recording statute protects the party's investment. *See* Bernhardt, *supra* at §9.47; *see also Oakdale Village Group v Fong,*

(1996) 43 Cal. App. 4th 539. More than nominal value is required, but the amount need not equal the full market value of the property in the case of a sale. *See* Bernhardt, *supra* at §9.47.

When only part of the agreed value has been transferred at the time of discovery of the earlier lien (as with progress payments under a construction loan or on an installment purchase), protection may be given to the payments made before discovery and denied to those made after notice. *See* Bernhardt, *supra* at §9.47; *see also Davis v Ward,* (1895) 109 Cal. 186.

The value requirement means that a recorded judgment lien will generally not prevail over a prior unrecorded lien, because the judgment creditor usually paid no value in reliance on the records when obtaining the judgment. *See* Bernhardt, *supra* at §9.47; *see also 20th Century Plumbing Co. v Sfregola*, (1981) 126 Cal. App. 3d 851, 853; *Hansen v G&G Trucking Co.*, (1965) 236 Cal. App. 2d 481, 486. This is also true for attachment lien holders. *See* Bernhardt, *supra* at §9.47; *see also Bumb v Bennett,* (1958) 51 Cal. 2d 294, 302; *Bank of Ukiah v Petaluma Sav. Bank*, (1893) 100 Cal. 590, 591; *Wells Fargo Bank v PAL Investments, Inc.*, (1979) 96 Cal. App. 3d 431, 157 CR 818.

C. Special Priority Rule For Purchase Money Loans

California Civil Code §2898(a) states:

> A mortgage or deed of trust given for the price of real property, at the time of its conveyance, has priority over all other liens created against a purchaser, subject to the operation of the recording laws.

Cal. Civ. Code §2898(a).

California Civil Code §2898(a) gives purchase money loans priority over certain other preexisting liens. *See* Bernhardt, *supra* at §9.48; *see also Mercantile Collection Bureau v Roach* (1961) 195 Cal. App. 2d 355. A loan is purchase money whether a third party advances funds to permit the borrower to acquire property or a seller extends credit to the purchaser. *See* Bernhardt, *supra* at §9.48; *see also Van Loben Sels v Bunnell*, (1898) 120 Cal. 680, 683.

Please note that the definition of "purchase money" for purposes of Cal. Civ. Code §2898 is broader than the meaning of "purchase money" under Cal. Code Civ. Proc. §580b (the purchase money antideficiency statute. *See* Bernhardt, *supra* at §9.48. Under §580b, third party loans, as opposed to seller financing, are considered purchase money only if the third party loan is made to assist in purchasing one-to-four-unit owner-occupied dwellings.) *Id.* The section has limited application, however, because it is subject to the operation of the recordation laws and because it gives priority only over liens against the purchaser. *Id.*

Furthermore, the purchase money priority rule of Cal. Civ. Code §2898 also breaks ties between parties whose interests attach simultaneously at close of escrow or on any similar occasion when multiple interests arise at the same instant, making ordinary rules for establishing priority—especially "first-in-time" and the recordation acts—unavailable. *See* Bernhardt, *supra* at §9.48; *see also, DMC, Inc. v Downey Sav. & Loan Ass'n*, (2002) 99 Cal. App. 4th 190 (owner who lost property in trustee sale subsequently obtained new loan to finance repurchase of property; holding that new loan was purchase money loan under Cal. Civ. Code §2898, the court held that new loan has priority over

preexisting lien that might equitably reattach to property at moment of "redemption”). *See* Bernhardt, *supra* at §9.48.

1. An Unrecorded Purchase Money Lien Is Vulnerable If Not Recorded

An unrecorded purchase money lien fails as against a subsequent lien that was taken without notice, given for value, and first recorded. *See* Bernhardt, *supra* at §9.49. Under such circumstances, the recordation act, Cal. Civ. Code §1214, prevails over any purchase money priority the first lien might otherwise have had under Cal. Civ. Code §2898(a). *See* Bernhardt, *supra* at §9.49.

2. A New Purchase Money Lien Will Have Priority Over Preexisting Liens That Are Not Against The Subject Property Itself

Purchase money liens do not take priority over preexisting liens against the property itself; they take priority only over preexisting liens against the purchaser personally. *See* Bernhardt, *supra* at §9.50. In this sense, Cal. Civ. Code §2898(a) is designed, in effect, to break ties in priority that occur at closure of a transaction when a purchase money interest is created and when preexisting judgment liens attach at the moment title is conveyed. *Id.*

II. A Review of California’s Rules Regarding Lien Priorities

We will now review California’s rules regarding vendor’s liens, mechanic’s liens, and tax and assessment liens.

A. Vendors Liens

California law gives a vendor's lien to a seller who is otherwise unsecured with regard to the unpaid balance of the purchase price. *See* Bernhardt, *supra* at §9.53; *see*

also Cal. Civ. Code §3048. This lien is not recorded, because it arises only when no express security instrument is created. *See* Bernhardt, *supra* at §9.53; *see also, Machado v Bank of Italy*, (1924) 67 CA 769, 776. Furthermore, attempts to place it in the records are generally unsuccessful. *See* Bernhardt, *supra* at §9.53; *see also, Brown v Johnson,* (1979) 98 Cal. App. 3d 844.

Consequently, it is junior to recorded liens that qualify under Cal. Civ. Code §1214. *See* Bernhardt, *supra* at §9.53; *see also, Brock v First S. Sav. Ass'n*, (1992) 8 Cal. App. 4th 661 (vendor's lien is inferior even when subsequent beneficiary of deed of trust has actual knowledge, because it is merely equitable interest and gives way before legal interest created by recorded deed of trust). *See* Bernhardt, *supra* at §9.53; *see also, DMC, Inc. v Downey Sav. & Loan Ass'n*, (2002) 99 Cal. App. 4th 190.

The court in *DMC* employed essentially the same analysis as in *Brock* to accord priority to a contractual purchase money lien (that essentially replaced the original senior lien) over a preexisting lien that had been wiped out in a nonjudicial foreclosure but that may have equitably reattached to the property on the obligor's subsequent repurchase of the property. *See* Bernhardt, *supra* at §9.53.

B. Mechanic's Liens

California Civil Code §3134 provides that mechanics' liens are:

> preferred to any lien, mortgage, deed of trust, or other encumbrance upon the work of improvement and the site, which attaches subsequent to the commencement of the work of improvement, and also to any lien, mortgage, deed of trust, or other encumbrance of which the claimant had no

notice and which was unrecorded at the time of commencement of the work of improvement.

Cal. Civ. Code §3134.

As noted above, mechanics' lien priority depends on the date work begins on a property, not on the date the lien is recorded. *See* Bernhardt, *supra* at §9.54. Thus, if a contractor begin work at a real property collateral on January 1' 2011, but does not record a mechanic's lien against the real property collateral until June 1, 2011, that mechanic's lien will relate back to the date the work began at the collateral property (on January 1, 2011).

Under this relation-back theory, mechanics' liens may take priority over purchase money liens and vendor's liens created after work commenced even though recorded before recordation of mechanics' liens. *See* Bernhardt, *supra* at §9.54; *see also Schut v Doyle* (1959) 168 Cal. App. 2d 698. This special priority rule requires a construction lender to inspect the property visually before funding to assure itself that no construction has started, lest any mechanics' liens prevail over the deed of trust despite the order of recordation. Title insurers issue special endorsements to cover this risk. *See* Bernhardt, *supra* at §9.54.

Helpful Tip For Lenders To Minimize Priority Disputes With Contractors:

A lender providing construction financing for a project can minimize the risk of a future priority dispute with the general contractor and/or one of the subcontractors by requiring the general contractor and all of the subcontractors to execute subordination agreements in favor of the lender before work begins at the project. In the subordination agreement, the general contractor and the subcontractors would agree that any past,

present or future mechanic's lien claims would be subordinated to the lender's security interest in the real property collateral.

Additional Helpful Tip For Lenders To Minimize Priority Disputes With Contractors: In addition to requiring general contractors and subcontractors to execute subordination agreements in favor of the lender, a lender may also consider having a ribbon cutting ceremony before construction begins on a large construction project. This is only practical for large construction projects. Prior to the ribbon cutting ceremony, the lender would record its security interest (deed of trust) against the real property collateral. Thereafter, the lender would conduct a videotaped ribbon cutting ceremony at the real property collateral, and the borrower, general contractor and subcontractors would be present. On the videotape, and in the presence of all of the aforementioned parties, a lender representative would state that construction at the project will begin after the cutting of the ribbon on such and such date. All of the parties would sign a joint stipulation that construction at the project began on or after the date of the ribbon cutting ceremony. The video tape of the ribbon cutting ceremony would be prima facie evidence of the date when construction at the real property collateral began, and could be admitted as evidence in any future mechanic's lien litigation.

C. Tax and Assessment Liens

California Revenue and Taxation Code §2192.1 provides:

> Every tax declared in this chapter to be a lien on real property, and every public improvement assessment declared by law to be a lien on real property, have priority over all other liens on the property, regardless of the time of their creation. Any tax or assessment described in the preceding sentence shall be given priority over matters

> including, but not limited to, any recognizance, deed, judgment, debt, obligation, or responsibility with respect to which the subject real property may become charged or liable.

Cal. Rev. and Tax Code §2192.1.

Thus, property tax liens have leapfrog priority over all previous liens, even those of record. *See* Bernhardt, *supra* at §9.55. On the scope of §2192.1, *See* Bernhardt, *supra* at §9.55; *see also Isaac v City of Los Angeles*, (1998) 66 Cal. App. 4th 586, 600.

The California legislature has police power to give its own liens priority over preexisting private liens. *See* Bernhardt, *supra* at §9.55; *see also German Sav. & Loan Soc'y v Ramish*, (1902) 138 Cal. 120. The priority of a tax lien depends entirely on legislative intent, as expressed in the particular statutory provision that creates the lien. For detailed discussion of relative priorities of various tax and assessment liens, *See* Bernhardt, *supra* at §9.55; *see also* Miller & Starr, California Real Estate §§11.93-11.175 (3d ed. 2000). Federal, not state, law sets the priority of federal tax liens. *See* Bernhardt, *supra* at §9.55; *see also U.S. v R.F. Ball Constr. Co.*, (1958) 355 US 587, 593, 2 L Ed 2d 510, 78 S Ct 442.

III. Conclusion

In conclusion, this article provides a helpful summary of California law regarding priority disputes and lien issues. As explained above, lenders can reduce their exposure from threats to the priority of their security interest in real property collateral in California by purchasing title insurance for every loan that they make in California, and requiring general contractors and subcontractors to execute subordination agreements in

favor of the lender on contraction projects. Anticipating problems before they occur and planning ahead is always the best approach for lenders making loans in California.

ABOUT THE AUTHOR

Terrance J. Evans is a partner in the Trial Practice Group of Duane Morris in San Francisco. He concentrates his practice in representing the financial services industry, which includes international, national and community banks; loan service companies; and insurance companies. During his career, Mr. Evans has both recovered and saved clients of the firm tens of millions of dollars in settlements, judgments and extrajudicial procedures.

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Mr. Evans has been recognized both locally and nationally for his professional accomplishments. In 2010 and 2008, Mr. Evans was honored by the American Business Trial Lawyers of Northern California for his dedication and professionalism. In addition, he was named one of the top 100 minority associates in the United States for 2007 by the Stakeholder Organization. Mr. Evans has also received special honors from the NAACP, the Congressional Black Caucus, the 100 Black Men of Los Angeles, the Young Black Scholars Program, the Black Women Lawyers Association of Los Angeles, the American Legion and many other organizations.

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Evictions After Foreclosure

Submitted by Leonard E. Marquez

Evictions After Foreclosure

Leonard E. Marquez, Esq.

Mr. Marquez is a Partner with Wendel, Rosen, Black & Dean LLP specializing in landlord-tenant disputes, including commercial evictions.

I. **Occupation / Condition of Property**
II. **Eviction Procedures**
III. **Unlawful Detainer Remedies**
IV. **Abandoned Property**

I. Occupation / Condition of Property

Occupied Property

- If the property is occupied, the mortgagee will have to wait until the property is sold at the foreclosure sale and then begin the eviction process.

- If a party in possession of the property threatens to injure or waste the property, it may be possible to obtain injunctive relief pending completion of foreclosure proceedings and obtaining possession of the property by the purchaser at the foreclosure sale. Code Civ. Proc. § 745.

Injunctive Relief

Code of Civil Procedure section 745 empowers a court, "for good cause shown," to enjoin a party in possession of real property from doing any act to the injury of real property "[d]uring the foreclosure of a mortgage on the property."

Appointment of Receiver

The mortgagee may also seek appointment of a receiver pursuant to Code of Civil Procedure section 564. Section 564(b) authorizes the appointment of a receiver where "[i]n an action by a secured lender for the foreclosure of a deed of trust or mortgage and sale of property … where it appears that **[1] the property is in danger of being** lost, removed, or **materially injured, or that the condition of the deed of trust or mortgage has not been performed**, and **[2]** that **the property is probably insufficient to discharge the deed of trust or mortgage debt**."

Securing Vacant Property

- Unoccupied property raises the threat of vandalism, liability for injuries and squatters.

- Secure the property to the extent practicable. For example, by installation of chain link fencing or boarding up windows. Recent legislation, SB 1137 that went into effect on September 7, 2008, requires the legal owner of a foreclosed, vacant property to maintain the property or be subject to fines. *See*, Civ. Code § 2929.3(a)(1).

- Consult with professional services specializing in securing vacant property.

Right to Enter to Inspect

> **A secured lender may enter and inspect** the real property security **for the purpose of determining the existence**, location, nature, and magnitude **of any past or present release or threatened release of any hazardous substance** into, onto, beneath, or from the real property security on either of the following: [¶] (1) Upon **reasonable belief of the existence of a past or present release or threatened release** of any hazardous substance into, onto, beneath, or from the real property security not previously disclosed in writing to the secured lender in conjunction with the making, renewal, or modification of a loan, extension of credit, guaranty, or other obligation involving the borrower. [¶] (2) After the commencement of nonjudicial or judicial foreclosure proceedings against the real property security.

"Hazardous Substance" Broadly Defined

- The statute broadly defines what constitutes a "hazardous substance." Civ. Code § 2929.5(e)(2).

- Evidence of dilapidation or lack of upkeep may be enough to show a threatened release of sewage or a natural gas leakage due to a lack of maintenance. *See*, Civ. Code § 2929.5(e)(2)(B) and (C) ("hazardous substance" includes sewage and natural gas).

24 Hour Notice of Inspection / Court Order

- Except in an emergency, the lender is required to give the borrower or tenant reasonable notice of the inspection. The statute provides that 24 hours' notice shall be presumed to be reasonable notice in the absence of evidence to the contrary. Civ. Code § 2929.5(b).

- If the lender is refused the right of entry and inspection by the borrower or tenant of the property, or is otherwise unable to enter and inspect the property without a breach of the peace, the lender may, upon petition, obtain a court order for the inspection. Civ. Code § 2929.5(d).

II. Eviction Procedures

What is an "eviction" action?

An eviction action is a special type of lawsuit called an "unlawful detainer." The purpose of an unlawful detainer lawsuit is to permit a party to recover possession of real property when an occupant has wrongfully continued to occupy the property.

Basis for Eviction after Foreclosure

- A **former owner** or **an existing tenant** occupying a property and holding over after a foreclosure are, generally speaking, subject to eviction under Code of Civil Procedure section 1161a.

- Whether an existing tenant is subject to eviction depends on several things.

Eviction of Tenants after Foreclosure

- A **senior lease** survives a nonjudicial foreclosure. A lease senior to the encumbrance (deed of trust) being foreclosed is not extinguished by virtue of the foreclosure (including valid *assignments* of the lease made *after* the recording of the encumbrance).

- A **junior lease** subordinate to the encumbrance being foreclosed is automatically extinguished by a nonjudicial foreclosure. In such a case, the tenant is treated as a holdover without any further right of possession under the lease.

► **TIP**: Although a senior lease survives foreclosure, any amendments to the lease subsequent to the recordation of the foreclosing deed of trust are extinguished. *R-Ranch Markets No. 2 v. Old Stone Bank* (1993) 16 Cal.App.4th 1323, 1328-1329 (amendment to preexisting commercial lease extinguished by trustee's sale).

Judicial Foreclosure

The rules are different with respect to a **judicial foreclosure**. A junior lease is not automatically extinguished by a judicial foreclosure. The tenant must be named in the foreclosure suit in order to extinguish the junior lease.

Subordination Agreements and Attornment Clauses

However, whether a lease terminates as a result of a foreclosure may be affected by:

- Whether a lease or other applicable agreement contains language altering the priority of the lease vis-à-vis the foreclosing encumbrance, such as a **subordination or nondisturbance agreement**.

- Whether the lease contains an **attornment clause** which, depending on the language of the agreement, may give the foreclosing mortgagee the right to elect to retain the lease or may preserve the lease if the mortgagee accepts the premises subject to the lease.

What are the steps in bringing the unlawful detainer action?

- Serve any required notice on the occupants (former owners or tenants).

- File Unlawful Detainer Complaint with the court once any required notice period has expired.

What notice is required to be given to the former owner?

- The default statutory notice provision requires service of a **three day notice to quit** in order to evict a holdover occupant following a foreclosure. Code Civ. Proc. § 1161a(b).

- However, longer notice periods are required in residential evictions and in other cases as the result of recently enacted mortgage protection legislation.

Longer Notice Periods for Residential Evictions and in Certain other Circumstances

- Code of Civil Procedure 1161a requires a **30 day notice** in the case of an eviction of a tenant or subtenant from a "rental housing unit." Code Civ. Proc. § 1161a(c).

- However, in Code of Civil Procedure 1161b, the legislature enacted a temporary extension of the notice period effective September 8, 2008. Section 1161b requires at least **60 days notice** be given to a "tenant or subtenant in possession of a rental housing unity at the time the property is sold in foreclosure…" Code Civ. Proc. § 1161b. This provisions sunsets on January 1, 2013.

► CAUTION: In some circumstances, a notice regarding the legal notice requirements applicable to the eviction of residential tenants must be posted along with the notice of sale during the foreclosure process. *See*, Civ. Code § 2924.8.

Protecting Tenants at Foreclosure Act of 2009

- As a result of federal legislation, further restrictions on residential evictions have been put into place. Congress enacted the **Protecting Tenants at Foreclosure Act of 2009** effective May 20, 2009.

- This act provides certain protections to residential tenants following a foreclosure. The Act sunsets on December 31, 2012.

- The Act applies to the successor owner following any foreclosure on a "federally-related" mortgage loan or on any residential property after the enactment of the Act. Pub. L. 111–22, div. A, title VII, § 702 (12 U.S.C. § 5220, Notes).

Protecting Tenants at Foreclosure Act of 2009

- The Act increases the notice required to be given to residential tenants before eviction. For a residential tenant without a fixed term lease, such as in the case of a month to month tenant, **90 days notice** is required. Pub. L. 111–22, div. A, title VII, § 702(a)(1) (12 U.S.C. § 5220, Notes).

- In the case of a tenant with a fixed term, the purchaser at foreclosure takes subject to the tenant's right "to occupy the premises **until the end of the remaining term of the lease**" unless the purchaser at the foreclosure sale will occupy the premises as a primary residence. Pub. L. 111–22, div. A, title VII, § 702(a)(2) (12 U.S.C. § 5220, Notes) (emphasis added).

Rent Control and "Just Cause" Ordinances

- In the case of residential evictions, it is crucially important to determine whether the premises falls under the jurisdiction of a rent control or "just cause" for eviction ordinance. Any such ordinance must be carefully reviewed in order to ensure compliance with any applicable substantive or procedural requirements.

- Most ordinances impose strict procedural requirements, such as required language to be included in the "notice to quit" and even relocation payments in some circumstances.

- **Under some ordinances, foreclosure is not a ground for eviction of an existing tenant.** *See*, Berkeley Municipal Code (BMC) section 13.76.130A.

Can a tenant's lease waive the statutory notice requirements?

- A residential tenant's notice rights are protected by statute and non-waivable. Civ. Code § 1953(a) (provisions of lease purporting to waive or modify a tenant's "procedural rights in litigation in any action involving his rights and obligations as a tenant" or "right to a notice or hearing required by law" are void as contrary to public policy).

- However, a commercial lease may waive or modify the statutory notice requirements. The lease may provide for any substitute form of notice different from and superseding the statutory notice requirements. *See*, *Folberg v. Clara G.R. Kinney Co., Inc.* (1980) 104 Cal.App.3d 136, 140.

Is a waiver of any notice valid?

Although a commercial lease may "waive" statutory notice requirements, whether a lease may validly waive any notice whatsoever is an open question. Giving any tenant a minimum of three days' written notice is advisable.

The court in *Folberg v. Clara G.R. Kinney Co., Inc.* held that the parties to a nonresidential lease could agree to a lease provision expressly waiving "any notice required by any statute or law now or hereafter in force." *Folberg v. Clara G.R. Kinney Co., Inc.* (1980) 104 Cal.App.3d 136, 140. However, the lease nonetheless required "written notice by the Lessor to the Lessee" and a failure by the tenant to pay within 10 days after receipt of the written notice. *Id.* The court upheld this "substituted requirement of 'written notice,'" but was not confronted with a lease waiving all notice of non-payment. *Id.* at 140-141.

► **TIP:** Review any notice provisions in the lease carefully. The statutes [Code Civ. Proc. §§ 1161a, 1162] also contain specific requirements for the content and service of a notice. **A valid notice strictly conforming to the statutory requirements is a prerequisite to a valid cause of action for unlawful detainer.** *Levitz Furniture Co. v. Wingtip Communications, Inc.* (2001) 86 Cal.App.4th 1035, 1038 (due to the summary nature of an unlawful detainer action, a three-day notice is valid only if the landlord strictly complies with statutory requirements and a notice that fails to comply with the strict statutory requirements is invalid and will not support an unlawful detainer action).

III. <u>Unlawful Detainer Remedies</u>

What damages can a landlord recover?

A party who is entitled to recover possession of real property in an unlawful detainer lawsuit is also entitled to recover compensation in money for the wrongful occupation of the property.

What damages are recoverable in an unlawful detainer <u>NOT</u> based on non-payment of rent?

Daily Rental Value Damages. Daily rental value damages are pleaded in the unlawful detainer complaint as the *reasonable rental rate per day*. The damages accrue during the period of wrongful detention of the property [i.e. from the termination of the tenancy (upon expiration of the notice to quit) through entry of judgment].

Is the landlord entitled to recover attorneys' fees and costs?

Costs of suit are awardable to a "prevailing" plaintiff in an unlawful detainer action as in civil actions generally. Attorneys' fees are recoverable if provided for the parties' lease agreement. *See*, Code Civ. Proc §§ 1032(b), 1033.5(c)(5), 1021 and 1717. However, if there is no contractual relationship (and applicable fees provision) between the purchaser and the occupant, there will be no basis to recover fees.

Are there any other items of recoverable damages in a commercial unlawful detainer?

When a landlord is found to be entitled to possession of real property and damages in an unlawful detainer action and the landlord proves that the party that unlawfully detained the property acted with malice in continuing to occupy the property, the law permits an award of statutory damages of up to $600.00 to the landlord.

- ► Code Civ. Proc. § 1174(b).

How does the court restore possession to the landlord?

After prevailing at the trial of the eviction action or the court's entry of a "default" by the defendant (i.e., the failure to timely respond to the lawsuit), the plaintiff is entitled to a **judgment for possession**.

What is the next step in the eviction process?

Once a judgment for possession has been entered by the Court, the clerk of the Court will issue a **writ of possession**. The county sheriff's office will then enforce the writ by "posting" the premises with a written notice of the eviction with instructions to the occupants and a date by which the occupants must

vacate the premises. The sheriff will then return to the property to conduct a physical eviction of the occupants from the premises on the appointed day.

How long does it take?

<table>
<tr><th colspan="4">Phases of Eviction Procedures and Litigation</th></tr>
<tr><td>Serve Any Required Notice</td><td>File Unlawful Detainer Complaint and Serve Summons</td><td>Set Case for Trial or Take Default at End of Summons Period / Litigate Case (conduct discovery, settlement and trial proceedings if necessary)</td><td>Sheriff Eviction</td></tr>
<tr><td>NOTICE</td><td>SUMMONS</td><td>LITIGATION</td><td>EVICTION</td></tr>
<tr><td rowspan="2">• 3 Days for Former Owner Occupants or Commercial Tenants

• 60 or 90 Days for Residential Tenants (depending on applicability of federal Protecting Tenants at Foreclosure Act of 2009)</td><td>5 Days (assuming personal service on defendants)</td><td>20+ Days (may be shorter if default taken)</td><td>Typically 7 to 14 Days</td></tr>
<tr><td colspan="3">With the usual processing times by the court and process servers, the whole process will typically exceed 45 days and can take considerably longer depending on the occupant's actions in the litigation.</td></tr>
</table>

IV. Abandoned Property

What happens to personal property in the premises belonging to the former owner and/or tenant?

Abandoned personal property worth more than $300.00 must sold at a public auction if the tenant fails to claim the property and pay reasonable storage costs within 15 days.

What procedures govern the public sale?

If the tenant fails to reclaim the property within the time allowed by statute after eviction, then the public sale procedures set forth in Code of Civil Procedure section 1988 will govern the sale of the property at public auction. Any proceeds of the sale not claimed by the former owner or tenant must be turned over to the county, after deducting the allowable costs of the sale.

Alternate Public Sale Provisions

However, in the case of a commercial tenancy, the Code of Civil Procedure, starting at Section 1993, contains an alternate procedure for the disposition of personal property. The important distinction is that under these statutes, the owner may retain or dispose of the personal property of the former commercial tenant if **the resale value** of the property is less than **"the lesser of" $750 or one dollar ($1) per square foot** of the occupied premises.

Ethics In Foreclosure

Submitted by Steven M. Morger

VI. ETHICS IN FORECLOSURE

A. Ethical Parameters/Constraints

In considering ethical considerations for any practicing attorney, one would necessarily start with the Rules of Professional Conduct. Without limitation, Rules which would bear on counsel's ethical duties in the foreclosure context include:

Rule 3-100 – Duty to retain client's confidential information

Rule 3-110 – Obligation to act competently

Rule 3-210 – Duty not to advise violation of law

Rule 3-300 – Duty not to take interest adverse to client

Rule 3-310 – Duty not to represent adverse interests

Rule 3-500 – Duty to communicate with client

Rule 4-300 – Prohibition on purchasing property at foreclosure sale in which attorney represents a party

Each of these Rules will be discussed separately, as applicable, in the following sections.

A. Duty of Competency

The primary ethical consideration in the real property foreclosure context would necessarily be a practitioner's duty to act competently. Speaking from years of teaching the subject at the University of California's School of Law, California real estate secured transactions have many aspects which are counter-intuitive and in which many practitioners have little experience or training.[1] While many of these issues have been discussed previously, issues which tend to trip up the unwary include:

- The requirement that a creditor exhaust its security before seeking recourse against any other non-security asset of the debtor;
- The consequences of a creditor's failure to exhaust its security before proceeding after the debtor;
- The fact that purchase money loans remain non-recourse from inception even following a loan modification where significant consideration may flow from the creditor to the debtor;
- Consequences of a "Full Credit Bid";

[1] The author has been co-teaching the Real Estate Secured Transactions course at the University of California, Berkeley, School of Law for approximately 15 years. Out of a class of approximately 400 students, the course draws approximately 20-25 students. Given the curriculum, the remaining 375-380 students will leave school with little or no exposure to the issues discussed in this seminar.

- The ability of the defaulting *debtor* to control how the claims against it proceed;
- The measure of deficiency based on the creditor's bid and not what the creditor actually realizes when the property is disposed of "for real";
- The right of a debtor to redeem the property following a judicial foreclosure without consideration to the deficiency or fair value or that such right is transferable; and
- The fact that post-sale rights of redemption do not extend to junior creditors;

And the list goes on.

By practicing in the real estate secured transaction arena, a practitioner will be deemed to have the knowledge of the area of law in which he or she practices. Failure to competently perform in this area could subject the practitioner to claims for malpractice or discipline. (See, e.g., *Crookall v. Davis, Punelli, Keathley & Willard* (1998) 65 Cal.App.4th 1048.)

B. Conflict Situations

1. Acting as Trustee

As an attorney, it is not a stretch to say that an attorney owes a fiduciary duty to his or her client. It is not uncommon (although rarely advisable) for an attorney to act as a trustee in a nonjudicial foreclosure proceeding. In such circumstances, as trustee, the attorney owes agency duties to each of the beneficiary and trustor (and potentially to third party bidders) in accordance with the scope of its duties to either reconvey or commence nonjudicial foreclosure proceedings. (*Hatch v. Collins* (1990) 225 Cal.App.3d 1104, 1111-1112) In a contested foreclosure proceeding, the practitioner by acting in these dual capacities will put him or herself squarely in a conflict situation.

2. Advising Trustee/Quarterbacking Foreclosure Sale

Frequently, whether counsel is acting as trustee or simply advising a beneficiary on a pending foreclosure, the client will look to the attorney to handle or assist the trustee in handling various aspects of the foreclosure proceeding. Mirroring the duty of competency, there are numerous areas that can cause a practitioner problems:

3. Preparation of the Notice of Default

A valid Notice of Default requires at least one valid default as of the date the notice is recorded. Yet, what may not be evident is that the trustor need only cure those specified defaults which were present at the time of recordation (and *subsequently* occurring defaults) in order to reinstate the obligation. Unspecified defaults are not waived; however, invocation of such defaults would require commencement of a new nonjudicial foreclosure proceeding—with the attendant additional cost and lost time. Thus, it is critical that a practitioner investigate all potential defaults and make sure they are adequately addressed in any Notice of Default.

4. Calculation of debt.

One of the more fundamental aspects of a foreclosure is the calculation of the amount due under the loan. While at first blush this issue might be one for the client alone to calculate, it is not an isolated occurrence where counsel's advice is required. For instance, while trustee's fees are specified by statute, does the statute also limit attorney's fees that can be charged? Yes. Can both trustee's fees and attorney's fees be charged? Yes, subject to statutory and contractual limits and depending on services provided by counsel. Can reinstatement require payment of both? Maybe. Can a creditor maintain both judicial and nonjudicial foreclosure proceedings concurrently? Yes. In the event, dual track foreclosures are maintained, can the creditor collect the costs of both proceedings on a payoff or reinstatement? Arguably, no.

The consequence of miscalculation of the debt or a demand for amounts which cannot properly be collect might subject a foreclosure sale to be set aside, might result in a claim of wrongful foreclosure (if, for instance, a tender of reinstatement were improperly rejected) or might result in the creditor being obligated to the debtor or junior lienholders for any excessive monies that might have been paid or credit bid to the foreclosing creditor.[2]

5. Bidding Strategy

Bidding strategy is critical to allowing a creditor to maximize both the recovery against the debtor, if a deficiency is being sought in a judicial foreclosure proceeding, or to maximize the resort to multiple items of security.

The nature of determination of a deficiency in a judicial foreclosure—with the interplay between the bid at the foreclosure sale (frequently a "credit" bid and rarely forced to be true market value by competitive bidding)—is counterintuitive to anyone not familiar with real estate secured transaction law. In truth, the amount of deficiency has no bearing on what the creditor might ultimately receive when it disposes of the property. By law, a deficiency is determined by a comparison of the debt on the date of the sheriff's sale to (a) the amount bid, or (b) the "fair value" of the property on the date of sale as subsequently determined by a judge after the fact. The deficiency will be the smaller of the differences. The right of redemption is based solely on the amount bid at the sheriff's sale.

Thus, in order to maximize a deficiency, the creditor's bid should equal to the "fair value" of the property. Yet, it is difficult to foretell what a judge will do weeks or months in the future in a contested proceeding. At best, a beneficiary or counsel will have to estimate what a judge would do, ideally by realistically evaluating the evidence, without regard to advocacy. If the bid price does not equal the fair value, the creditor will lose a portion of its theoretical deficiency. Potentially more problematic, if the bid is too low, a deficiency will be limited by the fair value but the right to redeem will be based on the artificially low bid.[3]

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[2] The court in *6 Angels, Inc. v. Stuart-Wright Mortgage, Inc*. (2001) 85 Cal.App.4th 1279 made clear that a creditor or third party bidder will be bound by its bid even if the bid is clearly in error.

[3] In a "war story," counsel attended (as a spectator) a sheriff's sale where no outside bidders showed up. The lender's counsel, seeking to maximize the creditor's return on a $400,000 loan, elected to bid $10,000 and was the successful bidder. The property was worth $450,000. Instead of a large deficiency for his client, the lender's counsel instead was subjected to a malpractice action from his client.

Bidding strategy might also be critical in a non-judicial context as well. While no deficiency is normally available following a trustee's sale, a trustee's sale will not preclude a lender from exhausting other collateral it may hold. Thus, if a creditor has three deeds of trust to secure a single obligation, it may serially foreclose until it has been paid in full. A full credit bid on the first sale would act to release the balance of the security, while a lower bid would preserve the balance of the unsatisfied loan to bid on the second and third property foreclosures. See *Dreyfus v. Union Bank of California* (2000) 24 Cal.4th 400.

Failure to understand the significance of what many might view as an insignificant, ministerial act with no bearing on "real" damages can have far reaching consequences both on a client and, through malpractice, on the practitioner as well.

6. Disclosures v. Bid Chilling

One of the more precarious positions for a beneficiary or its counsel in a nonjudicial foreclosure relates to the balance between provided required disclosures (as required by *Karoutas v. HomeFed Bank* (1991) 232 Cal.App.3d 767) and illegally discouraging bidding (which may be a crime—Civil Code §2924h(g)). In *Karoutas*, the court found that a beneficiary owed a duty to disclose to potential bidders known problems with the property. Clearly, such disclosures might serve to discourage bidders from participating in any sale. Yet, Section 2924h(g) makes it a crime to "chill" bidding. Normally, there should be no question whether a disclosure is warranted for full disclosure instead of bid tampering. However, the balance between the two need be considered since over aggressive disclosures could and would likely constitute attempts to chill bidding.

7. Purchasing at Sale

While never recommended, if a practitioner ever wished to purchase property for his or her own account, the extent of disclosure should be great, with very explicit written waivers approved by the client, with the advice from an independent third party counsel advising the client. Given the inherent conflicts, it is hard to envision a situation where purchasing (or bidding) on property adverse to a client could ever be advisable. (Rule 4-300)

8. General Advice to Client

Much of the above discussion focuses on application of the law or legal principles to a hypothetical client. However, it is the rare client that fits the definition of the hypothetical client. While an exhaustive list could never be prepared, a client's (or opponent's) circumstance may dictate that attempts to maximize legal rights are limited. As an example, if a client has no ability to maintain property, either physically or financially, it may not want to become the owner of property it holds as security. In such circumstances, it might be amenable to rendering an opening bid below the value of the property to encourage third party bidders. Similarly, if the debtor has no ability to answer for a deficiency, the creditor might want to make its bid greater than the expected fair value of the property to discourage any potential post-sale redemption.

Suffice to say that the various rules we have discussed must necessarily be tailored to fit the specific circumstances befitting our clients and not rigidly applied

simply because they are "rules."

Complex Commercial Foreclosure Issues: A Review Of California Foreclosure Law Regarding Possession And Receivership

Submitted by Terrance J. Evans

Complex Commercial Foreclosure Issues: A Review of California Foreclosure Law Regarding Possession and Receivership

By Terrance J. Evans, Esq.

During the foreclosure process, lenders are often very concerned about the preservation of their real property collateral, and their ability to prevent a defaulting borrower from impairing or depleting the rents and/or profits from the estate. In order to properly strategize regarding how to deal with these complex issues, it is important to understand the pertinent legal issues involved. In this article, we will examine possession and receivership issues under California law.

I. Lenders Have Limited Rights to Possession and Rents

A mortgage or deed of trust provides a lender or creditor with a lien against the debtor's interest in the real property collateral, which can be satisfied through a judicial or nonjudicial foreclosure on that security interest. *See*, Roger Bernhardt, *California Mortgages, Deeds of Trust, and Foreclosure Litigation* §6.1 (4th ed. 2011). Nevertheless, prior to foreclosure, the lien by itself does not give the lender any independent right to possession of the real property collateral (*see* Bernhardt, *supra* at §6.1; *see also People's Sav. Bank v Jones,* (1896) 114 Cal. 422) or to the rents derived from the property (*see* Bernhardt, *supra* at §6.1; *see also Lee v Ski Run Apartments Assocs.*, (1967) 249 Cal. App. 2d 293). Cal. Civ. Code §2927; Cal. Code Civ. Proc. §744.

Under California law, if the loan documents do not contain an assignment of rents clause or an analogous provision, a default by the debtor does not deprive the debtor of possession of the property or its rents until after a foreclosure has been completed. *See* Bernhardt, *supra* at §6.1. The result would be completely different had the default

occurred in one of the title theory states, which hold that a mortgage gives the creditor title to the mortgaged property (and therefore to its possession and right to rents from the possession). *Id.* at §6.1.

However, California follows a lien theory regarding rents, even when a deed of trust is involved, which means that absent an assignment of rents provision a lender does not have a right to collect rents from the real property collateral until a foreclosure sale extinguishes the debtor's title. *See* Bernhardt, *supra* at §6.1; *see also Kinnison v Guaranty Liquidating Corp.*, (1941) 18 Cal. 2d 256. Additionally, without special language in the security instrument, the creditor has no right to possession before the foreclosure sale. Bernhardt, *supra* at §6.1.[1]

A. The Effect Of An Assignment of Rents Clause

Institutional lenders making loans in California typically use standardized loan documents and deed of trust forms that contain an assignment of rents clause. *Id.* at §6.2. Essentially, an assignment of rents clause in a deed of trust gives the beneficiary a right to collect rents immediately upon the trustor's default. *Id.* at §6.2. Assignment of rents provisions are regulated by statute in California, and must be enforced in a court receivership action . *Id.*

The remedies available to a beneficiary upon the default of a debtor will be substantially enhanced or limited depending on whether or not the security instrument contains an assignment of rents provision. Bernhardt, *supra* at §6.2.

It comes as no surprise that a defaulting debtor in possession of real property collateral is less likely to maintain, secure, and/or insure the property after defaulting on

[1] Please note that following a judicial foreclosure sale, the purchaser is entitled to rents but not possession until expiration of the redemption period. Bernhardt, *supra* at §6.1.

the loan. *Id.* Furthermore, since an uncontested foreclosure in California can take at least four months to complete, and a contested foreclosure involving litigation and bankruptcy can take over a year to complete, there is a serious risk that the defaulting debtor will allow the real property collateral to deteriorate during the lengthy foreclosure process. *Id.* Such a scenario could seriously jeopardize the value of a lender's real property collateral. Additionally, a defaulting debtor may attempt to collect rent and profits from the real property collateral during the foreclosure process without making any attempt to cure the outstanding default on the delinquent loan. *Id.* Assignment of rents and profits clauses are designed to prevent such "waste" and "skimming." *See* Bernhardt, *supra* at §6.2; *see also U.S. v Haddon Haciendas Co.,* (9th Cir 1976) 541 F. 2d 777; *see also Cornelison v Kornbluth,* (1975) 15 Cal. 3d 590.

B. Using A Receivership In The Workout Of A Defaulted Loan

In light of the ongoing financial crisis in the United States, lenders are increasingly using receiverships to address and resolve issues arising from defaulted commercial loans. *See* Bernhardt, *supra* at §6.2A

The resulting transaction is called a "workout." *Id.* However, this is not a traditional workout between the defaulting borrower and the lender or special servicer but a sale in which a third party purchases the real property collateral subject to the existing deed of trust and assumes the existing loan. *Id.* The principal balance of the loan may be modified to reflect the sales price or some other restructuring of the existing debt may occur. This is especially important for Commercial Mortgage Backed Securities loans ("CMBS loans"), which are held in Real Estate Mortgage Investment Conduits (REMICs). *See* Bernhardt, *supra* at §6.2A. Since the federal tax rules and contracts that govern REMICs typically forbid them from issuing new debt, a receivership sale and an

assumption of the loan allows lenders and special servicers an alternative to foreclosure and resale. *Id.* Additionally, a receivership can provide the following advantages:

- The lender does not have to wait until after the foreclosure process to remove the defaulting borrower as the manager of an income-producing property or a project under construction; *Id.*
- The appointment of a receiver reduces the risk of rent skimming and waste; *Id.*
- A receiver taking over a project under construction will have the authority either to complete the project or to shut it down and secure it if completion is not feasible (lending institutions do not usually have the experience to do this effectively without outside assistance); *Id.* and
- When the court gives the receiver authority to sell the property through a multiple listing service (MLS) by a real estate broker, in most cases the sale will net significantly greater proceeds than a foreclosure sale (this alternative also allows the lender to avoid holding the property in the lender's REO (real estate owned) inventory). *Id.*

Bernhardt, *supra* at §6.2A.

Notwithstanding the above noted advantages that selling a property subject to the loan may provide to CMBS trusts and their servicers, this approach is not entirely without risk. *See* Bernhardt, *supra* at §6.2A. During the negotiating process, the defaulting borrower may stipulate to the appointment of the receiver and consent to the receiver's sale of the property to a new buyer in exchange for a complete or partial waiver from the lender of a deficiency judgment or a complete or partial reduction in the guarantor's liability under the guaranty. *Id.* However, if the defaulting borrower does not consent, California's one-action rule, which is set forth in Cal. Code Civ. Proc. §726(a), and California’s antideficiency protections raise the following questions:

- **Is the receiver's sale a judicial foreclosure?** If a judge were to find that a receiver's sale of a distressed property subject to a lien securing a loan in default is not a de facto foreclosure, then the lender risks not qualifying for a deficiency judgment because of not having (1) proceeded by judicial foreclosure, (2) sold the property subject to the post sale statutory right of redemption (an essential antideficiency protection), (3) applied for a timely deficiency under Cal. Code Civ. Proc. §726(b), or (4) satisfied the fair value process. Bernhardt, *supra* at §6.2A.
- **Does the fact of court authorization of the receiver's sale preclude application of the one-action rule?** *See Aplanalp v Forte*, (1990) 225 Cal. App. 3d 609; judicial offset of verdict in favor of borrower against debt owed to lender violated Cal. Code Civ. Proc. §726(a)). Bernhardt, *supra* at §6.2A.
- **Does the exemption from the one-action rule under CCP Cal. Code Civ. Proc. §564(d) apply?** The order appointing the receiver may permit the receiver to sell the property (*see* Cal. Code Civ. Proc. §568.5) if the moving party shows that an imminent financial crisis will occur if the sale is not made. But the power to sell under §568.5 is not expressly mentioned in Cal. Code Civ. Proc. §564(d), which only provides that an action by a secured lender to appoint a receiver under California's receivership law is not an "action" for purposes of CCP Cal. Code Civ. Proc. §726(a). Bernhardt, *supra* at §6.2A.
- **Assuming the receiver's sale is tantamount to a judicial foreclosure allowing a post sale deficiency judgment, how is the deficiency measured?** Bernhardt, *supra* at §6.2A.
- **Even if the borrower consents to the receivership and the sale, is this an invalid waiver of §726(a)?** Bernhardt, *supra* at §6.2A.

Bernhardt, *supra* at §6.2A.

When a receivership action is brought for the above noted purposes, the procedures vary depending on whether there is an assignment of rents clause in the deed

of trust. Bernhardt, *supra* at §6.2A. If no assignment of rents clause exists and the real property collateral is worth less than the amount owed, Cal. Code Civ. Proc. §564(b)(2) enables the lender to obtain appointment of a receiver to take possession pending a judicial foreclosure action by showing the following two things:

1. The mortgaged "property is in danger of being lost, removed, or materially injured, or that the condition of the deed of trust or mortgage has not been performed"; *Id.* and
2. that "the property is probably insufficient" in value to satisfy the secured debt. *Id.*

Bernhardt, *supra* at §6.2A.

II. A Lender's Right to Possession and Rents Before Foreclosure

A. Mortgagee In Possession

One option available to a lender seeking to protect against waste and reach the rents is to take possession of the real property collateral, with the debtor's consent, during the life of the loan. Bernhardt, *supra* at §6.3. A secured creditor who takes such consensual possession of the real property collateral is referred to as a "mortgagee in possession." *Id.* It is important to remember that a lender who becomes a mortgagee in possession acquires both advantages and liabilities. *Id.* This status carries with it consequences beyond those created in a normal deed of trust or mortgage. *See* Bernhardt, *supra* at §6.3.

In light of the legislative overhaul and rationalization of the rents and profits procedures and concepts, few mortgagee-in-possession issues arise. *See* Bernhardt, *supra*

at §§6.3,6.20, 6.25-6.28. Many lenders take steps to avoid mortgagee in possession status because of the liabilities involved. *See* Bernhardt, *supra* at §6.3.

B. Rights Of A Mortgagee In Possession

It is well established under California law that a lender who becomes a true mortgagee in possession may retain possession of the real property collateral until the debt is paid. *See* Bernhardt, *supra* at §6.4; *see also Snyder v Western Loan & Bldg. Co.*, (1934) 1 Cal. 2d 697. Even when an action to collect on the promissory note would be barred by the statute of limitations, a mortgagee in possession may remain in possession as long as the obligation is unsatisfied. *See* Bernhardt, *supra* at §6.4; *see also Spect v Spect*, (1891) 88 Cal. 437. This is typically not important to the beneficiary under a deed of trust because the power of sale remedy is generally not subject to time limitations, however, classification as a mortgagee in possession can be very important to a lender or creditor holding a mortgage or hidden security instrument that is subject to a statute of limitation. *See* Bernhardt, *supra* at §6.4; *see also Aguilar v Bocci*, (1974) 39 Cal. App. 3d 475.

In addition to the foregoing, another reason why a lender or creditor may want to become a mortgagee in possession is that such possession carries with it the right to take the rents and profits generated by the real property collateral. *See* Bernhardt, *supra* at §6.4. A mortgagee in possession may apply the profits from the real property collateral toward payment of the debt even if there is no assignment of rents clause in the security instrument. *See* Bernhardt, *supra* at §6.4; *see also Nelson v Bowen,* (1932) 124 Cal. App. 662; *see also Johns v Moore,* (1959) 168 Cal. App. 2d 709. Rent is consideration for the right to possess property; thus the right to receive rents belongs to the party that has the

right to be in possession, which is the lender or creditor when it is a mortgagee in possession. *See* Bernhardt, *supra* at §6.4.

C. Liability Issues

A mortgagee in possession is accountable to the debtor for management of the real property collateral and is liable for failing to act reasonably and in a businesslike manner in handling the real property and the rents collected. *See* Bernhardt, *supra* at §6.5; *see also Davis v Stewart,* (1944) 67 Cal. App. 2d 415. Notwithstanding its obligations, the mortgagee in possession is not entitled to compensation for its management efforts. *See* Bernhardt, *supra* at §6.5; *see also Earp v Earp*, (1991) 231 Cal. App. 3d 1008, 1014. A mortgagee in possession does not ensure the profitability of the premises but is responsible for any losses caused by its negligence. *See* Bernhardt, *supra* at §6.5; *see also Murdock v Clarke,* (1891) 90 Cal. 427, 438. This liability extends to junior creditors as well as to the debtor. *See* Bernhardt, *supra* at §6.5; *see also Anglo-Californian Bank, Ltd. v Field,* (1908) 154 Cal. 513.

By comparison, a creditor with an assignment of rents clause in its security instrument may obtain most of the advantages of possession without the accompanying liabilities through the appointment of a receiver (which does not carry mortgagee-in-possession status). *See* Bernhardt, *supra* at §6.5. Rent assignment clauses are therefore considerably superior to the direct taking of possession by the creditor. *Id.* Mortgagee-in-possession status is particularly dangerous if there is any risk that the real property collateral is contaminated because any owner or operator may be held responsible for clean-up costs *(*see Bernhardt, *supra* at §§6.54.54-4.57, 5.60).

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D. Debtor's Consent Required

Pursuant to California's Civil Code, a mortgage does not automatically entitle the mortgagee to possession of the mortgaged property (as was true under the title theory of mortgages at common law). *See* Bernhardt, *supra* at §6.6; *see also* Cal. Civ. Code §2927; *see also* Cal. Code Civ. Proc. §744.

A debtor may make an independent agreement with the lender, however, to let the lender take possession of the property, either at the inception of the loan or at a later time; and no additional consideration is required. *See* Bernhardt, *supra* at §6.6; *see also Nelson v Bowen* (1932) 124 Cal. App. 662. The mere entry by the lender with the debtor's consent is sufficient. *See* Bernhardt, *supra* at §6.6. A formal agreement is unnecessary; consent is implied, especially when the lender has entered after a default and without the debtor's objection. *See* Bernhardt, *supra* at §6.6; *see also Hooper v Young,* (1903) 140 Cal. 274 (deed absolute); *see also Spect v Spect,* (1891) 88 Cal. 437 (mortgage).

Some California courts have even found that a peaceable entry may be all that is required for a lender or creditor to become a mortgagee in possession. *See* Bernhardt, *supra* at §6.6; *see also Snyder v Western Loan & Bldg. Co.*, (1934) 1 Cal. 2d 697; *see also Nelson v Bowen, supra.* Nevertheless, *see Freeman v Campbell*, (1895) 109 Cal. 360. Bernhardt, *supra* at §6.6. A forcible entry, however, will subject the intruding lender or creditor to liability for forcible entry and trespass rather than creating mortgagee-in-possession status. *See* Bernhardt, *supra* at §6.6; *see also McGuire v Lynch*, (1899) 126 Cal. 576 (trespass); *see also Calidino Hotel Co. v Bank of America Nat'l Trust & Sav. Ass'n*, (1939) 31 Cal. App. 2d 295, 306, (forcible entry).

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E. Entry Following Invalid Foreclosure Sale

There appears to be no clear rule regarding entry into possession subsequent to an invalid foreclosure sale. *See* Bernhardt, *supra* at §6.7. For example, the California Supreme Court has held that a purchaser who took possession under a judicial sale that was void for lack of an indispensable party was nevertheless a mortgagee in possession. *See* Bernhardt, *supra* at §6.7; *see also Burns v Hiatt*, (1906) 149 Cal. 617. Conversely, the California Supreme Court has also held to the contrary when the entry followed a private sale under a power of sale in a mortgage (as distinct from a deed of trust) that was barred by the statute of limitations. *See* Bernhardt, *supra* at §6.7; *see also Faxon v All Persons*, (1913) 166 Cal. 707.

When a lender or creditor takes possession under circumstances that do not entitle it to claim mortgagee-in-possession status, it loses all the advantages of that status. *See* Bernhardt, *supra* at §6.7. The lender cannot retain possession to force payment of a debt that is otherwise barred (*See* Bernhardt, *supra*; *see also Faxon v All Persons, supra*), and it cannot apply rents collected toward reducing the debt (*See* Bernhardt, *supra*; *see also Freeman v Campbell* (1895) 109 Cal. 360). Any money collected must be turned over to the debtor even though the mortgage debt remains unpaid. *See* Bernhardt, *supra* at §6.7; *see also Belcher v Aaron*, (1937) 8 Cal. 2d 180. Thus, the lender must return to the debtor any rents, which it will likely not be able to recover thereafter because of California's antideficiency laws. *See* Bernhardt, *supra* at §6.7.

F. Acts That Do Not Trigger Mortgagee In Possession Status

Mortgagee-in-possession status does not result automatically simply by taking a security interest in land. *See* Bernhardt, *supra* at §6.8. Neither a mortgage nor a deed of trust in and of itself gives the lender or creditor a right to possession of the real property.

See Bernhardt, *supra* at §6.8; *see also* Cal. Civ. Code §2927; *Snyder v Western Loan & Bldg. Co.,* (1934) 1 Cal. 2d 697; *Bank of America v Bank of Amador County,* (1933) 135 Cal. App. 714. Nor does a deed absolute intended as a mortgage authorize the lender or creditor to take possession of the property unless the deed expressly so provides. *See* Bernhardt, *supra* at §6.8; *see also McGuire v Lynch*, (1899) 126 Cal. 576.

Physical acts of management—not merely rent collection—are required for a creditor to become a mortgagee in possession (*see* Bernhardt, *supra* at §6.8; *see also Bank of America v Bank of Amador County, supra*). The creditor does not become an automatic mortgagee in possession merely because any of the following four circumstances exist:

1. **The security documents contain an assignment of rents clause** (*See* Bernhardt, *supra* at §6.8; *see also Freeman v Campbell,* (1895) 109 Cal. 360; *Bank of America v Bank of Amador County, supra*);
2. **The creditor personally collects rents from the tenants under an assignment of rents clause** (*See* Bernhardt, *supra* at §6.8; *see also* Cal. Civ. Code §2938(e)(1); *Strutt v Ontario Sav. & Loan Ass'n,*, (1972) 28 Cal. App. 3d 866, 879; *but see Johns v Moore* (1959) 168 Cal. App. 2d 709, suggesting, in dictum and in pre-Cal. Civ. Code §2938(e)(1) context, that creditor's collection of rents would be enough to impart mortgagee-in-possession status);
3. **The creditor enters the premises to make repairs to preserve the security** (*See* Bernhardt, *supra* at §6.8; *see also Gudel v Ellis*, (1962) 200 Cal. App. 2d 849; or
4. **The creditor obtains the appointment of a receiver to manage the property** (*See* Bernhardt, *supra* at §6.8; *see also* Cal. Civ. Code §2938(e)(1); *Tourny v Bryan,* (1924) 66 Cal. App. 426; *Murdock v Clarke*, (1891) 90 Cal. 427).

If a lender convinces a debtor—following the debtor's default—to allow the lender to collect rents without assuming responsibility for property management, this should not have the effect of making the lender a mortgagee in possession. *See* Bernhardt, *supra* at §6.8. In the examples described above, the lender still must account for rents actually collected but is not subject to the prudent business standard that courts apply to a true mortgagee in possession (*see* Bernhardt, *supra* at §§6.8, 6.5).

III. Obtaining a Receivership When There Is No Assignment of Rents Clause

A. Cal. Code Civ. Proc. §564(b)(2): Waste or Default; Insufficient Security

When the deed of trust does not contain an assignment of rents clause, the beneficiary nevertheless may have a receiver appointed to protect the property as part of a judicial foreclosure action under Cal. Code Civ. Proc. §564(b)(2). *See* Bernhardt, *supra* at §6.15; *see also Neider v Dardi*, (1955) 130 Cal. App. 2d 646. In order for a creditor to obtain an order appointing a receiver as part of a foreclosure action, grounds must exist for foreclosing. *See* Bernhardt, *supra* at §6.15. It is unclear whether mere neglect of the property or the trustor's waste is a ground for foreclosure, even if the security instrument contains a covenant against waste, unless it also provides that waste is an event of default. *Id.* Most trust deed forms contain such a covenant. Nothing in Cal. Civ. Code §2929 or Cal. Code Civ. Proc. §745 (see §§6.10, 6.14) authorizes a foreclosure on the basis of waste alone. *See* Bernhardt, *supra* at §6.15; *see also* Leipziger, *The Mortgagee's Remedies for Waste*, 64 Cal L Rev 1086 (1976).

It is important to keep in mind that the criteria for appointment of a receiver under Cal. Code Civ. Proc. §564(b)(2) are more stringent than those applicable to a receiver appointed under an assignment of rents clause in a specific performance action. *See*

Bernhardt, *supra* at §6.15. To obtain a receiver in a judicial foreclosure action when there is no assignment of rents, the beneficiary must show either of the following (*See* Bernhardt, *supra* at §6.15; *see also* Cal. Code Civ. Proc. §564(b)(2)):

- The property is in danger of being lost, removed, or materially injured; or
- The trustor has failed to perform a condition of the deed of trust.

See Bernhardt, *supra* at §6.15.

Since the purpose of §564(b)(2) is to preserve the sufficiency of the security to discharge the debt (*see* Bernhardt, *supra* at §6.15; *see also* T*itle Ins. & Trust Co. v California Dev. Co.*, (1912) 164 Cal. 58, 61), under either scenario, the beneficiary must also prove that the property would be or is probably insufficient to satisfy the debt. *See* Bernhardt, *supra* at §6.15. Notably, the first clause in §564(b)(2) supports the appointment of a receiver when the property is threatened by loss, removal, or material injury and the relative value of the property after the infliction of injury would be insufficient to satisfy the debt. *Id.* If the threatened injury is considerable but would "leave enough of the property remaining intact to be ample security for the debt, the court should not interfere." 164 Cal at 61; Bernhardt, *supra* at §6.15. Thus, when applying for a receiver under this clause, the plaintiff must show not only that the property is in danger of material injury but also that such injury would so depreciate its value that it would not afford adequate security for the debt. 164 C at 62; Bernhardt, *supra* at §6.15.

When applying for a receiver under the default provision of §564(b)(2), it is not enough that the beneficiary show nonpayment of the debt (or other default) and a decline in the value of the security; the property value must have fallen below the unpaid balance of the loan. *See* Bernhardt, *supra* at §6.15. This situation necessitates an evidentiary

showing of the property's present value. *See* Bernhardt, *supra* at §6.15; *see also Hibernia Sav. & Loan Soc'y v Ellis Estate Co.*, (1933) 132 Cal. App. 408. Because the appointment of a receiver is viewed as a harsh and drastic remedy, a clear showing that less onerous remedies are inadequate may be required. *See* Bernhardt, *supra* at §6.15; *see also Cohen v Herbert* (1960) 186 Cal. App. 2d 488.

The language of §564(b)(2) may be interpreted not to require a showing of insufficiency of security when the property is threatened by loss, removal, or material injury. *See* Bernhardt, *supra* at §6.15. Notwithstanding the decision in *Title Ins. & Trust Co. v California Dev. Co., supra*, beneficiaries may argue that requiring a showing of potential inadequacy of value in cases of threat to the security denies them the right to maintain an adequate margin of security. *See* Bernhardt, *supra* at §6.15. For further discussion of margin of security, *see* Bernhardt, *supra* at §§6.15, 4.51, 5.18, 8.70-8.71; *see also People ex rel Dep't of Transp. v Redwood Baseline, Ltd.*, (1978) 84 Cal. App. 3d 662.

B. A Lender Has Limited Ability To Collect Rents Without An Assignment Of Rents

A difficulty confronting a beneficiary whose deed of trust lacks an assignment of rents clause is that a receiver appointed under Cal. Code Civ. Proc. §564(b)(2) may be limited to preserving the real property collateral from waste and may not be entitled to claim rents except as needed to avoid waste. *See* Bernhardt, *supra* at §6.16. It is important to keep in mind that rents and title are different interests, and one may have title to property without having the right to receive rents from it. *See* Bernhardt, *supra* at §6.16; *see also Walmsley v Holcomb*, (1943) 61 Cal. App. 2d 578. Therefore, mortgaging the title does not itself convey a present right to the rents from it. *See*

Bernhardt, *supra* at §6.16; *see also Locke v Klunker*, (1898) 123 Cal. 231; *Turner v Superior Court*, (1977) 72 Cal. App. 3d 804, 812. Even if the rents are treated as directly connected to the title, title still remains in the trustor until the foreclosure sale is completed. *See* Bernhardt, *supra* at §6.16. Consequently, without an assignment of rents clause, the rents from the property may be a separate and unencumbered asset. *See* Bernhardt, *supra* at §6.16; *see also Snyder v Western Loan & Bldg. Co.*, (1934) 1 Cal. 2d 697.

It is well established that appointing a receiver cannot increase the scope of the lien against the property. *See* Bernhardt, *supra* at §6.16. If the deed of trust does not cover rents, the receivership may not either. *See* Bernhardt, *supra* at §6.16; *see also Turner v Superior Court,* (1977) 72 Cal. App. 3d 804, 812. Although Cal. Code Civ. Proc. §568 empowers a court to authorize a receiver to collect rents, that power is limited to circumstances where there is an independent ground for placing the rents under the court's control, i.e., when the mortgage has an assignment of rents clause or when the rents must be used to preserve the property. *See* Bernhardt, *supra* at §6.16; *see also Gudel v Ellis*, (1962) 200 Cal. App. 2d 849.

In the past, beneficiaries tried to avoid these difficulties by requiring the trustor to stipulate in the deed of trust that a receiver would be appointed whenever the trustor defaulted. But this stipulation is of little help because the courts have held that jurisdiction to appoint a receiver cannot be conferred merely by consent. *See* Bernhardt, *supra* at §6.16; *see also Baker v Varney*, (1900) 129 Cal. 564. *See also Barclays Bank v Superior Court,* (1977) 69 Cal. App. 3d 593. Notwithstanding such a stipulation, the beneficiary must still prove probable insufficiency of the security to obtain the

appointment. *See* Bernhardt, *supra* at §6.16; *see also Bank of Woodland v Stephens* (1904) 144 Cal. 659. When weighing the facts to determine if they support the statutory bases for a receivership, however, the court may consider the stipulation. *See* Bernhardt, *supra* at §6.16; *see also Barclays Bank v Superior Court, supra*.

C. Additional Grounds For Receivership

The beneficiary has additional remedies for obtaining possession before or during foreclosure absent a rents and profits clause. *See* Bernhardt, *supra* at §6.17. In particular, Cal. Civ. Code §2929.5 and Cal. Code. Civ. Proc. §564(c) permit the appointment of a receiver for the limited purpose of inspecting for hazardous substances. *See* Bernhardt, *supra* at §6.17. This particular receivership provision, however, is very narrow, infrequently invoked, and by no means a satisfactory alternative to a broadly worded assignment of rents clause. *See* Bernhardt, *supra* at §6.17.

D. Liability For Receiver's Conduct

Provided that there is no conspiracy or inappropriate control over the receiver, the beneficiary is not liable for the receiver's behavior and is not charged with mortgagee-in-possession status by virtue of the receivership. *See* Bernhardt, *supra* at §§ 6.8; 6.18; *see also Tourny v Bryan* (1924) 66 Cal. App. 426. The beneficiary, however, may be responsible for any shortfall in administrative expenses. *See* Bernhardt, *supra* at §§ 6.8; 6.18; *see also Ephraim v Pacific Bank*, (1900) 129 Cal. 589, 592, cited with approval by the United States Supreme Court in *Atlantic Trust Co. v Chapman,* (1908) 208 US 360, 373, 52 L Ed 528, 534, 28 S Ct 406.

IV. Conclusion

In conclusion, a lender or creditor's rights to possession and rents are strongest where there is an assignment of rents provision included in the loan documents. To the

extent that a lender or creditor finds itself in a position where its loan documents do not contain an assignment of rents provision, this article provides some helpful alternative approaches for consideration.

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Terrance J. Evans is a partner in the Trial Practice Group of Duane Morris in San Francisco. He concentrates his practice in representing the financial services industry, which includes international, national and community banks; loan service companies; and insurance companies. During his career, Mr. Evans has both recovered and saved clients of the firm tens of millions of dollars in settlements, judgments and extrajudicial procedures.

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