So Your Client Wants to Buy At a Foreclosure Sale: Pitfalls and Possibilities

By Bruce J. Bergman

Late night television infomercials have for years touted the purchase of foreclosed properties as a path to riches available even to the uninitiated. Propelled by unalloyed enthusiasm, the voluble pitchmen and sundry financial mahatmas are persuasive, supported by testimonials from ordinary folks who enthusiastically boast of much success following the methods promulgated by the cheerleaders. For those without cable access and so denied the chance to fall under the spell of real estate impresarios, there always seems to be an enticing story heard about a friend who bought a foreclosure, turned it over quickly and garnered the proverbial handsome profit – with ease.

Can it all be so? It *can*, sometimes, but it is not necessarily as easy or risk-free as the program purveyors suggest. And for the uninformed, it can be conspicuously Barmecidal. Although the underlying framework of lending and foreclosure is inherently designed to render a foreclosure sale purchase a bargain, unmentioned in the rosy prognoses are the shrouded perils, including: the question of value, the erosion of the equity, holdover tenants, title problems, real estate tax issues, the tenuous physical condition of the property and some of the obscure nuances attendant to judicial foreclosure sales.

Understanding the Foreclosure

A better appreciation of some possible dangers in purchasing at a foreclosure sale emerges when the foreclosure process is understood. Presenting this in elemental fashion to a prospective sale bidder can prove instructive.[1]

If a lender contemplates taking a mortgage (which is the pledge of real estate as security for debt), the presentation needs to address two evaluations – a business decision and a legal decision. If, for example, someone wishes to borrow $400,000 to buy a house worth $500,000, the loan to value ratio is 80%, perhaps a typical limit many lenders would consider prudent. The ultimate question they ask themselves is, "In the event of a default and a foreclosure, will someone pay $400,000 to buy a house worth $500,000?" The reasonable answer is "yes."

Then the lender proceeds to the *legal* decision. Based upon a title search, and assuming that the contemplated loan is to be a first mortgage, will the mortgage be in a first lien position so that the mortgage will be superior to all other interests that might later attach?[2] If the answer to that inquiry is also in the affirmative, the lender knows that in the unwelcome event of default necessitating a foreclosure, any *later* mortgages, judgments or liens will be extinguished by the foreclosure proceeding so that the original scenario is forever frozen in time – a foreclosure sale purchaser paying $400,000 to buy a $500,000 property.

Foreclosures in the Real World

That's the theory, but it doesn't always work that way in practice. Although speedy non-judicial foreclosure pursuant to Real Property Actions & Proceedings Law Article 14 (RPAPL) exists in New York, it is unavailable for residences, and it has limitations even for commercial properties.[3] That leaves only judicial foreclosure, which is prone to considerable delay. Graphically expressed, here is what can happen:

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MORTGAGE PROCEEDS	$400,000
(LOAN AT 15% DEFAULT INTEREST)	
EQUITY CUSHION	$100,000
*	
PERCEIVED VALUE OF PROPERTY	
AT INCEPTION OF MORTGAGE LOAN	$500,000
*	
*	2 Yrs. Interest at 15% Adds
*	$120,000 to Debt and Erases Equity
*	
DEBT AT END OF TWO YEARS IF	
NO PAYMENTS MADE ON MORTGAGE	$520,000
*	
DEBT AT CONCLUSION OF FORECLOSURE	
WITH ADDITION OF LEGAL FEES, COSTS,	
DISBURSEMENTS AND ALLOWANCES	
IN FORECLOSURE ACTION	$530,000
LOSS AT FORECLOSURE SALE TO LENDER:	
DIFFERENCE BETWEEN VALUE AND	
DEBT OWNED	$ 30,000

Even if the interest on the mortgage was 8%, most mortgages contain a provision for a rate upon default that is higher than the note rate and could easily be *considerably* higher than the 15% default rate in the example. In the New York City metropolitan area, for example, a combination of court delays and a borrower dedicated to contesting the case could readily stretch duration of the action to two years or more. Although a foreclosure sale purchaser may have no concern about the trauma and angst generated by the earlier combat in the case, the time factor translated into interest accrual. In turn, that increased the mortgage debt and thereby eroded – and in this example, eliminated – the equity cushion.

Is It a Bargain?

It doesn't take much for litigation and the time it devours to upset the lender's initial formulation. While foreclosure sale purchasers *would* typically pay $400,000 for a $500,000 house, when the debt that the lender must be paid out of foreclosure sale proceeds becomes $480,000 or $495,000, or actually exceeds the property's value, then there may be no bargain to be had. (The lender could choose to accept less money than is due rather than take the property back to resell, but that is a less likely result.)

Even in a garden variety foreclosure that suffers no detainment and only minor legal expense, *some* interest and expenses accumulate, consequently reducing the equity. At this point, a key commandment for any foreclosure sale purchaser is *know the value of the property*. Quite simply, this is the paramount consideration, because it is the relationship of that value to all the potential expenses to be incurred that either generates a profit or causes a loss.

The prospective foreclosure sale buyer must decide in advance of bidding how much to pay for the property. Obviously, the bidder must plan its own equity cushion between what is bid and the expected resale price, with a sufficient margin for a profit *after* allowing for the unexpected problems.

What Will the Price Be?

While knowing what the property is worth is much of the battle, being aware of the bid price range is critical too. Because counsel for the foreclosing plaintiff may not know what the plaintiff's bid (or upset price) will be until a very short time before the sale – or may be unwilling to reveal that information – the bidder should be independently well-armed with knowledge.

A typical notice of sale published in a newspaper recites an approximate sum due, and that, in turn, is based upon the filed judgment of foreclosure and sale. Although that sum will consist of all principal and interest as computed by the referee, the actual computation relates back to some date around the time the referee prepared his calculations. That will likely be months (or sometimes years) prior to the date of the judgment. This requires adding interest (at the default rate if applicable) from the "as of" date in the referee's report of amount due until the date of the judgment.[4]

In addition to the aggregate of principal and interest – which itself bears interest – the judgment will also recite and assess costs, disbursements, (most often) allowances and legal fees, all of which items may also accrue interest. What that rate of interest will be can be critical in determining the ultimate sum due, especially if there is a long hiatus between entry of judgment and conduct of sale. (This can occur when there are bankruptcy filings, lengthy settlement efforts or protracted post-judgment litigation, none of which are uncommon.)

Once the judgment is entered, interest accrues at the prevailing legal rate,[5] currently 9%. But there is an exception to that rule. If the mortgage explicitly provides that some particular interest rate shall apply and not merge into the judgment, then the intention of the parties will control.[6] Thus, a high default rate of interest that survives the judgment could precipitously boost the sum due.

There is then the subject of hidden advances. Of course, the judgment quantifies, in numerals, the amount due. But it also authorizes additions to the sum due, not in numbers, but in categories expressed in prose, such as entitling the plaintiff to add on or collect advances made to protect the lien of the mortgage. For

example, if real estate taxes were in arrears and loss of title to the taxing authority (and concomitant extinguishment of the mortgage) was to occur subsequent to judgment but before the foreclosure sale, the plaintiff might elect to pay those taxes, thereby increasing the debt due. Depending upon the type and location of property, as well as the duration of the tax default, this sum could be thousands, tens of thousands, or hundreds of thousands of dollars.

Categories of authorized advances that can increase the upset price also include sums paid to prior mortgagees or for hazard insurance premiums, among others. Hence, some measure of uncertainty lurks here too.

Even when the full sum due the foreclosing plaintiff is finally unearthed, the terms of sale can create the further addition of interest upon the ultimate bid price. Because the closing is almost invariably declared to be 30 days after the sale, the terms of sale will often impose interest on the bid beginning with the 31st day. Contemplating that interest is lost to the plaintiff as of the very first day after the auction, some terms of sale will decree interest due on the bid beginning immediately. Obviously, the larger the bid and the more the delay until closing, the greater becomes this further expense to the bidder.[7]

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The Pitfalls

Being familiar with the particular methodology of the foreclosure sale is important too. This is decidedly *not* the no-money-down realm of other real estate schemes. Instead, 10% of the amount bid is a normal requirement, usually in the form of cash, certified check or bank check payable at the auction to the referee. (Third-party checks may not be accepted.)

Critically, the purchase is almost invariably *not* subject to obtaining a mortgage. That means that at the foreclosure sale closing (usually, as noted, about 30 days after the auction sale) the bidder needs the balance of the purchase price in cash.

A bidder who erroneously assumed that a mortgage would be forthcoming to finance the purchase might then default for want of funds to close title. And there could be any number of other reasons why a bidder might be unable to close or experience a change of heart. The bid deposit is then at risk, but only to the extent of that deposit.[8] (Should a subsequent foreclosure sale yield the same or a greater sum, the bid deposit would be refunded.)

The cost of money then becomes an important part of the profit equation. Factoring in the length of time necessary to put the property in salable condition, advertise it and close on a resale means that the purchase price advanced for each parcel is unavailable to earn interest or otherwise be invested. The successful foreclosure sale bidder is not playing with someone else's money.

Title issues are another immediate concern. In New York, the goal of the foreclosing party is to extinguish all subsequent interests, accomplished by naming and serving all persons with positions subordinate to the mortgage being foreclosed. Did the attorney for the foreclosing plaintiff do that? The bidder will need a title search to know, although even if diligence confirms the efficacy of what the lender did, it is hardly unusual for defendants to come to court after the sale swearing that they were never served. That is a potential time-killer.

Observe too that the property will be sold subject to any number of possible interests, for example, prior mortgages (this could have been a *second* mortgage in foreclosure), prior judgments, zoning ordinances and tenancies, if any, among other things. Despite the general proposition that the mortgage would not have been consummated in the first place if there were liens *senior* to the mortgage to be delivered, there are exceptions. That is to say, there could be various encumbrances not subject to extinguishment by the foreclosure which therefore continue to burden the property. This is something the purchaser must examine in advance, because it is an integral part of what is being bought. Title insurance doesn't cover such interests.

As to tenancies, in a perfect world, the defaulting borrower, or his tenants, would quietly depart the foreclosed premises after the foreclosure sale and before the closing. In this conspicuously imperfect world, however, many such people recognize that they can continue to live rent free until the legal system ousts them. How long after the foreclosure such holdovers will finally be constrained to depart is problematical. It might consume but a few weeks in some upstate areas of New York, but it easily takes many months in New York City and a few months even in Nassau and Suffolk Counties. Such a morass both incurs legal fees and denies physical possession of the property for whatever period until entry is finally available. This is yet another infirmity that must be quantified when addressing the foreclosure purchase.

Real estate taxes are still another consideration. There are four issues here:

- The amount of real estate taxes affects the value of the property so those taxes need to be determined in advance.
- Any exemptions that benefited the property, such as for veterans or seniors, will be lost upon a resale, unless the new purchasers so qualify.
- In New York, real estate taxes that are a lien on the property must be paid out of sale proceeds, but those taxes will, of course, accrue until the property is sold, and therefore are another carrying charge that must be accounted for.
- In the unusual circumstance of such a directive in the judgment, the terms of sale will shift the obligation to pay outstanding real estate taxes to the foreclosure sale purchaser.

Thus, a $400,000 bid price could suddenly become $410,000 – or much more.

Nor can transfer taxes be dismissed as irrelevant. Although, as a matter of statute, transfer taxes are the obligation of the seller, the better rule is that this responsibility can be altered by contractual agreement.[9] Counsel to foreclosing plaintiffs will frequently shift the burden of paying transfer taxes to the bidder in the terms of sale. Because in many instances this sum can be thousands of dollars, bidders must listen carefully to terms of sale read by referees and be aware of this possible – indeed likely – responsibility.

Any hope that rent arrears that may have accrued at the foreclosed premises can be collected by the bidder is dashed as a matter of law. A claim for pre-foreclosure sale rent has no legal basis,[10] and New York law is clear that such arrears are unrecoverable.[11]

Perhaps the most discomforting hidden surprise is the condition of the foreclosed premises. Before the foreclosure auction, a prospective bidder can (and certainly should) view the outside of the property to assess the value of that parcel in that neighborhood. Until the hammer falls at the auction sale, however, the borrower continues to own the property and need not – and typically will not – afford entry to strangers. Although a lender has certain rights in this regard and could become a mortgagee in possession, or have a receiver of the premises appointed to assume physical control or secure the premises against vandalism should it become vacant, those situations are the exception. Usually, the interior of the property is unavailable to be seen, either because the occupants deny entry or because the property is sealed.

The inside condition is thus a critical imponderable. Paint could be chipped or be lead-based, appliances non-functional or removed, piping pulled out or burst – any imaginable ill that could afflict a neglected or abandoned property. Sometimes disgruntled borrowers – or others – willfully destroy the premises. The would-be bidder must leave room in the valuation for a worst-case situation.

Ultimately, time becomes an inescapable element in planning for a profit. The most accurate calculation of market value combined with a sage purchase price eventually will be banished to irrelevance if all the possible problems consume too much time. So it is exigent to estimate the duration from foreclosure sale purchase until resale. During that time, money has a cost, taxes and utilities must be paid, tenants must be evicted, repairs must be made. In the end, there will be closing costs, legal fees and, if the foreclosure sale purchaser doesn't assume the task, brokerage fees. It all might not be so alluring in the end.

The Best Case

Having endeavored to flush out the landmines, we should not deter the ardent. If there really is value in the property under foreclosure, it is reasonable to assume that besieged borrowers would rescue that equity by selling the property themselves and satisfying the mortgage. They have an absolute right to do so, which is precisely why in times of prosperity or increasing real estate values most foreclosure cases never arrive at the auction sale stage.

Sometimes, though, the borrower-owners are husband and wife involved in an acrimonious divorce. The bitterness is such that they cannot agree upon a sale and so they suffer a foreclosure. That one could be a bargain.

Then there is the owner who, for whatever reason suffers a surfeit of judgments and liens on the property. Because together with the mortgage those other liens aggregate more than the value of the property, it cannot be sold. But in a foreclosure, all those liens are extinguished and a wise bidder *can* buy a $500,000 house for $400,000, or a $300,000 house for $125,000 – or however the numbers develop.

There remains some further comfort for bidders. One source of such comfort is the maxim that a good faith foreclosure sale purchaser is insulated from liability for prior rent overcharges where the purchaser had no notice of this existence of rent overcharge claims.[12] (But that protection does not extend to a subsequent purchaser.[13])

To be sure, yet other issues have an impact upon the process: risk of loss after the foreclosure sale and before delivery of the deed;[14] the bidder's possible liability for prior rent overcharges;[15] reversal of the foreclosure on appeal.[16]

The problems don't evaporate, but an astute awareness of them might level the playing field or present a

chance to earn a profit. Care and practical wisdom can legitimize the theories of those late-night acolytes.

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1. For a far more detailed review of foreclosure basics, see 1 *Bergman on New York Mortgage Foreclosures*, Chapter 2, "Overview and Guide to the Basics of Mortgage Foreclosure Concepts and Strategies," Matthew Bender & Co., Inc. (rev. 2003).
2. Real estate taxes and certain statutory "super liens" will be superior even to an earlier recorded mortgage, but these concepts are understood by mortgage lenders and represent a risk factor for which they presumably plan in advance.
3. For an explanation of the availability and infirmities of non-judicial foreclosure (more accurately foreclosure of mortgage by power of sale) see 1 *Bergman on New York Mortgage Foreclosures*, Chapter 8, Matthew Bender & Co., Inc. (rev. 2003).
4. For a more complete review of the interest principles see 2 *Bergman on New York Mortgage Foreclosures* § 27.04, Matthew Bender & Co., Inc. (rev. 2003).
5. CPLR 5004; *Taylor v. Wing*, 84 N.Y. 471 (1881); *European Am. Bank v. Peddlers Pond Holding Corp.*, 185 A.D.2d 805, 586 N.Y.S.2d 637 (2d Dep't 1992).
6. *Banque Nationale De Paris v. 1567 Broadway Ownership Assocs.*, 248 A.D.2d 154, 669 N.Y.S.2d 568 (1st Dep't 1998); *Marine Mgmt. v. Seco Mgmt.*, 176 A.D.2d 252, 574 N.Y.S.2d 207 (2d Dep't 1991).
7. Perhaps in part because issues such as this necessitate disposition at the closing, the question of whether this interest mandate is enforceable has not been the subject of reported litigation. Unofficially, however, there is an unreported case ruling that the interest must be paid: *Bankers Trust Co. of California, etc. v. Roberta Hall as Guardian of the Person and Property of Jean L. Bogan, et al.*, short form order, Oct. 1, 2002, Sup. Ct., Queens Co., Martin J. Schulman, J., Index No. 6532/98.
8. *See* 3 Bergman on New York Mortgage Foreclosures § 30.07[3], Matthew Bender & Co., Inc. (rev. 2003).
9. *Regency Sav. Bank v. Terry Ross Assocs.*, N.Y.L.J., Nov. 27, 2002, p. 21, col. 4 (Sup. Ct., Queens Co., Price, J.); *LaSalle Nat'l Bank v. Taylor*, Index No. 4604/96. *See Trefoil Capital Corp. v. Creed Taylor, Inc.*, 125 Misc. 2d 152, 479 N.Y.S.2d 308 (1984), *rev'd other grounds*, 121 A.D.2d 874, 504 N.Y.S.2d 112 (1st Dep't 1986). For a more thorough review of this subject, see 3 *Bergman on New York Mortgage Foreclosures*, § 30.05[1][f], Matthew Bender & Co., Inc. (rev. 2003).
10. *Bankers Trust Co. v. Glasser*, N.Y.L.J., Nov. 18, 1998, p. 25 (Dist. Ct., Suffolk Co., Spinner, J.) *See* 3 Bergman on New York Mortgage Foreclosures § 31.10, Matthew Bender & Co., Inc. (rev. 2003).
11. *Bankers Trust Co.*, N.Y.L.J., Nov. 18, 1998, p. 25 (citing *Metropolitan Life Ins. Co. v. Childs Co.*, 230 N.Y. 285 (1920)).
12. *See* 3 Bergman on New York Mortgage Foreclosures § 31.01[6], Matthew Bender & Co., Inc. (rev. 2003).
13. *Gaines v. New York State Div. of Hous. & Community Renewal*, 230 A.D.2d 631, 646 N.Y.S.2d 106 (1st Dep't 1996).
14. N.Y. General Obligations Law § 7-105; *Tischler v. Key One Corp.*, 67 A.D.2d 886, 413 N.Y.S.2d 710 (1st Dep't 1979).
15. *See* 3 Bergman on New York Mortgage Foreclosures § 31.02[4], Matthew Bender & Co., Inc. (rev. 2003).
16. *See* 3 Bergman on New York Mortgage Foreclosures § 31.03[5], Matthew Bender & Co., Inc. (rev. 2003).