What Happens if the Current Crisis Overturns Foreclosure Sales?

The unprecedented media firestorm about possible robo-signing, lack of lender documentation and questionable notarizations (let's call this the latest crisis) has raised the specter of completed foreclosure sales being overturned because of the claimed infirmities. How could this happen as a legal matter and what might it mean as a practical matter?

A recent case in New York (having nothing to do with the current crisis)—*Seidman v. Industrial Recycling Properties Inc.* (2010)—supplies a non-answer answer and leads to discussion of the peril.

How foreclosure sales might be in jeopardy

If a borrower is in default, it will be apparent that the mortgage holder (through its servicer, if applicable) should have the right to foreclose—and it does. Because legislators and courts to some extent have concluded that borrowers—homeowners, at least—are victims of an oppressive system, foreclosures in many judicial foreclosure states (New York prime among them) have become remarkably cumbersome and time-consuming. Unfortunate roadblocks aside, any litigant is absolutely entitled to due process so that foreclosures must assuredly be pursued in accord with the law—obviously.

If a lender's records confirm that a borrower is in default and the sum due is *x* (there should be little doubt about this), that some person on behalf of the lender or servicer attested to a fact about which he or she had no actual knowledge is a practice to be condemned. It can't be done that way, and no one could legitimately argue to the contrary. But that failing, does not change the actuality or the quantum of the default. Nor does a flawed notarization (just as wrong and unacceptable) change the reality.

So if that foreclosure is attacked, the lender would be in a position to properly confirm the default and the sum due and (presumably) preserve the legitimacy of a foreclosure sale under those circumstances.

More troubling, however, are carelessness or deficiencies in confirming that the foreclosing party was the holder of the note and mortgage at the inception of the action—a critical issue.

If the plaintiff did not hold the note and mortgage at the outset, then it had no standing and the action could be declared void. This happened with some regularity in New York before the current contretemps, so such a circumstance may indeed be a basis for lenders' jeopardy. This should still be happening at most in a very small minority of cases.

How might the danger appear?

This is probably more a political than a legal question. The prosecution of a mortgage foreclosure action is an arcane calling, laden with law and procedure—much of it obscure. Even for lawyers it is a treacherous arena, unless they practice it with dedicated regularity. Attorneys who focus upon foreclosures are therefore skeptical when non-practitioners try to become intimately involved with the process.

A very sage, experienced financial expert was recently interviewed on Bloomberg Radio opining about the possible outcome of this latest crisis. If adults are involved, he said, it won't come to much. But if it is in the hands of politicians and the courts (not the needed adults, by his definition), then the final result is pointedly unpredictable. The author of this column shares the same concern.

With attorneys general and various elected officials and regulators possibly believing that borrowers have been hoodwinked by avaricious, oppressive lenders and servicers, it is impossible to say what the fate of completed home loan foreclosures will be. It may (or may not) depend upon the nature of the miscue, as reviewed earlier.

The threat that foreclosure sales may be sundered is a manifest danger to mortgage lenders and servicers. But the problem has a parlous hidden component as well. If a foreclosure title is subject to extinguishment, title companies will at least be reluctant to insure; and if a foreclosure title is uninsurable, it devalues the property. At the same time, it will discourage more than a few bidders, constraining lenders to take back even more properties.

What does the law say?

As a general rule (in New York), a third-party purchaser at a foreclosure sale is a *bona fide* purchaser for value. Even if the purchaser knew that a foreclosure action was on appeal, it does not change his character. The sale is thus inviolate and cannot be overturned; that is, the purchaser (the foreclosure-sale bidder, now owner) retains his title (see *Aubrey Equities Inc. v. Goldberg*(1998). (For readers delving more deeply into the legal aspects, for nuances on this see *Marcus Dairy v. Jacene Realty Corp.* [2002].)

The new case

Because the law is clear that a foreclosure-sale purchaser is likely to retain his title, should a foreclosure sale be successfully assaulted for some claimed shortcoming, what would be the practical result? The property is still gone—so then what?

Here is what happened in the recent case and its result.

A (private) lender began a foreclosure for claimed failure to maintain insurance. (Major servicers do not often foreclose for such a breach, but it is authorized in standard mortgage provisions.) The borrower opposed the foreclosure. (The basis for the opposition, not critical to our exploration, was that the lender was obliged to first apply to and be turned down for insurance by two carriers.) The trial court agreed with the lender, ruling that it had fulfilled its obligations, and therefore allowed the action to proceed. The borrower appealed, but because no stay was procured, the action proceeded to foreclosure sale and was purchased by a third party.

It was only *after* the sale that the appeals court reversed, ruled that the lender had not met a condition precedent (as to the two insurance carriers), and thereby dismissed the foreclosure complaint—again, subsequent to the sale of the property by the foreclosure referee.

Because the mortgaged property itself was gone, the remedy imposed was to send the case back to the trial court to determine the interest—if any—of the borrower in the proceeds of the sale (those proceeds to be held in escrow).

It can now be recognized why this resolution is, in the end, only partly enlightening. We know that the borrower in this case had a claim. We know the property was sold, so that it is instructive to rule that the borrower's claim now attached to the sale proceeds. (If the lender had been the bidder, then the property would revert to the borrower and the foreclosure would go back to some intermediate stage or need to be begun anew.)

But the court did not characterize or measure what interest the borrower might have in the proceeds. It was, and remains, an open question. If the lender was paid in full, it is satisfied and the borrower is relieved of its monetary obligation—except that the borrower no longer has the property, so it has been damaged. How is that to be quantified? The case does not say.

If the sale brought less than full payment to the lender, what claim can the borrower have to the proceeds? It could be readily opined that at least the borrower should not be liable for a deficiency because there never should have been a foreclosure sale.

If the sale generated a surplus, the borrower would have had some ultimate claim to the excess proceeds even without sending the case back to the trial court, so no wisdom emerges on that aspect.

Conclusion

The law advises us only to a limited extent.

Most foreclosures should not be subject to being vacated. Such is the view from here, but what will actually result will remain an imponderable.

If a sale is vacated and the lender was the bidder at the sale, the only question is whether the foreclosure will begin at the beginning or some intermediate stage.

If the property was sold to a third party, we know now that in New York the borrower will have a claim to the proceeds of the sale. What the extent of that claim is, however, remains an open question.

We are now slightly more knowledgeable about this than we were before the new case was decided, but not by much.

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