

# ARE THERE BARGAINS IN BUYING AT FORECLOSURE SALES?

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To immediately answer the question posed in the title, "yes, sometimes," but perhaps more often than might be expected, "no."

So many of those late night cable shows inviting *everyone* to get rich in real estate promise that a world of profit awaits the buyer at foreclosure sales. Because that seductive entreaty can be true on occasion, one must be careful in debunking the concept. But the truth is that garnering the trove of riches available from time to time on the steps of the courthouse requires some considerable foresight and expertise to astutely glean when those genuine bargains exist. For the prospective millionaire not thoroughly familiar with the nuances, the courthouse steps can quickly turn to quicksand.

Underscoring the need to be a knowledgeable bidder is an understanding of why the windfalls tend to be somewhat rare. When lenders make mortgage loans, whether or not they are relying upon the credit of the bor-

rower, they are looking for an equity cushion. In other words, the amount of money loaned cannot exceed a set percentage of the appraised value of the property.

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Although lending policies vary widely, most banks will not make a mortgage loan for more than eighty percent of the appraised value. Many will not go beyond

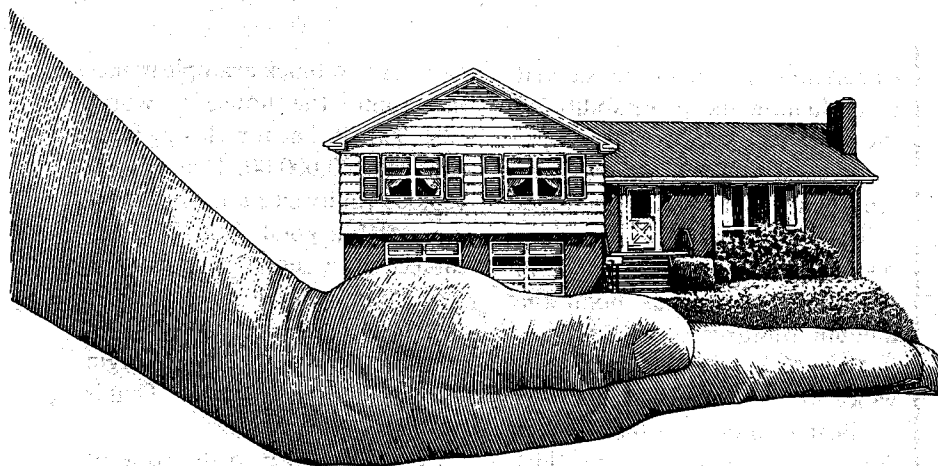
seventy or seventy-five percent.

## A Science and an Art

Because real estate appraising is a combination of science and art, there is always room for variation in interpretation. Possibly generous appraisals were not much of a problem up to the time of the stock market crash in 1987 because real estate values were escalating so wildly. Whatever the extent of an overly optimistic appraisal in 1985 or 1986 would more than be made up by almost instantaneous increases in the value of the property.

Precipitous declines in values, though, after the real estate market peaked in late 1987 meant that for many properties, the amount due on mortgages was either dangerously close to or greater than the value of the property securing the loan. When that happened, buying *that* property at a foreclosure sale can't be a prudent purchase.

That a property even reaches a foreclosure sale most often sug-



gests that it is *not* a bargain. This, in turn, requires a familiarity with some other basic concepts. The moment a mortgage loan is in default, and when that default leads to a foreclosure action, ultimate loss of ownership can occur. The owner then recognizes, or should realize, that unless *something* is done, the property will be lost. Other than working something out with the lender to reduce the interest rate on the loan or extend its term, which if successfully pursued means there won't be a foreclosure sale to even contemplate, there are only two things an owner-borrower can do. He can either refinance the loan or sell the property.

### The Equity Cushion

Another lender, however, cannot be enticed to give a new mortgage loan unless a favorable equity cushion still exists. If market conditions have eroded or eliminated that margin of equity, refinance won't be possible. Therefore, if the *owner* can't extricate himself from the dilemma through refinance, this immediately suggests that such a property coming up for sale at a foreclosure is probably not a good deal.

A like analysis applies to a sale. Suppose, for example, someone wanted to buy a house for \$300,000.00. Assume that a bank would loan up to eighty percent of value and accordingly gave a mortgage of \$240,000.00. All

other things being equal, an owner subjected to foreclosure who will lose everything should in theory be able to sell that house for its full worth. The lender would then be paid \$240,000.00 (ignoring the accrual of interest and other charges associated with a default) and the owner would recoup the equity of \$60,000.00. To sell quickly, the owner could consider reducing the selling price to \$290,000.00, or even \$270,000.00, and still emerge with some money.

If the numbers would allow such a sale, presumably it would occur. Then, this property would never reach the point of a foreclosure sale. But if it is foreclosed, it again suggests that the equity is not there and equity is what the bidder at a foreclosure sale is buying. This recited scenario urges that the properties offered at foreclosure sales may not be so fertile for purchase.

### The Formula in Reverse

There is, though, a reverse to the formula. Although it should be obvious to a borrower how he can save himself, not every situation is rationally approached—for a broad variety of sometimes inexplicable reasons. For example, couples involved in an acrimonious divorce can be in such a bitter contest that they simply can't agree to sell or refinance. Sometimes, an unsophisticated, infirm, or ill-advised owner is simply unable to effectively face

the situation. On some occasions, the trauma of a foreclosure is such that the owner simply refuses to contemplate remedial action. Whatever the reason—and there are others—it is true that equity does remain in some properties which arrive at foreclosure sale.

Assuming that there *might* be value in a property to be auctioned at a foreclosure sale, the prospective bidder must be in a position to assess that value in order to know what to bid. This leads to further considerations.

Lenders typically (but not always) will bid at the foreclosure sale up to the amount they are owed. It therefore behooves someone intending to bid to determine in advance what that sum is. A call to the lender's attorney will usually bring a response. Then, the bidder must ascertain the value of that property in that neighborhood. If the lender is owed \$200,000.00 and will bid up to that amount, a property worth \$205,000.00 is no bargain.

That a lender holds a mortgage is not the same as owning the property. Consequently, only the occupants of the premises can afford entry to a prospective purchaser. Although it is clearly in the best interest of an owner to let you in to see the house, most often they won't allow it. Since the condition of the house inside can greatly affect its value, an outside view alone may render a determination of worth quite tenuous.

### Know Your Market

Even assuming a would-be purchaser is thoroughly versed in local values, and has gained access so that the estimate of value is truly accurate, further familiarity with the market is essential. But then, how long will it take to sell that house? Whatever the purchase price at the foreclosure sale was, money has a cost. Interest on the amount paid to buy is lost until the property is resold. This

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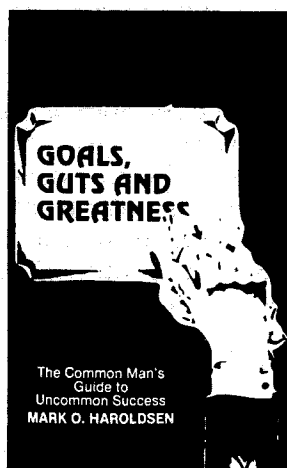
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calculation should be considered in evaluating the profitability of the transaction.

Related to this duration is the requirement that real estate taxes will accrue during the period of ownership. How critical this is in the equation depends upon the amount of taxes on the property—a vital fact to determine in advance.

Bear in mind too that not infrequently the defaulting borrowers, or their tenants, friends or relatives who may be in occupancy, will not voluntarily vacate the premises after the foreclosure sale. In that instance, the foreclosure sale purchaser must engage an attorney to effectuate an eviction. That costs money and can take months to achieve. This is yet another cost factor to consider.

### Terms of Sale

Even having satisfactorily disposed of all these points, there remain important technical considerations about the bidding process to understand. At the sale, the referee will in most states read what are called "terms of sale." These terms are in essence the contract which the bidder must sign. Almost invariably, the purchase is on an all cash basis. It is *not* subject to obtaining a mortgage to complete the purchase. The referee or auctioneer *might* give you time to get a mortgage, but you can't count on it. The closing is typically scheduled for thirty days after the auction sale and that is not much time to place financing.

This "contract" will recite those legal interests which continue to encumber the property. For example, there could be prior mortgages and judgments which survive the sale. Normally, the *amount* due on these prior interests will not be disclosed in the terms of the sale. So, if there is, for example, a prior mortgage, you must know what is due on that

mortgage. A quick example makes the point, the house is worth \$260,000.00. The foreclosing bank is owed \$200,000.00. That leaves a \$60,000 equity cushion which may make this a good deal. But it is subject to a senior mortgage of \$55,000.00 which is no doubt why the owner could not sell or refinance. *Now*, the actual margin of equity is only \$5,000.00. That is not a prudent purchase.

Finally, return to the issue of real estate taxes. In some jurisdictions, the property cannot be sold subject to taxes. That means that any real estate taxes which are a lien of record will already be in the sum bid and will be paid out of the proceeds. Elsewhere, however, the property *can* be sold subject to taxes. Most astute lenders will do it just that way. Therefore, a bidder is well advised to search the records and find out the amount of those taxes. It could definitely affect the wisdom of the purchase.

### An Educated Consumer

In summary, the "get rich quick" pitch of the foreclosure sale is not so pervasively easy. You must know what you are doing. You should have the advice of counsel who is thoroughly versed in real estate titles, and preferably foreclosure as well.

Bargains *do* exist. There *is* money to be made in buying foreclosures. The trick is to know which properties those really are. Yes, an educated consumer may indeed be the best customer. [FFR]

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