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Foreclosure Shortfalls

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Several years ago, in *Aplanalp v Forte* (1990) 225 CA3d 609, 275 CR 144, some sellers were hit hard by the antideficiency rules. The buyers sued the sellers for fraud and stopped paying on their note, but while the fraud action was pending, the buyers obtained an injunction against the sellers' foreclosure. The fraud case ended successfully for the buyers, although the $96,000 the buyers recovered almost equaled the amount due on the sellers' note. Blithely unaware of the pitfalls (as most of us would have been), the sellers' attorney successfully moved to offset the fraud damages against the note arrearages, and then foreclosed on the $700,000 debt.

The court of appeal held that the sellers' equitable offset was an action; therefore, under the one-action rule (CCP §726), no further relief was available. The result: The sellers lost their security (and presumably their debt). Their $100,000 offset cost them nearly $700,000.

This year it was déja vu all over again. In *Birman v Loeb* (1998) 64 CA4th 502, 75 CR2d 294 (reported at p 147), the buyers sued the sellers for fraud and enjoined the foreclosure during the lawsuit. The sellers were held liable for fraud, resulting in a setoff of $1 million against the sellers' $4 million note. The sellers then foreclosed.

This time, however, there were procedural differences. The *Birman* judgment was a peculiar one: Instead of awarding $1 million in damages to the buyers, the trial court reduced the principal amount of their note by $1 million (from $4 million to $3 million) and then increased the principal by $665,000 in unpaid interest, bringing the principal amount of the note to $3.6 million. At the same time, the court awarded the buyers over $300,000 in attorney fees but did not add that award to the principal of the note. It remained an independent judgment in favor of the buyers.

Thereafter, the buyers made no payments on the note, so the sellers conducted a trustee sale, credit bidding $2 million against the (by now) $4.2 million they were owed. This left a shortfall of $2.2 million (a true shortfall, apparently, because both sides seemed to agree that the property was worth no more than the amount bid).

Shortfall versus Deficiency

A shortfall—even a true one—is not the same as a deficiency judgment. Even if the sellers could have shown that the property's value was only $2 million, no deficiency judgment could have been obtained because the debt was purchase money (CCP §580b) and the foreclosure sale was nonjudicial (CCP §580d). But if a deficiency judgment was barred, did that prohibit the shortfall from being used as an offset against the buyers' $300,000 judgment for attorney fees?

The trial court granted the offset, and I probably would have done the same. Attorneys always hope that foreclosure losses, even if not convertible into deficiency judgments, could fall under the general principles of offsetting debts. See Crocker, *Beneficiary's Underbid a Neglected Tool*, 44 LA Bar Bull 295 (May 1969); see also Johnson & Smith, *The Case Against the Full Value Bid*, 12 CEB RPLR 141 (July 1989).

Elusive Offsets

That hope seems forlorn. The *Birman* court rejected the offset while acknowledging that the general policy of compensating offsetting claims is independent of whether the claims are secured or unsecured. Because an offset, if permitted, allows the creditor to recover something more than the security's value, the policy considerations underlying CCP §580b prohibit it, even though the offset is clearly neither (1) a deficiency judgment (it is not measured the same way

and does not impose personal liability on the debtor), nor (2) a violation of the one-action rule (the previous trustee sale was nonjudicial). For purposes of CCP §580b, it seems that "deficiency judgment" means anything of economic value over and above the value of the security.

Birman's logic may not be persuasive, but it is now the rule to be followed. Moreover, the rule that an "unsecured, unenforceable" claim is not a mutual obligation that can be used as an offset probably applies to CCP §580d as well as CCP §580b. Thus, secured non-purchase money creditors who are held liable in some manner to the debtor can claim an offset only if they first obtain a collectible deficiency judgment. That is, they must (1) judicially foreclose; (2) underbid at the foreclosure (*i.e.,* bid less than they are owed); and (3) prevail at a fair value hearing. Failure to take all three steps probably leads, as in *Birman*, to a claim that cannot be offset.

Foreclosures and Offsets

The unpaid creditor who faces potential liability exposure has a tortuous path to follow. It may not seem worth the ordeal of proceeding with a judicial foreclosure and awaiting the expiration of the postsale redemption period merely to forestall the possibility of being sued. But a trustee sale, even if undertaken by a non-purchase money creditor and concluded by a justifiable underbid, ends the chance of offset protection.

Furthermore, there are timing problems. The creditor should foreclose quickly in order to obtain a deficiency judgment in case an offset is ever needed. *Aplanalp* showed how dangerous a preforeclosure offset can be. Both *Aplanalp* and *Birman*, however, granted injunctions to defaulting buyers, which postponed the sellers' foreclosures until the fraud claims were resolved. How does the seller stay execution by the buyer for as long as it takes to create a deficiency judgment and offset?

Finally, there are accounting problems. Buyers can request an offset much earlier than sellers can, because their recovery can be applied against the note balance before the sellers obtain a deficiency judgment (as seems to have been the case in *Birman*). But there are complications: If buyers owe $1 million on their note but recover $100,000 in damages and claim an offset, should they be given an immediate credit for the next $100,000 of payments ("off the top") or should they continue to make the payments when and as due under the note until the remaining $900,000 is paid ("off the bottom"), or what? (In effect, the *Birman* trial court gave the buyers $665,000 of payment-free possession during the trial; by adding unpaid interest to the note while reducing the principal sum by the amount of the fraud liability, however, the court seems to have taken the offset "out of the middle.")

One week after the *Aplanalp* decision, the California Supreme Court held in *Security Pac. Nat'l Bank v Wozab* (1990) 51 C3d 991, 275 CR 201, that debt forfeiture was too "draconian" a sanction for violating the one-action rule. Although the facts in *Wozab* were significantly different (a self-help nonjudicial offset by a bank), there was some reason to think that the courts might soften the *Aplanalp* sanction in later cases. In some ways that did in fact happen. The secured sellers in *Birman* "lost" only $300,000 because of the court's generous reading of CCP §580b. Although they did "lose" $2.2 million on the loan, recovery of that loss was clearly barred by CCP §580b. The court could have held that the sellers had lost their security entirely by the offset of their fraud liability against their secured debt and allowed the buyers to keep the property. In terms of what might have been, under California's imaginative foreclosure rules, the sellers in *Birman* almost made out like bandits!