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Title Insurance and Foreclosure: What Type of Title Coverage do Lenders Need in Connection with a Foreclosure in California?

By Robin Freeman and Mark Mengelberg

With mortgage defaults on the rise, a growing number of lenders are being forced to foreclose on their collateral, either judicially or non-judicially, exercising the private power of sale. Once a lender determines that it must take title to the property securing the loan, it is important that the lender understand what title coverage it has and needs during and after the foreclosure process. What protection does a Trustee Sale Guaranty and/or Litigation Guaranty provide the lender? Does the lender's current Lender's Title Policy provide it with sufficient protection, or does the lender want to obtain a new Owner's Title Policy? The following is a description of the title protection that a Trustee Sale Guaranty and Litigation Guaranty provide a California lender and a brief discussion of the factors to consider when deciding whether to obtain an Owner's Title Policy after a foreclosure sale.

Trustee Sale Guaranty/ Litigation Guaranty—An Assurance, Not Insurance

One of the first decisions a California lender must make after deciding to foreclose is whether to do so judicially or non-judicially (i.e. a trustee's sale). If the lender takes the non-judicial foreclosure route, it should purchase a Trustee's Sale Guaranty from a title

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One Deed of Trust and Several Obligations: The Case for Layered Foreclosure in California

By J. Dean Heller

In California, deeds of trust are a common and generally effective means of securing debt and other payment obligations. While the "one form of action" requirement of Section 726 of the Code of Civil Procedure (with its judicially created corollary rule that a creditor must resort to its "security first") and the anti-deficiency provision of Section 580d of the Code of Civil Procedure severely limit the enforcement options of a real estate secured creditor, the ease and efficiency of non-judicial foreclosure under California law seems a more than fair exchange for the loss of other remedies.

Yet this balance can tilt dramatically when the payment obligations secured are not readily susceptible to acceleration: that is, of being reduced to a single sum certain that can be enforced all at once. Use of real estate to secure non-accelerable or contingent, serial obligations, such as rent payments or indemnification obligations, can easily lead the creditor to a Hobson's choice, between immediate enforcement of a currently due payment at the pain of forfeiting the balance of the secured obligation, or a long-delayed recovery of the whole.

The obvious solution to this problem—and to similar dilemmas where one deed of trust secures multiple obligations held by multiple creditors—would be to permit serial foreclosures, in which one undivided "layer" of the real estate collateral could be sold to recover amount(s) currently due without disturbing the lien on the whole property securing future payment obligations. As a matter of modern practice, though, this type of layered foreclosure never occurs and, from the lack of any attention paid to such a remedy, one can infer that most California practitioners regard it as impermissible (if they consider it all).

In fact, precedents exist for exactly this kind of a partial foreclosure: old, but never rejected. There is also a long-ignored statute—Section 728 of the Code of Civil Procedure—that without great strain can be read to authorize layered foreclosures. This article reviews the arguments, legal and practical, for and against a contemporary revival of such a remedy, and shows how it could be usefully applied in situations involving modern structured real estate financings, where the mortgage debt is held by a Real Estate Mortgage Investment Conduit.

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Q&A with David Reiner, Managing Director, Grosvenor Investment Management US, Inc. *By Ronald Gart*

David B. Reiner is the Managing Director of Grosvenor Investment Management US, Inc. (GIM), is responsible for the development and implementation of GIM's business strategy, capital markets activities, fund and investment development, fund raising, fund operations, and investor relations. He also is Co-Manager of Grosvenor Residential Investment Partners I, L.P. (GRIP), a fund that invests in the U.S. homebuilding industry.

What is your outlook for the real estate investment market in the coming year?

We generally believe that the real estate market across most sectors will continue to improve along with the economy. Traditional debt is becoming more available as more participants have entered the market. We are even starting to see a renewed CMBS market beginning to gain traction. There are still risks, however, in this business. There is a huge amount of CMBS-related mortgage coming due in the next few years, and there are real questions as to how that will be dealt with. In addition, the number of CMBS mortgages being referred to special servicing has increased.

What types of investments is Grosvenor Investment Management targeting?

We are focusing on the residential market, both rental apartments and "for sale." On the apartment side, a shortage of new apartment construction combined with demographic trends have driven down vacancies and driven up rents in many key markets. Adding to this is the growing number of foreclosures nationwide and the difficulty in qualifying for mortgages, which in turn is driving down the national homeownership rate and creating many new renters. We like apartment development in particular; we want to create Class A product that will attract the best renters and core asset buyers, thus creating our exit strategy.

Why are you bullish on "for sale" residential?

We are finding that many of the same forces propelling the demand for rental apartments also are increasing demand for for-sale residential product. These trends include a stable growing economy, new household creation, and absorption of existing product. In addition, there has been a nationwide re-pricing of virtually all for-sale housing assets, including existing homes, finished lots, and residential land. At the same time, there is a huge shortage of organized capital focused on the industry. These trends are creating some very attractive opportunities.

Many leading analysts believe that the for-sale market will bottom out nationally in 2011. Several early-to-recover markets already have bottomed out and are now stabilized; some are even seeing price increases. These markets include greater Washington, D.C., several Texas metros, Seattle, and parts of southern California. On the other hand, other markets will continue to face major challenges, such as many parts of Florida, Arizona, and Nevada.

Over the past 13 months, GIM has made 11 separate investments across the country in the for-sale residential market. We believe that this sector is starting to find its legs, but continues to be capital-starved. This situation provides our fund with very attractive returns, while enabling our local partners to pursue their projects profitably.

What did you see in 2009 that convinced you to launch a for-sale housing fund when the market was crashing?

Actually, we began planning the fund, Grosvenor Residential Investment Partners I, LP (GRIP), as far back as 2005, with the original investment strategy focused on creating new inventory of entitled land, finished lots, and new homes inventory to satisfy the nation's apparently insatiable demand for new homes. GRIP planned to target the fastest-growing metro areas that were setting records for home deliveries driven by growing populations and investor demand.

In 2007, we closed on the fund, which is co-sponsored by GIM and Key Fund Management Group. But then the market began to deteriorate rapidly, and the GRIP acquisitions team was unable to find suitable investments. Underwriting quickly recognized that home prices were rapidly falling, while land owners were still holding to their asking prices. This caused margins to be compressed, which produced low returns on investments.

So then what happened?

It was not a pleasant time to be an investment manager entrusted with $100 million that was not being deployed. During 2008, the GRIP team conducted a thorough review of the housing market and GRIP's strategy in order to determine whether the strategy should be changed or even if the fund should be discontinued. We decided to adapt the fund's strategy to the new market realities. We narrowed the fund's geographic strategy to about a dozen "first to recover" markets including Washington, DC, Seattle, Philadelphia, Dallas, Houston, Portland, Los Angeles and San Diego. Within these markets, we targeted infill locations, which are better protected from new home competition and have less exposure to foreclosures and distressed sales. We shifted from being a creator of new inventory to acquiring existing inventory at big discounts to original cost, primarily by acquiring distressed partially completed projects—mostly from financial institutions—and repositioning them to fit current market conditions, working with surviving builders and developers that offer strong market expertise. In addition, the fund shifted from being a mezzanine lender to a senior lender to fill the void of senior debt in the market, while preserving projected returns.

Are you seeing more foreign investment? Which foreign investors are the "next big thing" likely to make substantial investments in US real estate?

Many foreign investors, including European pension funds and funds backed by retail investors, have targeted the U.S. for investment in 2011-2012. We also expect many of the world's sovereign funds, including those from the Middle East and Asia, to redirect capital to the U.S. I think that foreign investors tend to believe the U.S. is beginning to recover economically, and given the turmoil all over the world, the U.S. remains a safe haven with a large and deep real estate market.

What is your perspective on the CMBS market, what will change?

The CMBS market is clearly gaining some momentum. Estimates for 2011 issuance range from $25 billion to $40 billion, up significantly from $3.5 billion in 2009 but still a far cry from the 2007 peak of $240 billion. The recent wave of activity is being hailed by many as "CMBS 2.0" due to new structural features and more stringent underwriting standards. Lenders are aiming for lower LTV's and higher DSCR's in pools with mortgages on fewer properties. But, as on the core side, there is a lot of capital chasing a relatively small number of top-tier assets and, as market fundamentals improve, there will be increased competition to loan, notably from insurance companies and the GSE's. The question going forward is, in a competitive yield-chasing environment, how long will the modified underwriting standards of CMBS 2.0 last?

What do you see as the changing needs and desires of institutional investors? For example, managed accounts, niche investments?

Many institutional investors have expressed a desire to invest through separate accounts and club-type funds, as opposed to commingled, closed-end vehicles with 10-20 other Limited Partner funds. They want more discretion and control over investment decisions and strategy and are also demanding more attention and direct communication from their General Partners. As a result, they are putting downward pressure on certain types of fees and requesting more favorable governance features in their funds and accounts. Another trend we're seeing is investors wanting to invest with fewer GPs—essentially preferring larger relationships with a smaller number of managers. That said, there does not seem to be as much interest in the "mega-fund" asset-allocation vehicles which have been prominent in recent years. Many investors are targeting more focused strategies with "best-in-class" managers in specific sectors. There are over 400 funds in the market at the moment so investors and their consultants certainly have a lot to choose from.

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insurance company and if it decides to foreclose judicially, it should purchase a Litigation Guaranty from a title insurance company. The purpose of the guaranties is not to provide title insurance. Rather it provides assurance to the foreclosing party that the proper parties are being provided notice with respect to the sale. The Trustee's Sale Guaranty provides assurances to the trustee of the name of the vested owner of the property and the proper posting, recording and mailing of the notices in the foreclosure process (Cal. Civ. Code §2924(b)). The Litigation Guaranty provides assurances to lender's counsel of all possible interest holders or claimants who might be proper defendants to the judicial foreclosure litigation. The failure to properly notify these parties will invalidate the sale. Both the Litigation Guaranty and the Trustee Sale Guaranty must purchased at the commencement of the foreclosure process before, in the case of a non-judicial foreclosure, recording the notice of default and, in the case of the judicial foreclosure, filing the judicial foreclosure action.

In some situations, a lender will want to proceed under both a non-judicial and judicial course of action if it has not decided whether to try and seek a deficiency judgment against the borrower (in California, deficiency judgments are only allowed following a judicial foreclosure). In that case, it would behoove the lender to request that the title company give the lender a pricing package which provides the lender with a reduced rate for both the Trustee's Sale Guaranty and Litigation Guaranty, thereby making it feasible to purchase the dual-track guaranties.

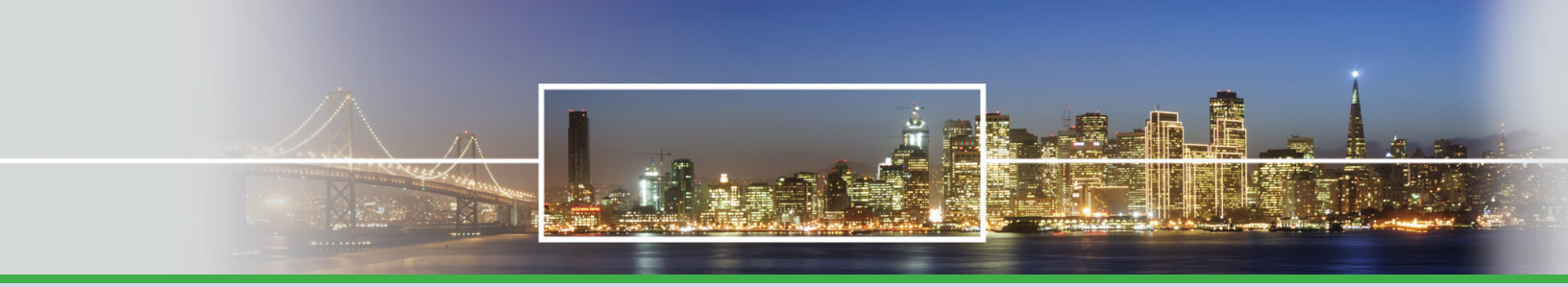
In many instances, though, the lender will commence both a non-judicial and judicial course of action even though it knows, at the onset, that it only intends to foreclose non-judicially to avoid the time and expense of litigation. The reason for filing the judicial foreclosure action in these instances is that the lender wants to have a receiver appointed to protect its collateral during the non-judicial foreclosure process, and this requires a judicial process such as judicial foreclosure (in California, the lender can pursue both paths and not elect its remedy until the last moments). Since the lender has no intent of pursuing a judicial foreclosure, there is no need for a Litigation Guaranty and the lender need only purchase the Trustee Sale Guaranty. However, in instances where the lender wants to start a non-judicial foreclosure action that it does not intend on pursuing (e.g., in order to gain negotiating leverage over a borrower), the lender will still need to purchase a Trustee's Sale Guaranty because title companies will likely refuse to even commence a non-judicial foreclosure without a Trustee's Sale Guaranty.

Is the Lender's Policy Sufficient?

Once the lender forecloses (assuming it is the entity that purchases the property at the foreclosure sale) the lender must decide whether its existing Lender's Title Policy will be sufficient title coverage after it takes title to the property or whether it should purchase a new Owner's Title Policy. The Lender's Title Policy stays in effect once title is transferred to the lender, but although the lender has title coverage, the title coverage differs from that of a new Owner's Policy in two ways.

The first difference lies in the measure of damages. It must be remembered that the original Lender's Title Policy remains a Lender's Title Policy; it continues to insure the lender (now property owner) in the original loan amount. Further, the measure of damages under a Lender's Title Policy is generally the lesser of the policy limits and the balance of the loan. Since the loss under a title insurance policy is measured by the diminution of value to the property, it is only when that value has eaten up all the unencumbered equity in the property that the loss begins to affect the loan portion. Too much equity-over-loan amount would bode poorly for the insured. So, in an appreciating market, the existing coverage under the continuing Lender's Title Policy might be insufficient to protect the lender in the event of a title claim. Let's take the example of a purchase money mortgage. A borrower buys property in 2002 for $100 million and takes out a loan to finance that purchase in the amount of $75 million. The lender then gets a Lender's Title Policy in the amount of $75 million. In 2006, the borrower defaults on the loan and the lender is forced to foreclose and take title to the property. If by the time of the foreclosure, the borrower had paid down its loan to $60 million and the property value has appreciated to $125 million, the Lender's Title Policy would insure the lender for up to $60 million (the lesser of the policy limits and loan balance). In 2008, a $30 million title issue is discovered. In this case, the Lender's Title Policy would provide the lender with no coverage for the title claim since the $30 million title problem would still leave the lender with property valued at $95 million, well over the amount of the $60 million coverage. If the lender had purchased an Owner's Title Policy in 2006 it would be covered for the entire amount of the loss. As demonstrated above, in an appreciating market the lender would suffer a loss and its Lender's Title Policy would not provide sufficient title coverage.

In a depreciating market, however, the lender would suffer a smaller loss on the same size claim. Using our example above, if at the time of the $30 million title loss, the property value had decreased to $75 million, then the lender would own a $75



million asset insured for only $60 million. The first $15 million loss in value would not affect the insurance; the title company would cover the lender for $15 million (the first $15 million being loss of equity that is not covered by the policy). Continuing on this analysis, if the property had depreciated to a value below that of the loan balance, any loss would be a covered loss even under the original Lender's Title Policy.

The second difference between the two policies is the date of coverage. The original Lender's Title Policy continues after the foreclosure but the Date of Policy remains as of the date of the loan origination. If a lender relies on its existing Lender's Title Policy, it is not insured for the foreclosure itself. If an issue arises with the foreclosure, the title company will not protect the lender for any loss it suffers as a result of the foreclosure problem because the existing Lender's Title Policy only protects the lender for events that occur prior to the date of issuance of that policy (i.e., matters on record as of the date of the loan origination). For example, if the trustee conducting the trustee's sale makes a procedural mistake during the trustee's sale and the mistake causes the sale to be set aside or invalidated, the lender has no title policy to protect its interest in the property. The lender's recourse in that situation would be to sue the trustee for damages.

The trustee's duties and obligations arise from the deed of trust and by statute. The trustee has a general duty to conduct the foreclosure sale openly and fairly, and failure to do so opens the trustee up to both civil and criminal liability. For instance, California Civil Code Section 2924h(g) makes it unlawful for a person to offer or accept from another consideration not to bid, or to fix or restrain the bidding. Civil Code Section 3333 extends the trustee's liability to all other damages proximately caused by its wrongful conduct, regardless of whether the damages were foreseeable or not. If the lender had an Owner's Title Policy, however, it would have a title claim rather than having to resort to a tort suit against the trustee in order to cover its damages. In addition, in the event the coverage on the Owner's Title Policy is not sufficient to compensate the lender for the damages sustained by the invalidation of the sale, the lender could still sue the trustee for those excess damages. It is important to note, however, that neither the Owner's Title Policy nor a Lender's Title Policy would protect the lender in the event that the procedural mistake during the foreclosure sale was caused by the lender. In that circumstance the lender would have no title protection and they would not be able to sue the trustee for damages.

Conclusion

In addition to determining whether to proceed to foreclose judicially or non-judicially, California lenders must decide whether to obtain a Trustee's Sale Guaranty or a Litigation Guaranty, and whether to obtain a new Owner's Title Policy after the foreclosure sale is completed. Although a lender will have to bear an additional cost, it is important to obtain a Trustee's Sale Guaranty or Litigation Guaranty, whichever is applicable, to assure the lender that it is properly noticing all necessary parties to the foreclosure (and, practically speaking, any lender that wishes to complete a non-judicial foreclosure sale will be required by the foreclosure trustee to purchase the Trustee Sale Guaranty as a condition to that trustee filing the notice of default and conducting the sale). However, the decision of whether to obtain an Owner's Title Policy after foreclosure must be made on a case-by-case basis. As is discussed above, an Owner's Title Policy provides the lender with greater title coverage in the event that the value of the property has appreciated, and it also provides the lender with affirmative coverage that the foreclosure sale was properly conducted, which can be very valuable to the lender particularly when it goes to resell the property.

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Junior Lien Holder Bankruptcy Can Stay The Foreclosure of a Senior Lien

By Richard (RJ) Hamilton

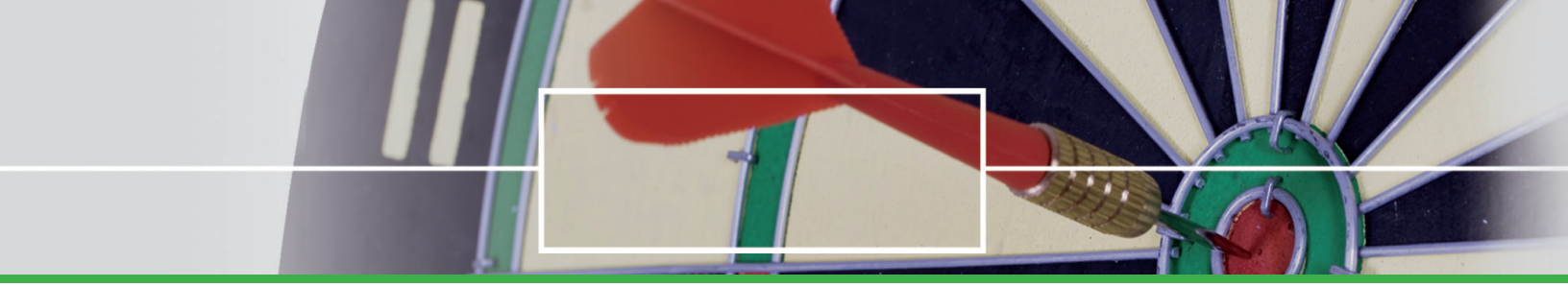
The second priority lien held by a junior lien holder is a property interest sufficient to trigger the protection of the automatic stay. *In re Three Strokes L.P.*, 379 B.R. 804 (Bankr. N.D. Tex. 2008). Inasmuch as a senior lien holder's foreclosure proceedings would have the effect of extinguishing the debtor's second lien interest, a court may only lift the stay and permit the foreclosure to proceed upon such senior lien holder's showing of adequate protection. In other words: the bankruptcy of a junior lien holder can frustrate or prevent a senior lien holder's attempts to foreclose its interest even when the record owner of the property is in default of its loan obligations.

In *Three Strokes*, the real property owner took a development loan from the senior lender in the amount of $28,600,000, evidenced by a note and secured by a first priority mortgage on the property. The senior lien holder entered into a commercially standard intercreditor subordination agreement with a junior lien holder, which held a note from the property owner in the amount of $1,992,643, secured by a second priority mortgage on the property. Subsequently, an appraisal confirmed the as-stabilized value of the property to be only $27,700,000. The property owner thereafter defaulted on its first priority mortgage obligations, which gave rise to the subject foreclosure; the junior lien holder (an entity related to the property owner) declared bankruptcy on the eve of foreclosure.

The senior lien holder argued that the Section 362 automatic stay did not apply to non-judicial foreclosure proceedings commenced pre-petition, or, to the extent that it did, that there was cause to lift the stay pursuant to Section 362(d) and permit the foreclosure to proceed. The court stated that even though the real property was not the property of the debtor/junior lien holder's bankruptcy estate, the second lien interest was in fact a property interest that triggered the automatic stay. The court reasoned that if the foreclosure extinguished the second lien interest, the senior lien holder would have gained "control" over a portion of the debtor/junior lien holder's estate, and, pursuant to Section 362, all entities—not merely creditors—are prohibited from exercising "control" over a debtor's bankruptcy estate. In this case, the court stated, the senior lien holder must petition the court to lift the stay, whereupon the court would evaluate whether the second lien interest has any value (i.e., whether, based on the factual evidence, such as the appraisal, any equity remained to debtor) and whether the second lien interest was necessary to an effective and realistic reorganization of the debtor's estate.

The holding of *Three Strokes* followed earlier holdings in several other jurisdictions and confirmed the prevailing interpretation of Section 362 with respect to the applicability of the automatic stay to senior lien holder foreclosure actions in the context of a junior lien holder bankruptcy, an interpretation ultimately distilled from the broad scope of "property of the estate" under the Bankruptcy Code. For instance, in a case under the prior Bankruptcy Act, the court held that first and second lien mortgage interests constituted "property" of the estate and that a water district tax lien foreclosure could not wipe out either the first priority mortgage or second priority mortgage without permission of the court. *See Florida Institute of Tech. v. Carpenter (In re Westec Corp.)*, 460 F.2d 1139 (5th Cir. 1972). Another court held that the automatic stay in the debtor/junior lien holder's bankruptcy was violated when a senior lien holder accepted a deed in lieu of foreclosure from the trustees under the senior deed of trust, which, according to the court, interfered with the debtor's right of redemption—also property of the estate. *In re Capital Mortgage & Loan, Inc.*, 35 B.R. 967 (Bankr. E.D. Ca. 1983) (citing cases therein). In fact, in a case in which a creditor improperly foreclosed on real property thought to be owned solely by the debtor's non-debtor spouse but was actually community property of both debtor and his non-debtor spouse, the court held that the automatic stay provisions even reached property of uncertain ownership or status (*i.e.*, "arguable" property). *In re Chestnut*, 422 F.3d 298 (5th Cir. 2005).

Three Stokes confirms the prevailing approach that the "property" of the debtor's estate is broad in scope, encompassing even security interests in real property not owned by the debtor. In the context of the bankruptcy of a junior lien holder, a senior lien holder's attempts to foreclosure its interest in the underlying real property may be frustrated or prevented—even when the record owner of the encumbered property is in default but has not sought the protection of the bankruptcy court.



Mortgage Foreclosure as A Voidable Preference

By Joseph Manello

Prior to the 1984 Amendments to the Bankruptcy Code[1] (BAFJA), there was a split as to whether a transfer of title to real estate by virtue of a mortgage foreclosure constituted a transfer as defined in §101 of the Bankruptcy Code.[2, 3] However, BAFJA made it clear that a "transfer" included "the foreclosure of a debtor's equity of redemption."[4] This change in definition has a significant impact on the application of both §547 (preference) and §548 (fraudulent transfer).

Although *Durett* was decided before the enactment of BAFJA, its safe harbor of 70% of fair market to avoid the application of §548 was often followed by lenders when pursuing foreclosure. The issue, however, was seemingly resolved with finality by the Supreme Court's decision in *BFP v. RTC*.[5] In *BFP*, the court, Scalia, J., held (5 to 4) that for the purposes of determining "reasonably equivalent value" as that term is used in §548, the "price in fact received at the foreclosure sale so long as all of the requirements of the State's foreclosure law had been complied with" is "reasonably equivalent value."[6]

Thus, an action under §548 to avoid a regularly conducted mortgage foreclosure sale is generally foreclosed by the holding in BFP. Many state adoptions of the Uniform Fraudulent Transfer Act defined "reasonably equivalent value" to include the acquisition of property at a regularly conducted mortgage foreclosure sale.[7]

However, if the mortgage foreclosure sale took place within 90 days of the commencement of a bankruptcy proceeding by or against the mortgagor, a recovery may be possible as a preference under §547. A recent case highlighting this issue is *In re Gregorio Villarreal*.[8] In *Villarreal*, the debtor granted a third mortgage on a parcel of real estate to secure a debt of $70,000. The two prior mortgages secured debts aggregating $750,000. Debtor defaulted. Mortgagee bid in for the amount of the third mortgage debt. The foreclosure took place within 90 days of the commencement of the Chapter 13 proceeding. The debtor brought an adversary proceeding to avoid the transfer as a preference. The court found the fair market value of the real estate to be $4,020,000. The court held that the creditor had received $3,250,000 by reason of the transfer, and this was more than the creditor would have received in the Chapter 7 liquidation, and therefore the foreclosure was voidable as a preference under §547.

There are cases, however, which refuse to apply §547 to the mortgage foreclosure on two different grounds:

1. Applying the thinking of the court in *BFP* that the Bankruptcy Code, absent a clear and manifest purpose, should not be used to upset State regulation of real estate transactions.[9]
2. In a regularly conducted sale, the creditor who bids in does not receive "more" in his status as a creditor but may receive more on a subsequent resale. Had the bidder been a third party, there could be no contention that a preference was received. The mortgagee should be in no worse position than the third party purchaser. [10]

Clearly, the matter is not free from doubt and it does not take a totally egregious difference between fair market value and the mortgagee's bid at foreclosure to result in a claim that a preference has been received.

[1] Bankruptcy Amendment and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 STATS 333.

[2] Hereafter references to "§" only will be to sections of the Bankruptcy Code. 11 UCC § 101, et seq.

[3] Cf; Durett v. Washington Nat. Ins. Co., 621 F.2d 201 (5th Cir., 1980) and In re Hulm, 738 F.2d 323 (8th Cir., 1984) [Foreclosure was a transfer]; In re Madrid, 725 F.2d 1197 (9th Cir., 1984) and In re Winshall Settlor's Trust, 758 F.2d 1136 (6th Cir., 1985) [Foreclosure not a transfer].

[4] *See 11 USC § 101 (54) (c).*

[5] *BFP, Petitioners v. Resolution Trust Corporation, as Receiver of Imperial Federal Savings Association, et al., 511 U.S. 531, 114 S. Ct. 1757, 128 L. Ed. 2d 556 (1994).*

[6] 511 U.S. 531 at 545.

[7] See MGL c. 109 A § 4 (b).

[8] *413 B.R. 633 (Bkptcy, S.D. Tex., 2009).*

[9] *In re FIBSA Forwarding, Inc., 230 B.R. 334 (Bkptcy, S.D. Tex., 1999); In re Pulcini, 261 B.R. 836 (Bkptcy, W.D. PA, 2001).*

[10] *In re Ehring, 900 F.2d 184 (9th Cir., 1990).*

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The Vanishing Security Interest

Non-lawyers—and lawyers unversed in the complexities of enforcing deeds of trust and mortgages—sometimes hit upon the idea of securing a non-accelerable set of payment obligations with real estate. In one instance, for example, the seller of a company retained ownership of the company's manufacturing site and after the sale the company leased the property from the seller. Wanting something more than just a landlord's remedies for breach of lease, the seller insisted that the buyer pledge other real estate as security for rent payments.

What the seller and his counsel failed to consider was that, under California (and most other state) laws, a landlord cannot accelerate a tenant's rent obligation. Under the statutory provisions governing enforcement of California deeds of trust, were the tenant to stop paying rent or otherwise default in a payment obligation under the lease, the landlord would appear to have three legal alternatives, which might be properly called "worst, worse and bad."

Immediate Foreclosure on Breach by Tenant

Plainly the worst alternative would be for the landlord to seek prompt and (relatively) cheap relief, through a trustee's sale of the real property collateral under California Civil Code Section 2924. After the so-called non-judicial foreclosure sale has occurred, the tenant (or, more likely, a related party) could purchase the property by paying the delinquent rent installment, plus interests and foreclosure costs. The deed of trust has now been discharged, leaving future rent payments unsecured. But that is the lesser part of the disastrous result. Under Section 580d of the California Civil Code, the seller, having foreclosed non-judicially, is barred from bringing any further action to collect rent; Section 726 of the California Code of Civil Procedure—the "one action rule"—will probably bar any other action (such as unlawful detainer) to enforce the lease. The tenant, at the cost of a few months' rent and foreclosure expenses, also has obtained a rent-free lease of the property for the rest of the lease term.

Foreclosure on Expiration of Lease

The second alternative—waiting until the lease expires to foreclose—does not lead to such a disastrous result, but for a long-term lease it may mean years in which when the landlord is unable to collect rent. Having secured the rent obligation with real property, the landlord is barred by Section 726 from bringing any action on the obligation other than a suit for foreclosure and, thus, has cut himself off from other legal remedies, such as a breach of contract action to recover rent. And even though a judicial foreclosure (as opposed to a non-judicial trustee's sale) does not trigger Civil Code Section 580d, unless the property lends itself to piecemeal foreclosure (see discussion of Civil Procedure Code Section 726, below), it will preclude the landlord from bringing any further action on the rent payment obligation, which is why the landlord must wait until the lease term has almost ended to have an enforceable right to recover all that he is owed.

Combined Actions

The third alternative, assuming that it works procedurally, is for the landlord to combine a judicial foreclosure action with an action to terminate the lease and recover both accrued rent and future rent loss damages. While this combined action will take longer and almost certainly cost considerably more than either a foreclosure suit or unlawful detainer action alone, it should enable the seller to enforce both the lease and the real property security.

This alternative is available only because California Civil Code Section 1951.2 permits recovery of future rent loss damages (computed as the present value of the excess of the future stream of rents payable under the lease over the reasonable rents that the tenant proves the landlord can receive by re-letting) and then only when the lease expressly provides for such remedy. For other non-accelerable obligations secured by real property (*e.g.*, child support payments, alimony payments, environmental indemnities), the creditor who thinks that securing serial obligations with a deed of trust or mortgage provides a hammer to use against a recalcitrant debtor will find the instrument much more like a millstone around the neck.

Section 728 Of The Code Of Civil Procedure

The Code of Civil Procedure does provide one remedy for the hapless, and ill-advised, creditor who secures non-accelerable payment obligations with a California deed of trust. Section 728 provides:

If the debt for which the mortgage, lien, or incumbrance [sic] is held is not all due, so soon as sufficient of the property has been sold to pay the amount due, with costs, the sale must cease; and afterwards, as often as more becomes due, for principal or interest, the court may, on motion, order more to be sold. But if the property cannot be sold in portions, without injury to the parties, the whole may be ordered to be sold in the first instance, and the entire debt and costs paid, there being a rebate of interest where such rebate is proper.

Under Section 728, if less than all of the encumbered property can be sold "without injury to the parties," then the property must be sold "in portions" and the foreclosure sale cease when the sale proceeds are sufficient to pay the amount due. The deed of trust or mortgage remains a lien on the unsold portions of the property and, as other of the secured amounts become due, the creditor party may move the court to order further foreclosure sales. If the properly cannot be sold piecemeal, the court may order the whole to be sold and the aggregate amount of the secured obligations paid, after being appropriately discounted so that the creditor does not receive unaccrued interest. Effectively, Section 728 provides a creditor with an acceleration right when the creditor neglected to contract for one.

Unaltered since its enactment in 1872, Section 728 has been only rarely cited in California appellate decisions after 1900 and, then, only for exemplary (as opposed to dispositive) effect. Still, it remains the only statutory provision in California dealing expressly with foreclosure of a real property lien where obligations secured are not then all due.

The remedy preferred by §728—selling off the real property collateral in pieces as sequential payment obligations mature—is not really suited to most types of income-producing properties, which typically are both physically and legally indivisible. For a series of obligations consisting of fixed, non-contingent payments, or even floating-rate interest payments, however, the alternate remedy in Section 728 should work well. Unfortunately, this type of non-accelerable, installment obligation generally results from a lack of care or sophistication on the part of the creditor (or the creditor's lawyer) and, with the proliferation of form notes and deeds of trust, each with a proper acceleration clause, is rarely encountered even in do-it-yourself transactions. When a deed of trust has been used to secure a set of obligations that are uncertain as to amount, timing, or even occurrence, the "acceleration" remedy of Section 728 will likely be impracticable.

Layered Foreclosure And Section 728

There is another form of partial foreclosure that does not require a physical division of the real property collateral and that the phrasing, if not the common understanding, of § 728 could accommodate. Rather than foreclose on a parcel of the encumbered property "sufficient" to pay the installment then due, the creditor would foreclose a "layer" of its security—that is, foreclose on all of the interests in the property subordinate to its own lien, but leave that lien undischarged and undisturbed as to all of the secured payments not yet due. Just as with a piecemeal foreclosure, the court's decree could authorize further foreclosure sales, subject to the remaining future payment obligations, as each installment became delinquent. The landlord with a lease secured by a deed of trust could bring an action to foreclose its deed of trust only insofar as it secured any delinquent rent installments, in effect treating the lien for those installments like a "second" deed of trust subordinate to the lien for rent payments not yet overdue. Then, on motion, the landlord could obtain similar sales of the entire property each time another rent payment was missed.

Every decision citing Section 728 has assumed that its reference to "portions" requires a physical subdivision of the property, but in both legal and ordinary usage "portion" can mean "share" as well as "part," and a share commonly refers to a partial interest in an indivisible whole. Under this reading, a "portion" on the property could be a fee interest in the whole property, subject to the continuing lien for the remaining, immature secured obligations. One might argue that such an interpretation would render the less-preferred "acceleration" remedy in Section 728 a vestige, since it would always be possible to apportion the property in this legal, rather than physical sense.

Yet there could be situations in which such an apportionment could not be accomplished "without injury to the parties," still leaving a role for Section 728's understudy remedy to play. Take, for instance, a fixed but relatively small monthly payment obligation extending over many years and secured by real property but lacking any other provision for accelerating future payments upon an installment default. Though serial foreclosures of the entire property would not be as impractical as repeated foreclosures of separate pieces of the property, it would force the creditor to suffer the expense, delay and considerable inconvenience of numerous foreclosure proceedings. In theory, perhaps, the creditor could recover interest and enforcement costs; in reality, however, the cost of such enforcement will likely greatly reduce, if not eliminate, the net recovery, forcing the creditor to wait until enough monthly payments have become overdue to justify the expense. This alone ought to satisfy the condition that partial foreclosures must cause some "injury" to a party before the creditor may resort to Section 728's back-up remedy.

Layered Foreclosure And The California Supreme Court

No California appellate court has ever applied Section 728 in

the manner suggested here, but the California Supreme Court has not once, but twice, approved of layered foreclosures of an entire mortgaged property to enforce multiple obligations. Curiously, these decisions did not rely upon Section 728, though they clearly applied its principals.

McDougal v. Downey

An 1872 decision of the court, *McDougal v. Downey* concerned a series of child maintenance payments. The plaintiff had agreed to advance the annual payments on behalf of the defendant, who was obligated to make them; to secure the repayment of these advances, the defendant gave the plaintiff a mortgage on "certain lands" the defendant owned. When the defendant defaulted in repayment of some of the moneys advanced, the plaintiff obtained a foreclosure decree that expressly "declared a lien upon the land for amounts to be subsequently paid to the minor" under the plaintiff's agreement with the defendant. Later, the plaintiff brought a second action to foreclose the mortgage with respect to such later payments and the defendant demurred citing the previous action as a bar. The trial court sustained the demurrer "for the reason that a former recovery and judgment had been had on the same mortgage . . . ." The supreme court reversed and remanded with directions to overrule the demurrer.

In its one paragraph opinion, the court based its decision on the fact that, at the time of plaintiff's first action, plaintiff had no claim for the later payments and thus could receive no relief under Section 248 of the Practice Act (which later became Section 728 of the Code of Civil Procedure). Rather than finding authority for the plaintiff's serial foreclosure in §728, the court's justification rested on 728's not being applicable. The opinion is silent regarding the "one-action rule," then found in §246 of the Practice Act of 1951, implying that the justices did not find any impediment to serial foreclosure actions in that rule.

Stockton Savings & Loan Soc. v. Harrold et al.

Twenty-eight years later, the California Supreme Court was less reticent. In *Stockton Savings & Loan Soc. v. Harrold et al.*, a unanimous Court declared that "Section 726, Code Civ. Proc., providing that there shall be but one action to recover any debt secured by mortgage, does not . . . prohibit successive foreclosures—when required by the circumstances—for distinct debts secured by the same mortgage." There, the court approved "[t]he power of a court of equity to direct a sale of property on foreclosure of a mortgage, saving from the effect of the sale a further lien secured by the same . . . incumbrance," finding this procedure "sufficiently established by authority" in other jurisdictions.

The Stockton Savings facts are convoluted and, since they offer several grounds (in addition to its age) for distinguishing the decision, merit exposition. McKee, the mortgagee-appellant, had made a series of loans to H. W. Cowell and N. S. Harrold, including a loan of $33,000 to Cowell alone and a loan of $9,941 to Cowell and Harrold jointly. The first loan was secured by a mortgage on, among other property, a 2,240 acre tract of land owned by Cowell and already encumbered by a mortgage to plaintiff Stockton Savings & Loan. The second loan, made a few months later, was secured by a mortgage on a separate tract of 960 acres, owned by Cowell and, apparently, not otherwise encumbered. The later mortgage also served as additional security for the first loan.

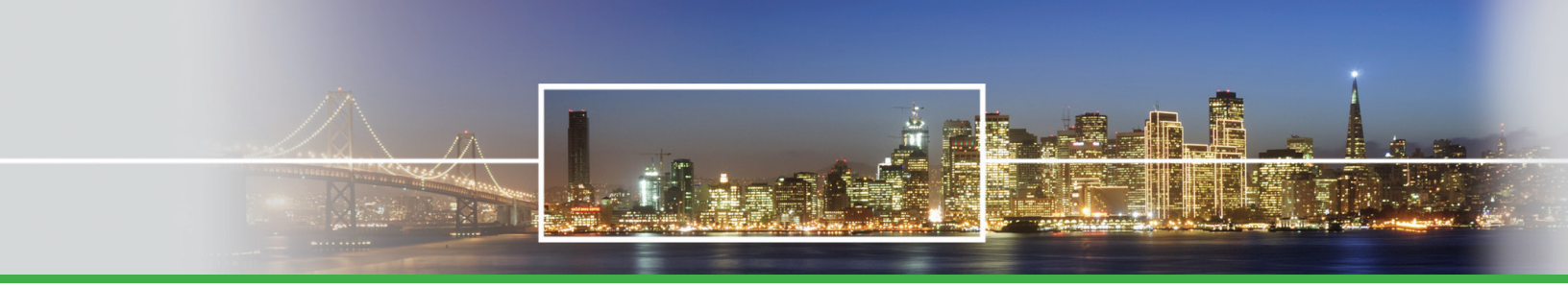
A few years later, Cowell defaulted on his note to Stockton Savings, which commenced a foreclosure action naming McKee as a defendant by virtue of his junior lien on the 2,240 acre tract. McKee then cross-complained for foreclosure of his mortgages on both the 2,240 acre tract (as to which his lien was subordinate to the mortgage held by Stockton Savings) and the 960 acre tract (which had no mortgage prior to his). The S&L opposed the cross-complaint, presumably because it expanded the original action by adding other properties and parties, and the lower court struck McKee's cross-complaint as to foreclosure on the 960 acre tract. At the same time, the court awarded McKee a deficiency judgment on the $33,000 note, notwithstanding that he had not yet exhausted all of the real property security for that note.

The supreme court reversed, ruling that McKee was entitled by his cross-complaint to foreclose on all of the mortgages securing the $33,000 note. The court's opinion then went on to state:

The decree for the sale of the tract of 960 acres to satisfy the note for $33,000, with interest, etc., should direct that the sale be made of that tract subject to the lien of the mortgage of May 23d for the payment of the note for $9,491 . . . .. [emphasis added]

The May 23rd mortgage, of course, was the same mortgage being foreclosed on the same property to satisfy the larger note.

The *Stockton Savings* court did make clear, in upholding the power of a court of equity to permit a layered foreclosure, that the circumstances made this a "proper case" for the exercise of that power. The court noted that the $9,491 note represented a "wholly distinct debt" from the $33,000 note and that the mortgage of the 960-acre land, "so far as it regards the



smaller note, is therefore, virtually a separate mortgage for the security of that note." Doubtless, given the attention paid to the procedural aspects of the case, the court also took into account that McKee could not, in this particular action, both exhaust his real property security for the larger note (thus preserving his deficiency rights) and foreclose the lien for the smaller note, which the court implicitly found too unrelated to the original action by Stockton Savings to permit it to be included.

Precedential Value of MCDougal and Stockton Savings

McDougal and *Stockton Savings* provide clear authority for layered foreclosure of multiple obligations secured by a single deed of trust or mortgage "in a proper case," but their age and sparse citation history invite skepticism about how much precedential force they retain. One highly respected commentator, citing *McDougal* and another California Supreme Court decision of similar vintage as upholding successive, piecemeal foreclosure actions, cautions that the court's 1974 decision in *Walker v. Community Bank* "is fundamentally hostile to idea of piecemeal judicial foreclosure." Whatever aversion post-Walker courts may have to piecemeal foreclosure, they presumably will not attempt to overrule Section 728 of the Code of Civil Procedure, despite its age. Still, if the courts accept as an essential part of the holding in *Walker* the court's statement that the purposes of Section 726 of the Code of Civil Procedure include preventing "multiplicity of suits" (*Walker*, supra, at 736), they are likely to limit the *Stockton Savings* and *McDougal* precedents as far as the judicial arts of distinguishing and deconstructing prior decisions allow. And that could well be far enough to prevent layered foreclosure from ever again being an available remedy in California.

Yet does, or should, *Walker* be read as disapprobation by the state's highest court of layered foreclosures? In *Walker*, the supreme court held that the creditor bank, by judicially foreclosing first on personal property security and obtaining a deficiency judgment against the borrower in that action, had triggered the sanction effect of Section 726 and forfeited his real property security. By the time Walker was decided, it had been settled that a borrower-trustor did not have to raise Section 726 as an affirmative defense in an action against him personally on the secured debt in order later to invoke the 726 sanction when the creditor attempted to foreclose. It takes no great stretch of the judicial imagination to regard a deficiency judgment in an earlier action as the functional equivalent of a personal action upon the debt. The novel issue raised in *Walker* was whether enactment of Section 9501 of the California Commercial Code in 1963, coupled with a concurrent amendment of Section 726 to eliminate any reference there to debt secured by a mortgage on personal property, created parallel and mutually non-exclusive rights to foreclose collateral and obtain deficiency judgments. Lacking any legislative guidance, the court held that foreclosure under the Uniform Commercial Code and foreclosure under Section 726 were mutually exclusive, at least where the creditor sought and obtained a deficiency judgment in its UCC action.

In support of its decision, the court's opinion cites Sections 726, 580a and 580d of the Code of Civil Procedure as "intended to prevent multiplicity of actions, to compel exhaustion of all security before entry of a deficiency judgment and to require the debtor to be credited with the fair market value of the secured property before being subjected to personal liability." The inclusion of "multiplicity of actions" in this litany has the mark of a make-weight, thrown upon the scale to make it tip even more in favor of the decision but wholly unnecessary to the holding. Section 728 of the Code of Civil Procedure, enacted at the same time as Section 726, plainly belies any purpose on the part of the legislature to prevent multiplicity of actions except in the most formalistic of senses, preferring as it does multiple foreclosure proceedings (if by a series of motions rather than complaints) to the acceleration of otherwise non-accelerable obligations to permit a single foreclosure. In *Higgins v. San Diego Sav. Bank* the 1900 California Supreme Court gave little weight to the fact that Section 728 requires repeated motions in a single action, allowing piecemeal foreclosure by separate actions to recover annual annuity payments under a husband-wife "contract of separation." Where the court in a previous foreclosure action did not determine that any future sums would be due under the contract and made no provision in the decree for further sales to recover such not-yet-due installments, "[w]e do not think . . . the mortgagee is compelled to resort to a motion, under §728, supra, nor would it be proper for him to do so [citing *McDougal v. Downey*, supra]."

Nor has the legislature otherwise signaled that Section 726 was meant to express reverence for judicial efficiency. Originally, 726 and its statutory precursor read "There shall be but one action for the recovery of any debt . . ." and continued to read this way during the period in which *McDougal*, *Higgins*, and *Stockton Savings* were decided. In 1933, the wording was changed to "but one form of action." According to the Bernhardt treatise, "California courts have ascribed no significance to this revision," but it would take a semantic contortionist to see in this change a desire to overrule legislatively those prior decisions. In 1985, reacting to the *Walker* decision, the state legislature amended UCC Section 9501(4) to expressly permit multiple actions in cases of mixed real and personal-property collateral. In effect, the legislature upheld the core holding in *Walker*, enforcing the

Section 726 sanction where a creditor obtained a deficiency judgment in an UCC foreclosure action, while plainly rejecting any requirement that the creditor be limited to a single action, either against its personal property collateral under the UCC, or against all the collateral under Section 726.

Arguments Against Layered Foreclosure

Assuming that preventing "multiplicity of actions" or proceedings is not, standing alone, sufficient reason for a court of equity to abandon a full-hearted love of doing justice, what other reasons might justify a rule forbidding layered foreclosure? Consistent with what is more usually named as the central purpose of Section 726—requiring the real estate secured creditor to exhaust his collateral before seeking person recourse against the borrower—the following appear to be the most cogent arguments against layered foreclosure:

1. Allowing the property to be sold subject to a continuing lien for the remainder of the secured debt may "chill" the bidding at the foreclosure sale, thus reducing the sale price and increasing the borrower's personal liability.
2. Layered foreclosure "clogs" the borrower's equity of redemption since it denies the borrower the opportunity to redeem the property fully until after the final foreclosure sale.
3. The "fair value hearing process" required under Section 726(b) as a pre-requisite to the creditor's obtaining a deficiency judgment does not contemplate, nor easily accommodate, a series of foreclosure sales under the same mortgage. Permitting the creditor to seek a deficiency judgment and obtain a fair value hearing after each foreclosure sale would seem clearly to violate the requirement that the lender first exhaust the real property collateral before having recourse to the borrower personally. On the other hand, deferring any deficiency judgment until the final foreclosure sale would violate the express requirement of Section 726(b) that the creditor file its application for a fair value hearing within three months after the date of the foreclosure sale.

The first argument exalts the ideal of a real estate foreclosure sale over the reality of such a sale. It may once have been true that real bidding—that is, multiple bids by qualified buyers—occurred at these sales and the property had a good chance of being sold to a third party. In modern practice, however, the lender is the successful (if not only) bidder nine times out of ten in residential foreclosures, and in foreclosures of commercial property that proportion quickly approaches 100% as the value of the property increases. For a host of reasons, not the least including the requirement that any bidder other than the foreclosing lender must bring cash (or its equivalent) to the auction, purchase out of foreclosure is an impractical way to acquire larger commercial properties. As a practical matter, then,, there is usually no bidding to chill at a foreclosure sale. The California legislature long ago recognized this, when (in 1933) it enacted Section 726(b). The debtor's real protection rests in that statute's limitation of any deficiency judgment to the excess of the secured debt over the greater of the amount bid at the foreclosure sale and the "fair value" of the property at the time of sale.

If anything, were actual, competitive bidding the rule, rather than the rare exception, a layered foreclosure might encourage third-party bidding, especially for more valuable properties. One of the chief obstacles to serious third-party bidding at foreclosure sales is the requirement for payment in cash at the time of purchase. The foreclosure process makes it difficult, if not wholly impractical, to arrange any contemporaneous debt financing, unless by the foreclosing creditor. Layered foreclosure would supply a mechanism for providing a third-party purchaser with concurrent, insured debt financing (in the form of the remaining and still secured debt).

Nor is there any clear basis for concluding that a layered foreclosure would discourage third-party bidding (if at all) more than the piecemeal foreclosures that Code of Civil Procedure Section 728 indisputably authorizes. In some easy-to-imagine circumstances—half-finished lots in a half-completed subdivision project gone south, for example—piecemeal foreclosure would plainly be a far worse alternative than a layered foreclosure for any lender or borrower hoping to attract bidders to a foreclosure sale (the cost per lot of completing infrastructure and other finishing work being prohibitive if spread over only a few of the lots).

That a succession of layered foreclosures can have no worse effect than a succession of piecemeal foreclosures also answers the second argument against permitting the former procedure. While the borrower gets to retain the unsold pieces of the real property collateral, for a while, they remain encumbered with the debt and beyond the borrower's immediate right to redeem them. A more powerful counter, though, is that a borrower with the means to redeem mortgaged property must also have the means to pay the secured debt as it falls due. The "equity clogging" effect originates not with the foreclosure process, but with the borrower's undertaking of a serial obligation that, by inadvertence or express agreement, cannot be prepaid. Certain kinds of serial obligations that are secured by property may well constitute an unpermitted clog on the borrower's equity of redemption—*e.g.*, an interminable obligation to pay "additional interest" measured by operating cash flow—and the imprudent

lender that structures such an obligation risks the borrower being able to avoid it by defaulting on the debt and forcing the borrower to foreclose.

The third argument advanced is the strongest, though the question of how to accommodate successive foreclosures under the same mortgage is one that Section 728 already begs, even if that provision is limited to piecemeal foreclosures. Attempting to preserve both the lender's deficiency rights under Section 726(b) and the right to foreclose piecemeal when the secured obligation consists of a non-accelerable series of obligations leads to two possible solutions. In one, the deficiency is established on a foreclosure sale by sale basis, treating the mortgage or deed of trust as severed into two separate liens each time the property is partitioned for sale so as to avoid violating the rule that, for any debt secured by a mortgage, the collateral must be exhausted before a deficiency judgment is awarded. The other solution would be for the court to require a fair value hearing after each sale, but to refrain from determining the amount of recoverable deficiency until the last piece of the property has been sold. Either way, to protect the borrower, the "fair values" determined from the various sales would have to be cumulated, so that any excess of fair value over the greater of the bid or debt amount for one sale could be set off against any deficiency in another. Otherwise, piecemeal foreclosure could result in a legal deficiency considerably greater than the actual amount by which the total secured debt exceeded the aggregate value of the property.

In practice, the difficulties posed by any reconciliation of Sections 726(b) and 728 may be mostly academic. Lenders generally do not choose judicial foreclosure to seek a deficiency judgment, because doing so preserves the borrower's one-year right of post-foreclosure redemption and this right effectively clogs the lender's equity in the property. Until the redemption period runs, the lender (or other foreclosure purchaser) cannot truly act as the owner of the property: the borrower's pre-emptive right to redeem inhibits any sale, financing or improvement of the property. To avoid this, a creditor finding it necessary or advisable to foreclose judicially will usually waive its right to a deficiency judgment, thereby cutting off the borrower's right of redemption when the hammer falls at the foreclosure sale. If the creditor does not waive deficiency rights, a court might well conclude that the complications presented by a series of inter-linked fair value hearings, over months or years, posed sufficient risk of "injury to the parties" to justify accelerating the debt and holding a single foreclosure sale under the second part of Section 728.

Modern Application of the Layered Foreclosure

Granting that statute and precedent—though both hoary with age—as well as logic support layered foreclosures, judicial opposition could still form around the banner of "why bother?" Stockton Savings & Loan has been cited by California appellate courts only twice in the last 50 years—in one instance merely in paraphrasing the appellant's argument and in the other to describe the holding in Stockton permitting serial foreclosure as dictum on which the appellate court expressed no opinion of its own. Section 728 of the Civil Procedure Code appears to have been last cited by a California appellate opinion in 1932. The conspicuous lack of citation history plainly indicates that there has been no pressing need in California for judicial attention to the question of non-accelerable obligations that have been secured by real property.

Yet, there is at least one very contemporary context in which a clear approval of layered foreclosure could offer a general economic benefit. Structured real estate financings, whose excesses nearly tumbled the world's financial system, have left behind a mounting debris flow of overleveraged hospitality, multi-family and commercial real estate. Most of the structured debt for these properties ended up being (in part) "securitized" and the securitization vehicle of choice, at least for larger income-producing real estate, is a Real Estate Mortgage Investment Conduit, or REMIC. REMICs are tightly corseted by a rigid frame of tax laws and regulations, which they break on pain of substantial tax liability. One of the statutory limitations essentially prevent REMICs from acquiring or making any new loans.

An effect of this limitation is that, after a REMIC forecloses on a defaulted mortgage loan, it can only dispose of the "REO" property for cash: it cannot, without severe tax consequences, provide any seller financing to the buyer. For smaller properties and in times when debt financing for commercial real estate is more readily available, this stricture may not greatly impede an orderly disposition of REO properties in REMIC portfolios; in the current credit famine, however, and for larger or more challenged properties, the inability of REMICs to finance sales of their REOs may unleash a chain of consequences that will further damage the real estate market. If REMICs, for lack of financing alternatives, must dispose of REO properties at fire sale prices, this will depress market values for the classes of assets affected and force institutional lenders, such as banks, pension funds and insurance companies, to write down the values of similar properties—and loans secured by such properties—that they hold. In turn, this may drive some of those lenders into insolvency, triggering further discounted sales.

One way a REMIC can work around the "no new loan" limitation is to arrange with the borrower for a "short sale" of the defaulted mortgage property in which the borrower conveys the property, still encumbered by the loan, to the buyer. Because the loan is in

default, the REMIC is allowed considerable latitude in modifying it and, by negotiating the terms of modification with the buyer, it can effectively provide financing for the sale. Obviously, though, such a transaction requires borrower cooperation and that cooperation is likely to have a price, including waiver by the lender of any claims it may have under any guaranties or indemnities against the borrower or its affiliates.

The availability of layered foreclosure would give REMICs and their servicers a means of accomplishing the same result without borrower cooperation. For debt structures in which the mortgage loan has been split into a securitized "A" note and one or more unsecuritized, subordinated notes, a "B" note holder could, for example, play the foreclosing lender while the "A" note holder kept its loan, unaccelerated for the moment, in place. If the entire mortgage loan had been securitized and there was but a single note, the lender might elect not to accelerate and instead foreclose only as to payments already due.

Admittedly, either of the scenarios just envisioned would require a considerable judicial leap forward, even if the court took as its launch point the decision in *Stockton Savings* and the broader reading of Code of Civil Procedure Section 728. Section 728 describes the secured obligations to which it applies simply as "debt . . . not all due," and this could include debt that the lender has not elected to accelerate as well as an obligation that the lender has no right to accelerate, but it is unlikely anyone has looked at the provision in this way. McKee, the mortgagee in Stockton Savings, did apparently have the right to accelerate both of the notes secured by his mortgage; however, the procedural toils in which he had become entangled prevented him from foreclosing on both in the same proceeding. Applying either the statute or the precedent to a lender's voluntary election to foreclose in layers rather than all at once would be pushing hard on an old and brittle envelope.

As a practical matter, no REMIC lender or servicer who can accelerate is likely to find an attempt to expand the law of foreclosure worth the time or expense. If the borrower is acquiescent and no one else is likely to object or bid at the foreclosure sale, the loan servicer might explore the possibility that the foreclosure court would be willing to experiment with a layered foreclosure decree—one that expressly preserves the remainder of the lien. Res judicata would then protect the lender from any afterthought on the part of the borrower or any other party named as a defendant in the foreclosure action. Still, it is hard to imagine that the quicker and cheaper, not to mention surer, option for the lender would not be to buy the borrower's cooperation in a short sale. Of course, there is always the possibility that Congress will see fit to amend the Internal Revenue Code to permit REMICs to provide some kind of seller financing of REO properties (assuming that Congress can agree on any changes in the tax code—something it has found difficult for several years now).

Conclusion

California courts have looked upon Section 728 of the Code of Civil Procedure—when they have looked at all—as providing a partial foreclosure remedy only when it can be applied to a physically severable portion of the real property security. This article has argued that logic, language and case law support a broader application of Section 728, to permit foreclosure on an undivided "layer" of the real estate collateral while leaving the security interest intact as to the remaining, undivided fee interest in the property. If the occasion arises for California appellate courts to entertain the revival of layered foreclosures in the modern era, they should address the question understanding that both precedent and practicality favor a flexible approach.

The preceding was an abridged version of this article. For a complete version of this article (including footnotes), please contact the author.

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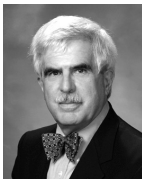

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Dealmaker Summaries

The following are descriptions of just a two of the recent transactions handled by SREF attorneys:

Cross-office Seyfarth Team Closes Complex Transaction for Major Life Company Lender

In another sign of some recovery in the transactional markets, a cross-office, multi-disciplinary team led by Jay Wardlaw closed a complex $181 million loan secured by nine senior living facilities in five different states for a major life company lender. The fast-moving transaction compressed a 60-day process into three weeks, an especially challenging proposition for licensed facilities, and drew upon Seyfarth's diverse transactional skill sets and geographic reach.

The core closing team in Atlanta was able to draw upon our exceptional health care expertise on complex licensing, documentation and structuring aspects of the transaction. **Deb Gordon**, **Tom Shapira**, **Scott Ellsworth** and **Maureen Farrell** (all Chicago office) combined with **Kathryn Gottlieb** and **Saima Shaikh** from our Houston health care team to handle research, due diligence and a portion of the drafting of the 180-plus documents involved. **Paul Baisier** provided expert assistance on bankruptcy and SPE matters.

The collateral included assisted living facilities in northern California, and Jay and the Atlanta team were again able to draw upon our strong platform by calling on **Mark Mengelberg**, **Robin Freeman** and **Anthony Burney** from our San Francisco for California structuring issues, due diligence and legal opinions.

The Atlanta team was led by **Jay Wardlaw**, and included **Cristina O'Brien**, **Jill Hunt**, **Paul Mattingly**, **Paul Baisier**, **Laine Kravitz**, **Sue Nutter**, **Hannah Grant**, **Linda Troutman**, **Allison Kocher**, **Loretta Lowe**, **Kim Adams**, and **Anna Rogers**.

DC Team Closes Multiple Mezzanine Deals with Institutional Fund

Ronald Gart and **Richard (RJ) Hamilton** (Washington, D.C. office) have represented Grosvenor Residential Investment Partners I, L.P. (GRIP) in connection with all of its investments structured primarily as mezzanine debt facilities to finance the acquisition of residential lots and in some instances, partial horizontal and vertical construction suitable for single family homes, townhomes, and condominiums. Recent transactions included the finance of 60 lots and vertical construction in Southern California, 36 lots and vertical construction in Fairfax, Virginia, and 61 lots and vertical construction in the State of Washington. The GRIP investments are typically entrepreneurial in nature and, at times, involve last-minute challenges. For instance, the deal in the Southern California was logistically challenging because it involved a pledge of interests in the borrower, which was owned by more than eight separate revocable trusts with beneficiaries scattered across the United States. The Seyfarth team worked with GRIP, Borrower's counsel, and GRIP's UCC insurer on designing a more efficient entity structure that would meet the needs of the parties, be more efficient and reduce overall costs.

SREFacts

RECENT ADDITIONS

Sacramento Partner Morgan Jones joins the Real Estate Practice Group. Morgan Jones joins us from McDonough Holland & Allen, where he specialized in banking, with a particular emphasis on financing transactions and workouts, and real estate. His practice also has included various corporate matters and domestic and international business transactions. **Morgan** brought with him associate, **Robert (RJ) Wood**. **RJ** represents secured and unsecured creditors in connection with the protection and enforcement of creditors' rights, both before and during bankruptcy, as well a the defense of "lender liability" and other business tort actions.

Downtown Los Angeles office adds two partners to join the Real Estate Practice. Steven Fein joins us from DLA Piper. Steve focuses his practice on a wide range of commercial real estate transactions, including joint venture formations, joint venture equity investments, real estate related lending, acquisitions and dispositions, and workouts. **Thomas Masenga**, who arrives from Allen Matkins, is recognized nationally for structuring and closing complex real estate transactions for institutional investors, including pension funds and their advisors, banks, life insurance companies, private equity funds, and REITs. **Tom's** practice is focused on secured lending, equity investments, acquisitions and dispositions, and debt restructuring and workouts.

Eric Sidman and Lester Bliwise have joined the firm's New York office. **Eric** has joined as partner and **Lester** as of counsel. Both come to us from Sutherland Asbill & Brennan LLP. **Eric** and **Lester** have broad practices representing institutional investors in acquisitions, financing, dispositions and joint venture arrangements. They represent clients nationally and in all sectors, including office, retail, industrial, apartment and hotel properties.

We are pleased to welcome them to Seyfarth Shaw.

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