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## Potential Pitfalls of Purchasing Properties in Foreclosure

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Current difficulties in the sub-prime mortgage industry, and the “softening” or downturn in the residential real estate market, have resulted in many California homeowners being in danger of losing their homes through foreclosure. Although unfortunate for the homeowners who find themselves in this situation, this normal market correction has also created opportunity for those investors who are positioned to take advantage of current market conditions.

The combination of upwardly-adjusting interest rates on adjustable mortgage loans and stagnant or declining home values has prompted some homeowners and real estate purchasers/investors to look for “creative” or unconventional methods which will provide the results each desire to achieve. A method which has generated, and continues to generate, substantial interest among all concerned is the “short-sale”, a term which is understood to mean that situation wherein a lender accepts in satisfaction of the balance due on a loan secured by real property (usually residential real property) less than the amount which actually is due under the promissory note.

Why would a lender agree to a short-sale? In reality, it reportedly is very difficult to convince a lender to consent to short-sale transactions. Like other companies, mortgage lenders are in business to make money, not lose or give away money. Thus, it does not make economic sense for a lender to accept a short-sale offer unless the borrower (homeowner) has not been making payments on a loan and it appears clear to the lender that (i) the borrower does not (and will not in the foreseeable future) have the financial ability to cure the default and (ii) the

financial loss to the lender of accepting a short-sale offer will be less than the loss the lender is likely to sustain by foreclosing on the loan. Additionally, lenders might consider subjective criteria associated with the acceptance of short-sale offers, such as the foreseeable expectations of future borrowers who might find themselves in a similar situation and the perceived likelihood of government intervention, that is, a government “bailout” of homeowners which, at taxpayers’ expense, might benefit the lender.

Real estate investors who pursue short-sale transactions on California properties have more to consider than simply whether the terms of any such offer can be made acceptable to the lender.

The California legislature, when enacting Civil Code § 1695, et seq., known as the Home Equity Sales Contract Purchase Act (Act), declared that “homeowners whose residences are in foreclosure have been subjected to fraud, deception, and unfair dealing by home equity purchasers.” C.C. § 1695(a). Rather than allow homeowners who have been subjected to “fraud, deception, and unfair dealings” to simply use existing laws and remedies to redress such wrongful conduct, C.C. § 1695, et seq., creates certain prophylactic procedural requirements intended to protect California homeowners in default who want to enter into contracts to sell their properties, protections homeowners may not waive.

The protections contained in the Act include those relating to the form and substance of certain real estate contracts, as well as a seller’s right to rescission (cooling-off period).

Purchasers of real property who violate the Act are subject to both criminal penalties (up to a \$10,000 fine and one (1) year in jail/prison for each violation) and civil penalties (actual and punitive damages, attorney fees). C.C. § 1695.7 has a four (4) year statute of limitations; C.C. § 1695.9 also provides that the Act's criminal and civil penalties/remedies shall be in addition to any other rights, remedies and penalties provided by law.

Some investors may be tempted to point out that, in the case of short-sale transactions, there is not, by definition, any "equity" in the subject property and, thus, erroneously conclude that the provisions of the Home Equity Sales Contract Purchase Act do not apply to short-sales. Unfortunately for such investors, the Act's name is somewhat of a misnomer, as the Act defines an "equity purchaser" as any person who acquires title to a residence in foreclosure, regardless of whether there is any equity in the subject property.

Exceptions to the Act include (i) cases where the buyer will use the property as the buyer's personal residence, (ii) deeds in lieu of foreclosure, (iii) deeds from a trustee in a foreclosure sale, (iii) sale of property authorized by statute, (iv) sale by court order or judgment, (v) transfers between spouses.

There are other statutes which seek to protect homeowners in foreclosure by regulating the activities of "foreclosure consultants". A foreclosure consultant is defined as any person (with certain limited exceptions) who solicits, represents or offers to a homeowner the performance of a service for compensation which effectively will save a homeowner from foreclosure, or assists a homeowner in obtaining the remaining proceeds from a foreclosure sale ("surplus funds"). C.C. § 2945.1.

Violation of the foreclosure consultant statutes subjects a violator to civil liability to the homeowner in the form of actual and/or punitive damages, injunctive relief, and attorney fees. Actions under the foreclosure statutes may be brought anytime within four (4) years of the date of the alleged violation. C.C. § 2956.6(b).

Damage awards under the foreclosure consultant statutes, like remedies under the Home Equity Sales Contract Purchase Act, do not preempt rights and remedies an aggrieved homeowner may

have under other provisions of law, C.C. § 2945.6(b), and may also be punished criminally, by a fine of up to \$10,000 and/or one (1) year in jail or prison for each such violation. C.C. § 2945.7.

Thus, while plentiful opportunity exists for investors to profit in the current real estate market, many legal pitfalls also exist which not only could eliminate any financial success an investor might experience, but which also could leave an investor in a position which is substantially less desirable than that in which the investor would have been had the investor not pursued California foreclosure properties.

Once again, the California legislature, while perhaps well-intentioned, has made it more difficult for Californians to manage their affairs. By enacting C.C. §§ 1695 and 2945, the legislature has made it less likely that real estate investors will seek to invest in California properties which are in foreclosure which, in turn, has the practical effect of leaving California homeowners who are in default with fewer options to resolve their financial difficulties than these homeowners otherwise might have had if the legislature had simply done nothing at all.

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Mr. Earle is licensed to practice law in all California state trial and appellate courts, the United States Supreme Court, the United States Court of Appeals for the Ninth Circuit, and federal trial courts in the Northern District of California. He is also a licensed Real Estate Broker.

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