

DIRT Periodic Developments for Friday, October 10, 2014
Najah v. Scottsdale Insurance Co.

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As was noted by several DIRTers earlier this week, this Sunday marks the 2nd anniversary of Pat Randolph's death. I hope all of our participants will take a moment this weekend to reflect on and appreciate the enormous contribution Pat made in creating and nurturing the DIRT community.

If that moment of reflection so moves you, you may recall that Pat's family established in his memory a scholarship fund at UMKC for the benefit of Chinese law students. Contributions can be made to the Professor Pat Randolph Chinese Scholarship Fund in care of The UMKC School of Law, 5100 Rockhill Road, Kansas City, MO 64110.

Najah v. Scottsdale Insurance Co.

California Court of Appeals, Second District, Division 4 (September 30, 2014)

Link to Opinion: <http://www.courts.ca.gov/opinions/documents/B241097.PDF>

SYNOPSIS: Under "full credit bid" rule, full credit bid by junior lienholder at foreclosure sale extinguished right of junior lienholder to insurance proceeds for preforeclosure damage to the property, even where the junior lienholder also held the senior lien securing senior debt that nominally remained unsatisfied.

FACTS: Jamshid Najah and Mark Akhavain sold commercial property in Riverside, CA, to Orange Crest Realty Corp. (Orange Crest). In the transaction, Orange Crest granted a first priority deed of trust to Lantzman Trust (securing a principal debt of \$2.021 million, and Najah and Akhavain took back a second deed of trust to secure the remaining \$2.55 million of the unpaid purchase price. After Orange Crest defaulted and Lantzman Trust began foreclosure, Najah and Akhavain purchased the senior note from Lantzman Trust and took an assignment of the first deed of trust. Najah and Akhavain then instituted foreclosure proceedings on the second deed of trust. Prior to foreclosure, Akhavain visited the property and discovered significant damage to the vandalism (with repair cost estimated at \$500,000). Ultimately, Najah and Akhavain acquire the property at the foreclosure sale by making a credit bid of \$2.8 million (the outstanding balance due on the second note).

Najah and Akhavain asserted a claim for the vandalism damage on an insurance policy that had been issued by Scottsdale Insurance Company (Scottsdale). This policy had been obtained by Orange Crest at the time it purchased the property, pursuant to provisions in each deed of trust requiring Orange Crest to carry insurance for the benefit of

Lantzman Trust and Najah and Akhavain, respectively. When Scottsdale denied coverage, Najah and Akhavain then filed a complaint against Scottsdale for breach of the insurance contract. Scottsdale moved for summary judgment, contending that by making a full credit bid at the foreclosure sale on the second deed of trust, Najah and Akhavain had extinguished the debt and any claim to insurance proceeds. The trial court granted summary judgment for Scottsdale, stating that any claim Najah and Akhavain had to the insurance proceeds as mortgagees under the second deed of trust was extinguished by their full credit bid at the foreclosure sale. The trial court acknowledged that Lantzman Trust had also assigned to Najah and Akhavain its right to insurance proceeds in conjunction with the assignment of the first deed of trust, but held that Najah and Akhavain's full value purchase of the first deed of trust extinguished the debt and any right to insurance proceeds. Najah and Akhavain appealed.

ANALYSIS: The California Court of Appeals ultimately affirmed the trial court's grant of summary judgment, holding that the result was consistent with the "full credit bid" rule:

Under the full credit bid rule, when the lienholder obtains a property at a foreclosure sale by making a full credit bid—bidding an amount equal to the unpaid debt, including interest, costs, fees, and other expenses of foreclosure—"it is precluded for purposes of collecting its debt from later claiming that the property was actually worth less than the bid. After acquiring the property in this manner, the beneficiary is generally unable to pursue " 'any other remedy regardless of the actual value of the property on the date of the sale.'" "This is because the lender's only interest in the property is the repayment of the debt. The lender's interest having been satisfied, any other payment would result in a double recovery." [citations omitted]

The court acknowledged that there is an exception to the full credit bid rule where the lender demonstrates that its full credit bid was a proximate result of fraud, but held that Najah and Akhavain were fully aware of the state of the property when they bid at the foreclosure sale. The court also noted that the full credit bid rule protected the integrity of the foreclosure sale process:

A lender who intends to later claim that the value of the property was impaired due to waste, fraud or insured damage, but nonetheless makes a full credit bid, interferes with that process by impeding bids from third parties willing to pay some amount between the value the lender places on the property and the amount of its full credit bid.

Najah and Akhavain argued that their full credit bid on the second deed of trust was irrelevant because they also held the position of the first deed of trust, which remained unsatisfied, and that the policy also insured them in that capacity. They argued that the trial court erred in concluding that the first debt was extinguished by their purchase of that debt from the Lantzman Trust. The court of appeals agreed that the trial court erred, correctly noting that "[n]otes and deeds of trust are transferable and assignable, and such

transfer or assignment vests in the transferee/assignee all of the rights, interests of the original beneficiary.”

Nevertheless, the court of appeals concluded that the full credit bid on the second deed of trust still barred the ability of Najah and Akhavain to recover on the insurance policy. The court reasoned that “applying the full credit bid rule to the combined debt where the holder of multiple deeds of trust forecloses on the most junior protects the integrity of the foreclosure auction process.” It noted:

This reasoning applies regardless of whether the mortgagee holds one or multiple deeds of trust. By making a full credit bid at the foreclosure sale on their more junior lien, appellants set an effective bid price for any other party interested in acquiring the property at \$4.627 million—the total of their bid and their outstanding lien—notwithstanding that appellants believed the property to be worth far less. In order to out-bid appellants, any other party would have had to bid an amount greater than appellants’ \$2.878 million credit bid, and would have taken the property subject to appellants’ outstanding \$1.749 million lien on the first trust deed. Thus, the effect of appellants’ bidding the full amount of their second lien, notwithstanding their belief that the property was worth less than the combined amount of the first and second liens, was to block other interested parties from “participat[ing] in setting the price for the property,” and preventing the property from going to the party placing the highest actual value on it. Having thus deprived Scottsdale of the benefit of a bona-fide mortgage foreclosure auction, they cannot now reasonably contend that they are entitled to insurance proceeds in the amount between what they freely paid to secure the property for themselves and the amount they now claim the property to be worth.

COMMENT: There is limited authority rejecting the full credit bid rule, particularly in situations where the mortgagee made a full credit bid without knowledge of the casualty loss. See *Ex parte Chrysler First Financial Services Corp.*, 608 So.2d 734 (Ala. 1992). This authority provided no shield for Najah and Akhavain, however, as they were fully aware of the damaged condition of the property at the time of the sale. And even under the weight of authority, their lack of knowledge would have been irrelevant, as expressed in the comments to Restatement (Third) of Property – Mortgages § 4.8, which embraced the full credit bid rule:

[I]t is unlikely that a court would relieve a third-party purchaser from the consequences of a bid entered without knowledge that the property was previously destroyed or damaged in a casualty loss. Surely the mortgagee should not be treated more favorably in this regard. More importantly, the position . . . clearly discourages improper mortgagee manipulation of the foreclosure process. For example, a mortgagee could enter a full credit bid “intending to discourage third party bidders and, ultimately, to collect the insurance proceeds as well.”

Restatement (Third) of Property – Mortgages § 4.8, Reporters' Note.

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