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Foreclosure Opportunities: Do Your Homework

The rise in the number of foreclosure filings is largely interpreted as a symptom of a reeling economy, and indeed it is. A positive thinker, however, will also perceive this phenomena as an opportunity. As more properties go through the foreclosure process, more properties end up being sold at the "fire sale" that often is the sheriff's sale of the foreclosed property. For the informed bidder at such sales, property can be purchased for a discount off the price it may otherwise command in a brokered commercial market. Success as a bidder in the foreclosure sale market requires due diligence and a plan.

Property purchased at a foreclosure sale often comes with strings attached. A successful bidder at a foreclosure sale may obtain not only a piece of real estate, but also a mortgage, tax debt and other liens that may not have been wiped out or "foreclosed" by the particular foreclosure proceeding at issue. This is because any given foreclosure action only forecloses claims based upon the lien (mortgage or otherwise) at issue and all other liens that have been recorded or filed subsequent to, i.e., are subordinate to, that lien. Moreover, certain debt that attaches to a property, most notably real estate taxes, are almost never foreclosed, even if the tax debt did not accrue until subsequent to the recording of the lien at issue in the foreclosure action. Unintentionally purchasing encumbered property at a foreclosure sale is not a basis for undoing that sale. Most likely, the price to get out of one's obligation to purchase property following a successful bid at a foreclosure sale is to forfeit the standard 10% down payment on the real estate.

The potential pitfalls identified above can be avoided with appropriate due diligence. That due diligence begins with identifying every interest-holder in the subject property and the nature of each interest. Such information can be obtained by obtaining a title report from a title company. The title report should identify all recorded liens and other encumbrances (such as easements, leases, judgment liens, tax warrants, etc.), the date on which each interest was acquired and perhaps even the dollar amount attached to each such encumbrance. Next, one must analyze those interests and determine how they will be affected by the foreclosure sale. Reviewing the timing of each encumbrance together with statutory exemptions and super-priorities will educate the bidder regarding the state of property, including encumbrances, on which he or she is bidding. From this due diligence, an informed bidder can devise a bidding plan.

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An example illustrates the bidding process and the differing strategies that participants may employ. The local newspaper announces the sheriff's sale for property XYZ. Your due diligence reveals that the property is encumbered with real estate taxes ($12,000), a purchase money mortgage that is being foreclosed ($345,000) and a judgment lien filed subsequent to the recording of the purchase money mortgage ($10,000). The mortgage holder typically bids at the sheriff's sale but caps the amount of its bid at the amount owing on the mortgage—it wants to set the bid floor at an amount that will result in the complete payoff of the mortgage debt. Likewise, the judgment creditor may seek to increase the bid floor by the amount of its judgments to ensure that its judgment is also paid off by the proceeds from the foreclosure sale. In this way, these lien holders are working to increase the bidding to reach at least a certain level.

A bidder who has no present interest in the property, on the other hand, will strive to purchase the property for the least amount of money. Ascertaining that amount can be done by applying a formula. In simple form, a bidder who wants to own property for investment or resale purposes should bid: the amount of money he or she believes the property could be resold for; less real estate taxes attached to the property; less rehabilitation/holding costs; less the desired profit the bidder wants to make on the resale of the property. In the example, if a bidder thinks he or she can rehabilitate the property for $40,000 and resell it for $500,000 and wants to make $20,000 on the resale, he or she should bid a maximum of $428,000 (less closing expenses such as brokerage commissions and title fees): ($500,000 less $12,000 (real estate taxes), less $40,000 for rehabilitation/holding costs, less $20,000 (desired profit)). In this simple example, with the mortgage holder and the judgment creditors driving up the bidding floor to $367,000, our disinterested bidder should have a bid window starting at $367,000 to $428,000 (less closing expenses) in which it makes economic sense to bid on the property. Again, the lower the bid price, the more profit the bidder will make on the rehabilitation and eventual resale of the property.

Of course, pitfalls other than those alluded to above may be present in any foreclosure sale. The existence of easements, options to purchase, whether the subject property is considered a homestead and other concerns all can materially affect the perceived value of property as an investment and as a candidate for resale. Nonetheless, with appropriate due diligence and a bidding plan that makes economic sense, the foreclosure sale market can be quite rewarding.

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