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CAVEAT EMPTOR: A RISK OF BUYING AT A FORECLOSURE SALE

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Many people believe that property purchased at a foreclosure sale is a bargain. Indeed, that can be true since the purchase price at a forced sale is almost universally less than that negotiated in a consensual sale. But buyer beware. Purchasing at a foreclosure sale carries risks that are not typically present in a traditional purchase transaction between a willing seller and a willing buyer. A recent Supreme Court decision highlights this risk and demonstrates that a successful bidder at a foreclosure sale may get a lot less than he or she bargained for.

In a typical sale of real estate, a seller makes certain representations and warranties to the buyer. Those include, but are not limited to, representations about the condition of the property. For example, a seller may represent that the plumbing, electrical, heating and cooling systems are in working order. Also, a seller often represents that the condition of the property at closing will be the same as at the time of contract, except for ordinary wear and tear.

However, a foreclosure sale presents a totally different scenario. In that context, there is no willing seller and there are no representations about the condition of the property. Instead of a contract of sale, the transaction is governed by: (a) the Judgment of Foreclosure; and (b) the "Terms of Sale" that a Court appointed referee reads aloud at the auction. Foreclosure Terms of Sale almost universally provide that the property is sold "as is" without any representations made by the referee or the foreclosing mortgagee. As such, a successful bidder at the sale is buying the property without regard to its physical condition. Furthermore, Terms of Sale often require the successful bidder to assume the risk of loss should one occur between the foreclosure sale and conveyance of the referee's deed.

A recent decision by Justice Giacomo of the Supreme Court, Orange County discussed this circumstance and how it resulted in great loss to the foreclosure bidders. In US Bank N.A. v. Cedeno , third parties bid successfully at a foreclosure auction. Their winning bid was $410,000. After the auction, the foreclosed owner allowed the bidders to enter and inspect the premises. They observed that it was in good condition. During the inspection, the foreclosed owner demanded that the bidders pay him $60,000, or he would damage the property. The bidders refused. Shortly thereafter, the foreclosed owner began to remove fixtures, countertops, a sauna, electrical outlets, kitchen appliances, lighting fixtures, and many other items of value. Even interior walls were removed. The total damage was estimated to be $150,000.

The referee presented an Order to Show Cause to the Court seeking guidance about the property damage. The Court ordered the foreclosed owner to stop damaging the premises but the foreclosed owner caused additional property damage until he was evicted. The bidders then moved to void the foreclosure sale or to obtain an abatement of the bid price.

Justice Giacomo denied the bidders' motion and directed them to close on a date certain, with time being of the essence. In reaching the decision, the Court first considered General Obligation Law § 5-1311, also known as the Uniform Vendor and Purchaser Risk Act. Under that statute, a seller cannot enforce a contract where all or a material part of the property has been destroyed without the fault of the purchaser. Where an immaterial part of the property is destroyed without the fault of the purchaser, both sides can still enforce the contract but the purchaser is entitled to an abatement of the purchase price.

However, Justice Giacomo noted that parties could modify this general provision in their contract. He then examined the Judgment of Foreclosure and the Terms of Sale. Both of those documents provided that the successful bidder assumed the risk of loss to the premises between the foreclosure auction and closing. Since the risk of loss was properly transferred to the successful bidders, they were not entitled to be relieved from their obligation under the Terms of Sale to pay the bid price of $410,000.

Justice Giacomo also rejected the bidders' argument that transferring the risk of loss to a foreclosure bidder violated public policy. The Court again cited General Obligations Law § 5-1311, which specifically allows for the transfer of such risk. As a result, what the bidders may have thought was a bargain when they bid at the sale, ended up costing them much more.

U.S. Bank v. Cedeno highlights a risk of buying at a foreclosure sale that is usually not present in a consensual sales transaction. Potential bidders must take into account not only the condition of the property at the time of the sale – if that can even be determined – but also that they may have no recourse if the property is damaged between auction and closing.

Moreover, counsel for a prospective bidder must remember to advise of this risk. Otherwise, not only will the "bargain" become a financial nightmare for a client, but it may become a professional liability issue for counsel as well.

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[1] ***U.S. Bank N.A. v. Cedeno, NYLJ, March 3, 2009, at 28, col. 1.***

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