DEFICIENCY JUDGMENT NOT TO BE REDUCED BY PROFIT ON LATER PRIVATE SALE OF COLLATERAL

The Appellate Court of Illinois, Second District, recently held that when a mortgagee obtains a deficiency judgment in a foreclosure action, purchases the property at a judicial sale, and then resells it to a third party for an amount that exceeds the price paid at the judicial sale, the debtor is not entitled to a setoff in the mortgagee's enforcement proceedings to recover the deficiency judgment.

A copy of the opinion is available at: **Link to Opinion.**

In June 2013, the trial court entered a judgment of foreclosure and sale with respect to a property. The judgment reflected an outstanding loan balance of more than $1.36 million. The defendants were guarantors on the loan.

On June 19, 2014, a sheriff's sale was conducted and the plaintiff purchased the property for $900,000. The guarantor defendants contested confirmation of the judicial sale on the basis that the plaintiff's bid was unconscionably low. Each party submitted appraisals on the property that varied between $1 million and $1.28 million. The trial court entered an order approving the sale at $900,000 and entered a deficiency judgment for the remainder owed to the plaintiff-lender. The defendants did not appeal the order.

Four months later, the plaintiff sold the property to a third party for $1.32 million.

In February 2015, the plaintiff initiated enforcement proceedings against the guarantor defendants seeking the full deficiency amount. The guarantor defendants filed a petition for equitable setoff, requesting a reduction in the deficiency judgment to reflect the difference between the plaintiff's winning bid at the judicial sale and its resale price.

The plaintiff moved to dismiss the petition on the grounds the guarantor defendants failed to state a claim upon which relief could be granted. The trial court dismissed the petition explaining that, in the foreclosure context, a claim for setoff is unavailable, because (1) it could cause foreclosure proceedings to drag on indefinitely; and (2) in many cases it would be impossible for the trial court to determine the setoff amount. The guarantor defendants appealed.

The issue presented was one of first impression in Illinois. The Appellate Court based its analysis on long-recognized principles from Illinois and other states.

In Illinois, a purchaser at a foreclosure sale takes under the decree and not under the mortgage or trust deed, and therefore the purchaser's rights are not dependent on privity of contract between the purchaser and the mortgagor. Thus, a new relationship is created. The foreclosure ends the mortgagor-mortgagee relationship and vests in the purchaser at the foreclosure sale all the rights, title, and interest of both the mortgagor and the mortgagee.

As you may recall, a setoff refers to a reduction of the damage award because a third party has already compensated the plaintiff for the same injury. It is derived from a contractual or equitable right. Without a contractual right, there is no inherent right to setoff in equity; rather, equitable setoff was conceived as a limited remedy. A right to setoff in equity arises only if the indebtedness is certain and already reduced to a precise figure without a need for the intervention of a court or jury to estimate it.

The Appellate Court noted that courts have approved a defendant's request for an award of setoff where an insurance company made payments on his behalf or where a co-defendant made payments for the same injury. The Appellate Court could find no case where a defendant was entitled to a setoff because a third party, who had no relationship to the defendant, made a payment to the plaintiff.

The Appellate Court noted that it did not matter whether the purchaser at a foreclosure sale was the plaintiff in the enforcement proceedings or a stranger to such proceedings. See *Kentucky Joint Stock Land Bank of Lexington v. Farmers Exchange Bank of Millersburg,* 119 S.W.2d 873, 877 (Ky. Ct. App. 1938).

Here, the Court held that the foreclosure action terminated the mortgagor-mortgagee relationship and the plaintiff obtained an unencumbered right of ownership at the judicial sale, which conferred the right to sell to a third party. The plaintiff did not receive an improper double recovery for the same injury, and the deficiency judgment represents a single satisfaction of the defendants' debt owed to the plaintiff.

The Appellate Court noted that reopening the judgment under the pretext of awarding a setoff would undermine the finality of the judicial sale and require a full evidentiary hearing on the amount and reasonableness of the mortgagee's expenses and other economic matters.

In addition, the Court noted, a mortgagee may not recover the difference in enforcement proceedings and its resale price when it sells for less than what it paid at a judicial sale. When the mortgagor-mortgagee relationship ends with the judicial sale, the debtor loses any input over how the property will be maintained, and thus faces no liability for potential losses incurred by the lender.

Moreover, the Appellate Court explained, the possibility of a setoff in enforcement proceedings might give the lender a perverse incentive to not bid on the property at all, resulting in a lower purchase price and a greater deficiency. Second, a lender who chooses to purchase the mortgaged property by judicial sale would be inclined to avoid a setoff by retaining ownership, to the extent that such retention is lawful, until the deficiency-judgment enforcement proceedings concluded. Third, defendants advocate a rule that could expand to cover all secured transactions besides mortgages.

The Appellate Court also held that the defendants' failure to appeal the confirmation order precludes them from receiving equitable relief. Under the undisputed facts of the case, the Appellate Court concluded that the trial court did not err in granting the plaintiff's motion to dismiss defendants' petition for a setoff.

Accordingly, the judgment of the trial court was affirmed.