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Failure to Follow Freeze and Seize Law Leaves County With No Interest in Surplus Funds

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In the recent case of *Integrated Lender Services, Inc. v. County of Los Angeles* (2018) 231 Cal. Rptr. 3d 902, the Second District Court of Appeal ruled on a dispute arising over surplus funds following a foreclosure sale by the City of Los Angeles (the “City”). The foreclosure trustee deposited approximately \$273,000 in surplus with the trial court pursuant to *Civil Code* §2924j¹, for proper distribution among claimants, including (1) the County of Los Angeles (the “County”), who had temporarily frozen the property, recorded a lis pendens, and obtained a criminal fraud restitution order; and (2) junior lienholders whose interests were recorded after completion of criminal proceedings for the restitution order. In short, the Court of Appeal found that the County’s failure to complete all steps to “seize” the property, meant that it had no interest in the property, and no right to the surplus funds and the County’s lis pendens did not give notice of any valid interest in the property.

Case Background

With a loan obtained from the City, the African Community Resource Center (“ACRC”) purchased the subject property in September 2000, whereby a deed of trust was recorded, securing the City’s loan (the “City’s Deed of Trust”).

The ACRC’s executive director, Nigisti Tesfai (“Tesfai”), was later charged with using the ACRC to commit fraudulent acts, specifically by obtaining loans from public agencies and using the funds for personal, rather than charitable, use. Charges against Tesfai included sentence enhancement allegations for a “white collar crime” under California *Penal Code* §186.11, i.e., the “Freeze and Seize Law.” *People v. Green* (2004) 125 Cal.App.4th 360, 363 (restitution award of seized property reversed for failure to file a §186.11 petition).

Section 186.11 provides a method for property held by the defendant to be “preserved by the superior court in order to pay restitution and fines” if the allegations ultimately are deemed true. The Freeze and Seize procedures involve a number of steps including obtaining a temporary restraining order (“TRO”), preliminary injunction, appointment of a receiver,

and recording a lis pendens. If a receiver is appointed, the court may order an interlocutory sale of the property and hold the proceeds. If the defendant is convicted and the trier of fact determines that the facts supporting the white collar enhancement under §186.11 are true, the court ultimately may make a finding as to what property “shall be levied upon to pay fines and restitution to victims of the crime,” and “may order immediate transfer of the property or assets to satisfy any judgment and sentence made pursuant to this section.” *Penal Code* §186.11(h)(1)(A).

In this case, the County recorded a lis pendens and obtained a TRO, Tesfai was convicted and in July 2012, restitution in the amount of \$341,404 was ordered in favor of the County to pay to multiple victims. However, critically, there was no finding to support the white collar sentence enhancement, and the court made no order as to whether the property should be levied to pay Tesfai’s restitution.

Eighteen months later, in January 2014, Tesfai obtained a new loan for \$12,000 from the Barrington 2005 Trust, which was secured by a junior deed of trust against the property. In July 2014, the City began foreclosure proceedings under the City’s Deed of Trust. Facing foreclosure, ACRC sold the property to Vista 2014 Trust. Juan Velasquez was identified as a co-trustee of both the Barrington 2005 Trust and the Vista 2014 Trust (the “Trusts”). Velasquez subsequently made a \$15,000 loan to the Vista 2014 Trust, and recorded another junior deed of trust against the property². After a bench trial, the trial court awarded surplus funds to the Trusts.

The Appellate Decision

The Court of Appeal affirmed the trial court’s decision and found that the County had failed to follow the Freeze and Seize procedure. Although the County had a restitution order and froze the property pending criminal proceedings, no determination was made to support the white collar enhancement under §186.11, and no finding was made as

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Without a determination or admission by Tesfai of the allegations necessary for white collar enhancement, and due to the failure of the County to record a judgment lien or otherwise take steps to recover its restitution, the County had no interest in the property and was not entitled to surplus funds following the City’s foreclosure sale.

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to what portion of the frozen property would be levied to pay restitution.

The Court further found that the County's lis pendens did not alone give the County any rights in the property. The Court noted that a lis pendens gives notice of the action and clouds title until the action is resolved or the lis pendens is expunged, and any party taking title after a lis pendens takes it with constructive notice of the pending action so that anyone who obtains a subsequent interest is bound by any judgment in that action. *Slintak v. Buckeye Retirement Co., LLC, Ltd.* (2006) 139 Cal.App.4th 575, 586-587, citing *BGJ Associates v. Superior Court* (1999) 75 Cal.App.4th 952, 966, 967 and *Bishop Creek Lodge v. Scira* (1996) 46 Cal.App.4th 1721, 1734; See also *Deutsche Bank National Trust Co. v. McGurk* (2012) 206 Cal.App. 4th 201, 214. However, the Court found that the Trusts took their interests after the criminal proceedings were complete, so the lis pendens would only have given the Trusts notice that the criminal proceedings "had ended without impacting title to the property." *Integrated Lender Services, Inc., supra*, 231 Cal.Rptr. at 909 (emphasis in original). The restitution order had no impact on title without further action by the County, so the Trusts were not bound by any judgment.

As to the TRO obtained by the County, the Court found that this did not give the County any interest in the property either. The TRO "at most restrained Tesfai and ACRC from transferring the [] property" during the criminal proceedings.

Without a determination or admission by Tesfai of the allegations necessary for white collar enhancement, and due to the failure of the County record a judgment lien or otherwise take steps to recover its restitution, the County had no interest in the property and was not entitled to surplus funds following the City's foreclosure sale.

From a trustee's perspective, the case provides guidance on determining the order of priority of claimants to surplus funds. However, given the specific statutory requirements and rulings necessary in criminal proceedings to seize property, the probable safest course of conduct in such a situation is to deposit surplus funds pursuant to *Civil Code* §2924j. The Court's discussion regarding the insignificance of a recorded lis pendens after a case has been dismissed or otherwise adjudicated may prove to have meaning for lenders/servicers who frequently must move to expunge a lis pendens even after the final disposition of a case. Title companies might be more

willing to insure title where there is a lingering lis pendens after the dismissal of the case.

¹ *Civil Code* §2924j provides the notice and claim procedures where there are proceeds remaining after payment of the amounts due under a deed of trust per *Civil Code* §2924k (a)(1) and (2). The trustee sends written notice to all persons with recorded interests in the real property, and claims are to be submitted as set for the in the statute. If the trustee is unable to determine the priority of claims after conducting due diligence, the trustee may deposit the funds with the superior court.

² Because the Trusts were aligned, the Court treated them together.



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