Arizona Mortgage Anti-Deficiency Statute Overview

Prepared by: Gregory D Hague

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A deficiency occurs when the proceeds from the sale of real estate at foreclosure (or an agreed upon "short sale") are insufficient to satisfy the underlying debt. The purpose of this article is to provide a brief overview of whether a creditor who obtains a deficiency judgment can execute against and collect that deficiency from other assets of the debtor.

Understanding the Terms

An understanding of the terms, operative documents and legal requirements involved in the creation and enforcement of real estate security instruments is an essential first step to knowing when and how to apply Arizona's deficiency statutes. A good comprehension of the following definitions, in and of itself, will provide a good overview of this area of the law.

A. **Mortgage**: This is a two party instrument (mortgagor/mortgagee). It involves the "pledge" of real property by the mortgagor to the

mortgagee to secure the payment of a debt. The **mortgagor** is the borrower. The **mortgagee** is the lender. A mortgage constitutes a lien against real property in "lien theory states". It represents a conditional conveyance (conditioned upon repayment) of real property in "title theory states". Arizona is a lien theory state.

B. **Deed of Trust** (Trust Deed): This is a three party instrument (trustor/trustee/beneficiary). It involves a conditional conveyance of title to real property by a borrower (**trustor**) to a neutral third party (**trustee**), who holds it as security for a debt owed to a lender (**beneficiary**). The **trustee** can be a person or other entity as qualified under Ariz. Rev. Stat. §33-803, and is given the private power to sell the property upon default of the borrower in accordance with procedures prescribed in Ariz. Rev. Stat. §33-807(A).

C. **Promissory Note:** This is a written promise by one party (**maker/borrower**) to pay a sum certain to another party (**payee/holder**) on the terms described in the note. Do not to confuse a note with a mortgage or deed of trust. The promissory note is evidence of the debt. The deed of trust or mortgage is the operative document that "attaches" to the real property as security for the payment of the promissory note.

D. **Foreclosure Sale:** A proceeding prescribed by law to terminate a defaulted borrower's interest in real estate. Title 33 of the Arizona Revised Statutes sets forth the procedures and restrictions for foreclosing under a mortgage or deed of trust.

E. **Deficiency Judgment:** A judgment obtained pursuant to a foreclosure when the sale proceeds (subject to the market value limitation) are insufficient to satisfy the debt (plus costs of sale). *See* Ariz. Rev. Stat. §§33-725, 33-729, 33-814, and 12-1566.

F. **Private Power of Sale**: This is a provision in a deed of trust authorizing the trustee to privately sell the property upon default of the trustor/borrower or its successor in interest no sooner than 91 calendars days after recording the notice of trustee's sale. *See* Ariz. Rev. Stat. §33-807(C). State statues dictate specific notice and procedural requirements. *See* Ariz. Rev. Stat. §§ 33-807 and -809. In Arizona, the trustee must file a notice of sale with the Recorder's office in the county where the real estate is located, and within five business days of that filing, provide a notice of sale and accompanying requisite additional notices (typically the statement of breach or nonperformance) to the parties to the deed of trust and to any know successor to the original trustor or beneficiary, excepting the trustee. *See* Ariz. Rev. Stat. §33-809(C). Another notice with recording

information must be sent within 30 calendar days of the filing to all persons having an interest of record in the property and any person who has recorded a request for notice. *See* Ariz. Rev. Stat. 33-809(B). The trustee must also publish the notice in a newspaper of general circulation in the county where the real estate is located once a week for four consecutive weeks, with the last date of publication no earlier than ten days prior to the sale. *See* Ariz. Rev. Stat. §33-808(A)(1). Notice must also be posted at the foreclosed property ten days prior to the sale, if it can be done without a breach of the peace, and also at one of the places in the county courthouse where the property is located as provided for posting of such notices. *See* Ariz. Rev. Stat. § 33-808(A)(2).

G. **Judicial Foreclosure**: This is generally a costly and time consuming court proceeding to obtain a judgment on a debt, and force the sale of the real estate that secured the debt to satisfy that judgment. In Arizona, judicial foreclosures are the only remedy available when a mortgage is used to secure a debt. *See* Ariz. Rev. Stat. §33-721. The judicial foreclosure is also an available remedy in Arizona for deeds of trust (they are foreclosed "as a mortgage"), but is rarely used because the private power of sale is more expedient and less expensive. However, when the loan was not used to purchase a qualified property (discussed later), a judicial foreclosure may be the only way for a lender to execute against other assets of the debtor pursuant to a deficiency judgment.

H. **Right of Redemption**: This is a statutory right granted to a borrower to recover property previously sold at foreclosure by paying the lender the amount received at the foreclosure sale (plus costs). In Arizona it is only available following a judicial foreclosure, not a trustee sale pursuant to a deed of trust. *See* Ariz. Rev. Stat. §§ 33-726 and 12-1281 *et seq.* The redemption period in Arizona is six months unless the property is abandoned, in which event it is 30 days. *See* Ariz. Rev. Stat. §§12-1281(A) and -1282(B). Some state statutes allow a mortgagor to occupy the property during the right of redemption period; however, Arizona statutes do not provide for this.

I. **Anti-Deficiency Statute**: A law that prevents a secured lender (mortgagee or beneficiary) from attaching other assets of the borrower (except the real estate pledged as security for the debt) pursuant to a deficiency judgment. The characterization "anti-deficiency" is a misnomer, because the statutes do not actually prevent deficiency judgments, they only eliminate execution against the debtor's other assets pursuant to a deficiency judgment. In Arizona, the primary statutes that govern deficiencies are Ariz. Rev. Stat. §§ 33-725, 33-729, 33-814 and 12-1566.

J. **Qualified Property:** In Arizona, Ariz. Rev. Stat. §33-814 prohibits any action to recover a deficiency judgment from other assets of the debtor when *"property of two and one-half acres or less, which is limited to and utilized for either a single one-family or single two-family dwelling is sold pursuant to the trustee's power of sale"*. Note that this provision prohibits recovery of deficiencies whenever the property is of a specific type (often called a "qualified property"), and the foreclosure process is the private power of sale under a deed of trust. The type of loan (purchase money, second trust deed, line of credit, home improvement loan, construction loan) is not relevant. This statute does not apply to judicial foreclosures, only foreclosures pursuant to the private power of sale in a deed of trust.

K. **Qualified Loan:** In Arizona, Ariz. Rev. Stat. §33-729(A) prohibits recovery of a deficiency judgment from the other assets of the debtor pursuant to a judicial foreclosure on a mortgage (mortgages can only be enforced judicially) when **the property is qualified, *and*** "**a mortgage was given ..., to secure a loan to pay all or part of the purchase price**..." (often called a "qualified loan"). In other words, if the loan was used to purchase the property, and the property is qualified (as defined above), the borrower is protected by the anti-deficiency statutes regardless of whether the lender forecloses judicially or pursuant to the private power of sale in a deed of trust.

L. **Refinanced Purchase Money Loans:** A subsequent refinance of a loan used to purchase a qualified property does not lose its character as a purchase money loan. In *Bank One (Ariz.) v Beauvis,* 188 Ariz. 245, 934 P.2d 809 (App. 1997), the court held that since the majority of a subsequent consolidated refinance loan consisted of purchase money, the entire loan would be treated as a purchase money loan, even though part of the proceeds were used for non-purchase money purposes. Initially the bank argued that the loan should be bifurcated, but it withdrew this argument, *Id.* At 251, 934 P.2d at 815.

M. **Credit Bid**: This is a bid by the lender to purchase the secured real estate at foreclosure sale. *See* Ariz. Rev. Stat. §33-801(B). It is usually for all or part of the amount owed. It is the only "bid" that can be placed before the public sale begins. It protects the foreclosing lender from receiving less than it believes the property is worth.

N. **Fair Market Value Limitation**: In Arizona and many states, a deficiency judgment is limited to the difference between the amount owed (plus costs) and *the higher of* the property's sale price or fair market value, as of the date of the foreclosure sale. In Arizona, fair market value for this purpose is defined in Ariz. Rev. Stat. §§ 33-

725(B) and 12-1566 (C) for judicial foreclosures, and Ariz. Rev. Stat. §§ 33-814(A) and 12-1566(C) for trustee's sales.

O. **Election of Remedies**: Generally, this means that a plaintiff must choose between two or more available remedies that could be asserted in a cause of action. In Arizona, this doctrine bars a lender in a judicial foreclosure from suing a borrower separately on the "note" while simultaneously pursing a foreclosure action.

Understanding the Background

The idea of protecting borrowers from losing personal assets other than their home from a deficiency judgment following a foreclosure was conceived in the 1930's. As a result of the Great Depression, many homeowners were forced to default on their mortgage loans. Extremely low prices were obtained for the real estate at the foreclosure sales.

These low prices resulted from the stigma associated with this type of sale, along with the paucity of people who had jobs, down payment money and, therefore, the ability to buy. Also, the sudden and severe contraction of the money supply coupled with lenders' fear of continued asset devaluation made real estate loans difficult to acquire, even for seemingly "qualified" buyers.

As a result of these factors, banks were routinely able to acquire foreclosed real estate at what were thought to be artificially low prices. To make matters worse, banks often routinely sold the foreclosed property (often by providing attractive financing to prospective purchasers) at substantial profit. The bank's right to obtain a deficiency judgment and attach the other assets of the foreclosed borrower compounded this profit. Lenders often recovered substantially more than the balance of their original loan.

At that time (and even today), lenders who purchase foreclosed real estate at bargain basement prices could sell at a profit, with no obligation to credit the profit toward a borrower's deficiency. The understandable public and legislative discontent led to the enactment of "higher of foreclosure sale price or market value" limitations analogous to that found in Ariz. Rev. Stat. §§ 33-725(B) and 12-1566 (C) for judicial foreclosures, and Ariz. Rev. Stat. §§ 33-814(A) and 12-1566(C) for trustee's sales.

The lender's enrichment in excess of the amount owed, compounded by the loss of the borrower's personal assets resulted in a public backlash and the eventual enactment of right of redemption and anti-deficiency statutes in many states, similar to those found in Arizona.

Understanding the Present

Arizona's anti-deficiency statutes were first enacted in 1971. They prohibit execution against and attachment of a debtor's assets (other than the secured property) in both a judicial foreclosure and a trustee's sale when **both** the property and the loan are "qualified" (as defined above). *See* Ariz. Rev. Stat. §§33-729 and 33-814. When foreclosure is pursuant to a private power of sale in a deed of trust, the anti-deficiency statutes apply as long as the property is qualified, regardless of whether the loan is qualified. Ariz. Rev. Stat. § 33-814(D).

The trustee under a deed of trust can elect to foreclosure judicially in the same manner as a real property mortgage. Ariz. Rev. Stat. § 33-814 (E). This provides the beneficiary with a procedural option to pursue the collection of a deficiency judgment against other assets of the debtor when the property is qualified, but the loan is not.

In *Cardon v. Cotton Lane Holdings, Inc.*, 173 Ariz. 203, 841 P2d.198 (1992), the Arizona Supreme Court determined that deficiency actions must be decided in accordance with the substantive law that applies to the underlying debt. In that case, California law applied to the underlying obligation. Therefore, the pursuit of a deficiency after a trustee's sale of Arizona property was prohibited, regardless of whether Arizona law would have allowed it.

There are two tests required to determine whether the anti-deficiency statutes apply in any give situation.

TEST #1- Decide whether the parcel of real estate is a "qualified property," as defined by Arizona's anti-deficiency statutes. "Qualified properties" must be one or two family dwellings situated on 2.5 acres or less, limited to and used for residential purposes.

- Multi-family (3 or more) apartment buildings do not qualify.
- Commercial properties and vacant land do not qualify.
- A home (or condominium) purchased as an investment, a rental property or a vacation home would qualify, if they are or have been occupied.
- A personal residence situated on 2.5 acres or less would qualify.

TEST #2- Decide whether the loan is a "purchase money" loan, meaning the funds were utilized to purchase the property:

- If more than the purchase price was borrowed (at the time of purchase), the loan would probably still qualify (there is no bright line test as to any amount of excess borrowing that would eliminate the protection).
- A loan against one property to purchase another property would not qualify since it was not secured by the home purchased.
- Home equity lines of credit (HELOC) obtained after the initial purchase do not qualify.

- If, when the home was purchased, the borrower obtained both a first and second position secured loan, and used some or all of the proceeds as "purchase money," both of these loans should qualify.
- If the borrower refinanced an original purchase loan, they are generally protected even if the borrower receives cash pursuant to a refinance for an amount higher than the payoff of the original purchase money loan.

If Test #1 applies, the lender cannot execute against the borrower's other assets following a trustee's sale. This is true regardless of whether or not the loan is purchase money. If both Tests #1 & 2 apply, the lender cannot execute against the borrower's other assets following either a judicial foreclosure or trustee's sale.

The following are some not so apparent situations:

- A new home under construction by a builder, but not yet occupied, would not qualify. The "utilized" for residential purposes provision in the anti-deficiency statutes has been interpreted to mean "has been used or is being used", not is intended for use.
- The purchase of a newly constructed investment property or vacation home, that has never been occupied, would not qualify. The logic is the same as set forth above.
- When combining a first and second position loan to effectuate a purchase, the anti-deficiency statutes do apply, even if part of the proceeds from the second loan were used for other purposes

Understanding the Future

In early 2009, the Arizona Legislature passed Senate Bill 1271,which proposed to amend Ariz. Rev. Stat. §33-814, effective September 30 of that year. This amendment required that to qualify for deficiency protection, the property must have been issued a certificate of occupancy, and **be utilized by the owner for six consecutive months** (prior to the foreclosure).

While the language was subject to varied interpretation, the apparent intent of the legislature was to require that the owner occupy the property for at least six months at some point prior to the foreclosure. This law was the subject of intense scrutiny and lobbying. As you might expect, the bankers were for it; the Realtor and consumer groups were against it. Before the amendment became effective, the Senate sponsor of the bill requested that it be repealed, pending further study, to remedy any unintended consequences. This was likely the result of intense lobbying efforts.