

ARIZONA MORTGAGE DEFICIENCY LAW

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During the Great Recession, an unprecedented wave of mortgage foreclosures engulfed many American homeowners, real estate investors and commercial developers, forcing them to face the unthinkable of both losing their home, or investment property, to foreclosure and still having to pay their lender for the remaining loan balance due.

Fortunately, for many Arizona homeowner borrowers, the State's broad anti-deficiency statutes¹ protected them from a lender suing them for the shortfall between the mortgage loan balance and the price that their foreclosed upon home brought at the trustee's foreclosure sale. At the same time, many other borrowers, found themselves ineligible for the statutory protection, due to any of several exceptions in the law that exposed them to liability for the post-foreclosure deficiency balance.

With the exception of Arizona based mortgage lenders, their attorneys, and others involved in the local real estate industry, few individuals appreciate the complexity of Arizona's mortgage deficiency statutes and the case law interpreting them.

This article, written largely for a lender audience, but meant to be helpful to anyone analyzing the risk of being obligated to a lender for a mortgage deficiency, includes a checklist of items to be considered in determining whether a mortgage lender has the right, pursuant to Arizona law, to obtain a mortgage deficiency judgment against a borrower, or guarantor, of a loan secured by real property subsequent to:

- an administrative non-judicial trustee's foreclosure sale of the subject property (trustee's sale);
- a judicial foreclosure lawsuit upon the subject property (judicial foreclosure); or
- a lawsuit upon the remaining unsecured promissory note and/or guaranty obligation following the closing of a short-sale pursuant to which the mortgage lender:
 - releases its mortgage lien on the subject property in exchange for receipt of funds in an amount less than the loan balance, and
 - obtains a written acknowledgement from the loan obligors that the lender is not waiving its deficiency rights (short sale).

The content of this article is not intended to address every possible scenario of Arizona mortgage deficiency law. Also, the term "mortgage" is used herein with the understanding that the vast majority of mortgage liens in Arizona are evidenced by recorded deeds of trust. Furthermore, this article should not be used as a substitute for conducting current legal research.

¹ A.R.S. §§ 33-729, 33-814 and 12-1566.

Step One

Determine whether the mortgage loan is “purchase money” vs. “non-purchase money.”

- A loan is a purchase money obligation if it secures a mortgage given to secure the payment of the balance of the purchase price, or to secure payment of all or part of the purchase price, of the real property being sold in the loan transaction.
- A construction loan is a purchase money obligation when (i) the deed of trust securing the loan covers the land *and* the structure constructed thereon; and (ii) the loan proceeds were in fact used to construct a single-family home or duplex (hereinafter, a “residence”) subject to the “anti-deficiency” statutes.
- A home improvement loan unrelated to the acquisition or construction of a residence is a non-purchase money obligation.
- Home equity loans that are not 80/20 loans typically are non-purchase money obligations.
- A mortgage loan secured by a borrower’s residence is a non-purchase money obligation if the proceeds of the loan are used to purchase a different residence, such as a vacation home.
- Refinancing a purchase money obligation by the original, or a new, mortgage lender does not, in and of itself, convert the nature of the obligation to non-purchase money. The refinanced loan remains a purchase money loan to the extent of the original purchase money amount. In addition, refinance loan proceeds used to pay interest, late fees and a mandatory construction deposit directly related to the original purchase money loan and rolled into to the refinanced loan are considered part of the purchase money obligation. Conversely, refinance loan proceeds used for any purpose other than to acquire or construct the residence (such as interest,

maintenance, utilities, marketing fees and penalties) are not considered part of the purchase money obligation.

- A mortgage lender may obtain a money judgment for the traceable *non-purchase money portion* of a mortgage loan in (i) a judicial foreclosure; (ii) a suit upon its unsecured mortgage loan note after its mortgage lien has been extinguished by a senior lien foreclosure; and (iii) in a suit when the mortgage lender elects to waive its collateral and sue directly on the mortgage loan note. This remedy is typically available concerning a “cash out” refinance loan of the original purchase money loan which results in the borrower, or borrowers, receiving funds in excess of the original loan balance from the refinance loan proceeds.

Step Two

Determine whether the real property that secures the loan fits within the statutory definition of a “qualified property” protected by Arizona’s “anti-deficiency” statutes.

The general rule is that deficiency judgments are barred by Arizona’s anti-deficiency statutes when the collateral for the subject mortgage loan is a *completed* single-family home or duplex located on 2.5 acres or less. Specifically, the plain language of the anti-deficiency statutes provide that a “*Qualified Property*” protected by Arizona’s anti-deficiency statutes means real property of “2.5 acres, or less” *and* that is limited to *and utilized as* a “single one-family or single two-family dwelling.”

Concerning Loans Originated on or before 12/31/2014. Analyze the physical characteristics of the real property which secures the mortgage loan to attempt to determine whether it is a qualified property protected by the anti-deficiency statutes:

- Vacant land *cannot be* “utilized as” a dwelling and *is not* a Qualified Property.

- A single one-family or single two-family residential structure, which is *not completed*, *cannot be* “utilized as” a dwelling and is *not* a Qualified Property.²
- Real property which secures a mortgage loan *and exceeds 2.5 acres in size* does not fit within the statutory definitions for anti-deficiency protection and is *not* a Qualified Property. It does not matter if a single one-family or single two-family residential structure is located on the property if it exceeds the acreage limit.
- Real property which has a structure located on it *that is not a single one-family or single two-family residential structure*, such as four condominium units, does not fit within the statutory definition and is *not* a Qualified Property.
- A 1/10th fractional interest in a single-family residential condominium is a “dwelling” within the anti-deficiency statutes definition and is a Qualified Property.

The type of borrower and their intent concerning use of the real property can be the determining factor of whether or not it is a “qualified property” protected by the anti-deficiency statutes.

- A *completed* single-family or single two-family residential structure is a “dwelling” as defined by the anti-deficiency statutes. If an *individual homeowner borrower, or borrowers*, intend to occupy the structure as their primary residence, *regardless of whether they have ever actually occupied the structure*, it is being “utilized as” a dwelling and, thus, is a Qualified Property.
- A *completed* single-family condominium is a “dwelling” as defined by the anti-deficiency statutes. If the condominium is owned by *investment borrowers* who occasionally occupy

and rent it out, it is “utilized as” a dwelling and, thus, the condominium is a Qualified Property.

- A *partially constructed* single-family residence owned by a *commercial builder-developer borrower* who is holding the residence for eventual sale to its first occupant and *does not intend to occupy* the residence is *not* “utilized” as a single one-family dwelling and, as such, the partially constructed residence is *not* a Qualified Property. This rule has been extended to apply to *fully constructed* and never occupied single-family homes owned by a *commercial builder-developer* as well.

Concerning Loans Originated *after* 12/31/2014. On April 22, 2014, Governor Jan Brewer signed into law House Bill 2018, which amended Arizona’s anti-deficiency statutes to add identical new subsections located at A.R.S. § 33-729(C) and (D) (applicable to judicial foreclosures) and § 33-814(H) and (I) (applicable to non-judicial trustee’s foreclosure sales). The amendments apply to loans originated after December 31, 2014, and clarify and expand the circumstances in which deficiency judgments are allowed.

New subsections (H) and (I) added to supplement A.R.S. § 33-814(G), the non-judicial trustee’s foreclosure sale anti-deficiency statute, are set forth in their entirety below:

H. For deeds of trust that are originated after December 31, 2014, subsection G [*the anti-deficiency definition subsection*] of this section does not apply to trust property as follows:

1. Trust property owned by a person who is engaged in the business of constructing and selling dwellings that was acquired by the person in the course of that business and that is subject to a deed of trust given to secure payment of a loan for construction of a dwelling on the property for sale to another person.
2. Trust property that contains a dwelling that was never substantially completed.

² On January 23, 2015, the Arizona Supreme Court overruled the Arizona Court of Appeals’ *Mueller* decision. See *M&I Marshall & Ilsley Bank v. Mueller*, 228 Ariz. 478, 268 P.3d 1135 (App. 2011) overruled by *BMO Harris Bank, N.A. v. Wildwood Creek Ranch, LLC*, 236 Ariz. 363, 366-67, 340 P.3d 1071, 1074-75, 704 Ariz. Adv. Rep. 19 (2015). The *Mueller* Court had found that individual homeowner borrowers were entitled to the protection of Arizona’s anti-deficiency statute A.R.S. § 33-814(G), following a non-judicial trustee’s foreclosure sale, when they had never actually occupied a partially constructed single-family residence, but “intended to occupy it upon its completion.” Under those facts, the Court concluded that the individual homeowner borrowers were “utilizing” the partially constructed residence as a dwelling for the purpose of applying the anti-deficiency statute definition. Whereas, the Arizona Supreme Court held in *Wildwood* as follows: (i) *vacant land* is not “utilized” as a dwelling even if the borrower intends to construct a home on the property in the future; and (ii) for real property to be “utilized” as a dwelling, *a residential structure must be completed on it* (emphasis added). *Id.* The *Wildwood* Court further explained that an individual homeowner borrower does not have to *occupy* a completed residential structure for it to qualify as being “utilized” as a dwelling for “anti-deficiency” protection under A.R.S. § 33-814(G), provided that the individual homeowner borrower has the requisite intent to occupy the property as their residence. *Id.*

3. Trust property that contains a dwelling that is intended to be utilized as a dwelling but that is never actually utilized as a dwelling.

I. For the purposes of this section, a dwelling is substantially completed if either of the following occurs:

1. Final inspection is completed, if required by the governmental body that issued the building permit for the dwelling.

2. If a final inspection is not required by the governmental body that issued the building permit, the dwelling has been completed in all material respects as prescribed in the applicable ordinances and regulations of the governmental body that issued the building permit for the dwelling.

Subsections (C) and (D) added to A.R.S. §33-729, the anti-deficiency statute applicable to judicial foreclosures, include the same language. The statutory amendments clarify that:

- a lender may obtain a deficiency judgment against a builder or developer concerning a construction loan that the builder or developer obtained in the ordinary course of business to construct a home and sell it to a third-party; and
- a lender may obtain a deficiency judgment against any borrower if (i) a dwelling *was never substantially completed* upon the property which secures the mortgage loan; or (ii) the structure upon the property which secures the mortgage loan *was never actually utilized as a dwelling*.

These amendments were intended to overrule the aforementioned *Mueller* Arizona Court of Appeals decision.

The amendments include a specific definition of a *substantially completed* dwelling to mean either (i) that a final inspection has been completed by the governmental body that issued the building permit for the structure; or (ii) if no final inspection is required by the government body, then the dwelling has been completed in all material respects prescribed by the applicable governmental ordinances or regulations.

Step Three

Consider whether contractual anti-deficiency protection or fair market value waivers included in the loan documents are enforceable.

- A borrower *cannot* prospectively waive anti-deficiency statute protections.
- A guarantor *can* prospectively waive anti-deficiency statute protections.
- Borrowers and guarantors *cannot* prospectively waive the *fair market value credit* required by the deficiency statutes and fully discussed below.
- A borrower *can* waive the right to a *fair market value credit* determination *after* a non-judicial trustee's foreclosure sale commences. Although there is no case on point, the same rule likely applies to guarantors as well.

Step Four

Determine which of the four general rules listed below apply to the mortgage loan to be sued upon by the mortgage lender.

Rule #1: Purchase Money Loan + Secured by a Qualified Property

- **Trustee's Sale: NO DEFICIENCY JUDGMENT IS ALLOWED AGAINST THE BORROWER.** Note that only deeds of trust may be foreclosed through a trustee's sale.
- **Judicial Foreclosure: NO DEFICIENCY JUDGMENT IS ALLOWED AGAINST THE BORROWER.**
- **Short Sale: NO DEFICIENCY JUDGMENT IS ALLOWED AGAINST THE BORROWER.** The mortgage lender cannot elect the remedy to voluntarily release/waive the mortgage lien on the real property collateral and sue the borrower directly on the unsecured note.
- Unless prospectively waived in the loan documents, a mortgage lender should presumptively assume that any guarantor of the mortgage loan will receive the same anti-deficiency protection against a deficiency judgment as the borrower.

- An example of when Rule #1 applies is if a mortgage lender has made a loan that the borrower used to purchase a single-family home or duplex located on 2.5 acres or less.

Rule #2: Purchase Money Loan + Secured by a Non-Qualified Property

- Trustee’s Sale: DEFICIENCY JUDGMENT IS ALLOWED AGAINST THE BORROWER. A mortgage deficiency lawsuit must be filed within 90 calendar days after the date of the trustee’s sale. The 90-day statutory deadline after the date of the Trustee’s Sale is an absolute bar against filing a mortgage deficiency lawsuit after that date.
- Judicial Foreclosure: DEFICIENCY JUDGMENT IS ALLOWED AGAINST THE BORROWER.
- Short Sale: DEFICIENCY JUDGMENT IS ALLOWED AGAINST THE BORROWER.
- Mortgage lender can obtain a deficiency judgment against a guarantor of the loan based upon the independent guaranty contract.
- An example of when Rule #2 applies is if a mortgage lender has made a loan to a borrower used to purchase real property used for any non-residential purpose (such as an office building, restaurant or other business purpose).

Rule #3: Non-Purchase Money Loan + Secured by a Qualified Property

- Trustee’s Sale: NO DEFICIENCY JUDGMENT IS ALLOWED AGAINST THE BORROWER.
- Judicial Foreclosure: DEFICIENCY JUDGMENT IS ALLOWED AGAINST THE BORROWER.
- Short Sale: DEFICIENCY JUDGMENT IS ALLOWED AGAINST THE BORROWER.
- Unless prospectively waived in the loan documents, a mortgage lender should presumptively assume that any guarantor of the

mortgage loan will receive the same anti-deficiency protection against a deficiency judgment as the borrower.

- An example of when Rule #3 applies is if a mortgage lender has made a non-purchase money loan to a borrower and the real property securing the loan is located on 2.5 acres or less and is “utilized” as a single one-family or a single two-family dwelling.

NOTE SPECIAL EXCEPTION: If a mortgage lender holds a non-purchase money promissory note and junior deed of trust lien upon a Qualified Property and a senior lien holder completes a Trustee’s Sale of the property to extinguish the mortgage lender’s junior lien, then the mortgage lender can sue the borrower and/or guarantor upon the remaining unsecured promissory note and/or guaranty for a deficiency. This exception applies even if the same mortgage lender holds both the senior promissory note and deed of trust lien foreclosed upon and the junior promissory note and/or guaranty and deed of trust lien extinguished by the senior lien Trustee’s Sale.³ In addition, the junior mortgage lender may apply for any excess foreclosure sale proceeds that result from the senior lien holder’s Trustee’s Sale, apply them against the junior loan balance and still sue the borrower for deficiency judgment. Furthermore, the 90-day limitations period does not apply to this type of suit, because it is technically a suit on the junior promissory note and not a deficiency lawsuit under the foreclosure statute.

Rule #4: Non-Purchase Money Loan + Secured by a Non-Qualified Property

- Trustee’s Sale: DEFICIENCY JUDGMENT IS ALLOWED AGAINST THE BORROWER.
- Judicial Foreclosure: DEFICIENCY JUDGMENT IS ALLOWED AGAINST THE BORROWER.
- Short Sale: DEFICIENCY JUDGMENT IS ALLOWED AGAINST THE BORROWER.

³ This has been the rule of law for many years. On December 8, 2016, however, the Arizona Court of Appeals held the opposite in an unpublished memorandum decision (which provides that it is not precedential). See *Northern Trust, NA v. Wareing*, 2016 WL 7156439 (App. 2016). In that case, a mortgage lender that conducted a non-judicial trustee’s sale of a purchase money loan first-priority deed of trust secured by a property located on 2.5 acres and utilized by the borrowers as a single-family residence was barred by the trustee’s sale “anti-deficiency” statute A.R.S. § 33-814(G) from bringing either a deficiency action or suing directly on the lender’s remaining unsecured non-purchase money home equity line of credit note that had been secured by a second-priority deed of trust lien on the residence prior to the trustee’s sale foreclosure. The Court did indicate that the mortgage lender could have elected to judicially foreclose both of its mortgage liens to obtain a deficiency judgment based on the junior non-purchase money home equity line of credit. This will likely be an evolving area of Arizona foreclosure law.

- Mortgage lender can obtain a deficiency judgment against a guarantor of the loan based upon the independent guaranty contract.
- An example of when Rule #4 applies is if a mortgage lender has made a non-purchase money loan to a borrower and the real property securing the loan is a real property used for a non-residential purpose (such as an office building, restaurant or other business purpose).

Step Five

Consider the “fair market value” credit limitation of any deficiency judgment obtained by the mortgage lender.

- Any deficiency following a trustee’s sale or a judicial foreclosure permitted against either a borrower or a guarantor is subject to a “fair market value” credit limitation.⁴ In particular, the deficiency amount is calculated as, and limited to, the loan balance due on the date of the foreclosure sale less the greater of the actual foreclosure sale price or the “fair market value” of the property on the date of the sale.
- Borrowers and guarantors cannot prospectively waive the “fair market value” credit limitation.
- The successful bid at a non-judicial trustee’s sale does not *per se* constitute admissible evidence of the “fair market value” of the property foreclosed upon by the lender. The lender must offer affirmative valuation evidence, such as an appraisal report and expert appraiser testimony, to establish the “fair market value” of the property as of the date of the foreclosure sale.
- The “fair market value” determination is made by the Court and not a jury.

Miscellaneous Matters

- There is no statutory right of “redemption” following a trustee’s sale.
- Any judgment debtor, or their successor-in-interest, in a judicial foreclosure is granted a

statutory right of redemption, which allows them to recover title to the subject property after the date of the Sheriff’s sale of the property. The redemption period is either 30 days or six months after the date of the sheriff’s sale, as determined by the Court pursuant to the requirements of the judicial foreclosure statute.

- To redeem the property, the judgment debtor must pay the purchase price at the Sheriff’s sale, 8% interest accrued thereon, and taxes and assessments. In addition, each judgment debtor is granted the right to apply to the Court for a “fair market value” determination within 30 days after the Sheriff’s sale of the property. Moreover, failure of a judgment debtor to make a timely request for a fair market value determination may result in denial of the request. When any judgment debtor applies for a fair market value determination, the right to redeem the property is extinguished as to all judgment debtors.
- An arbitration clause included in a promissory note is enforceable to compel arbitration of a mortgage deficiency action.
- The deficiency statute expressly provides that any deficiency judgment obtained subsequent to a non-judicial trustee’s sale may include interest on the amount of the deficiency from the date of sale at the rate provided for in the loan documents. Further, the deficiency statute has been held to authorize an award of attorneys’ fees and costs by the Court.

Conclusion

The vast majority of residential foreclosures conducted in Arizona concern trustee’s sales related to loans secured by deeds of trust upon single-family residences located on 2.5 acres or less. In such cases, if the mortgage lender completes the trustee’s sale, the lender may not obtain a deficiency judgment against the borrower or a guarantor, unless they have waived the anti-deficiency statute’s protection.

Despite the foregoing, as illustrated by the rules above, there are many instances in which a mortgage lender may pursue collection of a deficiency balance

⁴ Unless waived after a non-judicial trustee’s foreclosure sale has commenced.

from a borrower, or guarantor, subsequent to a trustee's sale, judicial foreclosure or short sale.

In such cases, if the mortgage lender completes a trustee's sale, the lender must file the deficiency lawsuit against the borrower and any guarantors within 90 days after the date of the foreclosure sale. This limitations period is a strictly enforced, absolute bar date for filing a mortgage deficiency lawsuit following a trustee's sale. In addition, the borrower and guarantors shall receive a credit against the loan balance due as of the foreclosure sale of either the actual sale price at the foreclosure sale, or the "fair market value" of the property foreclosed upon as of the date of the foreclosure sale, whichever is greater, which is determined by the Court.

A useful resource to assist in understanding the scope and applicability of the Arizona mortgage deficiency statutes is the *Ins and Outs of Foreclosures*, Third Edition 2010.

About the Author

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