

Letter to the Editor of Maricopa Lawyer:

I am writing in response to the recent article by Mark Winsor in the December 2009 edition of Maricopa Lawyer and attorney Kent Berk's subsequent letter to the Editor, both of which explored the application of Arizona's anti-deficiency laws to short sales.¹ The contrasting conclusions of these articles highlight the conflicting, confusing and sometimes incorrect information circulating regarding deficiency issues and short sales in Arizona. This letter is designed to clarify for consumers, real estate agents, lenders and attorneys when and how Arizona's anti-deficiency laws apply to short sales and act to bar a lender from suing a borrower for a deficiency following a short sale.

In Mr. Winsor's article, he concludes that Arizona's anti-deficiency statutes apply to short sale transactions on certain residential property, namely purchase money loans on qualifying trust property.² In Mr. Berk's letter to the Editor, he takes the position that neither of Arizona's anti-deficiency statutes apply to a short sale because a short sale "is not a completed trustee's sale or judicial foreclosure" and thus, "a lender likely is entitled to pursue a claim for a deficiency resulting from a short sale even if one of the anti-deficiency statutes would otherwise apply if the lender formally foreclosed by trustee's sale or judicial foreclosure." It is my opinion, supported by clear and long-standing Arizona case law interpreting Arizona's anti-deficiency statutes, that Mr. Winsor is correct -- Arizona's anti-deficiency statutes apply to short sales of residential properties encumbered by a purchase money loan on qualifying property. Moreover, under Arizona law, the protections afforded by Arizona's anti-deficiency statutes should also apply to most refinanced loans that combine clearly purchase money and clearly non-purchase money loans on qualifying property.³

This letter addresses two separate issues raised in Mr. Berk's letter to the Editor -- (1) whether Arizona law⁴ permits a lender to sue a borrower following a short sale on qualifying property, and (2) regardless of a lender's legal right to sue a borrower following a short sale on qualifying property, whether it is likely a lender will attempt to do so, or at least pressure a borrower into paying money following a short sale. On the first issue, Mr. Berk's letter and conclusions therein ignore the decision of Arizona's Supreme Court in *Baker v. Gardner*.⁵ Moreover, contrary to Mr. Berk's assertion, there is Arizona case law that addresses our anti-deficiency statutes in a short sale context.⁶

In *Baker*, the holder of a purchase money, second position deed of trust lien against qualifying property attempted to sue the borrower on its promissory note after the senior lender noticed a trustee's sale

¹ Arizona's anti-deficiency statutes are found in A.R.S. §§ 33-729(A) (dealing with judicial foreclosures) and 33-814(G) (dealing with non-judicial trustee's sales). However, many Arizona court decisions have interpreted these statutes and provided ample guidance on their application.

² Pursuant to A.R.S. §§ 33-729(A) and 33-814(G), in order to qualify for anti-deficiency protection, trust property must consist of 2.5 acres or less and have been utilized as a single one or two-family dwelling. Such property is referred to in this letter as "qualifying property". Only A.R.S. §§ 33-729(A) requires that the loan be a purchase money loan to qualify for anti-deficiency treatment; there is no such requirement in A.R.S. § 33-814(G). A purchase money loan is a loan used to pay for all or a portion of the purchase price of a qualifying property. A.R.S. § 33-729(A).

³ See *Bank One v. Beauvais*, 188 Ariz. 245, 934 P.2d 809 (App. 1997).

⁴ Whether Arizona anti-deficiency law applies to a particular loan should not be assumed since a deficiency action is governed by the substantive law that governs the promissory note and parties are free to select such law. *Cardon v. Cotton Lane Holdings, Inc.*, 173 Ariz. 303, 841 P.2d 198 (1992).

⁵ *Baker v. Gardner*, 160 Ariz. 98, 770 P.2d 766.

⁶ See *Tanque Verde Anesthesiologists, Ltd. Profit Sharing Plan v. Proffer Group, Inc.*, 172 Ariz. 311, 836 P.2d 1021 (App. 1992) (holding that *Baker* and *Mid Kansas Fed. Sav. & Loan Ass'n v. Dynamic Dev. Corp.*, 167 Ariz. 122, 804 P.2d 1310 (1991) prohibited a junior lien holder from releasing its deed of trust security in a short sale and suing the borrower on the note despite the borrower's written agreement to remain liable for the deficiency).

foreclosure under its deed of trust. The lender's theory in *Baker* was analogous to Mr. Berk's theory in his letter to the Editor – that is, that the lien of the deed of trust and the promise to pay under the promissory note are legally separate obligations and since the junior deed of trust holder did not conduct the foreclosure sale (*i.e.*, there was no foreclosure sale as to the junior lender's collateral), Arizona's anti-deficiency statutes did not affect the borrower's obligation under its promissory note or the lender's right to sue the borrower under the note. The *Baker* Court stated the issue as whether Arizona's anti-deficiency statute allows a lender to waive its security and bring an action against the borrower for the unpaid balance of the promissory note.⁷

The *Baker* Court analyzed Arizona's anti-deficiency statutes and concluded that the statutes were designed not merely as procedural laws, ***but were designed to destroy a lender's right to a money judgment with respect to purchase money mortgages on qualifying property.***⁸ Said another way, the "***legislature's objective . . . was to abolish the personal liability of those who give trust deeds . . .***" to purchase money lenders on qualifying properties.⁹ Thus, with respect to a lender that has ***NOT*** conducted a foreclosure or trustee's sale on qualifying property, the Court concluded that if the loan was a purchase money loan, Arizona's anti-deficiency laws don't allow it to sue the borrower on the note.¹⁰ Only if the lender holds a non-purchase money loan on qualifying property may it elect to waive its security and sue the borrower on the note.¹¹ The Court reasoned that if a lender were allowed to disregard its security (by waiving or releasing it) and sue a borrower on a note, the lender would be able to do an end-run around the legislative intent in enacting our anti-deficiency statutes.¹² Simply put, a lender of a purchase money loan on qualifying property can't obtain a result (a money judgment) that it would not be able to obtain had it actually conducted the foreclosure under either of our anti-deficiency statutes.

In a short sale transaction, a lender does not conduct a foreclosure. Rather, a lender waives (releases) its security to permit the short sale to close. If the lender in a short sale transaction holds a purchase money note on qualifying property, the *Baker* case clearly prohibits it from suing on its note and obtaining a money judgment against the borrower. This should be true regardless of any agreement between the lender and borrower to the contrary because A.R.S. § 33-729(A) states expressly that the anti-deficiency protection applies ". . . notwithstanding any agreement to the contrary." In fact, in both the *Beauvais* and *Tanque Verde* decisions, the lender had extracted certain waivers or agreements from the borrower in the workout note or short sale approval process that purported to acknowledge the lender's right to a deficiency.¹³ Yet, in both cases, citing the *Baker* rationale and Arizona's anti-deficiency statutes, the lender was prohibited from suing the borrower on its note.

As noted above, under the *Beauvais* holding, even where a loan on qualifying property was refinanced to include a payoff of another loan or increase the loan amount, a borrower should be protected by Arizona's anti-deficiency laws, notwithstanding any agreement extracted by the lender in a short sale approval.¹⁴ The *Beauvais* decision is the only clear authority with respect to such a "*combo*" note on qualifying property and provides a borrower with all the ammunition it should need to fend off a lender's collection efforts, unless a lender wants to challenge *Beauvais* and make case law in the process. Moreover, given the *Baker* Court's broad proclamation that a borrower has no personal liability on a purchase money loan on qualifying property and the clear statutory language in A.R.S. § 33-729(A) that no agreement can

⁷ *Baker*, at 99.

⁸ *Id.* at 102, 104 (emphasis added).

⁹ *Id.* at 104 (emphasis added).

¹⁰ *Id.* at 104.

¹¹ *Id.*

¹² *See Id.* at 103-104.

¹³ *See Beauvais* at 247; *Tanque Verde* at 313.

¹⁴ *See Beauvais*.

change the anti-deficiency protection, a borrower can argue that any promissory note or agreement to be liable for a deficiency as part of a short sale approval is unenforceable. However, cautious legal counsel will generally advise a borrower to reject any lender short sale proposal on qualifying property and a purchase money note if the lender conditions approval on the borrower agreeing to remain liable for a deficiency or providing the lender an unsecured note. Why should a borrower agree to a deficiency where none exists under Arizona law?

Although a lender's rights following a short sale of a purchase money loan on qualifying property are clearly restricted under well settled Arizona law, the second issue raised in Mr. Berk's letter is not so clear. As I remind clients frequently, although Arizona law is clear, there is no guaranty a lender won't try to pursue a borrower for an alleged "deficiency" even though it has no right to do so. There are laws against stealing and assault, but these laws are violated quite frequently. People and companies oftentimes assert rights and take legal action where they have no right to do so. In this vein, I am seeing and hearing of frequent lender attempts to collect on uncollectible, unenforceable debts and hearing of lawsuits on loans that are clearly protected by the *Baker, Beauvais* and/or related authority. Time and time again I have heard stories of lenders stating unequivocally that they have deficiency rights under Arizona law when in fact they do not, or that they don't care about Arizona law because they will do what they want in the short sale process (if the borrower wants the short sale approved).

The reasons for these lender actions may vary, but likely include ignorance of the law, arrogance of the law, or downright arm twisting of consumers with few resources to challenge a bank and its legion of attorneys. However, where a lender is attempting to collect on a purchase money loan on qualifying property after a short sale, a stern letter to the lender and its legal counsel explaining Arizona law and its applicability to a given loan, along with threat of legal action if such illegal collection efforts continue, should persuade the lender to pick another file to employ such unsavory tactics. Unfortunately, many attorneys are providing lenders fuel to continue their improper collection efforts and dampen borrowers' leverage in short sale negotiations by clouding whether Arizona's anti-deficiency laws apply to certain short sales. By not providing consumers and lenders clear direction on well settled Arizona law, the short sale process will continue to be fraught with unfair negotiating tactics and illegal collection efforts by lenders.

Of course, under *Baker*, in a short sale context, a clearly non-purchase loan on qualifying property is not covered by Arizona's anti-deficiency laws, nor are loans on non-qualifying property (*e.g.*, raw land and commercial properties) protected.¹⁵ Borrowers may also be liable for any voluntary waste of qualifying property, even if anti-deficiency rules apply.¹⁶ Given the confusion in the marketplace and tactics being employed by lenders in short sale and distressed property negotiations, a wise borrower will consult with legal counsel to confirm its obligations, rights and leverage before agreeing to a workout or short sale.

Sincerely,

Marc McCain
McCain & Bursh, PLC, Attorneys at Law
901 W. McDowell Rd.
Phoenix, AZ 85007
(602) 604-2138

¹⁵ It is important to distinguish that a lender that actually forecloses on qualifying property via trustee's sale is barred from seeking a deficiency even if the loan is a non-purchase money loan. This letter addresses the rights of lenders in a short sale context and generally to sue a borrower on its note.

¹⁶ See A.R.S. § 33-729(B).

www.mccainbursh.com
www.marcmccain.com
mmccain@mblawaz.com