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Update on Court Decisions and the Anti-Deficiency Statutes

Posted on 01 February 2009

Tags: anti-deficiency, Combs Law Group, Court Decisions, Legal, statutes

By Christopher A. Combs and Adam D. Martinez

Introduction

Arizona and a small minority of other states have adopted anti-deficiency statutes to prohibit a homeowner's personal liability after losing a home to foreclosure. In the past two years in Arizona there has been both a rapid increase in homeowners who are delinquent on their home loans and a rapid decline in home values. Therefore, the scope of the protection of the anti-deficiency statutes is now of heightened interest to both homeowners and lenders.

Frequent questions are: Can the lender waive the right to foreclose on a home and bring a collection action on the promissory note? Do investors and developers have the protection of the anti-deficiency statutes after foreclosure on a home? Do the anti-deficiency statutes apply to the refinancing by the homeowner of the original purchase money loan, even if a portion of the loan refinancing exceeds the original purchase money loan? This article will attempt to answer those questions.

Background

The Mortgage

A mortgage is a two-party instrument which is basically a pledge of real property given by a borrower (mortgagor) to a lender (mortgagee) to secure a loan. A mortgage is not a debt, rather it is a security for the performance of another act, generally the repayment of a promissory note. Arizona follows the "lien theory" rule, which provides that a mortgage is not a conveyance, rather the mortgage merely creates a lien in favor of the mortgagee. Therefore, neither legal nor equitable title passes to the lender upon the creation of a mortgage.

The Deed of Trust

Since the adoption of the Arizona deed of trust statutes (A.R.S. §33-801 *et seq.*) in 1971, the deed of trust has replaced the mortgage as the principal real property security interest used in Arizona. There are two reasons that the deed of trust has become more popular: (1) foreclosure without the courts and (2) no redemption period after sale. A deed of trust is a three-party instrument by which the borrower conveys to the trustee legal title to the property. The trustee holds legal title to the property on behalf of the lender, who becomes the beneficiary of the deed of trust. The beneficiary's remedies under the deed of trust include those available to the mortgagee, but also give the trustee a non-judicial private power of sale not available in mortgages.

Enforcement of the Security after Default

Because the mortgage or deed of trust itself is not a debt, the lender may release the security interest

under the loan without losing the lender's right to bring an action on the original indebtedness which is secured by the loan.

If a mortgagee chooses to enforce the security, the mortgage must be foreclosed by judicial sale, in which case the security is sold by court order.

The beneficiary under a deed of trust may enforce the security by either

1. foreclosing upon the property as a mortgage (by judicial sale); or
2. having the trustee exercise its private power of trustee's sale.

The power of sale is often preferred by lenders because it provides a quicker and less expensive remedy than judicial foreclosure, and may be completed as soon as ninety days after formal notice of the sale is recorded and sent to the proper parties. A trustee's sale cannot be held after an action to foreclose the deed of trust has been filed unless the foreclosure action has been dismissed.

The Deficiency Judgement

If the proceeds of the foreclosure sale of the property secured by a mortgage or deed of trust are insufficient to pay the full loan balance (after deducting certain expenses and interest), the mortgagee or beneficiary may be entitled to a personal judgment against the debtor for the difference between the debt and the foreclosure sale price or fair market value of the property, whichever is greater. This *in personam* remedy following the foreclosure sale is called a deficiency judgment and is authorized under A.R.S. §33-725 (mortgages) and A.R.S. §33-814 (deeds of trust).

General Rule: Lender Must Elect Remedy

In Arizona, separate actions on the debt and to foreclose cannot be maintained simultaneously. This rule is embodied in A.R.S. §33-722 which allows the mortgagee to either sue directly on the debt, thereby waiving the mortgage, or foreclose the mortgage. Similarly, the beneficiary under a deed of trust can generally choose to forego judicial foreclosure or the trustee's private power of sale, and bring an *in personam* action on the debt.

Arizona's Anti-Deficiency Statutes

Although historically the mortgagee has had the right to obtain a deficiency judgment, the Arizona legislature enacted A.R.S. §33-729(A) in 1971 to limit the right of certain purchase money mortgagees to obtain a deficiency judgment if the security does not exceed two and one-half acres and is utilized as either a one-family or single two-family dwelling. For the purposes of A.R.S. §33-729 (A), a "purchase money mortgage" is one given concurrently with a conveyance of real estate between the seller and the buyer, or given to secure a loan to pay all or part of the purchase price of the dwelling. When such a purchase money mortgage exists, A.R.S. §33-729(A) provides the following limitation:

...[T]he lien of judgment in an action to foreclose such mortgage shall not extend to any other property of the judgment debtor, nor may general execution be issued against the judgment debtor to enforce such judgment...

This anti-deficiency statute expressly limits the purchase money mortgagee who initiates foreclosure to only those proceeds of the foreclosure sale. By its express terms, the statute applies only to actual foreclosure situations; it does not expressly bar the right of a purchase money mortgagee to elect under A.R.S. §33-722 to waive the security and sue on the debt. Even the no "general execution"

language of the statute literally refers back to those actions taken by the mortgagee in foreclosure, although it is unclear if this language was intended to restrict the mortgagee from general executions arising out of an action on the note itself.

Presumably, the lender would prefer to waive the security and sue on the debt any time it appears that the indebtedness would exceed the foreclosure sale price, at least where the debtor has sufficient assets to enable the lender to collect upon the judgment. Thus, the conflict between two statutes arises: A.R.S. §33-722 permits an action on the debt, whereas A.R.S. §33-729 (A) demonstrates the legislature's intent that the residential purchase money mortgagor should be exposed to liability only to the extent of the home used as security for the debt.

A similar issue also arises with application of the anti-deficiency statute for residential deeds of trust (A.R.S. §33-814(G)). This statute is similar to A.R.S. §33-729(A) to the extent that by its express terms it prohibits a deficiency judgment after the property is sold. The statute is somewhat broader, however, because it is not limited to "purchase money" loans.

Supreme Court Decision In *Baker V. Gardner*

In *Baker v. Gardner*, 160 Ariz. 98, 770 P.2d 766 (1988), the Arizona Supreme Court resolved the statutory conflict regarding purchase money loans with respect to mortgages and deeds of trust described in A.R.S. §33-729(A) and 33-814(G). The *Baker* court held that any secured lender may not waive the purchase money security and bring a collection action on the loan. In support of its decision, the Court stated that the legislature's objective in enacting A.R.S. §33-814(G) was to "abolish the personal liability of those who give trust deeds encumbering properties of two and one-half acres or less and used for single family or two-family dwellings." *Baker*, 160 Ariz. at 105, 770 P.2d at 772.

The Supreme Court Decision in *Mid Kansas Federal Savings*

In *Mid Kansas Federal Savings and Loan Association of Wichita v. Dynamic Development Corporation*, 167 Ariz. 122, 804 P.2d 1310 (1991), the Arizona Supreme Court resolved another conflict arising out of Arizona's anti-deficiency statutes. Specifically, the Court decided what persons and what properties are included within the anti-deficiency statutes.

The anti-deficiency statutes provide that the property securing the debt must be two and one-half acres or less and must be limited to and utilized as either a single one-family dwelling or single two-family dwelling. The Court held that if the subject properties fit within the statutory definition, the identity of the borrower as either a homeowner or developer is irrelevant. While the Court implied that the legislature intended to protect individual homeowners rather than commercial developers, it stated that the language of the anti-deficiency statutes did not exclude any other type of borrower. *See also Northern Arizona Properties v. Pinetop Properties Group*, 151 Ariz. 9, 725 P.2d 501 (App.1986) (investors entitled to protection of anti-deficiency statutes).

In determining whether a subject property fits within the statutory definition, the Court held that residential lots owned by a developer for construction and eventual resale as dwellings are not within the definitions of properties "limited to" and "utilized for" single-family dwellings; a property is not utilized as a dwelling when it is unfinished, has never been lived in, and is being held for sale to its first occupant by an owner who has no intent to ever occupy the property.

The Court of Appeals *Beauvais* Decision

In *Bank One, Arizona, N.A. v. Beauvais*, 188 Ariz. 245, 934 P.2d 809 (App. 1997) the Court of

Appeals extended *Baker, supra*, to hold that the extension, renewal, or refinancing of a purchase money note retains its character as a purchase money note. In support of its holding, the Court of Appeals cited *Baker's* examination of the legislative objectives behind Arizona's anti-deficiency statutes and, in light of those objectives, the Court of Appeals determined that the legislature did not intend that the loan would lose its character as a purchase money obligation when the loan is extended, renewed, or refinanced. The Court of Appeals further stated that to hold otherwise would lead to the very result that the legislature intended to avoid through the anti-deficiency statutes, namely, putting homeowners unable to make mortgage payments "at the peril of facing personal liability as well as the loss of their homes."

Even though in *Beauvais* a portion of the consolidated loan was non-purchase money, Bank One did not argue that the loan could be bifurcated. Therefore, the Court of Appeals considered the entire loan to be a purchase money obligation. As a result, the Court of Appeals declined to further address what exactly constitutes a "purchase money" loan or discuss the extent to which the anti-deficiency statutes protect refinanced purchase money loans.¹

Thus, *Beauvais* does not resolve the issue of whether a homeowner who refinances a purchase money loan and borrows funds in addition to the remaining balance of the original loan amount will receive protection under the anti-deficiency statutes for the total amount of the new loan, or whether the amount can be bifurcated for the purpose of determining the purchase money and non-purchase money amount.

Conclusion

The Arizona legislature, in adopting our anti-deficiency statutes, undoubtedly intended that a homeowner, who is unable to make payments on a purchase money loan, should lose no more than their home. The Supreme Court of Arizona, in interpreting this intent, has held that a secured lender may not waive its security and sue directly on the note. Additionally, the Supreme Court has held that there is no distinction between a homeowner and an investor/developer seeking protection under the anti-deficiency statutes if the residential property fits within the statutory definition of "two and one-half acres or less" and is "utilized for either a single one-family or a single two-family dwelling." Finally, the Court of Appeals has held that the anti-deficiency statutes protect a homeowner who has renewed, extended, or refinanced the original purchase money loan.

What remains unanswered is whether the Arizona appellate courts will determine that a homeowner, who defaults on a refinanced loan in excess of the original purchase money loan, will have the full protection of the anti-deficiency statutes. In light of the enormous amount of foreclosures now in Arizona, that answer should be forthcoming shortly.

Christopher Combs and Adam Martinez of Combs Law Group are on the AAR Legal Hotline Team. Visit their [website](#) or contact them at 602-957-9810.

¹ In 1990 the Court of Appeals held that "[a] 'purchase money mortgage' for purposes of Arizona's anti-deficiency statute is one that encumbers the property being sold." *Cely v. DeConcini, McDonald, Brammer, Yetwin & Lacy, P.C.*, 166 Ariz. 500, 505, 803 P.2d 911, 916 (1990).

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