The Lender's Perspective: Some Issues When Litigating Anti-Deficiency Cases

What Happens to Anti-Deficiency Coverage When a Mortgage Loan Is Refinanced?

How Should Banks and Mortgage Companies Handle the Anti-Deficiency Issue on the Closing Disclosure (CD)?

Prepared by:
Carolyn Goldman
Managing Partner
Goldman & Zwillinger PLLC
Direct: 602-315-6526
cgoldman@gzlawoffice.com

I. Background Regarding Arizona Anti-Deficiency Statutes

In these materials, the phrase "mortgage loan" is used in a generic sense, as it is in the mortgage industry, to mean a loan secured by a consensual lien on real property whether that lien is in the form of a deed of trust or a mortgage. In Arizona, deeds of trust are utilized almost exclusively.

There are two statutes which provide anti-deficiency coverage to certain mortgage loans secured by certain residential property. Both statutes can apply to loans secured by a deed of trust.

A. The Deed of Trust Anti-Deficiency Statute -- A.R.S. § 33-814

The first statute, A.R.S. § 33-814, is in the title, chapter and article of the Arizona Revised Statutes which pertain to deeds of trust (Title 33, Chapter 6.1 and Article 1). A.R.S. § 33-814(A) provides the "general rule" that a lender may file an action for a deficiency judgment within ninety (90) days after the date of sale of the subject property pursuant to a non-judicial foreclosure of a deed of trust. The primary exception to the lender's right to file an action for a deficiency judgment following non-judicial foreclosure

of a deed of trust contained in A.R.S. § 33-814(A), which thereby confers anti-deficiency protection to a borrower in this scenario, is contained in A.R.S. § 33-814(G) which provides:

> G. If trust ***property of two and one-half acres or less*** which is ***limited to*** and ***utilized for either a single one-family or a single two-family dwelling*** is sold pursuant to the trustee's power of sale, no action may be maintained to recover any difference between the amount obtained by sale and the amount of the indebtedness and any interest, costs and expenses.

(emphasis added).

The anti-deficiency protection conferred by this provision following a non-judicial foreclosure, or "trustee's sale" is broad as many residential properties are "two and one-half acres or less" in size and used as a one-family or two family residence. As more fully discussed below, Lenders often find it more expedient or necessary to utilize the statutes governing foreclosure of a mortgage as discussed below.

There is an additional provision in A.R.S. § 33-814 which affords the ability to limit the lender's rights under A.R.S. § 33-814(A) to obtain a deficiency judgment. A.R.S. § 33-814(F) allows the lender and borrower to agree in the deed of trust by express language to prohibit the lender's recovery of a deficiency judgment. There is also a provision in A.R.S. § 33-814 which limits the anti-deficiency protection afforded to certain borrowers by A.R.S. § 33-814(G). This provision is A.R.S. § 33-814(H) which significantly limits the anti-deficiency protection afforded to builders in connection with deeds of trust for loans originated after December 31, 2014.

B. The Mortgage Anti-Deficiency Statute - A.R.S. §33-739

The statutes governing deeds of trust provide that a lender, otherwise known as the beneficiary, may elect to foreclose a deed of trust in the same manner as a mortgage. A.R.S. §33-807(A); A.R.S. §33-814(E). A.R.S. §33-807(A) provides:

> At the option of the beneficiary, a trust deed may be foreclosed in the manner provided by law for the foreclosure of mortgages on real property in which event chapter 6 of this title governs the proceedings.

Chapter 6 of Title 33 of Arizona Revised Statutes govern mortgages generally and foreclosure of mortgages.

A.R.S. §33-739 governs the anti-deficiency provisions in connection with foreclosure of a mortgage. Foreclosure of a mortgage is a judicial, rather than a non-judicial proceeding; an action must be filed in the superior court. A.R.S. §33-739(A). Therefore, the process of achieving foreclosure as to the subject property will most likely take a longer period of time when judicially foreclosing a mortgage than when non-judicially foreclosing a deed of trust. However, it is important to the lender that the borrower has less anti-deficiency protection when foreclosing a mortgage, as not only must the borrower's property be two and one half acres or less and limited to and utilized for either a single one-family or single two family dwelling, but in addition, the mortgage or deed of trust must be:

> **[G]iven to secure the payment of the balance of the *purchase price*, or to secure a loan to pay all or part of the *purchase price*, ...**

(emphasis added)

pursuant to A.R.S. §33-739(A), and must comport with the various court decisions interpreting what this phrase means as discussed in this seminar. The concept of the loan coming within the meaning of this phrase and the court decisions is often referred to as the loan being "purchase money." [1]

II. What Happens to Anti-Deficiency Coverage When a Mortgage Loan Is Refinanced?

A borrower may refinance a mortgage loan for a variety of reasons including:

- to reduce the interest rate;
- to change the interest rate, from for example, an adjustable rate to a fixed rate, particularly in times of low interest rates;
- to change the term, by for example increasing the term from 15 years to 30 years to lower the monthly payment;
- to increase the amount of indebtedness and to use the additional loan proceeds for a great number of reasons such as:
    - home improvement such as a new kitchen or the additional of a pool;
    - to obtain cash for a variety of purposes such as college tuition or a vacation;
    - payment of credit card debt;
    - costs of construction of a new residence;
    - costs to maintain a home;
    - landscaping;
    - accrued interest on a loan;
    - homeowners association dues and fees.

If the original loan was a "purchase money loan" within the meaning of A.R.S. §33-739(A), and the borrower defaults in connection with the new refinancing loan, there is a significant issue as to whether the borrower has anti-deficiency protection in connection with the new refinancing loan.

[1] A.R.S. §33-739 also contains exceptions to the borrower's ant- deficiency protection (1) when the borrower commits waste (A.R.S. §33-739(B)) and (2) for certain loans to builders. (A.R.S. §33-739(C)). Additional important statutory provisions include A.R.S. §12-1566 and A.R.S. §12-1281 *et seq*.

This issue arose in *Bank One, Arizona, N.A. v. Beauvais,* 188 Ariz. 245, 934 P.2d 809 (Ct. App. 1997) *declined to extend, Helvetica Servicing, Inc. v. Giraudo,* 241 Ariz. 498, 389 P.3d 867 (Ct. App. 2017). In *Beauvais,* the borrowers, the Beauvais, obtained a loan from Bank One Arizona ("Bank One") in the principal sum of $75,000 to exercise stock options and the stock was collateral for the loan (the "1988 Loan"). Approximately one year later, the Beauvais obtained a second loan from Bank One (the "Consolidated Loan") to fund the purchase of a home and which incorporated and paid the 1988 Loan for the stock. The Consolidated Loan was in the principal sum of $315,000 which was used to pay off the 1988 Loan and to pay the sum of $240,000 towards the purchase of the home. The Consolidated Loan was secured by the stock and a second lien position upon the home purchased.

In 1992, the Beauvais could not pay the balloon payment due under the Consolidated Loan and obtained a third loan from Bank One in the principal sum of $190,000 (the "1992 Workout Loan") which was used to pay off the Consolidated Loan. The Beauvais defaulted in repayment of the 1992 Workout Loan and Bank One filed a lawsuit based upon the 1992 Workout Loan. Bank One elected this remedy and did not foreclose.

The Bank argued that the 1992 Workout Loan did not evidence a "purchase money loan" because it evidenced a loan made three years after the Beauvais purchased the home. Furthermore, the Bank argued that the loan proceeds were used to pay existing obligations rather than to purchase a residence. The Bank also argued, in the alternative, that the court

could determine the pro rata portion of the loan which was "purchase money" but abandoned this argument and did not raise it on appeal.

The Beauvais argued that the 1992 Workout Loan was an extension of the Consolidated Loan which was used in part to fund the purchase of the home and therefore was "purchase money." The Beauvais also argued it is contrary to the intent of the anti-deficiency statutes to make homeowners liable for deficiency judgments because they refinance their loan.

The Court of Appeals relied upon statements of the Arizona Supreme Court and the legislature concerning the consumer protection purposes of the anti-deficiency statutes and held that, under the facts of this case, regardless of whether the 1992 Workout Loan was ***an extension, renewal or refinancing, it retained its character as a purchase money obligation protected by the anti-deficiency statutes.*** The Court did not address that a portion of the Consolidated Loan was originally for the purpose of purchasing stock and this fact did not impact the Court's decision. The Court also did not consider determining the pro rata portions of the 1992 Workout Loan which were purchase money and which were non-purchase money as the bank did not pursue this argument on appeal.

In *Helvetica Servicing, Inc. v. Pasquan*, 229 Ariz. 493, 277 Pd.Ds. 198 (Ct. App. 2012), the Court did address the issue of determining which portions of a loan are purchase money versus non-purchase money. The borrowers, the Paquins, purchased a 4,000 square foot house in Paradise Valley in May, 2003 (the "Property"). The purchase price was $935,000 and the Pasquans obtained a mortgage loan from Hamilton Mortgage Company

in the principal sum of $600,000 to pay a portion of the purchase price secured by a deed of trust upon the Property (the "Hamilton Loan").

In December, 2004, the Pasquans obtained a $1,600,000 loan from Desert Hills Bank ("Desert Hills Loan No. 1"). The proceeds of this loan were used to pay off the Hamilton Loan and also to fund the demolition of most of the home which existed on the Property and to construct an 11,500 square foot home in its place. The Desert Hills Loan No. 1 was secured by a new deed of trust upon the Property. The Pasquans obtained an additional loan from Desert Hills Bank in the sum of $100,000 secured by the same deed of trust and a second additional loan in the sum of $400,000 secured by a second deed of trust.

In September 2006, the Pasquans obtained a $3,400,000 loan which was serviced by Helvetica Servicing, Inc. ("Helvetic" and the "Helvetica Loan"). The Helvetica Loan was used to pay off the loans to Desert Hills Bank, and according to the Pasquans to pay interest due to Helvetica, and "improvements, landscaping, maintenance, taxes, utilities and marketing fees for the house."

The Court of Appeals held that the overarching issue in the case is whether the Helvetica Loan is "purchase money" and also held that to the extent the loan consists of both "purchase money and non-purchase money sums" the lender can obtain a deficiency judgment for the non-purchase money sums. The Court remanded to the trial court to determine the "***purposes for which the Helvetica Loan Proceeds were disbursed."*** The Court confirmed that refinancing a loan did not automatically mean that the new loan lost its character as a purchase money loan.

In the footnotes to the decision, the Court stated in *dicta* that it did not believe that interest payments to Helvetica were "purchase monies." (fn. 7) It also stated in *dicta* that there is a significant difference between loans to construct houses, which would be purchase money under some circumstances and home improvement loans, which would not be purchase money, mentioning in particular loans to build pools and block walls. (fn. 6). The Court further suggested in *dicta* that a "cash out" refinance would not be considered "purchase money."

In *First Financial Bank, N.A. v. Claassen,* 238 Ariz. 160, 357 P.3d 1216 (Ct. App. 2015), the Court decided, contrary to the *dicta* in the *Helvetica v. Pasquan* decision, that interest is properly considered a purchase money obligation. The Court also held that the "costs commonly associated with a refinancing of a loan" are considered purchase money obligations, including also late fees. In addition, a mandatory construction deposit due to the homeowner's association was also a purchase money obligation entitled to anti-deficiency coverage.

III. Lender May Proceed against Certain Collateral Pledged at Time of Loan Origination When Judgment Not Required

In *Pfeiffer v. Morgan Stanley Credit Corp.,* 922 F.Supp.2d 828 (Ariz. Dist. Ct. 2012), the District Court held that a lender may proceed to collect against a brokerage account which (1) the borrower pledged as collateral at the time the loan was originated and (2) upon which collection did not require a judgment. The Court found the foregoing two facts significant as well as that the borrower is not being subjected to unlimited personal liability.

The Court examined the legislative intent, as discussed in various Arizona appellate decisions, and determined that its decision comported with this legislative intent:

> Plaintiff relies heavily on the legislative intent behind Arizona's anti-deficiency statutes to support his reading of those statutes. *However, the Court's examination of the record pertaining to the legislature's intent reveals just the opposite-permitting borrowers to pledge and lenders to act on additional pledge collateral is consistent with the purpose of Arizona's anti-deficiency statutes. . . .*
>
> *Allowing borrowers and lenders to arrange for additional collateral to secure a loan for a qualifying property does not frustrate this objective* [as stated in *Baker v. Gardner*, 160 Ariz. 98, 770 P.2d 766 (1989)] *because it does not expose the borrower to unknown and unending liability. At the outset, the borrower knows the extent of his or her liability on the loan, and, at the default, the lender is limited to recovering only the pledged assets and cannot reach any other nonexempt property.* And while the Arizona Supreme Court also stated the legislatures intent in stronger terms—the abolition of personal liability—pledging additional collateral does not run afoul of this formulation either. *833 Id. at 103, 770 P.2d 766. Personal liability is unlimited, *and the legislature intended only to abolish this unlimited liability* that previously followed default on a mortgage for a qualifying property. ***Additional pledged collateral exposes the borrower to limited liability, and the legislature did not intend to affect this kind of liability.*** *Pfeiffer v. Morgan Stanley Credit Corp.*, 922 F.Supp.2d at 832.

IV. Lenders Must Make the Proper Disclosure regarding Arizona's Anti-Deficiency Laws on the Closing Disclosure (CD) as Required by the TRID Rule Enforced by the CFPB.

The Consumer Financial Protection Bureau ("CFPB") promulgated the TRID Rule (TILA-RESPA Integrated Disclosure Rule) [2] which it also refers to as the "Know Before You Owe Rule." The portion of this rule which governs the Closing Disclosure (CD) [3] is

[2] *See* Regulation Z §§ 1026.19, 1026.37 and 1026.38.
[3] The Closing Disclosure or "CD" replaced the HUD Settlement Statements in most residential mortgage lending transactions.

contained in Regulation Z §1026.38. One of the mandated disclosures is "Liability after Foreclosure" in which the lender must chose one of the two boxes on page 5 attached hereto. For each loan originated, the lender must choose either (1) that state law *may protect* the borrower from a deficiency judgment or (2) that state law does *not* provide such protection for the specific loan transaction in which the borrower is involved.

Regulation Z §1026.38(p) provides:

> **(p)** ***Other disclosures***. Under the heading "Other Disclosures": . . .
>
> **(3)** ***Liability after foreclosure***. A brief statement of whether, *and the conditions under which*, the consumer may remain responsible for any deficiency after foreclosure under applicable State law, a brief statement that certain protections may be lost if the consumer refinances or incurs additional debt on the property, and a statement that the consumer should consult an attorney for additional information, under the subheading "Liability after Foreclosure."

It is essential that the lender makes a fully informed decision based upon current applicable Arizona anti-deficiency law in selecting the appropriate box to check. Checking "may" in all cases should be avoided, as if there is no possibility of anti-deficiency protection for the particular loan, advising the borrower that protection *may* exist could be considered a serious violation of law by the CFPB, as well as a "UDAAP," otherwise known as an "unfair or deceptive act or practice," pursuant to the Dodd-Frank Act. The CFPB has been very aggressive in pursuing enforcement actions and litigation against lenders and other market participants. *See https://www.consumerfinance.gov/policy-compliance/enforcement/actions*