mack drucker & watson

DISTRESSED PROPERTY LAW AND ISSUES IN ARIZONA

By Dax R. Watson, Esq.

602-778-9900 or dwatson@mackazlaw.com

TABLE OF CONTENTS.

Subject	Pg.
Introduction	2
What is a Trustee Sale?	3
● The Trustee Sale Process	
● Important Things to Know	
What is a Judicial Foreclosure?	4
● The Judicial Foreclosure Process	
● Important Things to Know	
The Anti-Deficiency Statutes	5
● What Properties Qualify?	
● What Loans Qualify?	
● What is a Purchase Money Loan?	
● What is NOT a Purchase Money Loan?	
The Mortgage Forgiveness Debt Relief Act of 2007	8

- What are the Tax Consequences of Foreclosure?

Investment Properties 9

- How are Investment Properties Treated**?**

Options to Avoid a Foreclosure or Trustee Sale 9

- Short Sale
- Deed in Lieu of Foreclosure
- Loan Modifications

INTRODUCTION

The average person can be confused by the various rules and regulations that control Foreclosures and Trustee Sales. The following is designed to provide a broad-based, plain language, review of the Judicial Foreclosure and Trustee Sale process.

What generally is a "Foreclosure"? There is a lot of confusion about the term "foreclosure" and what it entails. However, most homes, either primary residences or investment properties, are encumbered by a mortgage, i.e. an agreement to repay a loan provided for the purchase of the home. The mortgage holder is typically the lender and the homeowner is typically the borrower. If the homeowner/borrower fails to make his or her monthly payments on the mortgage, the lender can then foreclose on the mortgage. This means the mortgage will be in default and the lender can proceed with the process of having the home sold to repay the loan.

There are two (2) ways in which a lender can have the home sold. The first is through a **Trustee Sale** and second is through a **Judicial Foreclosure**. Of the two, the Trustee Sale is far more common. This is often confusing as most people are familiar with the term "foreclosure," but not the concept of a "trustee sale." As a practical matter, they both accomplish the same thing – the repossession and sale of the home to satisfy the defaulted loan. But, there are distinct and important differences that all homeowners should know.

What is a Trustee Sale? Mortgages are typically secured by a legal document called a **Deed of Trust**. This is a document that is recorded against the title to the home

that is essentially the lenders collateral for the loan – it gives the lender an interest in the home should the borrower not make their required payments.

In the event of a default on the mortgage, the beneficiary (again, usually the lender) under a Deed of Trust actually can proceed with either a Judicial Foreclosure (discussed below) or they can exercise a trustee's **power of sale** (the Trustee Sale). *See* A.R.S. § 33-807.

Again, the Trustee Sale is by far the more common route taken by lenders. This is because the **power of sale** provides a quick and relatively inexpensive remedy that may be completed 91 days after formally noticing a non-judicial sale. In simple terms, the lender/mortgagor will have a trustee "notice" the public sale of the property, and the property will be sold as a means of collecting on the defaulted mortgage.

What is the process for a Trustee Sale? Pursuant to A.R.S. §§ 33-808 and 809, the lender must record a Notice of Sale, within the County the property is located, once the mortgage is in default. From there, a sale cannot occur anytime sooner than **91** days after the recording of the notice. Likewise, the Notice of Trustee Sale must be published in a newspaper of general circulation at least once a week for four consecutive weeks, with the last publication not less than 10 days prior to the sale date.

Within 5 days of the recording of the Notice of Trustee's Sale, notice must be mailed to all persons who are parties to the Deed of Trust. A 30 days notice will likewise be sent out. *See* A.R.S. § 33-809.

The Trustee Sale itself is nothing more than an auction and bidding process. The highest bidder at auction will have the opportunity to purchase the property, provided the bid price is paid by 5:00 p.m. the following business day.

Important things to know about a Trustee Sale:

1. **It can be quick.** The lender can hold the sale **91** days after proper notice is given of the default and sale. Proper notice is determined, in part, by the terms of the loan (i.e. the loan documents themselves will set forth notice requirements).

2. **The borrower can reinstate the Deed of Trust.** Prior to the Trustee Sale, if the borrow brings the loan current, including all missed payments, interest and penalties, the Trustee Sale is terminated.

3. **There is no right of redemption.** Although there is a right of reinstatement, there is no right of redemption after the Trustee Sale occurs. In other words, after the sale occurs, the borrower cannot attempt to pay-off the balance of the loan to retain the home.

What is Judicial Foreclosure? The second type, and less common, means of a lender forcing the sale of a home is through a Judicial Foreclosure. The Judicial

Foreclosure process is expressly governed by statute. *See* Arizona Revised Statute (A.R.S.) § 33-721.

As part of the Judicial Foreclosure process, the mortgage holder will file a civil lawsuit against the borrower. That lawsuit is governed by the Arizona Rules of Civil Procedure and the lender must obtain a Foreclosure Judgment from a Court of competent jurisdiction to actually enforce the Foreclosure. In other words, the lender must go before a judge, present its case and be awarded a judgment. As a practical matter, assuming the borrower is in default, the lender will be successful in this regard and will obtain the judgment.

Once the lender obtains the judgment, the Court will direct the mortgaged property to be sold to satisfy the judgment. *See* A.R.S. § 33-752(A)

What is the sale process after the lender obtains a Judgment? Upon receiving the Foreclosure Judgment, the lender will obtain a Special Writ of Execution, which is an order authorizing the County Sheriff to sell the property. The Sheriff, in turn, will post a notice of the sale, in at least three public places, including near the County Courthouse. The sale must be noticed not less than 15 days before the sale date.

At the time of the sale, the Sheriff will receive bids on the Property through an auction. The highest bidder will "win" the auction and be required to pay the bid price within 5 days of the auction. To be valid, the sale must conform to the fair market value for the property. *See* A.R.S. 33-725.

Important things to know about a Judicial Foreclosure:

1. **A Judicial Foreclosure is not quick.** Because it is a civil action, involving a court and requiring the lender to abide by the myriad of procedural rules that go with a court proceeding, these actions take as long as 9 to 11 months. In turn, this is the primary reason that lenders normally proceed through a Trustee Sale, as opposed to Judicial Foreclosure.

2. **The borrower cannot reinstate the mortgage as a matter of right.** Please be advised that most loans have an **"acceleration clause"** which mandate that, once a borrower is in default (misses a payment), the remaining balance owed under the mortgage is accelerated and is owed in full (e.g., if $100,000 is still owed on the mortgage, the entire $100,000 becomes due, instead of just the monthly payment). In the Judicial Foreclosure setting, the mortgage is accelerated and the borrower cannot reinstate the loan by simply bringing the past-missed payments current.

3. **There is a right of redemption.** While there is no right to "reinstate" the mortgage, there is a right to redeem the property (pay the entire balance of the mortgage) prior to the Sheriff sale and there are even certain statutory rights of redemption after the sale.

How will the borrower know if his or her Deed of Trust is been foreclosed upon through a Trustee Sale Foreclosure Process or an actual Judicial Foreclosure proceeding? As stated, a Judicial Foreclosure is a formal court action, in which a lawsuit is filed with the Court and served upon the borrower. It will give notice of the action, where it is pending (which Court) and provide a summons. A Trustee Sale is not a lawsuit, it is simply a written, but recorded, notice to the borrower that includes the date, time and place of the sale. In either event, the document received by the borrower will most assuredly have the key trigger words – i.e. they will note either a "Trustee Sale" or a "Foreclosure Action".

What happens if the Trustee Sale Foreclosure Process or Judicial Foreclosure does not generate a bid price that meets or covers the money still owed to the lender? This is the million dollar (no pun intended) question from individuals facing these issues. Put another way, the question is: what happens if there is a **deficiency?**

The Anti-Deficiency Statutes. With most mortgages, if there is a deficiency after a Foreclosure or Trustee Sale, the difference will be forgiven. For example, if a borrower owes $300,000 to a lender, but a Trustee Sale only generates $200,000, the remaining $100,000 is forgiven. Put another way, the borrower is no longer obligated to pay that $100,000. This is articulated in Arizona's Anti-Deficiency Statutes, A.R.S. § 33-729 and 33-814.

Under what circumstances is the borrower protected by the Anti-Deficiency Statute? To qualify under the statute, the **home** secured by the Deed of Trust must satisfy the following:

1. It is on a parcel that is two and half acres or less;

2. The home itself is a completed (fully constructed), single, one or two family dwelling; and

3. The home is at least occasionally occupied by the owner or another party (it is either the borrower's personal residence, a second home, or a rental/investment property that was or is being leased to a tenant).

In addition, and of great importance, the **loan** at issue must meet the following requirements:

1. The loan cannot be a VA loan. VA loans do not fall within Arizona's Anti-Deficiency Statutes.

2. The loan must be a **purchase money loan**. Because this is such an important concept, a further explanation of **what is a purchase money loan** is in order.

Briefly, a **purchase money loan** is a loan acquired to buy the property. In other words, it is the money that is paid to the seller when the home is first purchased. That is the key test – did the borrowed money go to the seller? If it did, then it is a purchase money loan. If it did not, then the loan is not a purchase money loan. What qualifies as a **purchase money loan?**

a. **The original loan to purchase the property;**

b. **A refinance of the original loan (to pay-off the original purchase money loan) does qualify.** *See Bank One v. Beauvais,* 188 Ariz. 245, 934 P.2d 809 (Ariz. App. 1997) (regardless of whether a workout note was an extension, renewal or refinancing of a prior consolidated loan, it retained its character as a purchase-money note). This means that, if the homeowner refinances the original loan, at any time, the new, refinanced loan, will take on the character of the prior loan and be covered. This is true whenever the refinance occurs (e.g. if the refinance is done two years into the loan, it would qualify).

c. **A refinance of the original loan, to pay-off the original purchase money loan and to upgrade the home, may qualify.** It is also possible that refinanced loans, obtained to pay-off the original purchase money loan, and that also include additional funds, including to upgrade the home, may also qualify. This is, however, a gray area. Still, Court's have interpreted these types of loans as qualifying for the statute if the loans primary purpose was to pay-off the original purchase money loan. In other words, the question will be how much of the refinance was to re-pay the purchase money loan and how much was for the additions-remodel. The higher percentage used for the re-payment of the original loan, the more likely the anti-deficiency statute will apply.

d. **Homes purchased with two loans.** It was not uncommon over the last few years for a buyer to use two loans to acquire a property, most commonly an 80/20 split. As long as both loans were used to buy the property and the borrowed monies went to the seller, both loans will fall within the protections of the anti-deficiency statute.

What are NOT considered purchase money loans?

a. **HELOC loans and/or Lines of Credit.** In recent years, homeowners utilized the equity in their homes to obtain lines of credit. Those types of loans are not considered purchase money loans.

b. **Loans for Additions to a home.** Unfortunately, although considered a gray area, loans acquired to build additions to a home are not considered purchase money loans.

c. **Other Loans.** Any loans that are secured by the property, but that were not loans used to purchase the property, will not qualify as purchase money loans.

Are there any exceptions to the purchase money loan rule that may allow HELOC loans and the like to qualify under the Anti-Deficiency Statute? YES. As stated above, there are two anti-deficiency statutes, A.R.S. §§ 33-729 and 33-814. Under A.R.S. § 33-814, the lender has to make an election (choose) how it intends to foreclose upon the property. If the lender elects to go with the Trustee Sale described above (the more popular method), then the lender waives any right, even under a HELOC loan and/or line of credit, to pursue a deficiency. Thus, in order to seek a deficiency, the lender must proceed with the more timely and costly Judicial Foreclosure proceeding.

Please note, however, that even under A.R.S. § 33-814, the property itself still must meet the requirements that it is 2.5 acres are less, that the home is fully constructed and that it is at least periodically occupied.

What happens if either the property or the loan at issue does not qualify under the Anti-Deficiency statute? If that occurs, then the lender may pursue the borrower for any deficiency from the sale. For instance, in our hypothetical above, the lender could pursue the borrower for the remaining $100,000 owed on the note.

What happens if the homeowner damages the property? It is important to note that the statute will not apply if the borrower has engaged in "voluntary waste" or tears-up the property, making it worthless or substantially impacting its value for resale. This is significant as, regrettably, more and more frustrated homeowners are causing harm to their homes, such as removing all appliances, damaging the home, letting it to go to disrepair, and even worse, during the foreclosure process. In turn, if the harm or damage done is substantial, the lender may petition a court for relief from the anti-deficiency act. In short, borrowers need to keep their homes in good repair and treat them as their homes – even if they are going to lose them.

In addition the State of Arizona is now prosecuting homeowners who damage the property

How are second mortgages treated? Again, the analysis is no different for first, second or third mortgages. If the second was used to secure the property, then it is protected, if not (such as a line of credit) then there is no protection.

The Mortgage Forgiveness Debt Relief Act of 2007.

What are tax consequences of a deficiency? Put another way, even if the Anti-Deficiency Statute applies to a loan in default, does the borrower have any tax consequences? The simple answer, it depends.

Because of the rash of foreclosures and mortgage issues, the **Mortgage Forgiveness Debt Relief Act of 2007** was signed into law, and is effective for discharges of debt (deficiencies) that came into effect after January 1, 2007 through January 1, 2012. In general, this Act states that a married couple can discharge (not be taxed upon) up to $2,000,000 in deficiency, and single individuals up to a $1,000,000.

To put in simpler terms, the $100,000 deficiency from our hypothetical will now be considered dischargeable income if the Trustee Sale of Foreclosure Sale occurs between January 1 2007 and 2012. The date of the origination of the loan (when the money was borrowed) is not controlling – just the date of the foreclosure sale. For example, a loan acquired in 2005 will be covered by the Act, provided the loan is discharged (foreclosed upon) prior to 2010.

HOWEVER, this relief only applies to **"principal residences."** In turn, a principal residence is a residence in which the tax payer resided at for at least two out of the previous five years preceding the tax reporting date. **Thus, this exemption will not apply to homes owned for less than two years, second homes, investment properties or rental properties.**

If the exemption does not apply, the borrower will receive a 1099 for the deficiency and have to include it as part of their gross income for the year – which could result in a substantial tax obligation. In other words, using our $100,000 example, the borrower's taxable income for the year will increase by $100,000. So, if the borrower made $50,000 in 2008, and was 1099'd for another $100,000, their taxable income would be $150,000. In turn, the borrower will have to pay taxes on the $150,000 in income, as opposed to the $50,000. In short, the taxes owed to the government will based on $150,000 for 2008 and could result in a significant tax debt for the year.

Are there any other means of avoiding tax liability if the Act does not apply? Yes. The deficiency may qualify under the **"insolvency"** exclusion. Normally, a taxpayer is not required to include forgiven debts in income to the extent that the taxpayer is insolvent. A taxpayer is insolvent when his or her total liabilities exceed his or her total assets. The forgiven debt may also qualify for exclusion if the debt was discharged in a Title 11 bankruptcy proceeding or if the debt is qualified farm indebtedness or qualified real property business indebtedness.

Please contact your Certified Public Account or Tax Advisor to counsel you on issues relating to "insolvency" and tax reporting for the year of forgiveness.

Investment Properties.

How do the Anti-Deficiency Statutes and Mortgage Forgiveness Debt Relief Act treat Investment Properties? The Anti-Deficiency Statute does not distinguish between investment properties and principal residences. As such, provided the property and loan meet the requirements identified above, a lender cannot pursue a deficiency from a sale of an investment property. However, as stated, the Mortgage Forgiveness Debt Relief Act only applies to primary residences and, thus, investment properties will be subject to taxes on the deficient amounts.

Other Impacts of a Foreclosure or Trustee Sale.

What is the other negative impact of allowing a Property to proceed to a Trustee Sale or Foreclosure? The other primary adverse impact relates to the borrower's credit. Although it varies from borrower to borrower, and based upon the loan in default, the borrower's credit, for the purposes of future borrowing, will likely take a "hit." In most cases, the borrower's overall credit score will decrease and the default will appear on their credit report.

Options to Avoid a Foreclosure or Trustee Sale.

Legally, a Foreclosure can be avoided through a **redemption** of the full amount owed. Likewise, as stated, a Trustee Sale can be avoided by **reinstating** the delinquency and bringing the loan current.

Further, a Trustee Sale can also be avoided if the Property is sold prior to the Sale. Sometimes, and more common now, that is accomplished through a "Short Sale."

What is a "short sale'? This occurs when a lender agrees to a sales price for the property that is less than what is owed on a mortgage. A "short sale" can be more complicated if the loan has been sold in the secondary market – then the lender will likely need permission from Freddie Mac or Fannie Mae. And, if the loan was a low down payment mortgage with private mortgage insurance, the lender also will need to involve the mortgage insurance company. Further, the borrower will have to convince the lender that he or she is "broke" and/or cannot make the payments – hence requiring the "short sale."

What should a homeowner (seller/borrower) be concerned about with a "short sale"? If a home is encumbered solely with a **purchase money loan**, a lender should not be able to seek a deficiency even through a "short sale." Although, we also always recommend that the seller/borrower be careful in verifying the exact status of the loan (is it truly purchase money???) and making certain the lender likewise agrees that there is anti-deficiency protection. **Leave nothing to chance!**

Moreover, in the event the seller/borrow has additional loans, including a HELOC or the like, the seller/borrower must verify that this loan, as well as its underlying "note," are

released. To explain: most loans include two important documents. First, there is a Deed of Trust, which authorizes the lender to force a sale of the property. Second, there is a Promissory Note that sets forth the amounts owed under the loan and for which the borrower agrees to pay.

To pass clear title to a prospective buyer in a "short sale," the lenders will have to release the Deed of Trust. That release by itself does not resolve any debt owed. Rather, to resolve all of the debt, the lender must also agree that the Promissory Note is fully satisfied (even if the lender takes less than owed – the lender is to release the Note and accept what is paid as full payment). So, in negotiating a "short sale," it is imperative that the Promissory Note be properly addressed. If it is not, and the loan is not one that ordinarily would have anti-deficiency protections, the lender can pursue the seller/borrower for the deficiency - **even after the "short sale" is processed.**

Moving on, one of the mechanisms for avoiding a foreclosure is also granting a **Deed in Lieu of Foreclosure.** In that instance, rather than force the lender to go through the entire foreclosure process, the borrower simply deeds his or her interest back to the lender. In exchange the lender will release the Deed of Trust or deem the mortgage satisfied. In that event, the lender will not seek a deficiency, and although the borrower's credit rating will still be impacted by this occurrence, the impact could be less.

The Deed in Lieu process can be a "quick" and "inexpensive" means of dealing with this issue. But, both **"short sales"** and **"Deeds in Lieu**" have to be negotiated with the lender and are not a matter of right statutorily. Further, with each, the lender will usually require substantial disclosures relating to the borrower's current assets, debts and the like, and a "hardship" letter indicating that the borrower cannot meet his or her obligations.

When should you consider allowing the property to go to foreclosure? In our opinion, foreclosure should be a last option. The homeowner is far better off with a "short sale," "deed in lieu of foreclosure" or even a "loan modification," than allowing the home to be sold through a foreclosure or trustee sale.

How do you accomplish a "short sale" or "deed in lieu of foreclosure"? The homeowner can always attempt to work directly with lenders to accomplish any of these avoidance measures. Homeowners can also use legal counsel and would even be wise to consider consulting with their CPA or accountant on tax issues. In short, there is help and assistance available to navigate through these difficult matters.

About the Author. Dax R. Watson is a partner and founding member of the law firm of Mack Drucker & Watson. Mr. Watson focuses his law practice in the area of real estate

law, with an emphasis in complex real estate litigation. Mr. Watson represents several of the largest real estate companies in the State of Arizona, including representing the Sates two largest real estate brokers, as well as numerous contractors, mortgage companies and lenders throughout the State. Mr. Watson is also an approved instructor with the Arizona Department of Real Estate, approved to teach real estate legal issues. Mr. Watson can be contacted at 602-778-9900.

This article is of a general nature and may not be updated or revised for accuracy as to statutory or case law changes following the date of its publication. Further, this article reflects the opinion of the author, is not intended as definitive legal advice and you should not act upon it without seeking independent legal counsel.

Dated: November 19, 2009