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The Lender-Borrower Tangle: Understanding California and Arizona Anti-Deficiency Legislation

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Rising foreclosure rates in the residential real estate market have prompted underwater borrowers to ask about possible foreclosure strategies—most notably, how to avoid deficiency judgments. Often overlooked, however, are the challenges that lenders face, primarily due to borrowers choosing to strategically default on their mortgage when the amount owing on the loan exceeds the value of their home. These challenges are of particular concern for lenders operating in states like Arizona and California that have enacted strict anti-deficiency laws to mitigate the effects of foreclosure and personal liability. Anti-deficiency legislation insulates the residential borrower from any personal liability on the outstanding debt. This article examines both Arizona's and California's anti-deficiency statutes and presents strategies that may affect a lender's decision to foreclose on residential properties.

There are two types of foreclosure in Arizona and California: the first type is "*judicial*" foreclosure in which a lender files a lawsuit and gets a court order to foreclose on the property, and the second is "*non-judicial*" in which the property is sold by a trustee's sale via a power of sale clause in a deed of trust.

When faced with a potential foreclosure, the threshold questions to be asked by a lender in either state are:

(i) does the state's anti-deficiency legislation restrict the lender's ability to seek a deficiency judgment for the difference between the outstanding loan balance and the proceeds received by the lender at the sale (or the fair market value of the property), and
(ii) is the underlying loan secured by a mortgage or a deed of trust, and is the debt secured by the loan purchase money or non-purchase money.

If the property does not qualify for anti-deficiency protection, no further discussion is necessary, since the lender can choose under which foreclosure statute it wishes to proceed. In turn, if the property does qualify, the next step is to determine which statute allows the lender to maximize its recovery.

In both Arizona and California, if the property is foreclosed by a trustee's sale, under no circumstances can the foreclosing lender collect a deficiency. On the other hand, if the lender elects to judicially foreclosure on the property, a deficiency *may* be pursued, and the lender *may* be entitled to recover the difference between the loan amount and the actual sale price of the property (or its fair market value). Although the facts and circumstances may vary, the answers to those questions can significantly influence the lender's strategy concerning the method of foreclosure, as well as the method of collecting any deficiency judgment.

Arizona Anti-Deficiency Legislation

In Arizona, Arizona Revised Statutes ("*A.R.S.*") §§ 33-729(A) and 33-814(G) limit a lender's right to seek a deficiency judgment against the borrower after the foreclosure of a residential property if the secured property meets certain qualifications. Regardless of which statute ultimately applies, in order for the borrower to qualify for anti-deficiency protection, the secured property must be "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." The Arizona courts have held that the use of the residence is irrelevant under A.R.S. §§ 33-729(A) and 33-814(G) by extending the anti-deficiency protection to owners of investment properties as well as homebuilders *so long* as the secured property has been completely constructed, i.e., no vacant land, and is at least occasionally used by either the owner or another party as a single-family dwelling.[1] Interestingly enough, the courts have refused to extend similar protection to speculative builders whose homes are in the process of construction and are not yet occupied, as such homes are not *yet* being "utilized" as dwelling.[2] The courts have similarly refused to extend protection to borrowers who secure multiple single one-family or single two-family dwellings under one blanket deed of trust by holding that the secured property was not being "utilized" either as a single one-family or a single two family dwelling, but rather as *multiple* single one-family or single two-family dwellings, contrary to the plain meaning of the statute.[3] Provided that the secured property does not qualify for anti-deficiency protection, a lender can shape its foreclosure strategy primarily based on the type and character of the loan.

The application of A.R.S. § 33-729(A), which pertains to both mortgages and deeds of trust that are judicially foreclosed upon, depends on the character of the loan at the time the loan is made. Specifically, under A.R.S. § 33-729(A), if the loan is a purchase money loan, i.e., "*given to secure the payment of the balance of the purchase price, or to secure a loan to pay for all or a portion of the purchase price*," the lender's only recourse is to sell the foreclosed property in an effort to satisfy the outstanding debt. In other words, the lender is barred from collecting a deficiency judgment out of any of the other assets of the borrower thereby eliminating any sort of personal liability for the borrower.

Worth noting is that under A.R.S. § 33-729(A), refinance of an existing purchase money loan does not re-characterize the initial structure of the loan.[4] Therefore, a borrower is still afforded protection under the statute *even if* the borrower refinances the original purchase money loan. Case law in Arizona, however, is unsettled as to whether such protection would be afforded to a borrower if the purpose of the restructure or refinance of the

original loan was to "cash out" or pull equity out of the property to buy unrelated home goods or pay off debts.

If, on the other hand, the loan is a non-purchase money loan, i.e., the loan was used for any purpose other than the purchase of the property, such as: an assumption of an existing mortgage,[5] mortgaging one home to purchase another,[6] or a home equity line of credit,[7] the lender could escape protection and pursue a deficiency by judicially foreclosing.

In contrast, under A.R.S. § 33-814(G), which applies *only* to deeds of trust, if the lender elects to foreclose on the property by a trustee's sale, rather than electing to judicially foreclose under A.R.S. § 33-729(A), *regardless* of whether the loan was a purchase money loan or a non-purchase money loan, the lender is thereafter barred from collecting a deficiency judgment against the borrower.

If the secured property does not qualify for anti-deficiency protection under either A.R.S. §§ 33-729(A) and 33-814(G), a lender may obtain a deficiency judgment.

California One Action Rule and Anti-Deficiency Legislation
California's anti-deficiency legislation is similar in nature to that enacted in Arizona in that the manner in which a lender eventually elects to foreclose can determine whether or not a lender can seek a deficiency judgment.

When a borrower defaults, California Code of Civil Procedure ("*C.C.P.*") *§* 726(a) forces the secured lender to take only "one form of action for recovery of any debt or the enforcement of any right secured by a mortgage upon real property."[8] In other words, the lender is forced to take only one action, whether it elects to judicially foreclose on the property and, unless barred by anti-deficiency legislation, obtain a deficiency judgment, or sue the borrower and/or guarantors for the underlying debt obligation.[9] As a result, the lender must foreclose on the real property *first* prior to collecting on the underlying debt. This requirement is known in California as the "*one action rule*."
The obvious benefit to the borrower is that it is only obligated to pay any deficiency that remains after the foreclosure sale (subject to fair value limitations) *provided that* a deficiency judgment is available.

In California, protection for residential borrowers is set forth in two anti-deficiency statutes: *C.C.P. § 580(b)* and *C.C.P. § 580(d)*.

Similar in concept to A.R.S. § 33-729(A), protection under *C.C.P. § 580(b)* depends upon the character of the loan at the time it is made. Specifically, under *C.C.P. § 580(b)*, a lender is barred from collecting a deficiency judgment under a deed of trust for an owner-occupied residential one-to-four dwelling where the loan proceeds were used to secure the payment of the purchase price of the property, i.e., a purchase money loan, or under a loan for any type of property, i.e., owner occupied residential, investment or commercial, financed through seller carry-back financing.[10] In turn, *C.C.P. § 580(d)* limits a lender's right to seek a deficiency against the borrower after the property is foreclosed by a trustee's sale *regardless* of the type of loan *or* the type of property being foreclosed if the sale did not generate enough proceeds to pay the full amount of the debt.[11] There is one significant proviso—580(d) protection only applies to the debt of the foreclosing lender. If the proceeds are insufficient to pay off a subordinate lien, that subordinate creditor may qualify as a "*foreclosed out junior lien holder*" which may enable the creditor to sue the debtor directly for the debt under certain circumstances. Again, worth noting here is that unlike Arizona, a borrower can lose its antideficiency protection under *C.C.P. § 580(b)* if it refinances a purchase money loan. In spite of California's anti-deficiency laws, a lender is permitted under certain circumstances, to sue the borrower for damages resulting from fraud; rent skimming; mistake; "bad faith" waste,[12] environment impairment or enforcement of "environmental provision" under C.C.P. *§ 736(a)*.

Conclusion
Anti-deficiency legislation in Arizona and California shields residential borrowers from personal liability at the obvious expense of the lender. Though the application of this legislation differs among the states, when the decision to foreclose is imminent, a lender should keep in mind that there are numerous variables to consider when formulating a foreclosure strategy to maximize its recovery and that no single approach works every time.

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1 *Northern Arizona Properties v. Pinetop Properties Group,* 151 Ariz. 9, 725 P.2d 501 (App. 1986).
2 *Mid Kansas Federal Savings and Loan Ass'n of Wichita v. Dynamic Development Corp.,* 167 Ariz. 122, 804 P.2d 1310 (1991).
3 *PNL Credit L.P. v. Southwest Pacific Investments, Inc.,* 179 Ariz. 259, 877 P.2d 832 (1994).
4 *A.R.S. § 33-729(A).*
5 *Southwest Savings and Loan Ass'n v. Ludi,* 122 Ariz. 226, 594 P.2d 92 (1979)
6 *Cely v. DeConcini, McDonald, Brammer, Yetwin & Lacy, P.C.,* 166 Ariz. 500, 803 P.2d 911 (1990)
7 *Baker v. Gardner,* 160 Ariz. 98 (1988)
8 *C.C.P. § 726(a).*
9 *C.C.P. § 726(a).*
10 *C.C.P. § 580(b).*
11 *C.C.P. § 580(d).*
12 *see, Cornelison v. Kornbluth,* 15 Cal. 3d 590, 542 P.2d. 981 (1975)