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Dear Client:

Before we meet to consider your particular loan situation, I need for you to study the following discussion about mortgage foreclosure and the anti-deficiency statute as your homework:

A. FORECLOSURE AND/OR SUIT ON THE DEBT.

First remember that the normal lienholder has three choices:

1. Sue on the Note.

He can simply bring a lawsuit to collect what he is owed on the note (the IOU).

2. Foreclose the Lien.

He can foreclose the lien, which takes the property to an auction, where the lender can bid all or part of his debt (plus attorney's fees, and sale expenses) as a "credit bid", while everyone else bids cash. The high bidder must pay up within 24 hours, and then gets the property. If that is someone other than the lender who brought the sale, that lender walks away counting the cash that was paid, up to what he bid.

The foreclosure process wipes out all junior lienholders, and also converts the lien that was foreclosed into the ownership that is sold at the auction. However, it does not impact any senior liens, so the high bidder at the auction in the foreclosure of a second lien, steps into the shoes of the owner with the first lien still on the property, but all other liens wiped off the property.

Since all modern lenders use deeds of trust instead of old-fashioned mortgages, they can either:

a. going to a <u>trustees sale</u> (*aka* <u>non-judicial foreclosure</u>), which is fast (can be set for 90+ days after the default, but lets the borrower cure the default right up to the day before the sale by only paying the back amount; or

b. a <u>foreclosure lawsuit</u> (*aka* <u>judicial foreclosure</u>), which is very slow and expensive, and lets the borrower cure the whole default up to 6 months after the sheriff's sale.

3. Foreclose the Lien and then Sue for Deficiency.

A third option is for a lender to first foreclose his lien, and not bid the full amount of his debt at the sale, and then file a lawsuit to collect on any deficiency (any shortfall between the sale price at the auction and the full amount he is owed), and get what is called a "deficiency judgment".

Under the Bankruptcy Code, a deficiency judgment is a debt of yours which can be discharged in bankruptcy proceedings, but a lender may still seek payment from your loan guarantor.

Pursuit of a deficiency judgment is essentially a business consideration, and the possibility of a deficiency should be considered by both you and the lender, along with alternatives to a foreclosure sale, such as mortgage restructuring, reinstatement of the mortgage, redemption, or a short sale, especially in light of the enactment of the Mortgage Forgiveness Debt Relief Act of 2007. (Part E below.)

B. ARIZONA'S ANTI-DEFICIENCY STATUTES.

But Arizona is one of 7 states that have special "anti-deficiency" statutes that prevent a lender who forecloses from then suing to collect any deficiency under two special conditions in two different cases. (Some people call them "single action" states because the lender is limited to one action for a default.) These are holdover protections for homeowners from the Great Depression.

The first two of those special conditions (what I will call "**Conditions 1 & 2**") are that: (1.) the property in question is a parcel of 2.5 acres or less in size, and (2.) it "is limited to and utilized for either a single one-family or single two-family dwelling." Note: To satisfy these first two conditions, the residence involved need not be owner-occupied, the homeowner's principal residence, or even his residence at all.

If both of those first two conditions apply, then A.R.S. § 33-814 (G) says that a lender who non-judicially forecloses his lien, (meaning he takes the property to a trustee's sale – which nearly all of the residential lenders do), simply cannot pursue the borrower for any deficiency. So, what I call "**Case A**" is any non-judicial foreclosure of a property that satisfies Conditions 1 & 2.

However, if the lender judicially forecloses a lien against the property that satisfies those first two conditions, under A.R.S. § 33-729 (A), he is only prevented from suing the borrower for a deficiency to the extent that the loan was a "purchase money mortgage", meaning the proceeds were used to purchase or improve the property. So what I call "**Case B**" is the judicial foreclosure of a purchase money mortgage (or purchase money deed of trust). This presents a problem for loans like Home Equity Lines of Credit ("HELOCs"), where significant portions of the proceeds are used for other purposes. However, it is rare for the lenders to judicially foreclose even those liens.

Arizona cases have also held that, where the loan is a purchase money mortgage (again, most HELOCs fail this test), and Conditions 1 & 2 apply, the lender cannot make the election available to it in all other cases, to waive its right to foreclose on the collateral, and simply sue on the debt. And they have even said that this applies to the holder of a second position purchase money mortgage who did not even attempt to foreclose its lien, but instead had its lien wiped out by the foreclosure of first mortgage.

C. DEED IN LIEU OF FORECLOSURE.

One idea is to consider is to offer the lender a *Deed in Lieu of Foreclosure*. In other words, he "buys" the property at a price equal to what he is owed on his debt.

To do this safely, the lender needs to make sure that there is no downstream debt on the property below his mortgage. This can be consensual liens (like ordinary deeds of trust for second mortgages and HELOCs) or non-consensual liens (like judgments and income tax liens against the owner recorded in the same county as the property that become a judgment liens on all real property owned by that debtor in that county, or mechanic's liens recorded by contractors for work on the property).

Any such downstream liens stay on the property and the lender is stuck with them. So he will reject a Deed in Lieu of Foreclosure, and foreclose and bid all of his debt so that he either is the high bidder and gets the property with that debt wiped off, or gets paid cash by a higher bidder.

But a deed in lieu is not a foreclosure, so the lender can still hold the borrow liable for the shortfall, unless they agree otherwise. So the important thing in a deed in lieu is to make sure that lender applies its full debt to the "purchase" of the property, and does not try to continue to hold the borrower liable for the shortfall.

This is all a matter of negotiation and watching the details of the transaction.

D. SHORT SALE.

"Short sales" are where the lender agrees to allow a sale and to release its debt in return for less than full payment of his debt. They consider this in really tough markets, when property values fall and no longer support their full debt. The trick is to make sure that they don't just release their mortgage/deed of trust but that they also cancel the note and do not try to continue to hold the borrower liable for the shortfall.

But a short sale is not a foreclosure, so the lender can still hold the borrow liable for the shortfall, unless they agree otherwise. So the important thing in a short sale is to make sure that lender doesn't just release its mortgage/deed of trust but that it also cancels the note and does not try to continue to hold the borrower liable for the shortfall.

This is all a matter of negotiation and watching the details of the transaction.

E. TAX RAMIFICATIONS OF DEBT RELIEF.

If a lender cancels a debt, the lender is obligated to send to the borrower and the IRS a "*Form 1099-C: Cancellation of Debt*" for the year in which the debt is cancelled. The resulting cancellation of debt may be taxable as ordinary income to the taxpayer. If the taxpayer cannot offset that "gain" with other losses, the effect could be a substantial amount of income taxes that are due.

Fortunately, Arizona's anti-deficiency statutes, the Internal Revenue Code and the Mortgage Forgiveness Debt Relief of Act of 2007 offer various exceptions for taxpayers who have received a 1099-C.

One exception pertains to "non-recourse" debt, in which the loan documents specifically state that, in the event of a deficiency, the lender would have no recourse against the borrower. In Arizona, many residential loan documents have recourse provisions (i.e., they theoretically preserve the lender's right to pursue the borrower for a deficiency). However, the state's anti-deficiency statutes render those recourse provisions ineffective. Whether the statutes render as "non-recourse" a loan agreement that contains recourse language is another unresolved issue, and the borrower's tax liability may depend on the IRS's interpretation.

The Mortgage Forgiveness Debt Relief Act of 2007 remedies some of these issues. The Act applies to transactions after January 1, 2007, and before 2012 and permanently excludes debt forgiveness from income if:

(a) the real property was the principal residence of the taxpayer;

(b) the debt was for the purchase, construction or substantial improvement of the foreclosed property; and

(c) the foreclosed property was the taxpayer's primary residence for two of the past five years

The following link goes into more detail on the Mortgage Forgiveness Debt Relief Act of 2007 visit the following website:

www.irs.gov/individuals/article/0,,id=179414,00.html

Before you put your home on the market for a short sale; negotiate a deed in lieu of foreclosure, or even walk away from debt because of the anti-deficiency statute, it's best to talk with a tax advisor about possible tax repercussions from any debt relief.

F. SECOND LIEN CONSIDERATIONS.

The lender who holds any junior lien has to be concerned about having his lien wiped off the property by a foreclosure of a senior lien. If that happens, his only remaining remedy may be to sue the borrow to collect on the note.

One remedy that any such junior lienholder has is to remedy any default on an upstream lien, in time to stop the foreclosure auction-sale, and then add that cure amount to what is owed under his own lien; declare a default on his own lien, and foreclose it. But this remedy does not make sense in a severely depressed market like the one we are in. This is because (using a foreclosure of the second lien as an example) the property will still have the first lien on it, and the equity above that first lien is so low that no one will outbid the second lienholder at the sale, and the second lienholder will not be able to recover enough profit at the sale to recoup the original loan amount, much less the additional costs it took to cure any default on the first lien.

However, one of the anti-deficiency statutes changes things here as well. As explained in part B above, Arizona cases have also held that for Case B, (where Conditions 1 & 2 apply – 2.5 acres or less single or double family dwelling, and the loan is a purchase money mortgage – again, most HELOCs fail this test), the lender cannot make the election available to it in all other cases, to waive its right to foreclose on the collateral, and simply sue on the debt. And they have even said that this applies to the holder of a second position purchase money mortgage who did not even attempt to foreclose its lien, but instead had its lien wiped out by the foreclosure of first mortgage.

Sincerely,

Noel J. Hebets
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