

**MEMORANDUM**

TO: **SENATORS SYLVIA ALLEN AND STEVE PIERCE  
REPRESENTATIVES JACK BROWN, BILL KONOPNICKI, BARBARA  
MCGUIRE**

FROM: **MARC MCCAIN**

DATE: **July 27, 2009**

RE: **SENATE BILL 1271 – ARIZONA ANTI-DEFICIENCY LAWS**

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In order to assist you and Arizona's legislature in evaluating the impact of Senate Bill 1271 and the many requests to repeal this Bill, this Memorandum:

- (1) explains existing Arizona anti-deficiency law;
- (2) examines the assumptions employed in considering Senate Bill 1271 and the stated loophole the Bill was designed to close; and
- (3) discusses some of the numerous unintended and negative impacts Senate Bill 1271 will have on individuals and Arizona's economy.

**I. Arizona's Anti-Deficiency Laws.**

Arizona's anti-deficiency laws are found in two statutes: (i) A.R.S. § 33-729(A) (regarding judicial foreclosures); and (ii) A.R.S. § 33-814(G) (regarding trustee's sales). Under both of these statutes, **anti-deficiency rules apply only if** the property being foreclosed meets the following criteria:

- (1) 2½ acres or less; and
- (2) limited to and utilized as a single one-family or single two-family dwelling.

For judicial foreclosures under A.R.S. § 33-729(A), there is the additional requirement that the loan be a purchase money loan for the borrower to get anti-deficiency treatment. Under Arizona anti-deficiency law, a purchase money loan is a loan that is used to pay for all or a portion of the purchase price of the residence.

However, in a trustee's sale under A.R.S. § 33-814(G), **both** purchase money loans and non-purchase money loans on qualifying property are covered by the anti-deficiency provisions of A.R.S. § 33-814(G). As a result, **any lender** that forecloses on qualifying property by conducting a trustee's

sale is barred from seeking a deficiency against the borrower. All the lender is entitled to do is foreclose on the property and take the collateral from the borrower. A common misconception is that only purchase money loans get anti-deficiency protection. This is simply not true under A.R.S. § 33-814(G).<sup>1</sup>

Arizona's Supreme Court has interpreted the anti-deficiency statutes in two seminal cases. In the first case, *Baker v. Gardner*, 160 Ariz. 98 (1988), the Supreme Court reviewed the legislative history and intent behind the passage of Arizona's anti-deficiency statutes. The *Baker* Court made several important statements regarding Arizona's anti-deficiency statutes, including:

- (1) “[T]he legislature’s objective in enacting § 33-814(E) 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.” *Id.* at 104 (emphasis added) (note that the statute was later renumbered to be § 33-814(G)).
- (2) “Finally, as to any inequities that *Baker* may visit on some lenders, **giving home purchasers the full benefit of legislative protection outweighs the hardships to lenders. Even assuming, arguendo, that this balance may upset some leaders, we believe it preferable to follow the clear legislative objective of protecting home buyers.**” (emphasis added).

In the second case, *Mid Kansas Federal Sav. and Loan Ass’n of Wichita v. Dynamic Development Corp.*, 167 Ariz. 122 (1991), the Supreme Court made several important comments and conclusions, including:

- (1) “[T]he Arizona provisions were designed to temper the effects of economic recession on mortgagors by precluding ‘artificial deficiencies resulting from forced sales.’ **Anti-deficiency statutes put the burden on the lender or seller to fairly value the property when extending the loan, recognizing that consumers often are not equipped to make such estimations.**” *Id.* at 127-128. (emphasis added) (citations omitted).
- (2) The unique features of a deed of trust **require a strict construction in favor of the borrower.** *Id.* at 131.
- (3) **Residential spec homes** being developed for sale but not actually used as a dwelling sale do **NOT** qualify for anti-deficiency treatment. *Id.* at 129.

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<sup>1</sup> Arizona's Supreme Court explained that the “[t]he [statute’s] purpose ... was to put nonjudicial enforcement of a deed of trust on a par with judicial foreclosure and sale.... [Prior to its enactment] ... [c]reditors preferred private sale because it avoided a statutory period of redemption. By exercising the power instead of foreclosing judicially, the creditor could obtain a deficiency judgment as well as the enhanced proceeds of a redemption-free sale. This procedure allowed the creditor to bid on the property himself at an unfairly low price - or offer that opportunity to someone else - secure in the knowledge that any deficiency would be recoverable in a personal judgment against the principal.” *Mid Kansas Federal Sav. and Loan Ass’n of Wichita v. Dynamic Development Corp.*, 167 Ariz. 122, 127 (1991) (citations omitted).

- (4) Arizona's anti-deficiency statute protects commercial transactions on qualifying property that is actually used as a dwelling. *See Id.* at 128.

In *Northern Arizona Properties v. Pinetop Properties Group*, 151 Ariz. 9 (App. 1986), Arizona's Court of Appeals weighed in on A.R.S. § 33-814(G) and its anti-deficiency provisions when it stated that:

- (1) the requirement that the property be used as a dwelling **does not** require that the dwelling constitute someone's permanent residence or normal place of abode. *Id.* at 12.
- (2) In addition, A.R.S. § 33-814(G) protects investment use. *Id.*

## II. Assumptions and Justifications in Support of Senate Bill 1271.

The Senate Research Staff Memorandum regarding Senate Bill 1271, dated June 11, 2009, includes several material **incorrect assumptions** regarding Arizona law and the impact of Senate Bill 1271, including:

- (1) "In many cases, the lender has the option to get a judgment [after foreclosure] in this amount [the deficiency amount] against the borrower, called a 'deficiency judgment.'"
- (2) "Current law protects a trustor (often the borrower) from losing their home in a deficiency judgment if he or she dwelt in the property and the lender takes a loss."
- (3) "Investment property . . . is not protected from a deficiency judgment."
- (4) Senate Bill 1271 "[m]akes technical and conforming changes."

The first assumption misstates the typical outcome when a lender on qualifying residential property forecloses. As noted in the *Baker* and *Mid Kansas* cases, the lender will be barred from seeking a deficiency after a trustee's sale. Accordingly, it is not true that the lender in such a situation will have the option to obtain a deficiency judgment against the borrower.

The second assumption misstates the "utilized as a dwelling requirement". As discussed in the previous section of this Memorandum, Arizona's courts have ruled that a qualifying property need only be put to use as a dwelling, not that the borrower actually live (dwell) in the property. Under current Arizona law, it is the type of property that matters, not the type of borrower.

The third assumption misstates our Supreme Court's findings in *Baker* and *Mid Kansas*. Simply stated, after looking at the legislative intent and justification behind the enactment of Arizona's anti-deficiency laws, Arizona's Supreme Court found no reason why qualifying residential property owned for investment purposes would not get anti-deficiency treatment.

The fourth assumption mischaracterizes the nature of the impact of Senate Bill 1271. By claiming Senate Bill 1271 made conforming changes (based on an incorrect assessment of existing Arizona law), Senators and Representatives were led to believe that the changes would not result in wholesale changes to existing anti-deficiency law. Nothing could be further from the truth – Senate Bill 1271 stands existing anti-deficiency law on its proverbial head!

Moreover, the comments made by banking lobbyists before the Senate Finance Committee (June 10, 2009) and House Government Committee (June 23, 2009) were inaccurate, misleading and/or narrow in scope. Miss Wendy Briggs, speaking on behalf of the Arizona Banker's Association, stated before both Committees that Arizona's anti-deficiency statutes were intended to protect "true homeowners" and "not investors". As discussed above, this is a complete misstatement of Arizona law as interpreted and set forth by Arizona's courts. In addition, Miss Briggs characterized anti-deficiency laws as "unusual". While anti-deficiency concepts may be difficult to grasp at first review, they are far from unusual. Many states have anti-deficiency consumer protection laws and these laws date back to at least the Great Depression. *See Baker*, at 102.

In addition, the scenario presented by banking insiders to each Committee in support of Senate Bill 1271 was that existing law was being manipulated by spec builders who in some cases were moving into a home for a day or two to qualify for anti-deficiency treatment. While it is conceivable a borrower could try to manipulate existing anti-deficiency statutes in this fashion, our Supreme Court has already ruled on this issue and stated that spec builders don't get anti-deficiency treatment unless they actually use the residence as a dwelling. Thus, all a lender has to do under existing law is show that the borrower's intent was to build and sell the home and that the borrower did not actually use it as a dwelling. Once a lender makes its case in a deficiency action (which it can do through proper discovery and evidence presented in the lawsuit), the burden of proof will shift to the spec builder to establish that it did in fact use the residence as a dwelling (and not merely camped out on the floor to claim protection). If manipulation is evident, this should subject the borrower to a deficiency following a foreclosure.

Speaking at the Senate Finance Committee meeting on behalf of Town Bank and Desert Hills Bank, respectively, Mr. Patrick and Mr. Ferendorph (sp?) suggested the intent of the Bill was (i) not to take anything away from true homeowners, and (ii) not to have a negative impact on a legitimate homeowner, but only to bring clarity to the existing anti-deficiency laws. One can only assume that banking executives were trying to say that the Bill would not impact people that actually live in their home. However, this is also false. The certificate of occupancy requirement and burden shifting provisions of Senate Bill 1271 will impact owner occupied borrowers, any second home owner could be impacted, and any owner that has not lived in the home for at least 6 consecutive months could be impacted (see next section in this Memorandum addressing issues raised by Senate Bill 1271).

Unfortunately, few questions were asked of banking lobbyists during Committee meetings. No questions were asked by the House Government Committee. Miss Briggs did not face any questions from the Senate Finance Committee. There were a few questions and comments made following Mr. Ferendorph's presentation, but these did not focus on the numerous substantive impacts the Bill would have on all borrowers and all lenders. Although I am certain Arizona's legislature had good intentions in passing Senate Bill 1271, it appears that the full range of consequences of this Bill and the policy reasons supporting anti-deficiency laws were not taken into consideration before its passage.

**III. Unintended Consequences and Issues Raised by Senate Bill 1271.**

1. Certificates of Occupancy are not issued for all residences. The certificate of occupancy requirement was presumably intended to satisfy the banking lobby's concern that a residence is actually completed to qualify for anti-deficiency treatment. However, there are major problems with this requirement, including:

(a) not all cities and counties currently or routinely issue a certificate of occupancy for residences;

(b) some cities, like Phoenix, only started issuing certificates of occupancy in more modern times;

(c) even if a certificate of occupancy can be obtained by a borrower, this requirement will tax already overburdened city and county staffs and budgets; and

(d) obtaining a certificate of occupancy for a residence where one was not issued can require an inspection and potentially costly upgrades to bring a home up to current certificate of occupancy standards.

2. The new 6-month requirement raises numerous issues and gray areas.

(a) Does the new law apply only to primary residences? Current law does not require the property to be a primary residence and Senate Bill 1271 did not address this issue. Does this mean that a second home or investment property is still protected provided it is not rented to a third party?

(b) Does the law really require the borrower to live in the residence, or just that the borrower put it to use as a dwelling? Current law does not require the borrower to live in the residence, just that the property is used as a dwelling by someone. However, the new law does not use the language "lived in" but kept the existing phrase "utilized as a dwelling".

(c) How will the 6-month requirement be interpreted? What about an extended illness or out-of-state work assignment that takes a borrower away from a residence? If a borrower lives in a home for 4 months, is hospitalized for a month, returns to live in the home for another 3 months and then is transferred out of state for work and ultimately loses the home to foreclosure, would the borrower be covered by the new law?

3. Rather than limiting Senate Bill 1271 to loans made after September 30, 2009, the Bill is applicable to all foreclosures that occur on or after September 30, 2009, regardless of when the loan was made. Retroactive application of Senate Bill 1271 will unfairly impact existing contractual rights of borrowers who took loans under the existing anti-deficiency scheme and now will face deficiency judgments. On the other hand, lenders that made loans knowing the existing anti-deficiency scheme will suddenly have at their disposal rights and remedies they never thought they would have in the event the borrower defaulted under the loan. However, such

retroactive application will almost certainly face constitutional challenge. Given the clear misunderstanding of Arizona law utilized in the passage of Senate Bill 1271, it is likely retroactive application will not pass constitutional muster.

4. Narrowing the application of Arizona's anti-deficiency law reduces a lender's incentive to cooperate with a loan workout, *e.g.*, a short sale or loan modification. Rather than negotiate a short sale or loan modification to assist a borrower, it may be in a lender's interest to take back the property and then sue for a deficiency. When a bank forecloses and takes title to a property in a down market, it oftentimes delays sale of the property, hoping to take advantage of a better market in the future.

5. Residential home prices will likely suffer further declines as fewer properties are sold via short sale and result in foreclosures.

6. Eliminating anti-deficiency protection for investors will increase investment risk for residential home buyers, thereby reducing the number of willing investors and second home buyers. This will stymie price appreciation and slow down Arizona's economic recovery.

7. Bankruptcy filings will soar as borrowers seek to avoid deficiency judgments. In addition, if deficiency judgments are obtained, potentially millions of dollars will be taken from individuals' pay checks, bank accounts and other asset pools. This will result in additional credit damage and decrease the ability of many individuals to obtain financing and participate in an economic recovery.

8. Eliminating anti-deficiency protection for investors will also eliminate an important exception to cancellation of debt income – the non-recourse loan exception. This will result in substantial tax liability for numerous investors. This money will largely go to the Federal Government and will be sucked out of Arizona's economy, further hindering Arizona's economic recovery.

9. Senate Bill 1271 protects banking superpowers more than community banks, all at the expense of consumers. The main concern of the legislature in passing this Bill apparently was that community banks are hurting and spec builders should not be able to manipulate existing law. While community banks may be hurting, so are consumers and investors. However, the changes to A.R.S. § 33-814(G) are not limited to community banks. This statute applies to ALL LENDERS and ALL BORROWERS. Considering a large majority of all Arizona residential home loans are made by national or regional banks, the impact of this legislation will be to provide another lifeline to banking superpowers, many of whom have received TARP or other bailout monies, while at the same time taking away an important consumer protection law intended to protect consumers during difficult economic times such as these.

10. The stated purpose of the Bill – closing a loophole in the law that is hurting Arizona's community banks – was overstated given existing law. As noted above, Arizona's Supreme Court has already held that spec homes held for resale do NOT get anti-deficiency treatment. Under current law, all a lender has to do is prove its case. Thus, the problem cited by the banking lobby is only a problem if a bank can't prove its case. Banks are better able to shoulder this burden than your average consumer or investor.

11. Shifting the burden of proof will prove an insurmountable task for many borrowers that deserve anti-deficiency protection. Generally, a party that files a lawsuit has the burden of proof to establish its claim. Once this burden is established on a particular fact, the burden shifts to the other party to rebut the fact. If Senate Bill 1271 is permitted to go into effect, all lenders will have to do is allege they are entitled to a deficiency because the 6-month requirement was not satisfied and the borrower will be forced to defend itself in court. This change will result in fishing lawsuits where lenders file lawsuits without having a good basis for knowing whether the 6-month requirement has been satisfied, but knowing full well that a cash strapped and outgunned borrower will be forced to prove its case in court. If the borrower does not appear in the matter, a default judgment will ensue. If a borrower is unable to hire a lawyer, it will be forced into litigation against its lender and their hired gun legal counsel.

12. Elimination of anti-deficiency treatment for a large segment of residential loans is contrary to the legislative purpose in passing the anti-deficiency laws. As noted above, our Supreme Court has stressed that anti-deficiency laws are based in the premise that lenders are better able to assess and absorb risk related to the value of residential homes. In a time of economic upheaval, eliminating such an important law is 100% contrary to the entire purpose of having anti-deficiency laws – they are intended to provide protection to borrowers against economic upheaval. Moreover, if lenders want the streamlined right to foreclose at a trustee’s sale, plus the right to seek a deficiency, then the 6 month right of redemption afforded in judicial foreclosures should also apply to trustee’s sale. Given Arizona’s economy was built largely on residential housing construction, and given the fees, interest and other profits many banks realized during the boom years, it is inconceivable that such an important consumer protection law would be taken from investors that are by and large struggling to stay afloat.

13. The new legislation will be ripe for manipulation by investors seeking to satisfy the new 6-month requirement. Assuming the law is interpreted to require a borrower to actually live in the dwelling, investors that own multiple properties will now be encouraged to simply move from house to house for the required 6-month period to avoid a deficiency. While this may slow the pace of some foreclosures as investors hold off foreclosure until the 6-month requirement is met, it certainly does not solve the problem of manipulation by “scammers” that was used to gain support for Senate Bill 1271. Rather, it only increases such manipulation.