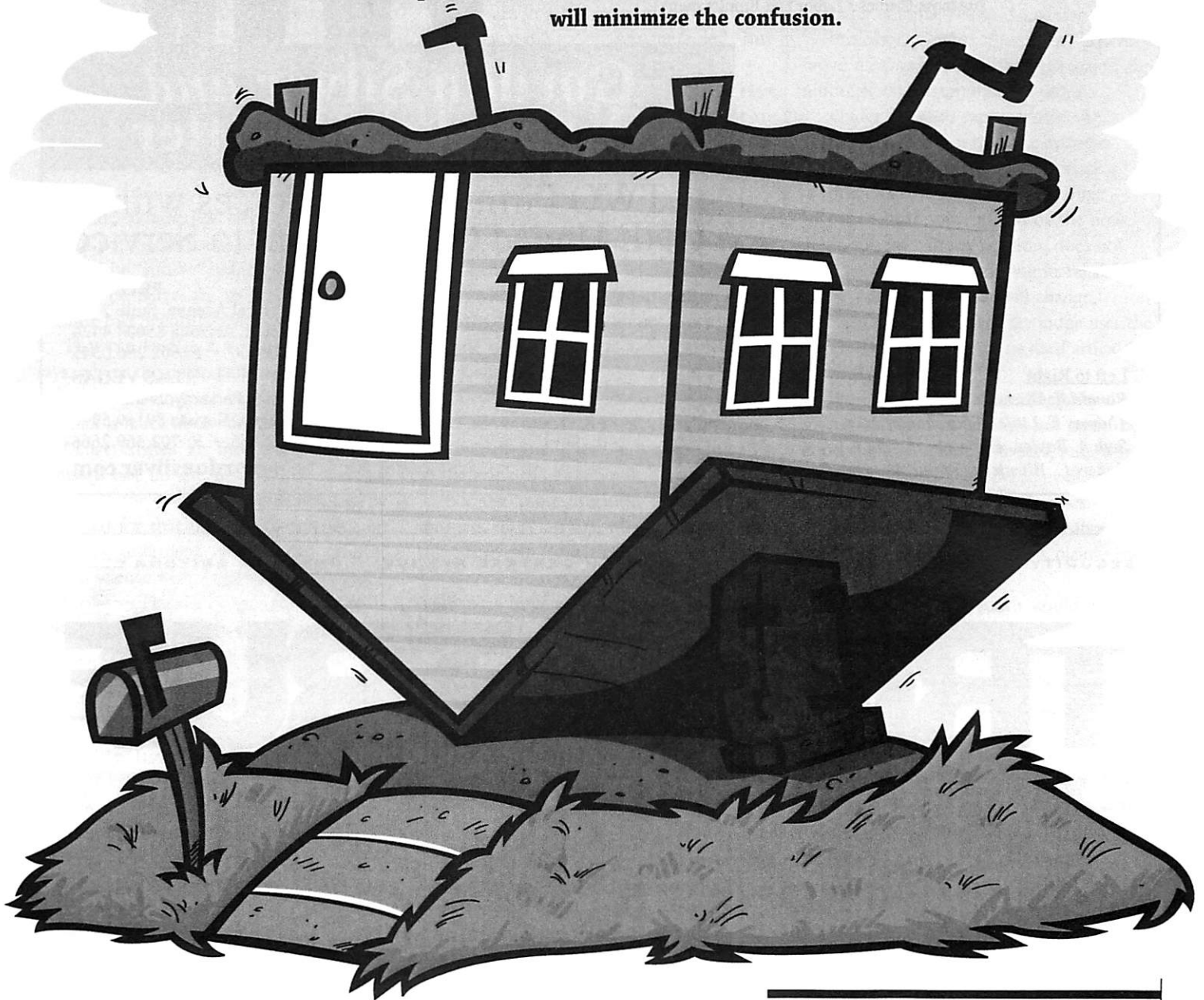


Top 10 Foreclosure and Short Sale Issues

In the current real estate market there is much confusion about foreclosures and short sales. We hope that this article—in “David Letterman” style—will minimize the confusion.



BY CHRISTOPHER A. COMBS & ADAM D. MARTINEZ

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1. No Deficiency Allowed After Foreclosure of Home

- a. If there is a trustee's sale foreclosure of the "home" by the lender, whether the loan was a purchase money loan—that is, a loan used to buy the home—or the loan was a home equity line of credit ("HELOC"), or other non-purchase money loan, the lender will *never* have a claim for deficiency against the "homeowner."^{1,2}
- b. This protection applies even if the "homeowner" is an investor or a homebuilder.³ In interpreting the anti-deficiency statutes the Arizona appellate courts have consistently ruled that, although the intent of the legislature in originally passing the anti-deficiency statutes may have been to provide for the protection only for primary residences, *i.e.*, "mom and pop" homeowners, the broad language of the anti-deficiency statutes also provides protection for investors and homebuilders.⁴
- c. This protection is only available if the "home" is a single-family or duplex, is on two and a half acres or less, and is used as a dwelling.⁵
- d. If the property is not a home, the lender is entitled to file a deficiency lawsuit within 90 days after the foreclosure sale against the owner of other real property such as land or an office building.⁶ For example, if a lot has a loan of \$200,000 but is worth only \$50,000, the lender can file a lawsuit after the foreclosure sale to collect a deficiency of \$150,000.

2. No Foreclosures By Second Mortgages

In the current real estate market a *second* mortgage loan, whether a purchase money loan or a non-purchase money loan such as a HELOC, will *never* foreclose. The reasons are: (a) the second mortgage lender may then have to pay off the first mortgage loan or lose the property to foreclosure; (b) there is generally no equity in most homes subject to foreclosure in this current real estate market; and (c) as discussed above, the second mortgage lender would not have any deficiency claim against the owner of the home.

(In prior "boom" years, however, a second mortgage lender would occasionally foreclose on the home and try to "flip" the home quickly to make a profit before the first mortgage loan foreclosed.)

3. Lender Can Sue Borrower if Non-Purchase Money Loan

If a loan was used to purchase the home, the loan is a non-recourse loan.⁷ In other words, the homeowner has no personal liability for the loan, unless there is excessive damage such as vandalism or flooding, *i.e.*, "waste" to the home.⁸ Therefore, the lender's only remedy after loan default is to foreclose on the home, and the lender cannot waive foreclosure and sue to collect the amount of the loan.⁹

If, however, the loan was not used to purchase the home—as in a HELOC—the lender can waive foreclosure and sue to collect the amount of the loan.¹⁰ For example, if the homeowner after purchasing the home borrows \$50,000 under a HELOC, the lender can waive foreclosure of the home and instead file a lawsuit in civil court to collect on the \$50,000 promissory note.

4. Protection Unclear if "Cash Out" Refinancing

If there is a refinancing of the original purchase money loan on the home, the anti-deficiency statutes still will protect the homeowner from a deficiency after foreclosure of the refinancing loan.¹¹ If, however, there is a "cash out" refinancing—that is, at the time of refinancing the original purchase money loan is paid off and the homeowner receives additional cash—then the law at this time is not clear, especially if the "cash out" was not used to improve the home.¹²

For example, if the homeowner buys the home with a \$100,000 loan and three years later refinances with a \$150,000 loan and takes \$50,000 "cash out" and buys a boat, the lender may be able to sue the homeowner for this \$50,000 "cash out."

5. Anti-Deficiency Statutes Unchanged

Although there was much activity in the 2009 legislative session attempting to

amend the anti-deficiency statutes to eliminate protection for investors, no final amendment is now effective. In the 2010 legislative session there was nothing. The "bottom line" is that the Arizona anti-deficiency statutes currently afford the same protection to homeowners that has existed since the enactment of the Arizona anti-deficiency statutes more than 30 years ago.¹³

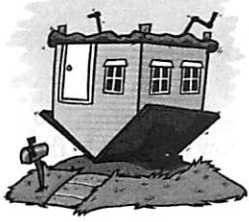
6. Rights of Tenants After Foreclosure

- a. New federal law protects tenants after foreclosure.¹⁴
 1. If it is a federally related loan, the tenant after foreclosure is entitled to stay in the home until expiration of the lease term.¹⁵
 2. Two exceptions to new federal law authorize termination of lease after foreclosure with 90 days' notice.
 - i. Month-to-month tenancy.¹⁶
 - ii. If the bank or other purchaser at foreclosure sale sells to a buyer who will use the home as a primary residence.¹⁷
 3. New federal law controls over state law, which requires only five days' notice after foreclosure, and then eviction in Superior Court of the tenant under A.R.S. § 12-1173.01.
- b. If foreclosure has already been scheduled, new state law requires notice to tenant of the foreclosure in the lease agreement. A.R.S. §33-1331.

7. No Liability for Short Sale Difference Unless Agreement

If the home is "upside down" and the lender approves a short sale by the seller/borrower, the short sale "difference" (not technically a "deficiency") is waived by the lender after the lender releases the loan in order for the seller/borrower to close the short sale to the buyer.¹⁸ If the loan is released, the seller/borrower has no liability for the short sale difference unless the seller/borrower agrees to the lender's requirement to pay back that difference.¹⁹

An example is a home worth \$60,000 and the loan is in the amount of \$100,000. The lender approves a short sale of \$60,000 to a buyer; the short sale difference is then \$40,000. After the short sale to the buyer closes, the sell-



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er/borrower has no liability to the lender for this \$40,000 short sale difference unless the seller agrees to pay this \$40,000 short sale difference to the lender.

If seller does not agree to lender's requirement of the payment of the short sale difference, the seller can cancel the contract with buyer because of an unfulfilled contingency.²⁰ If the seller agrees to repayment, however, then seller is bound. The seller must read the lender approval documents *carefully*. *Note*: Approval of the short sale may be needed from both the lender and any private mortgage insurer, such as the Mortgage Guaranty Insurance Corporation.

8. Cancellation of Short Sale While Waiting on Lender Approval

- a. The buyer can cancel at any time prior to notice from the seller of lender's approval.²¹
- b. The seller is required to wait a reasonable time before canceling,²² even if seller receives a much better offer or seller no longer wants to move. Reasonable time could be four weeks to six months after submission to lender, and it is a "lawyer's delight." The listing broker should discuss

with the seller at the time of contract if seller wants some right of cancellation. *Suggested language*: "If seller's lender does not accept short sale purchase contract within sixty (60) days, seller may cancel purchase contract."

9. Listing Broker and Buyer's Broker Not Required to Reduce Commission if Demanded by Lender

- a. A.A.C. R4-28-1101(D) prohibits commission disputes with another licensee from affecting a transaction, but it does not require either the listing broker or the buyer's broker to reduce the agreed compensation.
- b. Fannie Mae Announcement 09/03 prohibits Fannie Mae lenders from reducing commissions below six percent.²³
- c. Home Affordable Foreclosure Alternative ("HAFA") guidelines now prohibit reduction of commissions below six percent on short sales by participating banks.²⁴


10. Tax Consequences of Debt Forgiveness in Short Sales and Foreclosures

- a. The Mortgage Debt Relief Act of 2007 applies to all 50 states and basically provides for no tax on the short

sale difference or foreclosure deficiency of a purchase money loan, or a loan used to improve the home, if it's a primary residence.²⁵

- b. If the loan was used by the investor to purchase the home, the loan is non-recourse debt, and the lender cannot sue the borrower after short sale or foreclosure.²⁶ The IRS states that there is no debt forgiveness on non-recourse debt.²⁷ In Arizona, a purchase money loan for a home is a non-recourse debt because of the anti-deficiency statutes.²⁸
- c. If a non-purchase money loan is not used to improve a primary residence—*e.g.*, HELOC—but is used to buy a new boat, any debt forgiveness will be taxable income (Form 1099 from lender).
- d. The homeowner must check with his or her own tax lawyer or accountant to determine if Form 1099 will be received from lender after short sale or foreclosure.

Conclusion

Due to the increasing number of foreclosures and short sales in Arizona in the past few years, this area of the law is evolving. New Arizona appellate court decisions, especially on "cash out" refinancing, are anticipated. 

endnotes

1. Foreclosure judicially of a non-purchase money loan on a home may allow a claim for a deficiency. A.R.S. § 33-729(A). Lenders almost never foreclose judicially, however, because of (1) legal fees, (2) borrowers' redemption rights, and (3) minimal chance of collectibility of the deficiency from a borrower.
2. A.R.S. § 33-814(G).
3. *Mid Kansas Federal Sav. and Loan Ass'n of Wichita v. Dynamic Dev. Corp.*, 804 P.2d 1310 (Ariz. 1991); *Northern Arizona Props. v. Pinetop Props. Group*, 725 P.2d 501 (Ariz. Ct. App. 1986).
4. *See id.*
5. A.R.S. § 33-814(G).
6. *Id.* § 33-814(A).
7. *Id.* § 33-729(A).
8. *Id.* § 33-729(B).
9. *Baker v. Gardner*, 770 P.2d 766 (Ariz. 1988).
10. *Id.*
11. *Bank One, Arizona, N.A. v. Beauvais*, 934 P.2d 809 (Ariz. Ct. App. 1997).
12. *Id.*
13. *See* Christopher A. Combs, *Recent Developments in the Protection of Homeowners*, 25 ARIZ. ATT'Y, Dec. 1988, at 33.
14. P.L. 111-22 (May 20, 2009).
15. *Id.* at Sec. 702(a).
16. *Id.* at Sec. 702(a)(2)(B).
17. *Id.* at Sec. 702(a)(2)(A).
18. *Tanque Verde Anesthesiologists v. Proffer Group, Inc.*, 836 P.2d 1021 (Ariz. Ct. App. 1992).
19. *Id.*
20. *See* Arizona Association of REALTORS® Short Sale Addendum to Residential Resale Real Estate Purchase Contract, Lines 9-11.
21. *Id.* Line 41.
22. *See* *Byke Const. Co. v. Miller*, 680 P.2d 193 (Ariz. Ct. App. 1984).
23. Feb. 24, 2009 (amending *Servicing Guide*, Part VII, Section 504.02).
24. Fannie Mae Commitment to Purchase Financial Instrument and Servicer Participation Agreement, Section 1(A), Supplemental Directive 09-09.
25. P.L. 110-142 (Dec. 20, 2007).
26. *See* *Pinetop Props. Group*, 725 P.2d at 501.
27. IRS Publication 4681, p.11, updated Dec. 11, 2008.
28. A.R.S. § 33-729(A).