BANKING/REAL ESTATE

ARIZONA'S BROAD ANTI-DEFICIENCY PROTECTION CONFIRMED

by James S. Rigberg

The non-judicial foreclosure process affords banks and lenders a relatively "cheap" means of executing on their collateral in the event of a borrower's defaults. That cheaper process comes at a price, however. Arizona has a number of statutory protections for borrowers that either outright limit the amount lenders may recover from them or create procedures that may have a similar effect. A.R.S. Section 33-814(G), for example, precludes lenders from recovering any deficiency between the amount of a loan and the amount realized from the non-judicial foreclosure and sale of property that is two and one-half acres or less and is utilized for either a single one-family or a single two-family dwelling. Likewise, in circumstances where a lender may seek a deficiency after a non-judicial foreclosure, A.R.S. Section 33-814(A) entitles a borrower, upon request, to a hearing on the fair market value of the trust property at the date of the trustee's sale, and to have that value deducted from the amount owed in determining the amount of the deficiency judgment. Not surprisingly, lenders often attempt to maximize the amount recoverable from a non-judicial foreclosure by requiring borrowers to waive these anti-deficiency protections in their loan agreements, deeds of trust, and notes. In the last six months, however, the Arizona Court of Appeals has published two different decisions suggesting that lenders abandon the notion that these waivers will be effective.

The first of these decisions is *Parkway Bank and Trust Co. v. Zinkovic*, 2013 Ariz. App. LEXIS 112, 304 P. 3d 1109 (App. 2013). In 2006, pursuant to a written agreement, Equinox Development Corporation received a loan from Parkway. As security for the loan, Equinox's President, Zinkovic, executed a Deed of Trust on his residential property in favor of Parkway. The Deed of Trust included a provision waiving any anti-deficiency protection otherwise afforded to Zinkovic. In 2009, the parties re-negotiated their arrangement, which resulted in Zinkovic substituting for Equinox as the borrower under the 2006 loan agreement. In connection with this transaction, Zinkovic executed a new note which extended the original note's maturity date and incorporated its terms and provided that Illinois law – which would not afford Zinkovic anti-deficiency protection – would govern the deal. After Zinkovic defaulted under the loan agreement, Parkway foreclosed on the Deed of Trust and sold the residential property at a trustee's sale. Parkway brought a lawsuit against Zinkovic for the deficiency between the residential property's fair market value and the amount realized from its sale. The trial court granted summary judgment in favor of Parkway, concluding that Illinois law applied based on the parties' agreement and, as a result, Zinkovic could not rely on A.R.S. Section 33-814(G) to protect him.

The Court of Appeals reversed the trial court's decision. The Court of Appeals framed the issue as turning on whether the trial court properly decided that Illinois, rather than Arizona law should apply to the parties' agreements. The first step in resolving that issue was a determination of whether a conflict exists between Illinois and Arizona law:

> The parties agree that Illinois law allows a party to waive anti-deficiency protection. Thus, we must decide whether Arizona law likewise allows a waiver. If so, the parties' Illinois choice-of-law provision is controlling. [Citations omitted] . . . . If, however, Arizona law does not permit parties to waive anti-deficiency protections contractually, the court applies the "local law of the state selected by application" of the balancing test set forth in *Restatement (Second) § 188* to determine whether the parties could have resolved this particular issue by explicit agreement.

The Court of Appeals noted that the policy concerns underlying the enactment of A.R.S. Section 33-814(G) included, among other things, the protection of consumers from financial ruin and the allocation of the risk of inadequate security to lenders. Based on these concerns, the Court of Appeals held that, under Arizona law, contractual waivers of the protection afforded by A.R.S. Section 33-814(G) are unenforceable. 304 P. 3d at 1113 ("we conclude that permitting a prospective waiver of anti-deficiency protections would violate a policy choice made by the Arizona Legislature"). The Court of Appeals did provide that Illinois law, which would allow for such a waiver, still could apply, and remanded the matter to the trial court with instructions to review, in depth, the various factors that must be considered when determining how to select which state's law will apply in a dispute. The Court of Appeals emphasized that this analysis needed to rest on circumstances as of 2009, when Zinkovic executed the extension note, not 2006 when the original note was executed. The Court of Appeals also conducted a preliminary balancing test of these factors, the results of which – reading between the lines – reflected an inclination towards application of Arizona law and anti-deficiency protection.

In *CSA 13-101 Loop, LLC v. Loop 101, LLC, 1 CA-CV 12-0167* (App. 2013), the Court of Appeals considered whether a lender could effectively require a borrower to waive the ability to request a "fair market value" hearing under A.R.S. Section 33-814(A). In this case, both the loan agreement and a guaranty contained language purporting to waive the protection afforded by this statute. The loan was secured by a commercial office building. After the borrower defaulted, the original lender (MidFirst) assigned its interest under the loan agreement and deed of trust to an affiliate, CSA 13-101. That same day, CSA 13-101 was the successful bidder at a trustee's sale of the collateral. After the sale, CSA 13-101, commenced a lawsuit against the lender and guarantors for a deficiency equal to $5,066,567.87. The lender and guarantors filed a counterclaim in which they alleged that the credit bid was unreasonably low. CSA 13-101 argued that the lender and guarantors were *de facto* attempting to obtain a determination, otherwise available under A.R.S. Section 33-814(A), of the collateral's fair market value, and that this right had been waived in the loan documents. The trial court, agreeing that, under Arizona law, the lender and guarantors could not waive their right to a fair market value hearing, determined that the collateral's fair market value was high enough to eliminate the claimed deficiency.

The Court of Appeals upheld the trial court. The Court of Appeals stated that certain anti-deficiency statutes, including A.R.S. Section 33-729(A) (which eliminates the ability to recover a deficiency after judicial

foreclosure of residential dwellings on 2.5 acres or less for purchase money loans), contain language expressly prohibiting waivers. While A.R.S. Section 33-814(A) did not include such an express prohibition, the Court of Appeals concluded that one was implied by the statutory scheme governing the non-judicial foreclosure process. The Court of Appeals explained that this scheme balanced the lender's "benefit of a quick extrajudicial remedy with a borrower's need for protection because the borrower is stripped of many protections in a non-judicial foreclosure" and that A.R.S. Section 33-814(A) furthered that "scheme by protecting the borrower from inequitable deficiencies that may arise if the property is sold below market price." *Id*, paras. 16 and 17. The Court of Appeals concluded that "[t]he possibility of a reduced deficiency judgment discourages the trustee from creating an artificial deficiency by misconduct, such as refusing to mitigate or selling the property below market price and then pursuing the borrower for the full amount of the debt," which was the same misconduct that the borrower had alleged in the case. *Id*.

These decisions continue what appears to be a trend in Arizona (and perhaps other jurisdictions throughout the country) towards interpreting statutory protections afforded to borrowers as broadly as possible. Lenders in Arizona dealing with defaulting borrowers should re-assess their existing loan agreements and security documents and determine whether they still wish to use non-judicial foreclosures to execute on their collateral. Lenders who are in the process of providing new loans should do so with knowledge that the means they have used in the past to minimize risk may be ineffective.

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James S. Rigberg is a Member at Dickinson Wright/Mariscal Weeks. He can be reached at 602.285.5080 or jrigberg@dickinsonwright.com.