

ONLY IN THE ARDONLINE

The Anti-deficiency Statutes in the Refinancing Boom*by Richard Mack*

Most REALTORS, are familiar with Arizona's so-called anti-deficiency statutes. Under these statutes, when a creditor is secured by a deed of trust on residential property of two and one-half acres or less, which is "limited to and utilized for either a single-one-family or single-two-family dwelling," ("Residential Property") the creditor generally cannot seek a deficiency judgment after the trustee's sale. See A.R.S. §33-814(G). That is, the creditor is limited to the proceeds of the trustee's sale of the encumbered property, even if the creditor foregoes the convenience of a trustee's sale and judicially forecloses the deed of trust. The purpose of these statutes is to prevent creditors from realizing windfalls, and to protect homeowners from harsh deficiency judgments. See *W.D. Long v. Corbet*, 181 Ariz. 153, 888 P.2d 1340 (App. 1994).

But with rising home values and the recent refinancing boom, many borrowers have taken out multiple loans against their primary residence, and, in the course, have "cashed out" portions of their home equity. The fact that borrowers may have used these funds for purposes other than purchasing their homes complicates the anti-deficiency statutes' application. Whether the prohibition against deficiency judgments contained in A.R.S. §33-814(G) applies can often depend on if the deed of trust was used to "secure the payment of the balance of the purchase price, or to secure a loan to pay all or part of the [residence's] purchase price." A.R.S. § 33-729(A).

For most homeowners, the critical legal issue in determining if the anti-deficiency applies to a refinance loan or second loan is whether that loan is secured by a purchase money security device, either a mortgage or a deed of trust. A purchase money mortgage is a security interest that "encumbers the property being sold." *Bank One, Arizona, N.A. v. Beauvais*, 188 Ariz. 245, 247, 934 P.2d 809, 811 (App. 1997); *Cely v. DeConcini, McDonald, Brammer, Yetwin & Lacy, P.C.*, 166 Ariz. 500, 803 P.2d 911 (App. 1990).

The purpose of this article is to try and determine under what circumstances a homeowner can expect the protection of Arizona's anti-deficiency statutes. It addresses three common scenarios: (1) Refinance; (2) Consolidation of first and second loans; and (3) Home improvement second loans. In each case, the most important factor in determining if a loan is a purchase money loan is for what purpose the borrower used the loan proceeds. In cases where the borrower used the majority of the proceeds to purchase the qualifying residential property, the anti-deficiency statute should protect the borrower.

The "Refinance"

In recent years, many homeowners have taken advantage of the historically low interest rates and refinanced their existing homes loans at lower rates. Assuming a homeowner defaults on this refinanced loan, the issue arises of whether the anti-deficiency statutes applies, protecting the homeowner from a deficiency judgment. In most cases, it appears that it will.

In *Bank One, Arizona, N.A. v. Beauvais*, 188 Ariz. 245, 247, 934 P.2d 809, 811 (App. 1997), the Arizona Court of Appeals examined if a consolidated loan consisting mostly, but not entirely, of purchase money funds, that later turned into a

so-called "workout loan," was a purchase money loan for purposes of the anti-deficiency statute. In describing the workout loan as an extension of the original consolidated loan, the Court focused on the fact that the majority of the workout loan (around 75%) was used to purchase a qualifying residence. The Court did not believe that a loan "would lose its character as a purchase-money obligation when . . . it [was] extended, renewed, or the remaining portion of the original loan refinanced" and the original deed of trust renewed. *Id.* at 249-50, 934 P.2d at 813-14. It therefore held that "regardless of whether the workout loan was an extension, renewal, or refinancing of the [earlier] consolidated loan, it retained its character as a purchase money note. *Id.* at 251, 934 P.2d at 815. The analysis of *Bank One, Arizona, N.A. v. Beauvais* indicates that in most cases a typical refinance loan will retain its purchase money loan status. This result could be different if the refinance adds funds to the original loan.

"Consolidated First and Second Loans"

Likewise, the rationale and facts of *Bank One, Arizona, N.A. v. Beauvais* suggest that in many cases the consolidation of a first and a second loan will not change the character of the original purchase money loan. As in *Bank One, Arizona, N.A. v. Beauvais*, the typical consolidation will consist of a first loan, the proceeds of which are used to purchase qualifying residential property, and a second loan, which may be used for other purposes. Thus, provided that the majority of the consolidated loan is comprised of purchase money

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funds from the first loan, the fact that a second loan is rolled into it should not change the character of the original purchase money loan.

The "Home Improvement"

The anti-deficiency statute generally does not protect the borrower from liability on distinct obligations. Therefore, in cases where a borrower takes on a second loan secured by a mortgage or deed of trust on his or her residence, perhaps to make an improvement on that property, it is unlikely the borrower will enjoy the protection of the anti-deficiency statute. The case of *Southwest Savings & Loan Association v. Ludi*, 122 Ariz. 226, 594 P.2d 92 (19__) is instructive.

In *Southwest Savings & Loan Association v. Ludi*, the debtor, Ludi, assumed a first and a second mortgage and then defaulted on both mortgages. The creditor, Southwest, foreclosed the first mortgage, and sued directly on the second mortgage promissory note. The Arizona Supreme Court held that the anti-deficiency statute did not bar the creditor's action on the promissory note, reasoning that the action was not akin to an action to recover a deficiency. The Supreme Court observed that the purchaser from whom Ludi assumed the loan gave the creditor a "second mortgage and note, not for purchase money, but for a property improvement loan. That mortgage is clearly not covered by the [anti-deficiency] statute." *Southwest Sav. & Loan Ass'n v. Ludi*, 122 Ariz. at 228, 594 P.2d at 94. Accordingly, a separate loan given for a purpose other than to purchase the property, for example, to improve it, is not a purchase money loan. The anti-deficiency statutes therefore do not prohibit a lender from waiving its security and suing directly on the second promissory note.

Conclusion

In summary, there are several guidelines for homeowners delving into the refinance or second loan area. First, for most homeowners a simple refinance of their original home loan should retain its purchase money status. Second, in cases where a homeowner consolidates a first and a second secured loans, and the majority of the consolidated loan is comprised of purchase money funds from the first loan, the consolidated loan should retain its purchase money status. In both of these cases, creditors likely will be prohibited from seeking deficiency judgments. And finally, a second home improvement loan is not a purchase money loan. Thus, the anti-deficiency statutes do not apply to a home improvement loan. ▲

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