

## LOAN MODIFICATION, SHORT SALE, FORECLOSURE...

### ...WONDERING WHAT TO DO?!

Arizona apartment owners are being hit particularly hard by the downturn in the Arizona economy. Increasing vacancy rates, too few apartment renters and property values that have spiraled downward makes for a pretty depressing scenario. For many apartment owners, what seemed like a very solid investment a few years ago has turned into a nightmare with no end in sight. Any equity in a project is long gone and often the owner has been subsidizing the property and is now either unable or unwilling to cover the negative cash flow for the property.

**The worst thing to do is to do nothing.** Instead, this is an important time for an apartment owner to be proactive rather than reactive. In order to do so, the apartment owner first needs to understand Arizona foreclosure and deficiency laws, the scope of the personal liability for any loans on the property, and the available options in light of Arizona law and the loan documents. The apartment owner can then make an informed decision as to whether to seek a loan modification, let the property go through foreclosure, or sell the property through a short sale. In addition, since there may be "forgiveness of debt" income resulting from a foreclosure or short sale, the apartment owner should seek tax advice in order to understand the impact of the tax consequences from the various alternatives. Finally, any apartment owner considering bankruptcy should consult with a bankruptcy attorney early on in the process.

Sometimes a loan modification is in the best interests of both the lender and the apartment owner and may work if the lender is willing to absorb some of the decline in the value of the property through a permanent reduction of the loan amount and/or some payment relief while the economy recovers. Where a loan modification is not possible, the apartment owner may decide to let the property be foreclosed upon. In Arizona, a lender may foreclose by either holding a non-judicial trustee's sale conducted by an attorney or title company or by judicially foreclosing on the property through a lawsuit. The non-judicial trustee's sale process is used in the majority of situations because it allows the lender to acquire title to the property relatively quickly and at a reasonable cost. Under Arizona law, the trustee's sale cannot be held sooner than the ninety-first (91<sup>st</sup>) day following the recordation of the sale notice. The sale date can be postponed, and often is, if the borrower and lender are in negotiations for a short sale or loan modification.

In conjunction with the trustee's sale the lender often seeks to have a court appointed receiver take over the management of the property. Most commercial loan documents contain provisions whereby the borrower agrees in advance to the appointment of a receiver in the event of a default. As a result, it is often difficult to successfully challenge the appointment of a receiver. However, the borrower may be able to limit the scope of the receiver's duties so that the receiver is only authorized to do what is best for the protection of the lender's collateral rather than actions that may not be in the best interest of the property owner, such as the sale of the property.

After completion of the trustee's sale, the lender has ninety (90) days to file a lawsuit against the borrower and any guarantors to recover the "deficiency" resulting from the foreclosure sale. The "deficiency" is the amount equal to the difference between the amount owed to the lender and the amount realized by the lender through the foreclosure. Typically the lender obtains an appraisal of the property prior to the foreclosure sale and the opening bid at the foreclosure sale is the lender's credit bid which is equal to, or less than, the appraised value of the

CONTINUED ON BACK

property. In a deficiency action the borrower may dispute the lender's determination of the value of the property and, if successful, this may reduce the amount of the deficiency. Unless the borrower has some defenses to the obligation to repay the loan, however, there is usually no way to totally eliminate the deficiency.

Arizona is sometimes referred to as an "anti-deficiency" state because we have certain laws that prohibit a lender from suing a borrower for a deficiency following foreclosure if the anti-deficiency laws apply. Unfortunately, however, since the anti-deficiency laws only apply to a single one-family or two-family dwelling these laws will not provide any protection to an apartment owner of a complex consisting of more than a single duplex.

If an apartment owner does nothing and allows the property to be foreclosed upon, if the loan was a "full recourse" loan, the apartment owner is liable for the entire amount of the deficiency. In addition, if the apartments were owned by an entity such as a limited liability company and the principals of that entity executed a guaranty of the loan, the principals would also be liable for the deficiency. The borrower and guarantor liability may be eliminated if the loan is a "non-recourse" loan where the lender's only recourse is to foreclose upon the property. The liability may also be limited if the loan is a "limited recourse" loan where the property owner is liable only for "carve outs" such as the misappropriation of security deposits or rents following an event of default. In some cases, the loan documents may provide that a loan that is non-recourse becomes a full recourse loan in the event of a bankruptcy. A thorough review of the loan documents early in the process is highly recommended so that the apartment owner and its principals understand the extent of the potential liability if the owner is considering allowing the property to be lost through foreclosure.

An alternative to foreclosure is to pursue a "short sale" of the property. In order for a short sale to be approved by a lender, the lender must agree to take less than the amount owed to the lender. Since the short sale is a negotiated settlement with the lender for a discounted payoff of the loan, unless otherwise agreed by the lender, the borrower remains liable for any balance still owing to the lender after the lender's receipt of the discounted payoff. And, unlike the ninety (90) day limitation on the lender's ability to pursue a deficiency following the completion of a trustee's sale, in the case of a short sale, the lender's ability to pursue the borrower for the deficiency is subject to the Arizona statute of limitations on contract actions which may be as much as six (6) years. In order to fully release the borrower and any guarantors from any liability for the deficiency the lender will usually require a cash contribution. The cash contribution is typically a percentage of the deficiency amount and usually required to be paid at the closing of the short sale.

The short sale payoff terms ultimately agreed to by the borrower and lender will be set forth in an agreement executed by the lender, borrower and guarantors. The agreement will set forth the lender's approval of the short sale, any cash contribution requirement of the borrower and guarantors, the terms for payment of any such cash contribution (whether at the closing of the short sale or upon payment terms thereafter), and whether the lender is accepting the short sale proceeds and/or cash contribution in full satisfaction of the loan. This agreement should be carefully reviewed to be sure it reflects the business terms agreed to by the parties.

The options and the law may seem somewhat complicated, particularly for an apartment owner who has never defaulted on a loan or been in a situation where it may be best to walk away from an investment. However, an owner who understands Arizona law and the available options will be in a position to make informed decisions with respect to the loan or loans affecting the owner's apartment complex.

Meg Steiner, Real Estate Attorney

“Meg Steiner is a real-estate attorney with Lorona Steiner Ducar, Ltd. She may be reached at [meg@azlawyers.com](mailto:meg@azlawyers.com) or 602-277-3000. The information provided in this article is for general information purposes only and must not be regarded as legal advice. Consult your legal and/or tax advisers to ascertain your rights and obligations before making decisions.”