WHAT HAPPENS TO EXCESS FUNDS AFTER TRUSTEE SALE

In most cases, when a borrower has defaulted on his loan, the lender in first lien position files a Notice of Trustee Sale and eventually sells the property at auction. Arizona has specific rules regarding how the proceeds are distributed. If the property sells for less than the amount owed on the first mortgage, the trustee takes their fee and pays the rest of the proceeds to the beneficiary. It gets more complicated when the proceeds are in excess of these amounts. A.R.S. 33 – 812 specifically lays out what is required. After the trustee and the amount due to the beneficiary per the promissory note are paid, then "other obligations" are paid. Next, condominium association and HOA liens that are subordinate are paid. Next in line are the junior lienholders and finally the trustor.

The trustee may and usually does deposit the excess funds with the county treasurer before paying junior lienholders, the trustor or any other claims. The trustee must file a Complaint with the court outlining the details of the sale and the amounts already paid. They must identify interested parties and their potential claims. The Complaint then is mailed to all persons of interest including those that were entitled to receive a copy of the Notice of Trustee Sale pursuant to A.R.S. 33-809. Prior to filing the Complaint, the trustee will order a title search in order to discover potential claims and interested parties. Interested parties may file an application to receive the proceeds. If any interested party objects to the application of another, they may file a response objecting to the release of the proceeds. . If there are competing claims, the court will set the matter for a hearing to determine whose claim is superior.

The typical situation is a homeowner with two mortgages. He defaults on his mortgages and his first mortgage forecloses by trustee sale. The proceeds of the sale are more than required to pay off the first mortgage. The trustee sends a letter to the former homeowner that he can apply for the excess proceeds, The former homeowner thinks he is entitled to thousands of dollars and files an application to the court. He does not realize that the second position lienholder has not been paid any money. He must wait to see if the second lienholder also files an application. If they do not, the court will not release the proceeds to the former homeowner until 180 days has passed since the filing of the Complaint by the trustee . If no one, including the former homeowner, files an application to request release of the excess proceeds within two years, the funds will be considered abandoned and the funds will be deposited with the department of revenue.

The issue of "other obligations" referred to above was litigated in <u>Hanley v. Pearson</u>, 204 Ariz. 147, 61 P. 3d. 29 (Ariz. App. 2003). The debtor, Aaron Pearson, executed a first deed of trust to

World Savings and Loan Association and later a second deed of trust to John Pearson. The first deed of trust required the debtor to pay the assessed real estate taxes. Debtor did not pay the taxes or his mortgage payments. World Savings foreclosed. Linda Hanley purchased the property at the trustee sale for more than debtor owed to World Savings per the terms of the promissory note. There was a tax lien on the property for almost $3000.00. Tax liens, with few exceptions, are superior to other liens per A.R.S. 42-17153. Hanley objected to paying the taxes, alleging that they should be paid from the excess proceeds and deducted from the amount received by the second lienholder because she alleged they were "other obligations" pursuant to A.R.S. 33-812 (A) (3). World Savings had not paid the taxes and therefore was not asking for reimbursement. The court held that the purpose of the statute was to permit lenders to recoup funds they advanced on behalf of the debtor, and rejected Hanley's argument.

At the time this case was filed the statute read slightly differently. It did not specifically state that other obligations were those actually paid by the beneficiary before the trustee sale. It only referred to other obligations described in the deed of trust. The legislature must have realized that this part of the statute was unclear and made the necessary revision.

Certainly if there had not been excess funds, Hanley would have been liable for the taxes. Her argument was that they should be paid out of the excess funds and subtracted from the amount paid to the second lienholder. The court decided that permitting payment of the taxes from the proceeds could result in a change in the order of payment required by the statute.

Another issue that arises is whether a subordinate lienholder can sue the debtor or guarantor, if the lienholder has been paid part of his debt from excess proceeds after trustee sale. In the case of <u>Long v . Corbet</u>, 181 Ariz. 153, 888 P. 2d 1340 (Ariz. App. 1995),Leo Corbet, the guarantor asserted that he was protected by A.R.S. 33-814 (G). This anti deficiency statute precludes the lender from suing for deficiency after trustee sale if the property is 2.5 acres or less, a one or two unit property that has been utilized as a dwelling. The first position lienholder conducted the trustee sale. The second mortgage held by W. D. Long was not a purchase money loan. Therefore the anti deficiency statute did not prevent him from suing on the note. The lien held by Long was extinguished by the trustee sale. If there had been no excess proceeds, there is no reason to prevent a lawsuit by Long. The argument by Corbet that receipt of the excess proceeds was an election by Long to collect per the terms of his lien and therefore waive his right to sue was rejected by the court. Arizona law requires that Long waive his lien rights if he elects to sue for on the note. Long did not waive his lien rights. He was stripped of them by the trustee sale conducted by another lender.

Now that property values are rising, the instances of excess proceeds after trustee sale are increasing. It is helpful to know how the process works so the opportunity to receive excess funds is not lost.

Laura Bramnick is a partner in the law firm of Berens, Kozub, Kloberdanz & Blonstein, PLC. Located at 7047 E. Greenway Pkwy, #140, Scottsdale, AZ 85254. She can be reached by email at lbramnick@bkl-az.com or by phone at 480-624-2705.