

Second Liens – How They Impact the Success of a Short Sale

By Laura Bramnick, Esquire

A second lien can be a fixed rate or it can be adjustable. If the rate is fixed, the monthly payments remain the same over the life of the loan. If adjustable, it is usually referred to as an equity line or HELOC. HELOC stands for Home Equity Line of Credit. A HELOC can be adjustable in two ways. The interest rate can adjust because it is tied to an index, for example prime rate plus one percent. If the prime rate increases, so does the minimum payment. If the prime rate decreases, the minimum payment decreases. The principal balance due on the HELOC can also adjust depending on how much has been borrowed against the maximum amount permitted under the terms of the promissory note.

There seems to be a misconception that a HELOC is not a mortgage. In Arizona, we use the term mortgage to mean Deed of Trust. A HELOC has two components – the promissory note and the Deed of Trust. A HELOC can be in first position, but it is far more common to find it in second position. If a homeowner borrowed against equity in their home, the lender recorded a Deed of Trust. This lender will need to approve a request for a short sale in order for the homeowner, now the seller, to transfer clear title to the buyer.

Anytime you have two liens, it becomes more difficult to obtain approval for the short sale. The typical situation is that the first lien is underwater and this leaves little or no money for the second. What is the best strategy in this situation?

First you need to determine if the second lien is protected by the AZ anti deficiency statutes. ARS 33-814(G) prohibits a lender from pursuing deficiency if THAT LENDER forecloses by trustee sale, the property is 2.5 acres or less, 1 or 2 units, used as a dwelling. Therefore, if the lienholder in second position records a Notice of Trustee Sale and complies with the statutes, that second lien is protected by the language in ARS 33-814(G). This is not likely to occur if the first lien is underwater because the second lienholder is responsible for paying the first and would lose too much money with this strategy. Therefore, it is the first lienholder that will foreclose, which is why it is commonly thought that first liens are protected by the anti deficiency statute and second liens are not.

Second (and third liens, etc) are protected by the anti deficiency statutes if they are purchase money. ARS 33-729(A) applies to judicial foreclosure as well as trustee sale. This protects all liens, no matter how many and in which position of priority as long as the loans are purchase money loans, the property is 2.5 acres or less, one or two units, used as a dwelling. Purchase money loans are protected in both judicial foreclosure and trustee sale. This allows the lender to sell the property and receive the proceeds, but it prohibits the lender from pursuing the homeowner who is the debtor.

It is also important to note that when the loan is a purchase money loan, Arizona law does not permit the lender to waive the security and sue on the promissory note. In *Baker v. Gardner*, 160 Ariz. 98, 770 P.2d 766 (1989), the second lienholder sued to collect on a purchase money note prior to the trustee sale that had been initiated by the first mortgage. The court held that the second lienholder did not have this option. In the case of a purchase money mortgage protected by ARS 33-729(A) the only remedy is foreclosure. If the value of the property is such that there is no equity left to pay the second mortgage, they will receive nothing.

It is necessary to analyze these issues before listing the property for short sale. Even though the statutes are silent on short sales, it will determine how much leverage you have when negotiating with the lender. Certainly if a homeowner has two mortgages and both were used to purchase the house, he can use this information in his favor. The reason is that the lender will almost always net more from a short sale than from a trustee sale, they do not have to take possession of the property, the fees for the trustee are less and sometimes zero, they do not have to find a buyer and do not have to repair the property in preparation for resale.

Now what if the second lien is not purchase money. You lose the leverage of reminding the lender that under Arizona law they cannot pursue the homeowner for the deficiency. The homeowner needs to be aware that the lender can pursue them whether the property goes to short sale or trustee sale. Either way, the lender has up to six years from the date of default to pursue the collection of the debt. The first lienholder will usually allow \$3000 to be paid to the second in the short sale. This is usually not very much in relation to the total amount owed on the second lien. Sometimes you are lucky and get a buyer that is willing to contribute additional money to the second. This works sometimes but other times the first lienholder refuses to allow this. Their position is that any additional funds go to them. This can kill the deal. If the homeowner can come up with some funds to pay the second, they can try to come to a settlement with the second before the short sale closes. I make the first aware of this but they don't seem to care. Or the homeowner can negotiate a settlement with the second after the short sale closes. The second will usually, but not always, release their lien for the \$3000 or other small sum offered. This allows the short sale to close.

It is easier to negotiate both loans during the short sale process. This cannot always be accomplished. What happens after a trustee sale by the first lienholder or a completed short sale when the second lienholder can pursue the deficiency? Sometimes the collection of the loan gets transferred to the recovery department and they pursue collection of the debt. Sometimes the account gets charged off and sold to a third party collection company. Sometimes the lender keeps the debt on their books but assigns the collection to a third party collection company. I have had experience where the lender will accept a smaller settlement after short sale or trustee sale. I have also had experience where they demand more than they would have accepted prior to either of those events. Not knowing how this debt will get resolved causes fear and stress for homeowners.

The best strategy is to know all of your options and come up with a plan. You want to decide what you will do if the lender initially does not offer an adequate solution. There are several

opportunities to negotiate the debt. It is not unusual that settlement can be reached at a later time if not during the short sale. This is not ideal, but the lenders have not been aggressive about filing lawsuits in this current climate. Some homeowners opt for a short term payment plan in hopes that they will have funds to settle the debt within a few years. As time passes, the lender may be more likely to accept less than they initially demanded. Also, if they sell the loan to a third party collection company, they usually do so at a discount, which means that the collection company will likely accept a smaller percentage of repayment than the lender would have.

There is no cookie cutter approach to negotiations with the second lender in a short sale. Each scenario is unique and requires preparation, patience and perseverance. Each option must be weighed in light of what is best for the client at that time.

Laura Bramnick is a partner with the Scottsdale based law firm of Berens, Kozub & Kloberdanz, PLC, and may be reached at 480-624-2705 or lbramnick@bkl-az.com.