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Foreclosure After Divorce: Part I

Are both spouses on the hook for a community debt such as a mortgage after the judge orders one spouse to pay?

In today's economy, the story is familiar. A husband and wife purchase a home. Both sign the loan documents and take the home as "community property." Later on, they divorce. The judge awards the marital home to one spouse, perhaps to the husband, allocating the debt to him as well. The husband may even have an obligation to refinance the property into his own name. He may live in the home and pay the mortgage for a while. And commonly, he may fail to refinance the loan, leaving the wife on the note. What happens when he stops making mortgage payments? Well, it depends.

In most cases in Arizona, what people commonly think of as their "mortgage" is really a legal instrument known as a "deed of trust." In our scenario, if the husband had not refinanced the loan (even despite the judge's order to do so), the first consequence to the wife would likely be damage to *her own* credit for the loan delinquency. This is because a judge's order dividing up community debts does not impact the rights of third-party creditors. In other words, the judge's order that the husband pay the mortgage will not alter the bank's legal rights that arose against the wife pursuant to the loan

documents she originally signed.¹ Therefore, when the loan is not timely paid, the bank will report the delinquency to credit agencies on behalf of both the husband and the wife. Damage to the wife's credit will likely come as a surprise and seem very unfair. After all, she has a judge's order that the husband must pay the debt!

If the husband continues in his delinquency, the bank will likely foreclose on the deed of trust (again, a true "mortgage" is not typically used in Arizona). The wife and even the husband too may be wondering if they will be sued for a deficiency judgment.²

¹ This is true for other debts as well, e.g. vehicle loan or credit card debt—the judge's order that one spouse pay a debt will not stop a creditor from pursuing collection action against both spouses if a delinquency occurs.

² Nowadays, it is common for property to sell for an amount lower than the amount of the original loan. When a home is sold for less than the loan amount, the bank will lose money in the transaction. A deficiency judgment allows the bank to collect its loss from the debtor. For example, if a debtor owed \$200,000 on a property but the bank only obtained \$150,000 from the trustee's sale, the deficiency judgment (if allowed)

Arizona's anti-deficiency statutes, A.R.S. §§ 33-729(A) and 33-814(G), may protect both parties from a deficiency judgment, depending on whether the property securing the loan qualifies for protection, how the bank chooses to foreclose, and whether the loan was purchase money or non-purchase money.³

To receive protection, we first must look at whether the property securing the loan qualifies for protection. A qualified property is "two and one-half acres or less" and "is limited to and utilized for either a single one-family or a single two-family dwelling." This means that an actual dwelling must have been built, and furthermore, it must at least occasionally have been occupied. If these conditions do not apply, the bank could obtain a deficiency judgment against both the husband and the wife, regardless of who was obligated to pay the debt under the judge's order.

Assuming that the property qualifies, we must next look at how the bank chooses to foreclose and whether the loan is purchase money or non-purchase money. In Arizona, there are two ways for a bank to foreclose on a deed of trust: the bank may request a

against the debtor would be for \$50,000, plus the bank's fees and costs.

³ A purchase money loan occurs where the funds from the loan were actually used to purchase the property that secures the loan. A non-purchase money loan occurs when the funds from the loan were used for something other than the purchase of the property that secures the loan.

trustee's sale or the bank may judicially foreclose.

If the property qualifies and the bank requests a trustee's sale, both the husband and the wife are protected from a deficiency judgment by the bank regardless of whether the primary loan is purchase money or non-purchase money. However, if the bank judicially forecloses, the husband and wife are only protected from a deficiency judgment if the primary loan is purchase money.

In either case, things get complicated if the property secures more than one loan. The anti-deficiency statutes do not afford protection against a second or third lienholder (lending institution) who loaned non-purchases money to the husband and wife. Therefore, in our scenario, if the couple had taken out a loan to buy an "investment property" and used their home to secure the loan, the lender could pursue both the husband and the wife post-divorce, regardless of the judge's order that the husband was to pay the debt.

What this means for you.

If you are negotiating a property settlement agreement, do not underestimate the risk of your spouse failing to pay a community debt such as the home loan. If a community debt such as a home loan was already allocated to an ex-spouse who has stopped paying, read on the Foreclosure After Divorce Part II for information about what remedies you might have.