October 9, 2018

2018 Arizona Case Law Affecting Commercial Real Estate and Lending

The following information accompanies a presentation Mike gave to members of the Arizona Commercial Mortgage Lenders Association (ACMLA) on October 9, 2018.

Arizona Case Law – Credit Card Statute of Limitations

Mertola, LLC v. Santos (AZ Supreme Court 7-27-2018)

This case has drawn a lot of national attention from credit card issuers, debt buyers and consumer credit advisors. Santos acquired a credit card from Washington Mutual Bank with a $25,000 credit limit. The Bank's account agreement required monthly minimum payments with interest and provided that, if Santos failed to pay any amount due, the Bank had the right to declare the account balance immediately due and payable. The account agreement also contained a waiver by Santos of any right to notice of acceleration. From August 2007 to January 2008, Santos repeatedly made late minimum payments, and pursuant to the account agreement, the Bank increased its finance charges (interest rate) and began charging late fees. Santos missed the February 2008 payment completely and never made another minimum payment, although he made a $50 payment (which was less than the minimum payment due) in August 2008. The account continued to accrue interest until the Bank charged it off later in 2008, at which point the unpaid balance was about $17,000.

Mertola later acquired Santos's debt and, in July 2014, sued Santos for breach of the account agreement, seeking the entire outstanding balance. Santos argued that the claim was barred by Arizona's six-year statute of limitations applicable to credit card debt [the same time limitation applies to promissory notes and other written contracts under Arizona law], contending that the Bank's cause of action to recover the entire debt accrued (and statute of limitations commenced) when he first missed a payment in February 2008. Mertola argued that missing a payment gave the creditor the right to sue only for that payment, and that the cause of action for the entire debt could not accrue until the creditor accelerated the debt.

The trial court granted Santos's motion for summary judgment, but the Court of Appeals reversed, agreeing with Mertola that Santos's missed payments gave Mertola the right to sue for only those payments. As the Bank did not notify Santos that it was accelerating the debt when it charged off the account, and neither the Bank nor Mertola ever made demand on Santos for payment in full, the Court of Appeals concluded that the statute of limitations did not bar Mertola's action.

The Arizona Supreme Court granted review to decide when a cause of action accrues (and the statute of limitations commences) on a credit card debt subject to an optional acceleration clause. The Supreme Court concluded that credit card debt and closed-account debt should be treated differently for the purpose of determining when a cause of action accrues. The Supreme Court noted that, with closed accounts and closed-end installment contracts (such as promissory notes), the principal amount of the debt is fixed and there is a defined repayment schedule specifying the size and due date of each payment. In contrast, credit card contracts may establish a credit card limit, but the ultimate amount of consumer debt is unknown at the outset and fluctuates depending on how the card is used. The amount of the monthly payment and the date for payment in full fluctuate depending on the amounts charged, the current interest rate and the amount of the monthly payment above the minimum required by the contract.

The Supreme Court noted that, because a closed-end installment contract involves an exact sum that must be paid in full in equal installments by an agreed-upon date, the cause of action for the entire balance owed will accrue no later than that date, and the creditor cannot prevent the statute of limitations from running after that date by simply refusing to accelerate the debt.

In contrast, under credit card contracts, the date when the entire debt will become due is uncertain and might not occur until far in the future. Allowing a creditor to defer the commencement of the statute of limitations by declining to exercise its right to accelerate would give the creditor unilateral power to extend the statute of limitations period and permit interest to accrue long after it is clear that no further payments will be made, which would effectively eliminate the statute of limitations protection provided to defendants.

The Supreme Court therefore held that when a credit card contract contains an optional acceleration clause, a cause of action to collect the entire outstanding debt accrues on the date the debtor first fails to make a full agreed-to minimum monthly payment, regardless of whether or when the creditor exercises the acceleration clause. A debtor may cure the default if the creditor accepts a payment of arrearages that brings the account current consistent with the parties' contract, and by allowing the debtor to cure the default, the creditor will relinquish its pending cause of action to collect the debt, and the statute of limitations will commence only upon a new default. Partial repayment, however, does not cure the default or reset the limitations period.

Lender takeaways. Aggressive debt buyers continue to create bad case law for financial institutions. While this case relates to open-end credit card debt, it is foreseeable that a borrower or guarantor will attempt to extend its rationale to a revolving line of credit or other type of financing arrangement involving terms and amounts that may be unknown at the time of closing. Be cautious of loan document provisions that characterize a given occurrence or failure as an automatic event of default (regardless of whether the lender declares it to be an event of default). In light of the recent *Andra R. Miller Designs v. U.S. Bank* decision (discussed in my 3-13-2018 presentation to ACMLA) and this decision, if a lender agrees to accept a partial payment as a complete cure, it would be highly advisable to communicate to the borrower that the payment has been accepted as a complete cure and that any prior acceleration of the debt has been revoked and rescinded. This case also suggests that debt buyers need to better understand the payment histories of the accounts they are buying if they hope to later enforce them.

Arizona Case Law – Lien Reformation Statute of Limitations

Deutsche Bank v. Pheasant Grove LLC (AZ Court of Appeals 8-23-2018)

In 2000, the homeowners financed their purchase of Lots 8 and 9, Desert Mountain Phase II Unit Six, through Washington Mutual, and WAMU recorded a DOT that encumbered both Lots 8 and 9. The homeowners refinanced the loan through WAMU in 2001 and 2002; each time WAMU recorded a new DOT encumbering Lots 8 and 9 and released its prior DOT. The homeowners refinanced the loan again in 2003, and WAMU recorded a new DOT and released its prior DOT. However, the 2003 DOT described the collateral as only Lot 8 (but *not* Lot 9). Chase acquired the beneficial interest in the 2003 DOT from WAMU, and assigned its beneficial interest in the 2003 DOT to Deutsche Bank ("DB") in November 2012; the assignment also described the collateral as Lot 8 (with no mention of Lot 9).

In the meantime, the homeowners had borrowed $800,000 from First National Bank of Omaha ("FNB") in September 2006, and FNB recorded a DOT encumbering both Lots 8 and 9. The homeowners defaulted on the FNB loan, and FNB bought Lots 8 and 9 at a trustee's sale in July 2010. FNB quitclaimed Lots 8 and 9 to Pheasant Grove in December 2011.

The homeowners subsequently defaulted on the promissory note secured by the 2003 DOT, and DB learned that Pheasant Grove had obtained Lots 8 and 9 without satisfying the 2003 DOT. In August 2015, DB filed a complaint against Pheasant Grove seeking (i) *reformation* of the 2003 DOT to add Lot 9 to the legal description, and (ii) a *declaratory judgment* that the 2003 DOT encumbered both Lots 8 and 9 and was superior to Pheasant Grove's ownership interest and any other encumbrances.

Pheasant Grove argued that the reformation claim was barred by Arizona's 3-year statute of limitations [Arizona's 3-year statute of limitations applies to, among other things, an action for relief on the ground of fraud or mistake, provided that the statute does not start to run until discovery by the aggrieved party of the facts constituting the fraud or mistake], and that the quiet title and declaratory relief claims were inappropriate because DB did not hold the title to either Lot 8 or 9. DB argued that (i) the 3-year statute of limitations did not apply to its reformation claim, and (ii) the declaratory relief claim sought a determination that Pheasant Grove had constructive notice of the 2003 DOT, which had priority over FNB's DOT, or, *alternatively*, that the 2003 DOT was a replacement DOT for the 2000, 2001 and 2002 DOTs. The trial court granted summary judgment in favor of Pheasant Grove, and DB appealed.

DB argued that: (i) Pheasant Grove had constructive notice of DB's interest in Lot 9; (ii) because DB was seeking to enforce the 2003 DOT against Pheasant Grove's interest, the trial court should have applied a six-year statute of limitations, which applies to actions for debt; (iii) the six-year statute of limitations applies to the declaratory relief claim premised on constructive notice; and (iv) that DB satisfied the six-year time limit by filing its complaint in August 2015, which was within six years of the accrual of the claim (DB contended that the claim accrued when Pheasant Grove received title to Lots 8 and 9 in 2011, when a proper title search would have revealed the 2003 DOT to Pheasant Grove).

The Court of Appeals held that the three-year statute of limitations barred the claim for reformation and that the action for a declaratory judgment was nothing more than an action to reform the 2003 DOT to include Lot 9 in the legal description.

The Court of Appeals addressed DB's declaratory judgment claim based on the doctrine of *replacement* of mortgages. The replacement doctrine allows a senior lienholder that discharges its mortgage of record and records a replacement mortgage to keep its priority as against the holder of an intervening interest in the property. The court held that, in the present case, there was no "intervening interest" (between WAMU's 2002 and 2003 DOTs) for the replacement doctrine to apply to, as FNB did not record its DOT against Lots 8 and 9 until 2006.

Lender takeaways. This case illustrates what can go wrong (in addition to a potential loss of lien priority or arguably bringing your new lien forward into a lien avoidance challenge period created by a later bankruptcy) when a lender releases its previous DOT when refinancing its own loan. It is far safer to record a DOT amendment and notice of modification (referencing the unrecorded replacement promissory note and/or modification agreement) than to release your own DOT, particularly if you are aware that an intervening recorded or unrecorded interest, such as a potential mechanic's lien, might exist. Likewise, there is no reason to restate the collateral description in the assignment when assigning the beneficial interest under a DOT; the DOT already identifies the collateral and the assignment should simply reference the recording information from the relevant DOT.

Michael P. Ripp
ACMLA Legislative Chair
602-440-4823
mripp@rcalaw.com

Related Attorneys

- Michael P. Ripp

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