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The following information accompanies a presentation Mike gave to members of the Arizona Commercial Mortgage Lenders Association (ACMLA) on April 12, 2016.

Recent Arizona Case Law

Dobson Bay Club II DD, LLC v. La Sonrisa De Siena, LLC (AZ Court of Appeals 2016). The borrowers signed a $28.6 million note and DOT to CIBC. The note required interest-only payments with a final balloon payment at maturity; it also included a provision requiring payment of a 5% late fee on any unpaid installment, including the final balloon payment due at maturity. The borrowers failed to make the balloon payment. CIBC sent out a notice of default and thereafter sold its note and DOT to La Sonrisa, which started a trustee's sale and demanded payment of all amounts due under the loan, including a $1.4 million late fee (5%) on the balloon payment. The borrowers thereafter obtained new financing and paid La Sonrisa the outstanding loan balance except for the late fee, but La Sonrisa refused to release the DOT. The borrowers then sued for a declaratory judgment that La Sonrisa was not entitled to collect the late fee as a condition of releasing its DOT. The trial court held that the late fee was enforceable as liquidated damages, and the borrowers appealed.

The Court of Appeals looked to the Restatement of Contracts [a legal treatise that seeks to set forth and clarify generally accepted principles of contract common law (case law) and occasionally suggests new rules that contradict existing law] for guidance on the enforceability of liquidated damages provisions. The Court of Appeals held that, absent unusual circumstances, a 5% late fee on a balloon payment for a conventional fixed rate loan will generally **not** be enforceable as liquidated damages. In reaching its decision, the Court applied two tests from the Restatement of Contracts relating to liquidated damages provisions and concluded: (1) the late fee did not reasonably approximate the anticipated or actual damages suffered by the creditor (which had purchased the loan already knowing it was in default) as a result of the borrowers' failure to timely pay the balloon payment; and (2) the borrowers' breach presented no difficulties of proof, because the resulting damages were easily ascertainable. La Sonrisa has appealed this case to the Arizona Supreme Court, which has not yet accepted it for review.

Lender takeaway: Borrower's counsel often ask the lender to agree that the late fee applies only to monthly installment payments, and not to the balloon payment; in my experience, lenders routinely accommodate that request. If your documents allow you to charge the normal flat rate late fee on the balloon payment, even after negotiation with a knowledgeable borrower, do not automatically assume that it will be enforceable. If this issue is sufficiently important to you, consider providing that a smaller late fee/liquidated damages payment will apply to the balloon payment.

First Financial Bank v. Claassen (AZ Court of Appeals 2015). Claassen borrowed $5.5 million from Irwin Union Bank to finance the construction of a home, and secured the loan with a DOT. Construction was never completed and Claassen defaulted on the loan. The FDIC (as successor to the bank) filed a complaint for breach of contract and judicial foreclosure, and sought a deficiency judgment of about $1.1 million, which related to line items in the loan budget for (i) interest-only payments paid from an interest reserve during construction, (ii) a construction deposit paid to the HOA before construction commenced, (iii) accrued interest, and (iv) late fees. Neither Claassen nor his counsel (who had earlier withdrawn) participated in the trial, and the trial court entered judgment for the bank on each of those four items of damages.

Claassen filed a motion for new trial on the basis that the damages were not recoverable under Arizona's anti-deficiency statute (which provides that a deficiency judgment cannot be satisfied from other assets of the judgment debtor if the loan was given to secure a loan to pay all or part of the purchase price of real property of two and one-half acres or less which is limited to and utilized for either a single one-family or single two-family dwelling). Claassen did not claim in his motion that the interest payments made from the interest reserve were erroneously awarded. The trial court denied the motion for new trial, partly on the basis that Claassen failed to present evidence or raise legal issues at the trial.

Claassen appealed on the basis that: (a) the trial court erred in ruling that accrued interest, late fees and the construction deposit paid to the HOA were non-purchase money obligations that were not subject to the anti-deficiency statute; and (b) the trial court erred in finding that Claassen had waived any argument regarding the deficiency because he failed to raise it at the trial. The Court of Appeals concluded that interest, late fees and the mandatory HOA construction deposit were **purchase money** obligations that were subject to the anti-deficiency statute. Claassen had not raised on appeal, and the Court of Appeals did not decide, whether the interest paid from the interest reserve amount was a purchase money obligation. The Court of Appeals noted that the anti-deficiency statute expressly prohibits borrowers from waiving their anti-deficiency protections and found that the trial court erred in finding that Claassen had waived those unwaivable protections.

Bank of New York Mellon Trust Company v. Arizona HOA Acceptance, LLC (AZ Court of Appeals 2016). The borrower obtained a loan from the Bank and secured it with a DOT. The property was also subject to CC&Rs that provided for assessment liens in favor of an HOA. The borrower defaulted on the Bank loan, and the Bank foreclosed judicially [it is unclear from the opinion whether the Bank foreclosed judicially because the loan was a non-purchase money loan and the Bank was seeking a deficiency]. The Bank also named the HOA as a subordinate creditor in the foreclosure action, and the HOA stipulated that its $2,000 assessment lien on the property was junior to the Bank's DOT. The Bank obtained default judgment against the borrower for approximately $200,000 and bought the property at the sheriff's sale for a $22,000 credit bid. About one month later, the HOA assigned its rights to enforce its assessment lien to Arizona HOA Acceptance, LLC, which recorded a Notice of Intent to Redeem the property for the amount of the credit bid. The Bank argued that the HOA was not among the class of junior creditors entitled to redeem following a sheriff's sale. The trial court agreed with the Bank and Arizona HOA Acceptance appealed.

The Court of Appeals held that Arizona's post-foreclosure redemption statutes **do** allow the holder of an HOA assessment lien to redeem following a sheriff's sale, and remanded to the trial court to instruct the sheriff to issue a deed to Arizona HOA Acceptance upon payment of $22,000.

Lender takeaway: As most Arizona foreclosures occur by trustee's sale, foreclosing creditors typically do not need to think about the effect of redemption rights (the IRS has a 120-day right of redemption if it has recorded a federal tax lien against the owner and has been given notice of the trustee's sale, but private parties have no right to redeem following a trustee's sale). If a lender is conducting a foreclosure sale that *might* involve a right of redemption (either a sheriff's sale, or a trustee's sale with a known and noticed IRS lien), the lender must take into account the value of the property and the possibility of a post-foreclosure redemption when determining its opening credit bid. If the borrower and any guarantors are likely to be uncollectible, a lender rarely has a compelling legal reason to lowball a credit bid (perhaps some short-term property tax savings) given that, if a deficiency is collectible, the borrower and guarantors will get the benefit of an FMV credit in calculating the deficiency amount. This bank likely did not realize that the HOA could assign its lien and unwittingly sold/sacrificed its essentially free and clear ownership of the property for $22,000. Savvy distressed property buyers understand that they can buy property in this manner for the lender's opening credit bid without a competitive bidding risk at the sheriff's sale.

Other Recent Developments of Note

New ALTA Survey Standards. The new 2016 ALTA survey standards became effective on February 23, 2016. Surveys are now referred to as ALTA/NSPS (rather than ALTA/ACSM) Land Title Surveys. While an analysis of the 2016 standards is beyond the scope of this discussion, the new standards make the client (rather than the title company) responsible for providing zoning information to the surveyor if you wish to have the surveyor address zoning issues on the survey. The surveyor is no longer supposed to indicate on the survey what professional liability insurance it might carry, and the surveyor is instructed to use only the specified ALTA certification (instead of a customized lender-prepared form).

Lease Accounting Rule Changes. On February 25, 2016, the FASB issued a new lease accounting standard [ASU 2016-02 Leases (Topic 842)], which largely mirrors the IFRS 16 Leases rules issued by the IASB on January 13, 2016. Lessees will now need to reflect on their balance sheets a right-of-use asset (the value of the right to use the asset being leased) and a lease liability (equal to the present value of lease payments to become due) for virtually all of their leases, other than short-term leases of 12 months or less. Leases are classified as either *operating* leases (which result in a straight-line expense similar to current operating leases, and which are **not** presently shown on GAAP basis balance sheets) or *finance* leases (which result in a front-loaded expense pattern similar to current capital leases, and which **are** presently shown on GAAP basis balance sheets). Payments will be treated partly as amortization of the right of use and partly as interest charged on the rent payable.

Lessees will be required to show virtually all leases on their balance sheets, and will need to ensure they have an appropriate process to gather and report their leases. Leases may be imbedded in service arrangements along with other goods or services. This process may take considerable time and effort, and ongoing financial reporting and expanded disclosures under the new rules may require modification of existing systems and processes. Balance sheet changes could impact financial covenants, apportionment of income for state taxes and "lease versus buy" decision making.

The new FASB rules become effective (i) for US GAAP public companies for fiscal years, and interim periods within those fiscal years, beginning December 15, 2018, and (ii) for private companies (i.e., those not meeting FASB's definition of a public business entity), for fiscal years beginning after December 15, 2019, and interim periods beginning the following year. Early adoption is permitted.

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