

THE EFFECTS OF DECLINING VALUE ON COMMUNITY PROPERTY DIVISION

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- INTRODUCTION

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A1

• The Two Types of Distressed Property

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“Upside Down” vs. “Doomed” Property

“Upside Down” Property:
Blackacre’s secured debt exceeds its market value

“Doomed” Property:
Parties must sell Blackacre or lose it to foreclosure

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“Upside Down” vs. “Doomed” Property

- An **UPSIDE DOWN** Property is not necessarily **DOOMED**.
- A **DOOMED** Property is not necessarily **UPSIDE DOWN**.
- Determining whether Blackacre is **UPSIDE DOWN** is relatively easy, requiring only current loan statement(s) and reliable current appraisal.
- Determining whether Blackacre is **DOOMED** is difficult, requiring a prediction of future events.

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A2

- When Distressed Property Issues Arise

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**DISTRESSED PROPERTY ISSUES
ARISE AT THREE STAGES
DURING THE DISSOLUTION:**

- At OSC
- Between OSC and trial
- At trial

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**DISTRESSED PROPERTY ISSUES
AT THE OSC STAGE:**

- Exclusive possession orders
(FC§§2047(a), 6324 – orders after notice)
- Expense payment orders
(FC§§ 2047(a), 6324 – orders after notice)
- *Epstein* credit orders
- *Watts* charge orders

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DISTRESSED PROPERTY ISSUES BETWEEN OSC AND TRIAL:

- Trial setting and foot dragging
- Early property disposition orders
(FC§2108 – authority to liquidate assets)

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DISTRESSED PROPERTY ISSUES FOR TRIAL:

- Property valuation date
(FC§2552 – trial valuation date or alternate valuation date)
- Characterization and Reimbursement
 - Family Code section 2640(b)
 - Family Code section 2640(c)
 - *Moore/Marsden*

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DISTRESSED PROPERTY ISSUES FOR TRIAL:

- Should the distributee spouse receive credit for Blackacre's negative equity, or receive Blackacre at zero value?
 - FC§2622 – negative estates
 - FC§2550 – equal division
 - *Cream* limitation

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A3

- Some Distressing Concepts

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DEFICIENCY JUDGMENT

A deficiency judgment is a personal money judgment entered against a borrower for the difference between the price realized from the security at the foreclosure sale and the outstanding loan balance. (*Cornelison v. Kornbluth* (1975) 15 Cal.3d 590, 603; CCP §§580a, 726(b).)

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THREE TYPES OF DEBT:

- Recourse Debt
- Non-Recourse Debt
- “Rarely-Recourse” Debt

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B

• **IN-SPOUSE GOALS
AND OUT-SPOUSE
GOALS**

“Everybody wants something.”
It is good to have goals.

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In-Spouse vs. Out-Spouse

In-Spouse Irv:
in exclusive possession of
Blackacre

Out-Spouse Otto:
out of Blackacre
(whether by choice or by
exclusion order)

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IRV'S GOALS AT THE OSC STAGE:

- Wants order placing him in temporary exclusive possession of Blackacre
- Does not want order requiring him to pay PITI on Blackacre
- If pays PITI, wants to receive *Epstein* credits for payments
- Does not want to owe *Watts* charges to the community

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OTTO'S GOALS AT THE OSC STAGE:

- Does not want order placing Irv in temporary exclusive possession
- Wants order requiring Irv to pay PITI on Blackacre
- Does not want Irv to receive *Epstein* credits for PITI payments
- Wants Irv to owe *Watts* charges to community

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IRV'S GOALS BETWEEN OSC AND TRIAL:

- Wants a trial date as far in the future as possible
- Does not want an early disposition of property order

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OTTO'S GOALS BETWEEN OSC AND TRIAL:

- Wants a trial date as soon as possible
- Wants an early disposition of property order

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IRV'S GOALS FOR TRIAL:

- Wants Blackacre valued as of date of trial
- Wants to be awarded Blackacre
- Wants favorable rulings regarding FC§2640(b), FC§2640(c) and *Moore/Marsden*
- If Blackacre is awarded to him, Irv wants to take it at negative value

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OTTO'S GOALS FOR TRIAL:

- Wants Blackacre valued as of date of separation
- Wants favorable rulings regarding FC§2640(b), FC§2640(c) and *Moore/Marsden*
- If Blackacre is awarded to Irv, wants Irv to take it at zero value
- If Blackacre not awarded to Irv at zero value, wants Blackacre sold or abandoned

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ASSUME, FOR DISCUSSION PURPOSES:

- Blackacre, the family residence, is community property.
- Blackacre is both Upside Down and Doomed.
- At OSC, the trial court:
 - Placed Irv in exclusive temporary possession of Blackacre, and
 - Ordered Irv to keep current Blackacre's PITI payments.

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C

- Approaches to Distressed Property Issues at Each Stage

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C₁

- Distressed Property Issues at the OSC Stage

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ISSUES AT THE OSC STAGE:

EXCLUSIVE POSSESSION ORDERS AND *WATTS* CHARGES:

“To **stay** or not to stay,
that is the question.”

PITI PAYMENT ORDERS AND *EPSTEIN* CREDITS:

“To **pay** or not to pay,
that is the question.”

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Temporary Use

IRV CONTENTS AT OSC:

- The court may issue orders for the temporary use, possession, and control of property of the parties and the payment of any liens or encumbrances coming due during the period the order is in effect. (FCSS2047(a), 6324.)
- Under this authority the court should grant Irv temporary possession of Blackacre.

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Temporary Use

OTTO CONTENTS AT OSC:

- The court should not grant temporary possession of Blackacre to Irv, because it is a Doomed Property and should be sold.
- If the court does award temporary possession to Irv, it should be without prejudice to Otto's anticipated motion for a pretrial disposition of Blackacre.

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The Court Should Rule at the OSC

Both parties want rulings on *Epstein* credits and *Watts* charges

Both cite *In Re Marriage of Hebbring* (1989) 207 Cal.App.3d 1260, in which Justice King stated:

"Finally, the worst alternative is simply to defer the issue of reimbursement for decision by the trial judge."

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Payment Orders

OTTO CONTENTS AT OSC:

- The court may issue orders for the payment of any liens or encumbrances. (FC§§2047(a), 6324.)
- Under this authority the court should order Irv to make the PITI payments.
- Otto does not want his credit damaged.
- Otto desires loan modification or a short sale, and failure to pay PITI may complicate these possible solutions.

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Payment Orders

IRV CONTENTS AT OSC:

- He should not be ordered to pay PITI on Blackacre, because Blackacre is Doomed and PITI payments will not be any benefit to the community

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Epstein Credits

• IRV CONTENTS AT OSC:

- Existing precedent grants him *Epstein* credits for his post-separation PITI payments.
- “Thus, application of the no-reimbursement rule will discourage payment of community debts after separation, **exacerbate the financial and emotional disruption** which all too frequently accompanies the breakup of a marriage **and, perhaps, result in impairing the credit reputations** of both spouses.” (*In re Marriage of Epstein* (1979) 24 Cal.3d 76, 84.)

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Epstein Credits

- **OTTO CONTENTS AT OSC:**
 - Existing precedent is inapposite because Blackacre is a Doomed Property.
 - Irv's post-separation PITI payments regarding a Doomed property don't benefit the community.
 - *Epstein* credits to Irv would require Otto to pay a portion of a payment for which he will never receive a benefit.
 - Therefore, Irv should receive no *Epstein* credits.

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Watts Charges

- **OTTO CONTENTS:**
 - Existing precedent requires Irv to pay the community *Watts* charges for Irv's post-separation use of Blackacre.

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Watts Charges

- **IRV CONTENTS:**
 - He should not be subject to *Watts* charges because Blackacre is a Doomed Property regarding which no payments should be made.
 - Since the community has no investment/equity in Blackacre, the community should receive no return.
 - Once in default the community would not have the right to receive rents because of the trust deed's "assignment of rents" clause.

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C₂

- Distressed Property Issues Between OSC and Trial

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Trial Setting and Foot Dragging

IRV is motivated to do everything he can to delay the setting of trial in hopes that the real estate market continues to decline, and will allow him to retain Blackacre at a lower fair market value and greater negative equity.

This would allow Irv to receive other assets or an equalizing payment from Otto.

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Trial Setting and Foot Dragging

OTTO wants the trial set as quickly as possible or, in the alternative, an early disposition order.

Otto is concerned about further losses to the community, and concerned about building *Epstein* credits in favor of Irv.

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Pretrial Disposition Orders

IRV CONTENTS that, pursuant to *Lee v Superior Court (Lee)* (1976) 63 Cal.App.3d 705, a pretrial disposition order should be issued only where:

- It is necessary for a community asset to be sold (in *Lee*, a parcel of real estate) in order to preserve another community asset (in *Lee*, a business); and
- The court has made adequate safeguards to protect the interests of the spouse opposing the sale.

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Pretrial Disposition Orders

OTTO CONTENTS that *Lee v Superior Court* was superseded by the 1994 passage of Family Code section 2108 which states:

“At any time during the proceeding, the court has the authority, on application of a party and for good cause, to order the liquidation of community . . . assets so as to avoid unreasonable market or investment risks, given the relative nature, scope, and extent of the community estate.”

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Pretrial Disposition Orders

OTTO CONTENTS that Family Code section 2108 empowers the trial court to issue a pretrial order that Blackacre be either:

- Awarded to a spouse and valued at the date of the disposition to that spouse;
- Sold to a third party; or
- Abandoned to foreclosure.

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C₃

• Distressed Property
Issues for the Trial

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Valuation Date

IRV CONTENTS that Blackacre should be valued
as of date of trial, pursuant to Family Code
section 2552(a):

“ . . . except as provided in subdivision (b), the
court shall value the assets and liabilities as near
as practicable to the time of trial.”

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Valuation Date

OTTO CONTENTS that Blackacre should be
valued as of date of separation, pursuant to
Family Code section 2552(b):

“ . . . the court for good cause shown may value . . .
assets and liabilities at a date after separation and
before trial to accomplish an equal division of the
community estate of the parties in an equitable
manner.”

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Valuation Date

OTTO MAY CONTEND that Irv employed unfair gambits (e.g., delaying discovery responses, obtaining continuances through false pretences) to intentionally delay the trial as long as possible so Blackacre's value would be reduced.

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Valuation Date

OTTO INTRODUCES INTO EVIDENCE letters his attorney sent to Irv's attorney, demanding that Irv cooperate with an immediate sale of Blackacre and warning Irv that any failure to cooperate would breach Irv's of fiduciary duties. Otto contends that Irv's refusal to cooperate justifies:

- Denial of *Epstein* credits to Irv;
- Asset valuation as of date of separation; and
- Section 2108 early disposition order.

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Valuation Date

IRV CONTENTS that a delay in bringing a case to trial by itself does not justify an alternate valuation date as held by *In re Marriage of Priddis* (1982) 132 Cal.App.3d 349:

- H had exclusive occupancy of family residence, and paid its mortgage, during the parties' 11-year separation.
- Trial court valued residence as of date of separation, due to the long delay in bringing the case to trial.
- Court of appeal reversed, holding as follows:

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Valuation Date (continued)

"We perceive nothing in the fact of a lengthy separation, standing alone, that necessitates an alternate valuation date to accomplish the equal and equitable division of community property On the contrary, under such circumstances, when the value of community assets has been affected by inflation or other market factors, the fairest equal division of those assets lets the parties share equally in either gains or losses." (*Priddis*, at pp. 357-358.)

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Valuation Date

IRV CONTENTS that the traditional reasoning for a date of separation valuation (i.e. post-separation efforts such as involved in a professional practice – see *In Re Marriage of Green* (1989) 213 Cal.App.3d 14) is not generally applicable to valuation of real property.

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Valuation Date

IRV CONTENTS that the rationale of *In Re Marriage of Lehman* (1998) 18 Cal.4th 169 supports a date of trial valuation of the declining real estate, as both parties must share in increases and decreases in value that result from market forces.

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Valuation Date

OTTO COUNTERS that the rationale of *In Re Marriage of Hokanson* (1998) 68 Cal.App.4th 987 (wife's unreasonable failure to cooperate with the court's orders for the sale of a house is a breach of fiduciary duty) supports an alternate valuation date under FC§2552(b).

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C4

- Characterization and Reimbursement Issues for Trial

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C4a

- Family Code section 2640(b) Reimbursement Rights

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Philosophy behind FC § 2640(b)

Because Separatizer CAN'T PROFIT
it gets special protection

If future inflation, mortgage principal reduction
and/or capital improvements increase the
property's equity, Separatizer's right of
reimbursement is **FIRST TO BE REPLENISHED**.

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A Refi Is Either . . .

"Static Refi"

Refi of existing loan (e.g. obtain a
lower interest %) with **no equity
invasion**

"Cash Out Refi"

Refi that **invades equity**
There are net Loan Proceeds to
analyze

Or Both

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Two Species of Cash Out Loans

Invested
Funds

Funds used to
acquire or
improve an asset

Squandered
Funds

Funds used to
pay an expense

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"Squander" is a **Term of Art**

- The term "Squander" is used to mean expenditure of Cash Out Refi Proceeds for any kind of non-recoupable expense:
 - Even, for example, to pay for a life-saving medical treatment
 - "Squandered" doesn't mean "paid foolishly"
- "Invest", in contrast, means expenditure of Cash Out Refi Proceeds to acquire or improve an asset still in existence on date of trial

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"What happened to our equity?"

- Spouses obtained CASH OUT REFI PROCEEDS from Blackacre, and either:
 - "SQUANDERED" the proceeds ("Blackacre as ATM"); or
 - INVESTED the proceeds (*Walrath* question)
- Now Blackacre has **DECLINED IN VALUE**.

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Effect of Cash Out Loans on FC 2640(b)

- Additional loans secured by the property reduce net equity and can diminish 2640(b) reimbursement rights
 - A HELOC is no exception
 - All equity is available to the community, even if using it diminishes equity
 - Purpose of loan does not change the fact that it reduces the net equity

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Purchase Data

FMV at Purchase	500k
CP 1 st Mort <small>(interest only)</small>	<u>(400k)</u>
SP 2640 Contrib. (down pmt)	100k

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Subsequent Increase in Value

FMV Increased to	700k
1 st Mort Balance (same)	<u>(400k)</u>
Net Equity	300k

2640 Burden Remains 100k

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Subsequent HELOC Decreases Equity

FMV	700k
1 st Mort Balance (same)	(400k)
HELOC (squandered, not invested)	<u>(250k)</u>
Net Equity	50k

2640 Burden Amount 50k

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Subsequent Decline in Value

FMV Reduced to	600k
1 st Mort Balance (same)	(400k)
HELOC Balance (same)	(250k)
Net Equity	(50k)

2640 Burden Amount 0

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Have Your *Walrath* Chops Grown Rusty?

When Blackacre and Whiteacre both APPRECIATED, *Walrath* was irrelevant, because there was sufficient EQUITY in BOTH PROPERTIES to reimburse our generous Separatizer

But now that real estate is DOWN,
Walrath is UP

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Example: Blackacre Refi / Whiteacre Purchase

Parties use the \$100k to buy jointly-titled Whiteacre

Cash Out Refi Proceeds of \$100k

Blackacre's equity is \$500k
 $\$200k (40\%) = H2640 / \$300k (60\%) = CP$

Blackacre is CP subject to H2640(b)

75

Walrath: \$100k is pro-rated

Equity	from Blackacre	to Whiteacre
H2640(b)	\$100k x 40% =	\$ 40k
CP	\$100k x 60% =	\$ 60k

RESULT: A pro rated \$40k of the H2640(b) burden is moved from Blackacre to Whiteacre by "forced election."

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In 1998, FC § 2640(b) provided:

". . . the [separatizer] shall be reimbursed for the [separatizer's] contributions to the acquisition of **THE PROPERTY** to the extent the [separatizer] traces the contributions to a separate property source. The amount reimbursed . . . may not exceed the net value of **THE PROPERTY** at the time of the division."

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The Three Walrath Opinions

If the asset has sufficient equity at time of trial, the separatizer may be reimbursed from:

Brown majority opinion:	Whiteacre
Kennard dissenting opinion:	Whiteacre or Blackacre
Baxter dissenting opinion:	Any marital asset

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Senate Bill 1407
became effective 1/1/05

It cured the IRMO Cross
problem with FC § 2640(c)

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SB 1407 changed Section 2640(b) to read:

" . . . the [separatizer] shall be reimbursed
for the [separatizer's] contributions to the
acquisition of **PROPERTY OF THE
COMMUNITY PROPERTY ESTATE**
[formerly, "THE PROPERTY"] to the extent
the [separatizer] traces the contributions to a
separate property source. The amount
reimbursed . . . may not exceed the net value
of **THE PROPERTY** at the time of the
division."

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About Our Omniscient Legislature...

"The Legislature, of course, is deemed to be
aware of . . . judicial decisions . . . in
existence, and to have . . . amended a
statute in light thereof."

People v. Harrison (1989)
48 Cal.3d 321, 329

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How Retro of you...

ISSUE:

Does SB 1407 retroactively apply to a pre-2005 contribution of separate property?

ANSWER:

"No."

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Section 4 and *Fellows*

Family Code section 4 states the general rule that all Family Code amendments are fully retroactive.

See *In re Marriage of Fellows* (2006) 39 Cal.4th 179).

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Section 4 and *Fellows*

Family Code section 4(h) states the exception: "If . . . the court determines, that application of a particular provision of the new law . . . in the manner required by this section . . . would **substantially interfere with . . . the rights of the parties** . . . in connection with an event that occurred or circumstance that existed before the operative date, **the court may**, notwithstanding this section . . . **apply . . . the old law** to the extent reasonably necessary to mitigate the substantial interference."

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Hey, Remember Me?

- *In re Marriage of Buol* (1985) 39 Cal.3d 751
- *In re Marriage of Fabian* (1986) 41 Cal.3d 440
- *In re Marriage of Hilke* (1992) 4 Cal.4th 215
- *In re Marriage of Heikes* (1995) 10 Cal.4th 1211

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C4b

- Family Code section 2640(c) Reimbursement Rights

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Family Code §2640(c):

“A party shall be reimbursed for the party's separate property contributions to the acquisition of property of the other spouse's separate property estate during the marriage, unless there has been a transmutation in writing pursuant to Chapter 5 (commencing with Section 850) of Part 2 of Division 4, or a written waiver of the right to reimbursement. The amount reimbursed shall be without interest or adjustment for change in monetary values and may not exceed the net value of the property at the time of the division.”

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Family Code §2640(c):

1. Not limited to a disso action, as are:
 - a) FC §2581 (“For the purpose of division of property on dissolution of marriage or legal separation of the parties”); and
 - b) FC §2640(b) (“In the division of the community estate under this division”)
2. No reimbursement right if there has been a FC §852 transmutation (unlike FC §2640(b)).

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Family Code §2640(c):

3. Like FC §2640(b), reimbursement limited to net value of the property “. . . at time of the division.”
Query: when is the division?
4. Query: does the SP Owner have a fiduciary duty to the SP Contributor to preserve the Contributor’s reimbursement right? (See dicta in *In Re Marriage of Walker* (2006) 138 Cal.App.4th 1408, 1419 to the effect that a spouse does have a fiduciary duty to the other spouse as to separate property.)
5. Query: do *Walrath* principles apply to a §2640(c) reimbursement right? Arguably MORE SO.

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C4c

• Moore/Marsden
Issues

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Trial Judges Arguably Have Discretion

"Language used in any opinion is of course to be understood in the light of the facts and the issue then before the court, and an opinion is not authority for a proposition not therein considered." (*Ginns v. Savage* (1964) 61 Cal.2d 520.)

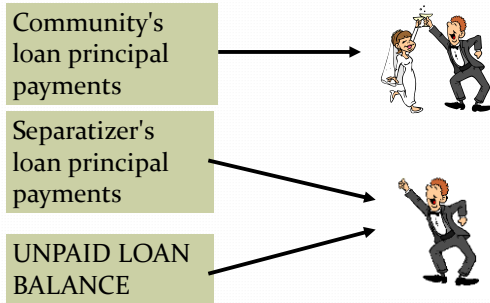
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Moore/Marsden and the Unpaid Loan Balance

- The *Moore/Marsden* formula:
 - Credits the COMMUNITY with its CASH contributions (e.g., its payments that reduce mortgage principal).
 - Credits the SEPARATIZER with her/his CASH contributions (e.g., down payment, pre-marital principal payments).
 - Credits the **SEPARATIZER** with the **UNPAID LOAN BALANCE**.

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The Loan Balance Benefits the Separatizer:



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If the Unpaid Loan Balance Is Ignored:

Community's
CASH loan
principal
payments



Separatizer's
CASH loan
principal
payments



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Traditional M/M Step II

CP principal payments

purchase price

X FMV appreciation
from DOM to DOT

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"Cash is King" M/M Step II

CP principal payments

total principal pmts

X FMV appreciation
from DOM to DOT

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Effect of the Unpaid Loan Balance on M/M:

- H purchases property before marriage
- Purchase price **\$500,000**
- HSP down payment **\$500**
- Mortgage **\$499,500**
- Before marriage, H pays down mortgage **\$300**
- Community pays down mortgage **\$50,000**
- After separation, H pays down mortgage **\$200**
- During marriage, property appreciates **\$400,000**

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If the loan balance is CONSIDERED:

W	45k (10%)
H	406k (90%)
Total	451k (100%)

If the loan balance is IGNORED:

W	221k (49%)
H	230k (51%)
Total	451k (100%)

Non-separatizer W receives **\$176k MORE** &
Separatizer H receives **\$176k LESS**

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Depreciated Property M/M Facts

- H bought Blackacre before DOM (remained in HSP title throughout marriage)
- H paid:
 - down payment at purchase date, and
 - loan principal payments before DOM
- Community paid loan principal payments during marriage (no refi)
- Property DEPRECIATED during marriage

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Depreciated Property M/M Issues:

Should the community's M/M rights:

- Be REDUCED by a pro rata share of the depreciation during marriage (Step I reimbursement REDUCED by Step II pro rata depreciation allocation)?
- Be LIMITED to the date of trial equity in the property?
- Focus on EQUITY instead of appreciation?
- Consider the unpaid LOAN BALANCE?

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	FMV	MORT	Equity
Purch.	900k	810k	90k
	<i>no change</i>	<i>30k</i>	
DOM	900k	780k	120k
	<i>200k</i>	<i>(180k)</i>	
DOT	700k	600k	100k

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Traditional Moore/Marsden Formula

STEP #1: Dollar-for-dollar reimbursement to the community of its \$180k loan principal payments.

STEP #2: Pro tanto allocation between community and separator of the property's APPRECIATION during marriage.

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Three Depreciated M/M Solutions

SOLUTION	TO COMM
Solution A: Full Step I reimbursement to the community	180k
Solution B: Step I reimbursement, reduced by share of Step II loss	140k
Solution C: Step I reimbursement, limited to date of trial equity	100k

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Additional Possible Solutions

SOLUTION	TO COMM
Solution D: Divide the equity, ignoring the loan balance	60k
Solution E: Divide the equity, considering the loan balance	20k

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Solution A

Full Step I reimbursement to the community: \$180k CP

\$180k due to community

(\$100k) date of trial equity

\$80k PAID BY SEPARATIZER

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Solution B

Step I reimbursement, reduced by share of Step II loss: \$140k CP

Reimburse principal pay down 180k

$$\frac{180k}{900k} \times (200k) = (40k)$$

Due to community 140k

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Solution C

Step I reimbursement limited to date of trial equity: \$100k CP

\$180k community's principal payments

~~(\$80k)~~ not reimbursable (lack of equity)

\$100k DATE OF TRIAL EQUITY

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Solutions D and E

Don't pro rate the APPRECIATION
(there is none) . . .

. . . instead pro rate the EQUITY

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Solution D

Divide the equity, ignoring the loan balance:
\$60k CP

(Solution D believes that "Cash is King")

Facts required for Solution D:
Amounts of CASH CONTRIBUTIONS
made by separatizer and community.

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Sol. D	FMV	MORT	Equity
Purch.	900k	810k	90k HSP
	<u>no change</u>	<u>(30k)</u> HSP	
DOM	900k	780k	120k
	<u>(200k)</u>	<u>(180k)</u> CP	
DOT	700k	600k	100k

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Solution D: Cash Contributions

180k COMMUNITY'S TOTAL
 90k separatizer's down payment
30k separatizer's principal payments
120k SEPARATIZER'S TOTAL
300k GRAND TOTAL

$$CP = 180k / 300k = 60\%$$

$$HSP = 120k / 300k = 40\%$$

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Solution D

60% x 100k Equity = \$60K CP SHARE

40% x 100k Equity = \$40K HSP SHARE

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Solution E

Divide the equity, considering the loan balance: \$20k CP

Solution E believes:

"The loan balance counts!"

Facts required for Solution E:
amounts of Cash contributions
made by separatizer and community
and the unpaid Loan Balance.

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Sol. E	FMV	MORT	Equity
Purch.	900k	810k	90k HSP
	<u>no change</u>	<u>(30k) HSP</u>	
DOM	900k	780k	120k
	<u>(200k)</u>	<u>(180k) CP</u>	
DOT	700k	600k	100k

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Solution E: Cash & Loan Contributions

80k COMMUNITY'S TOTAL

90k separatizer's down payment

30k separatizer's principal payments

600k separatizer's loan balance at DOT

720k SEPARATIZER'S TOTAL

900k GRAND TOTAL

$$CP = 180k / 900k = 20\%$$

$$HSP = 720k / 900k = 80\%$$

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Solution E

$$20\% \times 100k \text{ Equity} = \$20K \quad \text{CP SHARE}$$

$$80\% \times 100k \text{ Equity} = \$80K \quad \text{HSP SHARE}$$

116

A Legal "Buffet Table"

	<u>COMM.</u>	<u>SEP.</u>
Solution A:	180k	(80k)
Solution B:	140k	(40k)
Solution C:	100k	0
Solution D:	60k	40k
Solution E:	20k	80k

117

An Opportunity for Change . . .

Should rules regarding depreciated *Moore/Marsden* be tailored to benefit the community? The separatizer?

Is this an opportunity to right wrongs?

Do existing precedents unduly benefit the community? The separatizer?

What do YOU think?

118

M/M Currently Favors the Separatizer

1. M/M gives the community **NO CREDIT** for its mortgage **INTEREST** payments, property **TAX** payments and **INSURANCE** payments
2. Unless there has been a *Grinius* refi, the unpaid mortgage balance benefits the separatizer in the pro tanto calculations

119

M/M Currently Favors the Community

1. M/M grants the community:
 - a) A co-ownership interest in the property that is enforceable in DEATH, as well as in divorce.
 - b) A pro tanto SHARE IN APPRECIATION.
(M/M is superior in both ways to FC §2640.)
2. The community pays the separatizer **NO WATTS CHARGES** for its use of the property.
(*In re Marriage of Nelson* (2006) 39 Cal.App.4th 1546.)

120

M/M Currently Favors the Community

3. COMMUNITY INCOME TAXES HAVE BEEN REDUCED if (as is likely) the parties have jointly claimed the mortgage interest and property tax deductions.
4. The community pro tanto fraction is multiplied times the property appreciation THROUGHOUT MARRIAGE, despite the fact that the community payments were NOT MADE AT THE BEGINNING OF THE MARRIAGE.

121

Reasons to Favor the Community

Although the separatizer has concededly suffered a loss due to the declining market, that loss isn't the community's "fault" (any more than it is the separatizer's "fault").

In point of fact, the separatizer's loss would have been GREATER were it not for the community's mortgage principal pay down.

122

Reasons to Favor the Community

"Pro rata"
means
"in proportion."
"Pro tanto"
means
"as far as it goes."

123

Reasons to Favor the Community

Authorities confirming community's right to reimbursement for payments benefiting SP:

- *Weinberg v. Weinberg* (1967) 67 Cal.2d 557, 562-563
- *Marriage of Walter* (1976) 57 Cal.App.3d 802, 805-806
- *Marriage of Frick* (1986) 181 Cal.App.3d 997, 1010

124

Complex Issues, Vol. E, Ch. 2

1. A separater using CP to benefit SP breaches his/her fiduciary duty to the community, which results in the imposition of a constructive trust over the SP pursuant to Civil Code §1575.
2. The community receives reimbursement as a restitution remedy.

125

Reasons to Favor the Community

"If the trial court determines that the improvements to the trailer did not enhance the property's value, [the non-separatizer Wife's] recovery will be limited to reimbursement of one-half of the community funds spent on improving the [separatizer's] property." (*Bono v Clark*, at p. 1425.)

126

Reasons to Favor the Community

Moore/Marsden should reward the community with priority creditor status, in recognition of the community's willingness to invest in separatizer property . . .

. . . the same way FC § 2640 rewards the separatizer with priority creditor status, in recognition of the separatizer's willingness to invest in community property.

127

Reason to Favor the Separatizer

Counter-argument to the foregoing:

The Family Code section 2640 separatizer is MORE worthy of priority creditor status than is the *Moore/Marsden* community.

The *Moore/Marsden* community has a hope of receiving return on its investment, whereas the Family Code section 2640 separatizer has no such hope.

128

Moorebeam/Moorath Hypothetical Facts

- Blackacre is HSP with M/M
- \$300k in cash out refi proceeds are borrowed against Blackacre
- The \$300k in proceeds are used to purchase Whiteacre, which is owned in joint title

129

Moorebeam/Moorath Issues

- What relative CP and HSP interests have been transferred into Whiteacre?
- What relative CP and HSP interests remain in Blackacre?

130

Four Approaches to M/M Cash Out Refi

Beam "family expense tracing" doctrine

"FIRST OUT" refi proceeds are CP

Walrath "pro rata" doctrine

PRORATED refi proceeds are CP

Grinius "intent of the lender" doctrine

ALL refi proceeds are CP

"Unfeasible" doctrine

"FIRST OUT" refi proceeds are SP

131

No Precedent Yet

No appellate case has yet said what happens when Cash Out Loan Proceeds are taken from "HSP with M/M."

Is "*Moorebeam/Moorath*" in your office now?

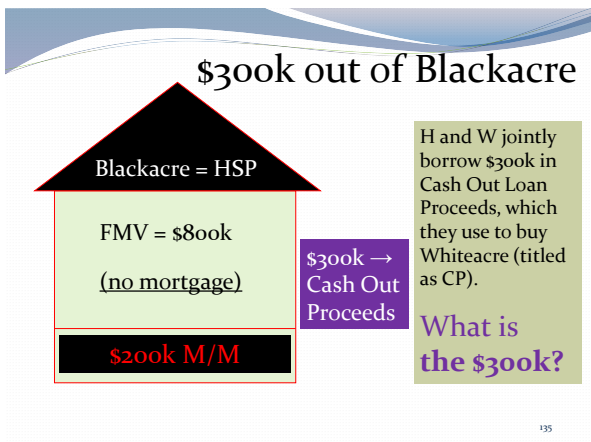
132

	FMV	MORT	Equity
Purchase (=DOM)	600k	150k	450k
	+200k	(150k)	
Day Before Refi	800k	0	800k

133

Moore/Marsden			
#1	Reimbursement		150k
#2	$\frac{150k}{600k} \times 200k$	=	50k
	Total		200k

134



135

Two Approaches to M/M Cash Out Refi

1

- "Take CP First Approach"
(*Moore* + *Beam* = "*Moorebeam*")
- First \$200k is CP
- Other \$100k is HSP

2

- "Pro Rata Approach"
(*Moore* + *Walrath* = "*Moorath*")
- (75% x \$300k =) \$225k is HSP
(25% x \$300k =) \$75k is CP

136

"CP First ("*Moorebeam*") Approach"

(\$200k is CP --remaining \$100k is HSP)

Judge Able agrees,
because consistent
with *Beam*.

Judge Adept disagrees,
because inconsistent
with *Walrath*.

137

"Pro Rata (*Moorath*) Approach"

(75% x \$300k =) \$225k is HSP
(25% x \$300k =) \$75k is CP

Judge Adept agrees,
because consistent
with *Walrath*.

Judge Able disagrees,
because inconsistent
with *Beam*.

138

If *Moorebeam*, result as to Whiteacre

If the \$300k comes "CP FIRST" out of Blackacre as:

\$200k = CP equity

\$100k = HSP equity

Will Whiteacre also be owned
PRO RATA?

Or will H be limited to a \$100k
FC §2640 reimbursement right?

139

H will be limited to a

\$100k

FC §2640 reimbursement right

(FC §2851)

140

\$100k HSP into Whiteacre

\$300k →
Cash Out Proceeds

Whiteacre is
owned:

CP subj
\$100k H2640

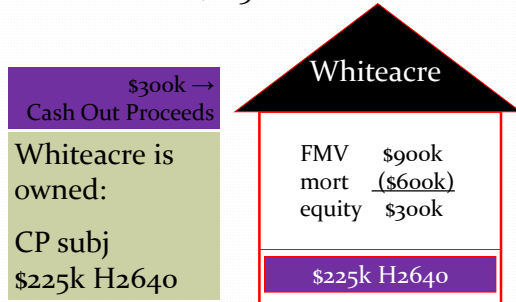
Whiteacre

FMV \$900k
mort ~~(\$600k)~~
equity \$300k

\$100k H2640

141

Similar result if \$225k HSP into Whiteacre



142

Moorebeam/Moorath Issues

- A question exists whether *M/M* Step II calculations should be performed at the time of refi
- There is a significantly different result:
 - Compare Table 1 and Table 2.

143

A Third Approach to *M/M* Cash Out Refi

- 3
- “All CP Approach” (*Moore + Grinius = “Mooregrin”*)
 - Entire \$300k is CP
 - No portion is HSP

144

"All CP ("Mooregrin") Approach"

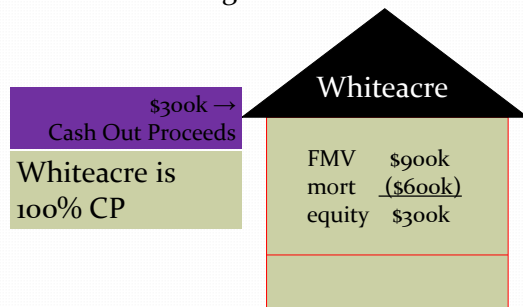
All \$300k is CP (nothing is HSP)

- AND -

the \$300k obligation
is all community!

145

Now ZERO HSP goes into Whiteacre



146

C5

- Property Division and Disposition Issues at Trial

147

C5a

- Should a Party Receive Blackacre at a Zero Value or be Credited for the Negative Equity?

148

Negative or Zero Value on CP Balance Sheet?

Issue:

What amount should be entered for Blackacre in Irv's column on the community property balance sheet:

- Negative \$100k ("the **Negative Option**" that Irv wants), or
- Zero ("the **Zero Option**" that Otto wants)?

149

Net Negative Estates

Where the entire estate is negative, the court has broad discretion pursuant to FC§2622(b):

"To the extent the community debts exceed total community and quasi-community assets, the excess of debt shall be assigned as the court deems just and equitable, taking into account factors such as the parties' relative ability to pay."

In this circumstance, the court can award Upside Down, Doomed Blackacre to Irv at a zero value.

150

Net Positive Estates

Where the property is Upside Down but the overall community estate has a positive value, the court is required to make a mathematically equal division of the parties' community property assets and liabilities pursuant to the mandates of FC§2550:

"Except upon the written agreement of the parties...the court shall...divide the community estate of the parties equally."

151

Court Must "Value" Liabilities

Family Code section 2552(a): "... the court **shall value the assets and liabilities**"

Family Code section 2551: "... in ... assigning the liabilities of the parties **for which the community estate is liable**, the court shall characterize liabilities as separate or community and confirm or assign them to the parties in accordance with Part 6 (commencing with Section 2620)."

ISSUE: in dealing with an Upside Down property, how is the court to "value" the asset and the liability?

152

THREE TYPES OF DEBT:

- Recourse Debt
- Non-Recourse Debt
- "Rarely-Recourse" Debt

153

DEFICIENCY JUDGMENT

A deficiency judgment is a personal money judgment entered against a borrower for the difference between the price realized from the security at a foreclosure sale and the outstanding loan balance.
(*Cornelison v. Kornbluth* (1975) 15 Cal.3d 590, 603; CCP §§580a, 726(b).)

154

RECOURSE DEBT:

Creditor **MAY OBTAIN** a judgment against Irv and Otto.

Examples:

- An **unsecured** loan.
- A loan **secured against personal property**, such as securities or a vehicle.
(*Florio v. Lau* (1998) 68 Cal.App.4th 637, 644-645.)

155

NON-RECOURSE DEBT:

Creditor **MAY NOT OBTAIN** a deficiency judgment against Irv and Otto.

Examples:

- A **purchase money loan** secured by a trust deed against a **dwelling**. (CCP §580b.)
- Any **seller carry back** purchase money loan (even one secured against a non-dwelling).
(*Brown v. Jensen* (1953) 41 Cal.2d 193.)

156

Obligations a Court Must Consider

In Re Marriage of Fonstein (1976) 17 Cal.3d 738, 748:

“The obligations to be allocated are those that **could be enforced against one or more assets** included in the division, **either because** the obligation is **secured** by an encumbrance on the asset **or because the asset could be reached on execution** if the obligation were reduced to a judgment.”

Under this analysis, an asset encumbered by a **non-recourse loan** should be awarded to the spouse at a zero value and no credit should be given for negative equity.

(Analogize with corporate stock.)

157

“RARELY-RECOURSE” DEBT:

Creditor **MAY WITH DIFFICULTY OBTAIN** a deficiency judgment against Irv and Otto.

- Judicial foreclosure is required.
- Irv and Otto have a 12-month right of redemption (CCP §729.030(b)).

158

EXAMPLES OF “RARELY-RECOURSE” DEBT:

- Any **non-purchase money** mortgage loan (CCP §§580b, d), such as a HELOC.
- A purchase money mortgage loan **secured against a non-dwelling**. (CCP §§580b, d).
- A lien that was **subordinated** to a construction loan. (*Spangler v. Memel* (1972) 7 Cal.3d 603.)
- The loan was **secured against a property other than the property sold**. (*Roseleaf Corp. v. Chierighino* (1963) 59 Cal.2d 35)

159

WHAT ABOUT A REFINANCED LOAN?

- A non-recourse loan refied with additional equity removed becomes a rarely-recourse loan. (CCP §580b.)
- A non-recourse loan refied (with no additional equity removed) **with the same lender** remains a non-recourse loan. (*DeBerard v Lim* (1999) 20 Cal.4th 659.)
- A non-recourse loan refied (with no additional equity removed) **with a different lender** becomes a rarely-recourse loan. (*Union Bank v Wendlend* (1976) 54 Cal.App. 3d 393.)

160

FIVE POSSIBLE REASONS TO PAY A DEBT:

1. Avoid a collection lawsuit
2. Protect credit score
3. Avoid cancellation of debt tax liability
4. Protect reputation
5. Fulfill moral obligation to pay

161

The Court May Disregard a Speculative Liability

Generally, liabilities that are speculative are not to be taken into account in valuing community property for purposes of division:

- See *In re Marriage of Fonstein* (1976) 17 Cal.App.3d 738 regarding speculative tax consequences.
- See *In re Marriage of Stratton* (1975) 46 Cal.App.3d 173, 176, which states it is inappropriate to consider speculative costs of sale of real property in determining value.

162

A Reason to Favor the Zero Option

Trial courts are encouraged to maximize the community property estate. (*In re Marriage of Kozen* (1986) 185 Cal.App.3d 1258.)

The Zero Option enlarges the community property estate.

163

Reasons to Favor the Negative Option

A judge may favor the Negative Option if:

- Irv has physical custody of a minor child who would benefit from remaining in Blackacre.
- Otto reduced Blackacre's equity in breach of his fiduciary duties to Irv (e.g., by gambling away HELOC proceeds).
- Irv lost a Family Code section 2640 reimbursement right in Blackacre.
- Irv was particularly attached to Blackacre. (*In re Marriage of Fink [Fink II]* (1979) 25 Cal.3d 877.)

164

C5b

- Other Debt Solutions – Approaches That May Avoid Credit for Negative Equity

165

Otto's Pre-trial Tactic

Perhaps OTTO, heeding his divorce lawyer's sage advice, avoided Negative Option/Zero Option debate entirely . . .
. . . by obtaining a pre-trial loan modification reducing the mortgage balance to (or below) Blackacre's fair market value.

166

Must Irv Cooperate?

If Irv refuses to cooperate with Otto's attempt to obtain a pre-trial loan modification, does the court have authority to compel Irv's cooperation?

167

The Court May Dispense with Irv's Consent

Section 1101(e) provides, in pertinent part:
"In any transaction affecting community property in which the consent of both spouses is required, the court may, upon the motion of a spouse, dispense with the requirement of the other spouse's consent if both of the following requirements are met:
(1) The proposed transaction is in the best interest of the community.
(2) Consent has been arbitrarily refused"

168

Otto's Tactic at Trial

OTTO offers as trial evidence:

- Expert testimony that **loan modification** was feasible, and
- A copy of the letter Otto's lawyer sent Irv's lawyer warning that, if Irv refused to cooperate with **loan modification**, Otto would use Irv's refusal in support of the Zero Option.

169

Otto's Tactic at Trial

OTTO offers as trial evidence:

- Expert testimony that **short sale** was feasible, and
- A copy of the letter Otto's lawyer sent Irv's lawyer warning that, if Irv refused to cooperate with the **short sale**, Otto would use Irv's refusal in support of the Zero Option.

170

Otto's Tactic at Trial

OTTO offers as trial evidence:

- Expert testimony that **deed in lieu of foreclosure** was feasible, and
- A copy of the letter Otto's lawyer sent Irv's lawyer warning that, if Irv refused to cooperate with the **deed in lieu of foreclosure**, Otto would use Irv's refusal in support of the Zero Option.

171

The Mystery of FICO Scores

IRV argues for the Negative Option, contending that collection lawsuit avoidance is only one reason for payment of a debt, and citing four other reasons:

- **Protecting credit score,**
- Avoiding cancellation of debt **tax liability,**
- Protecting **reputation,** and
- Fulfilling **moral obligation** to pay.

More about that credit score issue . . .

172

FICO computation:

Payment History (35%)

Credit Utilization (30%)

Length of Credit History (15%)

Recent Inquiries (10%)

Types of Credit (10%)

173

FICO computation:

Payment History (35%)

- **Payment track record**
- Length of positive history
- **Amount of current unpaid debt**
- **Time elapsed since last negative item**
- **Severity and quantities of delinquencies**

174

FICO computation:

Credit Utilization (30%)

- Number of accounts
- Amount of revolving debt
- Ratio of revolving debt balances to credit limits (paying off debt will lower the "utilization ratio")

175

FICO computation:

Length of Credit History (15%)

- How long accounts have been active
- Length of time since accounts were used

Recent Inquiries (10%)

Types of Credit (10%)

176

C5c

- Potential Tax Liability of Cancellation of Debt

177

Potential Tax Liability

IRV argues for the Negative Option, contending that collection lawsuit avoidance is only one reason for payment of a debt, and citing four other reasons:

- Protecting **credit score**,
- **Avoiding cancellation of debt tax liability**,
- Protecting **reputation**, and
- Fulfilling **moral obligation** to pay

178

“Cancellation of debt”

“Cancellation of debt” is the commonly used term.

The Internal Revenue Code refers to it as “relief from debt.”

(For example, see IRS form 982).

179

Transactions That Trigger COD Tax Liability

Transactions which reduce or forgive a debt owing by a taxpayer may result in tax liability for cancellation of debt (COD tax liability). This is true in each of the following circumstances:

- Loan modification which reduces loan principal or forgives accrued interest.
- Short sale.
- Deed in lieu of foreclosure.
- Foreclosure without a deficiency judgment.

180

Form 1099C

If a lender cancels or reduces debt, the lender is required to issue a 1099C to the borrower.

One problem here is that the lender will include the “fair value” in the 1099C, and it may be an inflated figure creating the appearance of a larger forgiveness of debt.

181

Recourse vs. Rarely-Recourse Loans

A distinction between recourse loans and rarely-recourse loans:

- A taxpayer **does incur** COD tax liability when relief is from recourse debt.
- The taxpayer **does not incur** COD tax liability when relief from non-recourse debt, unless the relief is due to:
 - A short sale, or
 - A loan modification of the principal balance.

182

Recent Legislative Relief

Recent federal legislation relieves a taxpayer of COD tax liability regarding a debt secured against the taxpayer's principal residence.

It is important that the taxpayer report the transaction.

Note that if both spouses vacate the property and rent it to a third party, they will lose their COD tax liability relief, because the property will no longer be their principal residence.

183

Tax Publications on COD

For additional information on COD tax liability, see these publications:

- IRS publication 4681: Canceled Debts, Foreclosures, Repossessions and Abandonments.
- IRS publication 544: Sales and Other Disposition of Assets.

184

C5d

- Disposition of Distressed Real Estate at Trial

185

OTTO CONTENTS that the court should force Irv to choose between:

- Accepting the Zero Option, or
- Suffering an order that Blackacre be disposed of either:
 - By sale to a third party or
 - By abandonment to foreclosure

186

IRV CONTENTS that that the court may not force him to make this choice, because *In re Marriage of Cream* (1993) 13 Cal.App.4th 81 forbids a court from:

- Conducting an auction, or
- Negotiating with a party

187

The Problem with Continuing Loan Liability

Is awarding Blackacre to Irv without taking Otto off the mortgage an equal division?

Arguably not – if the trial court fails to remove Otto from the mortgage, the trial court has failed to divide the community because the community mortgage debt is still “perched” on Otto’s credit score.

188

How Should the Court Handle the Continuing Loan Liability?

The Court has the authority:

Family Code section 2601: “Where economic circumstances warrant, the court may award an asset of the community estate to one party **on such conditions as the court deems proper** to effect a substantially equal division of the community estate.”

189

How Should the Court Handle the Continuing Loan Liability?

The court's options:

- Require Irv to defend and hold Otto harmless
- Irv to obtain loan assumption
- Require Irv to refinance mortgage

190

Structuring these Requirements

How should the refi requirement be structured – as a condition subsequent or as a covenant?

- If a contractual **condition subsequent** is not satisfied, the contract is cancelled.
- If a contractual **covenant** is not performed, the party who failed to perform the covenant must make alternate performance or be liable to pay damages to the other party.

191

Example of condition subsequent refi requirement:

“Irv shall use all reasonable, good faith efforts to forthwith refinance Blackacre to obtain net refinance proceeds of \$ _____ [e.g., the amount Irv needs to cash out Otto’s interest]. Otto shall cooperate with Irv’s efforts. If Irv is unable to so refinance Blackacre on or before _____, the parties’ settlement agreement in this matter shall be cancelled. The case is calendared for further settlement conference on _____ and for trial on _____.

192

Example of a covenant refi requirement:

"Irv shall use all reasonable, good faith efforts to forthwith refinance Blackacre to obtain net refinance proceed of \$_____ [e.g., the amount Irv needs to cash out Otto's interest]. Otto shall cooperate with Irv's efforts. If Irv is unable to so refinance Blackacre on or before _____, the parties shall forthwith list Blackacre for sale with a mutually-acceptable real estate broker and shall accept the earliest reasonable offer to purchase Blackacre. Any net sale proceeds shall be distributed between the parties as follows: _____. The court shall retain jurisdiction over all matters regarding Blackacre, including its listing and sale.

193

Is a Deferred Sale Order Appropriate?

Will a Family Code section 3800 deferred sale order be appropriate?

Such an order requires a determination of economic feasibility under Family Code section 3801.

194

Is a Deferred Sale Order Appropriate?

FC§3801(c) provides, in pertinent part:

"It is the intent of the Legislature, by requiring the determination under this section, to do all of the following: (1) Avoid the likelihood of possible defaults on the payments of notes and resulting foreclosures."

FC§3802 requires the court to consider: "The economic detriment to the non-resident parent in the event of a deferred sale of a home order."

195

Is Reserving Jurisdiction Appropriate?

- The court's obligation is to divide the community estate at time of trial. (FC§§ 2550, 2552.)
- The *Kelley* issue.

196

Was the Parental Loan “Real” or “Illusory”?

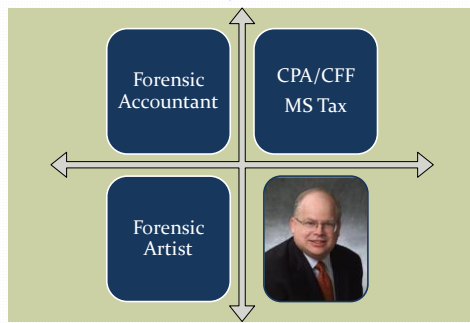
In re Marriage of Kelley (1976) 64 Cal.App.3d 82.

- Recognize a loan that is enforceable.
- Any concern about subsequent forgiveness or cancellation is not applicable to the community's liability.
- Reservation of jurisdiction is not appropriate.

The same rationale should apply to “rarely-recourse” loans. This would support giving credit for the negative equity.

197

Thank You, Jim Schaefer



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