Dividing Negative Equity When the Night is Still

Ronald S. Granberg and Robert E. Blevans

Dear Judge Fair:

I am preparing this letter because my conscience is bothering me and I have discovered that writing is the best way to tame runaway thoughts. Although I'll never send the letter, I'm hoping that having written it will help me sleep.

Some decisions I've made as a lawyer visit me when the night is still. Did I settle Case A too cheaply? Why did I reject that settlement offer in Case B? Should I have called an additional witness in Case C? I'll bet you have it worse than I do, Judge. Do decisions you've made ever visit you at night?

Marriage of NonRecourse

Yesterday you heard my client's custody modification OSC in Marriage of NonRecourse. Carol Darrence represented Harold NonRecourse, and I represented Wanda NonRecourse, just as we had at our trial last year. NonRecourse was the first case I ever tried.

Although Carol is tough and competent, she had obvious client control problems. It probably didn't take her long to figure out that she had a narcissist by the tail. Harold overstated his timeshare and understated his income – how original! I suspect that he committed domestic violence Wanda would never admit. Poor Wanda was so frightened and dependent that I had to help her decide which apartment to rent when she moved out of Battleacre, the family residence.

You identified Harold as a control freak during the pendente lite custody and support motions. Harold's and Wanda's sons have a mean and manipulative father, but are fortunate that Harold's folks are such wonderful grandparents.

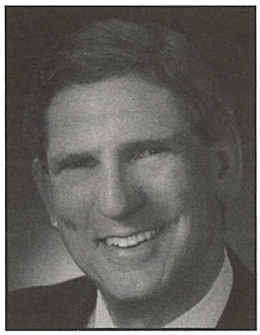
You looked surprised on the morning of trial last year when Carol and I recited our custody and support settlements on the record. Wanda made concessions against my advice. I begged her not to stipulate to that ridiculous 50/50 joint physical custody order. Harold had seen the boys only six times since separation, and four of those times had been at his parents' house. Harold probably played video games while his folks took the kids to the park. The 50% timeshare minimized Harold's child support, then Wanda torpedoed herself again by accepting Harold's lowball spousal support offer.

Harold and Wanda had agreed on all of the property issues except two when we walked into your department on the morning of trial. The property items they had settled were inconsequential – some furniture and two vehicles with little equity. Harold's metal fabrication business had no value because it was so new and its major equipment items were leased.

The values of the remaining two properties were coincidental: Battleacre had negative equity of $480,000, and the parties' high-basis stock account was worth $480,000. Battleacre's purchase money loan had never been refinanced, and thus carried anti-deficiency protection.

I was chagrined, but not surprised, by your decision to award Battleacre to Harold. You had solid reasons for deciding that, since Harold's fabrication business operated out of Battleacre's garage and Harold's parents lived right next door.

Carol contended that because Harold was assuming $480,000 in community debt, you were required to award the entire $480,000 securities account to him. No muss, no fuss, no equalizing payment. When you asked Carol for her authority, she cited Family Code section 2550:



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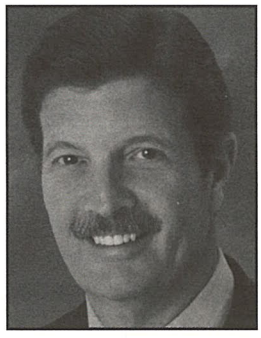

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> Except upon the written agreement of the parties, or on oral stipulation of the parties in open court, or as otherwise provided in this division, in a proceeding for dissolution of marriage . . . the court shall . . . in its judgment of dissolution of the marriage . . . divide the community estate of the parties equally.

When you asked me what Wanda's position was, I told you, "Awarding Mr. NonRecourse the $480,000 stock would be unfair – Ms. NonRecourse would be left with nothing." When you asked me what authority supported my contention, I replied, "None that I know of." You awarded the securities account to Harold.

When you heard yesterday's OSC, you learned what had happened during the year since the trial: Harold stopped paying the loan immediately after trial and lost Battleacre to foreclosure. How did that make you feel? It made me feel sick. Harold had pocketed $480,000. Wanda had ended up with a trickle of cash flow, no assets, and full responsibility for two young children.

I'm writing tonight to exorcise demons and organize thoughts. If I write it correctly, my letter can provide me a roadmap for future cases. The next time I'm involved with a case in which upside-down realty subject to a nonrecourse loan is being awarded to the other spouse, I'll argue this syllogism:

Major premise: A legally-unenforceable obligation must be ignored in a family law property division.

Minor premise: A purchase money obligation secured against a dwelling is legally unenforceable to the extent the obligation exceeds the dwelling's value.

Conclusion: To the extent it exceeds the dwelling's value, a purchase money obligation secured against a dwelling must be ignored in a family law property division.

Code of Civil Procedure section 580(b) provides, in pertinent part:

> No deficiency judgment shall lie in any event after a sale of real property . . . under a deed of trust . . . on a dwelling for not more than four families given to a lender to secure repayment of a loan which was in fact used to pay all or part of the purchase price of that dwelling occupied . . . by the purchaser.

The divorce court must value community liabilities. Family Code section 2552, subdivision (a), provides, in pertinent part:

> For the purpose of the division of the community estate upon dissolution of marriage . . . the court shall value the . . . liabilities . . . .

Does that mean a liability isn't always "worth" its unpaid balance? I think it does. Opposing counsel will argue that I'm reading too much into the phrase "value the . . . liabilities," and that the phrase simply means that the court must determine the amount of the unpaid loan balance. I disagree. In my view, a liability that a lender is unable to enforce is no liability at all. *In re Marriage of Fonstein* (1976) 17 Cal.3d 738, 748 specified the types of obligations a divorce court should allocate when dividing a community estate:

> 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. (citing to Walzer, *Cal. Marital Termination Settlements* (Cont. Ed. Bar 1971) § 4.2, p. 54.)

Battleacre's purchase money loan was nonrecourse obligation. The next time I'm asked whether any authority permits a court to award at zero value an upside-down residence encumbered by a purchase money mortgage, I'll have Code of Civil Procedure section 580(b), Family Code section 2552, subdivision (a) and *Fonstein* in my pocket. Perhaps someday I'll be able to save a client from Wanda's fate.

No *Cream* Violation

By the way, Judge, I respect you for not having attempted to force Harold to accept Battleacre at no value, the way many judicial officers would have done. Since the NonRecourse trial, I've seen three judges strong arm settlements by threatening to order a residence sold unless the in-spouse agrees to take it at zero value. In my view, such judicial coercion is exactly the type of interspousal auctioning and court-litigant negotiating that Justice King forbade in *In re Marriage of Cream* (1993) 13 Cal.App.4th 81.

Without Reservation

Bench officers these days are tempted to reserve jurisdiction over an upside-down residence in order to determine whether the distributee spouse actually makes the mortgage payments. I have heard *In re Marriage of Kelley* (1976) 64 Cal. App.3d 82 cited as authority for the proposition that such reservations are disfavored, but *Kelley* involved a loan from a spouse's parents as opposed to a loan from a commercial

lender. On date of trial Husband and Wife owed $12,000 on a loan from Wife's parents. The trial court allocated the obligation to Wife, but provided that any reduction in the debt balance due to forgiveness or unenforceability must "redound proportionately" to benefit of each spouse. The court of appeal reversed, holding that, "The court was not empowered to limit the right of one party to receive a gift, loan, inheritance, or bequest by the requirement that the other would participate pro rata in it." (*Id.* at p. 99.)

Even if a trial court doesn't feel constrained by *Kelley*, practical considerations argue against retention of jurisdiction. My goodness, Judge Fair, I don't see how you can possibly reserve jurisdiction over all the upside-down residences: your calendar is full of them.

Marriage of PersonaltyRecourse

Two weeks ago I watched Carol try a case in which her client, Wendy PersonaltyRecourse, was awarded a Range Rover worth $20,000 but encumbered by a $35,000 secured loan. Carol contended that her client should receive the Rover at a $15,000 negative value and Judge Just agreed.

That seems to be the correct result. A loan secured by personalty is a recourse loan (*Florio v. Lau* (1998) 68 Cal. App.4th 637, 644-645) on which lenders commonly sue to obtain deficiency judgments.

Marriage of RarelyRecourse

I'm set for trial later this year in Marriage of RarelyRecourse, which involves a recourse loan secured by realty. Examples of secured recourse loans include:

- A purchase money loan secured against a non-dwelling;
- A non-purchase money loan, such as a HELOC;
- A loan secured against property other than the property sold (*Roseleaf Corp. v. Chierighino* (1963) 59 Cal.2d 35);
- A mortgage that was subordinated to a construction loan (*Spangler v. Memel* (1972) 7 Cal.3d 603); and
- A nonrecourse loan that was refinanced (*Union Bank v Wendlend* (1976) 54 Cal.App.3d 393).

Legally speaking, these loans are recourse obligations; but practically speaking, they are not. I have come to think of them as "rarely recourse obligations" – a term I coined. A lender will very rarely file the requisite judicial foreclosure action (Code of Civ. Proc., §§ 580a, 725a, 726) seeking a deficiency judgment regarding a "rarely recourse obligation" due to:

- The costs and delays inherent in litigation;
- The borrowers' right to a fair value hearing (Code of Civ. Proc., § 726);
- The borrowers' 12-month post-judgment right of redemption (Code of Civ. Proc., § 729.030, subd. (b)); and
- The difficulties a lender faces in attempting to enforce a money judgment.

My favorite *Fonstein* quotation begins: "The obligations to be allocated are those that *could be enforced* . . . ." (Emphasis supplied; *In re Marriage of Fonstein, supra,* 17 Cal.3d at 748.) Does the term "could be enforced" denote a legal possibility or a practical likelihood? In other words, does the term mean that the obligation "could possibly be enforced under legal principles" or "might actually be enforced in the real world"? In Marriage of RarelyRecourse I will argue for the latter meaning. Judicial officers – and family law judicial officers especially – should base their decisions on the real world, not on some theoretical "legal" world. Our clients are real people, not theoretical entities.

As was true in Marriage of NonRecourse, in Marriage of RarelyRecourse the residence is upside down and I represent the non-distributee spouse. Once again, my goal is to persuade the court to award the residence to the other spouse at a zero value, instead of at a negative value. My task is obviously much more difficult now, since the mortgage secures a recourse obligation. I have an expert witness with extensive experience in the lending industry who will testify how rarely lenders file judicial foreclose suits against residences.

Compared with the syllogism I used in Marriage of NonRecourse, the syllogism I'll be forced to use in Marriage of RarelyRecourse is a weak one:

Major premise: An obligation that is highly unlikely to be enforced may be ignored in a family law property division.

Minor premise: A non-purchase money obligation secured by a trust deed against a dwelling is highly unlikely to be enforced to the extent the obligation exceeds the dwelling's value.

Conclusion: To the extent it exceeds the dwelling's value, a non-purchase money obligation secured by a trust deed

against a dwelling may be ignored in a family law property division.

Equity Won't Trump

Judge Just will be hearing Marriage of RarelyRecourse and I'll ask her to award the residence to the opposing party at a zero value, not at a negative value. If Judge Just feels bound by Family Code section 2550, I'll lose. Although I'll tug on her heartstrings with equitable arguments, I know that equity can't trump law. Equitable jurisdiction cannot defeat the express terms of a statute, and a court of equity cannot "lend its aid to accomplish by indirection what the law or its clearly defined policy forbids to be done directly." *(Lass v. Eliassen* (1928) 94 Cal.App. 175, 179.)

Paid To Try

Fortunately, I'm not paid to win cases – I'm paid to try to win cases. If I make all possible arguments and lose, at least I'll be able to find some peace when the night is still.

Goodnight,
Dana Divorcer