Beyond *Bell-Kilbourn* and *Drahos* – Disclaimer Deeds and Community Liens in Real Estate Cases

William D. Bishop
Bishop Law Office, P.C.

The purpose of this article is to address the legal effects of disclaimer deeds, the types of community contributions that are included in a community lien analysis, how the strict application of a Drahos or Barnett formula may not be equitable, and other potential issues that may arise.[1]

A. Disclaimer Deeds Signed at the Time of Acquisition Require a Contract Analysis.

The legal principles applicable to disclaimer deeds signed during a marriage depend in part upon the nature of the property when acquired.

Until recently, many practitioners believed that Bell-Kilbourn v. Bell-Kilbourn, 216 Ariz. 521, (App.2007) created a Pandora's box of issues, and that disclaimer deeds were treated differently than other agreements entered into during marriage (such as post-marital agreements). A closer review of the caselaw shows that Bell-Kilbourn and related cases do not do anything dramatic and that community and separate property concepts are still intact so long as community lien formulas are not applied blindly and so long as the Courts treat community and separate property contributions equally and proportionately.

When a party signs a disclaimer deed during marriage "**at the time of acquisition**," a disclaimer deed is presumed to be an enforceable contract unless the other party establishes an affirmative defense to the same. Bell-Kilbourn v. Bell-Kilbourn, 216 Ariz. 521, 524 (App.2007) (emphasis added). As noted by Bell-Kilbourn, "[p]roperty takes it's character as separate or community at the time of

[1] Drahos v. Rens, 149 Ariz. 248 (Ariz. App. 1985); Barnett v. Jedynak, 219 Ariz. 550 (Ariz. App. 2009).

acquisition and retains that character throughout the marriage." Id. at 523. A valid disclaimer deed effectively rebuts the presumption that the subject property acquired during marriage is community. Id.

Thus, the first issue is to determine the character of the property at the time of acquisition. Id. As such, a different legal analysis applies to disclaimer deeds signed at the time of acquisition as opposed to disclaimer deeds signed after the purchase is made (disclaimer deeds signed after acquisition are generally signed due to the refinance of the property).

Where a party signs a disclaimer deed at the time of acquisition, the analysis is subject to regular contract law under Bell-Kilbourn, as described above. As such, legal arguments that an enforceable contract was not entered into may be available. Bell-Kilbourn and Bender address two of these defenses, i.e. mistake and fraud. Because these are the only two defenses mentioned, a practitioner may jump to the conclusion that these defenses are exclusive. See Bell-Kilbourn at Id.; Bender v. Bender, 123 Ariz. at 997 (Ariz. App. 1979). Nothing in these cases expressly state that these are the only two contract defenses available, nor would such a holding make sense. One particular contract defense that is not mentioned in these cases is "lack of consideration." This defense may be more apparent in some cases than others. "Consideration is a performance or return promise that is bargained for in exchange for the other party's promise." Schade v. Dietrich, 158 Ariz. 1, 8 (1988). See also Armstrong v. Bates, 61 So.2d 466, 470-472 (La. Ct. App. 1952) (quit claim deed must be supported by lawful consideration); American Credit Bureau, Inc. v. Carter, 11 Ariz.App. 145, 146-148 (App. Div. 1 1969) (Non-complete agreement was not enforceable in part for lack of mutuality or consideration due to at-will nature of employment terms). Although a disclaimer deed may be signed so that one party can unilaterally qualify for a loan, one must ask what performance or return promise was made and was such bargained for?

If a disclaimer deed is held by the Court to be an enforceable contract, then the property would be deemed separate at the time of acquisition and the Court would proceed to a community lien analysis based upon the community contributions if applicable. Bell-Kilbourn, at 524. As noted in the section below regarding community lien analysis, however, the ultimate conclusion regarding the community's overall share of the equity in the property should not necessarily depend upon whether the disclaimer deed is technically enforceable so long as the community contributions and separate property contributions are treated equally.

Logically, it follows that a disclaimer deed signed at the time of acquisition would be enforceable as a contract to protect the separate property contribution. If a disclaimer deed was not signed and the property was titled jointly, the separate contribution would be presumed to be a gift to the community. However, as addressed in Section C *infra*, a disclaimer deed should only protect the separate property contribution and its proportionate share of any future equity. The disclaimer deed by itself does not convert a community capital contribution to a sole and separate capital contribution.

B. A Disclaimer Deed Executed After Purchase Should Require a Post-Marital Agreement Analysis.

If property is community at the time of acquisition and a disclaimer deed is signed later, the analysis should not be limited to contract principles alone. As noted by Bell-Kilbourn, property takes its character as separate or community "at the time of acquisition." Id. Thus, the issue is what legal effect does a disclaimer deed signed after the acquisition of the property have? If the property was community at the time of acquisition, regular contract principles alone should not govern as they did in the Bell-Kilbourn case. Rather, the analysis should be whether the disclaimer deed constitutes a valid and enforceable marital settlement or post-marital agreement because such would arguably transmute community property interests.

In Austin v. Austin, 237 Ariz. 201 (App.2015), the wife signed various agreements during the marriage which if enforceable would have affected her separate and community property interests. The husband argued to the Court that contract principles applied to the documents the wife signed pursuant to Bell-Kilbourn and other cited cases. Id. at 206. The Court rejected Husband's contentions as such, assessed the documents under a postnuptial agreement analysis, and found that such agreements must include built-in safeguards to ensure amongst other things that the agreements by the wife were entered into with her full knowledge of the property involved, her legal rights regarding the same, *and* that the agreements were fair and equitable. It's the proponent's burden to prove such by clear and convincing evidence (i.e., a much higher burden of proof than a standard contract burden of proof which is preponderance of the evidence). Id. (citing In re Estate of Harbor, 104 Ariz. 79 (1969)). In its analysis, the court also confirmed that a fiduciary relationship between spouses exists when dealing with community property. Austin 237 Ariz. at n.3 (citing Gerow v. Covill, 192 Ariz. 9 (1998)).[2]

In Buckholtz v. Buckholtz, 246 Ariz. 126 (App. 2019), the court addressed a marital settlement agreement signed three years before the dissolution proceedings were filed. Because this case involved agreements regarding community property, the court applied the same factors as Austin and In Re Harbor. Id. First, the Court looked to contract principles, i.e. whether there was an "offer, acceptance, consideration, and a sufficiently specific statement of the parties' obligations and mutual assent." Id. at ¶10 (citing Muchesko v. Muchesko, 191 Ariz. 265, 268 (App.1997). Second, if such agreement is determined to meet contract standards, the court must then determine whether the agreement is fair and equitable. In doing so, the court should consider the

[2] It should be noted that in Austin, the husband argued that the court should apply contract principles like the court did in Bell-Kilbourn. Austin, 237 Ariz. at 201. The court in Austin stated that disclaimer deeds are not analyzed as postnuptial agreements. Id. In making such statement, the court in Austin did not analyze the distinction between a disclaimer deed signed at the time of acquisition as opposed to one that would convert community to separate property.

economic circumstances and other relevant evidence such as the relationship, ages, finances, opportunities and contributions to the community estate. Id. at ¶17. In determining enforceability of the agreement, the court must determine whether the parties acted with "full knowledge of the property involved and [their] rights therein." Id at ¶22. "This necessarily includes knowing whether the property at issue is community or separate." Id. If the party that is arguing that the property was converted from community to separate property fails to meet such clear and convincing burden of proof, the agreement at issue is not enforceable. Id.

The legal principles applied in the Buckholtz case are substantially identical to the requirements set forth for valid post-nuptial agreements. See In re Estate of Harbor, 104 Ariz. 79, 88 (1969). Where parties contract to affect community property interests by a post-marital agreement, "this rule should include the built-in safeguards that the agreement must be free from any taint of fraud, coercion or undue influence; that the [party] acted with full knowledge of the property involved and [his or her] rights therein, and that the settlement was fair and equitable." In re Estate of Harbor, 104 Ariz. at 88. This is especially true where a party was ignorant of his or her rights and acted without independent counsel. Id. (citing Sande v. Sande, 83 Idaho 233, 240, 360 P.2d 998, 1003 (1961)).

Thus, where a disclaimer deed is signed at some point after acquisition of the property and regards what was initially community property, the Bell-Kilbourn and Bender analysis and facts do not apply and the disclaimer deed should be addressed under the heightened scrutiny and burden of proof applied to post-marital agreements.

Where problems arise is when a proponent attempts to argue that community contributions are subsequently converted to separate property pursuant to a disclaimer deed. In such event, the case law supports more heightened scrutiny applied to post-marital agreements. If the proponent is not arguing that community contributions are to be disregarded, it may not matter if a disclaimer deed is deemed enforceable so long as the equity is divided in direct proportion to separate and community capital contributions.

C. Community Lien Legal Analysis.

As noted above, if a property is as determined sole and separate in nature (whether by inheritance, pre-marriage ownership or a valid disclaimer deed), the next analysis is whether the community contributed toward the purchase, principle payments, to enhance the value of the home, or made other "capital" contributions. If so, the community is entitled to its equitable share of the equity in the home, including its proportionate share of the increase in equity. Bell-Kilbourn, 216 Ariz. at 524 (citing Honnas, 133 Ariz. 39, 40 (1982); Drahos, 149 Ariz. at 250). The community is also entitled to an equitable lien if the mortgage loan has been paid down even if the property has depreciated as such would still be considered a capital contribution (i.e., a reduction in the principle debt). Regarding a depreciating asset, such equitable lien however is decreased proportionately with the overall decrease in equity. Valento v. Valento, *supra* at ¶12.

When determining an equitable community lien, the court is required to determine the community interest based upon its proportionate contributions and what is equitable under the circumstances. Bell-Kilbourn, 216 Ariz. at 524; Cockrill v. Cockrill, 124 Ariz. 50 (1979). However, in real property cases, the equitable contributions by the community have been limited to "capital contributions" (i.e. principle payments, and improvements that have increased the value of the property). See Valento v. Valento, 225 Ariz. 477 ¶¶9 - 12 (App. 2010); Bell-Kilbourn, 216 Ariz. at 524, ¶12 ("[A]ny community funds expended to pay the mortgage or enhance the value of the house entitled the community to a share of any equity attributable to those efforts."). Footnote four of the opinion in Valento explains that community payments of interest (and other non-capital contributions) on separate property do not give rise to community lien rights as the community is typically benefitted from being able to use the property and "unlike equity, they are not recoverable in the market." Valento at n.4. Footnote five of the case explains that improvements to property may be included in the analysis only to the extent that they can be proven to have increased the market value and thereby increased equity. Footnote five goes on to articulate that improvements that have no material effect on market value are not included in determining a community lien. Valento at n.5.

This raises interesting issues regarding community contributions when the community did not receive offsetting benefits such as the use of the property. One issue I recently came across involved the closing costs associated with the purchase of the property. Even though closing costs paid by the community do not increase the value of the property or pay down the mortgage, they were necessary costs associated with the purchase or the refinance of the property.

It was often argued by practitioners that a disclaimer deed effectively eliminates the community contribution made up to the time of the disclaimer deed and that any community lien analysis calculation only applies to community contributions made after the disclaimer deed. Such contention was addressed in the recent memorandum decision in Kadiyala v. Vemulapalli, No. 1 CA-CV 17-01111 FC (App. Div. 1 January 24, 2019).[3] In Kadiyala, the husband argued that the community was not entitled to credit for any of its contributions before and up to the time that the disclaimer deed was signed by the wife based upon the language of the disclaimer deed which stated that no community funds were used and that there would be no community interest. Id. at 3. The Court of Appeals held that such argument ignores the reality of the community contributions stating, "Although the disclaimer deed recites otherwise, it does not trump the undisputed facts at trial for purposes of calculating an equitable lien." Id. at 6. The court goes on to explain:

> Husband appears to argue that an equitable lien calculation under *Drahos* includes only those additions to the house's equity that occur after the disclaimer deed was signed. But *Drahos* and its progeny do not

[3] This case is not for official publication, not precedential and may be cited only as authorized under Rule 111(c) of the Arizona Supreme Court.

> delineate between post-purchase mortgage payments and down payments on separate property; rather, the lien formula plainly considers "community contributions to principal," which we interpret to include both mortgage and down payments. *See Valentino*, 225 Ariz. at 472, ¶ 13 (citing *Drahos*, 149 Ariz. at 250, and *Honnas*, 133 Ariz. at 40-41).

In some cases, parties purchase a property during marriage with community funds but one of the spouses signs a disclaimer deed for loan qualification purposes or because the parties can obtain a lower interest rate because one of the party's credit is insufficient. Considering the findings in Kadiyala, it follows that if the parties' pay 100% of the purchase down payment, mortgage payments and improvements with community funds, the community should have a 100% community lien for purposes of the equity even if the home is technically one of the parties' separate property.

Other issues may include the source of improvements made to the property during the marriage that increases the value of the property. Although such improvements are addressed generally in Drahos and Barnett, they are not part of those case formulas. Thus, if the community makes improvements to a separate property home the increased value needs to be included as part of the community's capital contribution. The same thing applies where separate property makes improvements after the beginning value is established (i.e. the increased value attributable to such improvements needs to be included as a separate property capital contribution in the final calculations). If one merely includes the improvements as part of the overall value, then the community and separate property would share in such increased value even if the improvements were sourced entirely by the community or separate property.

As noted in Valento the cost of the improvements by itself is not relevant, but rather the increase in value associated with such improvements. Parties and/or their attorneys will need to ensure that competent evidence is submitted regarding the increase value to the property attributed directly to the improvements at issue.

Another issue that commonly arises is where mortgage payments are made from co-mingled funds. In a case that I was involved, two rental properties were purchased partially with separate property funds and partially with community funds. The rental proceeds were deposited into a single account (thus commingling the community and separate portions of the rental proceeds) and then comingled further with community funds contributions when the rental proceeds were not enough to pay the mortgage and/or repair costs. If not explicitly traced in accordance with Arizona law, the court would be required to treat all the mortgage payments as community contributions even if a portion of the rental proceeds would otherwise be separate property in proportion to its capital contributions. See Drahos, Ariz. 149 at 251 ("[i]t should be noted that if the mortgage payments were made from commingled funds, there is a presumption that community funds were used") (citing Cooper v. Cooper, 130 Ariz. 257 (1981)) (emphasis added).

Finally, an issue that "may" be worth mentioning is that Drahos and the other cited cases do not attribute a time-value to the separate and community property contributions. For example, a party purchased a separate property home in 1990 during the marriage with a separate property down payment of $100,000. The other party signed a disclaimer deed at the time of acquisition. Over the next thirty years the community made principle pay-down and other capital contributions of $100,000. The Drahos and Barnett formulas treat the contributions by both the separate property and community without a present value component. In cases where there is a significant time differential between the separate and community property contributions, a practitioner may want to explore having an expert calculate a reasonable rate of return on the separate property contribution before making the lien calculations.

D. Drahos / Barnett Formulas Should Not Apply to All Lien Analysis.

Finally, it should be pointed out that the formulas set forth in Drahos, Barnett, and Valento are not exclusive nor exhaustive. The entire concept of the community lien analysis is to achieve an equitable division of the community and sole and separate interests where both separate property and community property contributions were made toward the purchase, principle payments and/or improvements to the property. Drahos, 149 Ariz. at 250.

If one blindly adopts the Drahos or Barnett formulas without thought as to whether the community and separate property contributions are treated equally the separate property may receive a windfall. For example, the Drahos formula is C + ((C / B) x A) where A = appreciation, B = purchase price and C = community contributions to reduce principle.[4] The major problem from Drahos and Barnett is that the formula only works proportionately if there is no outstanding loan on the property. If the value of the loan is treated as a separate property asset, the separate property receives a disproportionate share of the increase in value even if it did not make a single payment. Such goes against the stated principle that separate and community rights are of "equal importance." Potthoff v. Potthoff, 128 Ariz. 557, 561 (App. 1981).

The following example (provided by Keith Berkshire in an appeal he is handling for my client) illustrates how the separate property holder would receive a windfall under a Drahos calculation where the property involves a mortgage. In this example, the separate property holder purchased the property one day prior to marriage for $100,000 and made a down payment of $1,000 (rounded for illustration purposes to a $100,000 loan). The community subsequently paid down $40,000 in principle during marriage (loan at time of dissolution = $60,000). The value of the property at dissolution equals $200,000. The appreciation thus equals $100,000 and the equity equals $140,000.

Formula application: A (appreciation) = $100,000; B (purchase price) = $100,000; C (community contributions) = $40,000. $40,000 plus [$40,000 / $100,000 x 100,000] = $80,000 community lien with the remaining $60,000 as the separate property portion. Thus, the community contribution of $40,000 only resulted in an

[4] In Barnett, B becomes the value at time of marriage thus allowing the separate property owner to realize pre-marriage appreciation.

$80,000 lien while the separate property contribution of $1,000 resulted in a $60,000 separate property portion. This hypothetical establishes that a pure Drahos / Barnett mathematical application clearly does not result in the community and separate property contributions being treated equally. Such result is contrary to well established principles that separate and community property rights are of "equal importance." Potthoff v. Potthoff, 128 Ariz. 557, 561 (App. 1981). This principle was further emphasized in Rueschenberg v. Rueschenberg, 219 Ariz. 249, 250 (App. 2008), which states that "each category of property, separate and community, should receive its fair and equitable share." Id. at 254 (citing Cockrill v. Cockrill, 124 Ariz. 50, 53 (1979). See also Drahos, at hn.5 (explaining that the purpose of the formula is to "effectively implement the mandate of *Honnas* and protect the interests of both spouses.").

E. Should the Community Always Receive a Proportionate Lien?

As a side issue, should the community always receive an equitable community lien where it has made contributions toward the mortgage or improvements to the property?

In Tester v. Tester, 123 Ariz. 41 (App. Div. 2 1979), the parties lived in the wife's separate property home for seven years and rented it for four years. The mortgage, expenses and repairs were paid out of community funds and the rents received were deposited to the community checking account. The husband did most of the improvements and repairs to the home himself. Id. at 42. The husband sought reimbursement for the community financial contributions as well as for his repairs and labor. The key concept applied by the court was that "the equities of the parties are balanced by mutual credits and debts between them" (citing Brown v. Brown, 58 Ariz. 333 (1941). The court cited Hanrahan v. Sims, 20 Ariz.App. 313, 318 (1973) for the proposition that "[t]he right to reimbursement is purely equitable, … and equitable principles dictate that benefits received by the community should be considered in determining the amount of reimbursement." In Tester, the court applied an overall equitable analysis to assess the benefits received by the community in denying the community's claim for reimbursement. Id. One of the equitable factors the court looked to was that the community lived rent free in the home for seven years, received the rental proceeds when the parties did not reside at the home, and that the community received other contributions from the wife's separate estate. Id. at 197. The crux of the Tester case is that a community lien is an equitable remedy. This is emphasized in footnote seven of Valento, which states:

> It merits note that the formulas prescribed in *Barnett* and this decision govern only the valuation of the community's interest. The court's discretion to divide property equitably pursuant to A.R.S. Section 25-318 is not restricted by these holdings.

Valento v. Valento, 225 Ariz. 477 (Ariz. App. 2010) at n.7.

Consequently, one should consider whether the community has received offsetting benefits. For example, were the community contributions toward the mortgage equal to or substantially less than fair rental value? In some cases, a separate property home may have been owned for many years and the mortgage payment may be substantially less than fair rental value. Although Drahos sets forth a formula that the trial court in that case found equitable, Tester and other cases that pre-date Drahos have not been overruled. As such, practitioners should consider arguments that the community was benefitted by the parties residing at the sole and separate property of one of the spouses and that the community contributions may be offset at least in part by the benefits received by the community. In making such arguments, one may potentially borrow the equitable principles applied in cases involving community lien claims to increase values in separate property businesses.

In Roden v. Roden,190 Ariz. 407 (1997) the court assessed whether the community had an equitable lien regarding the increase in value of the separate property business. The court found it equitable to offset the overcompensation the community received from the business against the community's share of the increase in value of the business, thus nullifying any community lien. See also Rowe v. Rowe, 154 Ariz. 616 (1987). Thus, where the community has benefitted from residing in a party's separate property home, wouldn't a similar analysis potentially apply, i.e. the difference between the fair rental value minus the community contribution with the differential offset against the alleged community lien? There is nothing that suggests that we cannot borrow from equitable principles applied in other scenarios.

F. Burden of Proof.

Practitioners are often confused about which party has the burden of proof in community lien cases. One school of thought was that the separate property interest always has the burden of proof to show that an increase in value should remain separate property in whole or in part because the increase in value was "acquired" during the marriage. The other school of thought was that property initially acquired as separate property remains separate property and that the community must thus establish its claim for a lien against the separate property, i.e. because such claim is an "equitable claim," the burden of proof would be on the community.

In the Drahos case, the issue was somewhat confused by the court's language that "all property owned during the marriage is presumed to be community and it is the appellant's burden to show separate funds were used." Id. at hn.6. The recent case Hefner v. Hefner, No. 1 CA-CV 18-0404 FC (App. Div. 1 FILED 12-10-2019) helps clarify such issues. Hefner dealt with the burden of proof associated with the portion of personal injury proceeds that were separate property and the portion that was community property, as well as the burden of proof to show if there was an increase in value to the husband's separate property business to which the community may have an equitable lien. The court in Hefner emphasized that "[t]he status of property in Arizona, as to whether it is community or separate property, is established at the time of acquisition." Id. at ¶15 (citing Bender v. Bender, 123 Ariz. 90, 92 (App. 1979); Drahos v. Rens, 149 Ariz. 248, 249 (App. 1985). Community contributions *may* give rise to a community lien, but do not change the status of the property as separate property. Id. The court made it clear that although a spouse claiming property as separate has the initial burden of proof to establish the same, once property is established as separate it is the community's burden of proof to establish that there was an increase in value and that all or a portion of the same resulted from community contributions or efforts. Id. at ¶17 (citing Tester v. Tester, 123 Ariz. 41, 44 (App. 1979) (when a spouse argues she has increased the value of the other spouse's separate property through community labor and funds, "the burden is on the claimant to show the amount of the increase"). The court applied the same analysis to the personal injury proceeds (i.e. because such were "personal" to the injured spouse, it is the claimant's obligation to establish any community reimbursement claim or lien). Id. at ¶¶8 - 9.

Thus, in a disclaimer deed scenario, the proponent would have the initial burden of proof by clear and convincing evidence to establish the property as sole and separate. When signed at the time of acquisition, this is a contract analysis to which Bell-Kilbourn tells us the disclaimer deed meets the burden of proof (absent valid contractual defenses). If the disclaimer deed is signed after acquisition and purports to convert community property to separate property, the burden of proof is on the party claiming separate property pursuant to a heightened burden of proof as addressed *supra*.

Once the property is established as separate property, then under the Hefner case analysis, the community has the burden of proof to establish its equitable lien. This would apply in the event of a disclaimer deed or with regard to inherited property or property acquired prior to marriage to which no disclaimer deed was necessary.

G. Conclusion:

The Kadiyala case clarifies what should have been a simple analysis, i.e. where a disclaimer deed is signed both the community and separate property contributions must still be treated equitably and proportionate to one another. If community and separate property capital contributions are treated equally and in proportion to one another it should not matter whether a disclaimer deed was signed in determining the respective separate and community percentages of the overall equity. This does not mean that a disclaimer deed has no meaning. If a disclaimer deed was not signed and the property was instead purchased in joint tenancy or as community property, the separate contribution would be presumed lost.

Practitioners must be cautious when applying formulas such as those set forth in Drahos and Barnett. These formulas were fact specific and do not always give rise to equal treatment of separate and community property contributions.

Moreover, practitioners should explore offsetting benefits received by the community when applying an equitable lien analysis. The Court has broad discretion in making an equitable division of community property including offsetting benefits the community received.

For those looking for a "bottom line" answer how to solve an apportionment case, the trial court "is not bound by any one method [of apportionment], but may select whatever will achieve substantial justice between the parties." Rueschenberg, 219 Ariz. 249 ¶14 (citing Cockrill, 124 at 53 (1979)).