CLAIMS AWARENESS
HOT SHEET
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Brace Yourself for Transmutations of Community Property

by Zi C. Lin, Partner
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Married couples commonly use community funds to purchase real property and take title as "husband and wife, as joint tenants." Under 11 U.S.C. section 541(a)(2), property of the bankruptcy estate includes "[a]ll interests of the debtor and the debtor's spouse in community property as of the commencement of the case." Whether property can be characterized as community property is the key issue when one spouse files for Chapter 7 bankruptcy protection, and the other spouse does not. If the property is community property, then it is part of the bankruptcy estate, which means the entirety of the property could be sold by the Chapter 7 trustee for the benefit of the creditors. In a highly anticipated decision, *In re Brace*, 9 Cal.5th 903 (2020), the California Supreme Court addressed the issues of whether property held by spouses in joint tenancy should be considered community property, and how spouses can transmute the character of community property into separate property.

Clifford Brace and Ahn Brace held title to two properties as "husband and wife, as joint tenants." (*Brace, supra*, 9 Cal.5th at 913.) Only Clifford filed for Chapter 7 bankruptcy protection, Ahn did not. (*Id.*) The bankruptcy trustee sought a declaration that the two properties were community property, which would put the properties entirely into the bankruptcy estate. (*Ibid.*) Chapter 7 trustees determine whether a property should be administered/sold by determining whether there is sufficient equity (after paying off liens) in a property to satisfy his/her professionals' fees and provide a significant dividend to unsecured creditors. There is typically not enough equity when only half of the property is part of the bankruptcy estate, but there may be sufficient equity if the entirety of a property is included.

The Bankruptcy Court for the Central District of California concluded the Braces' properties were part of the bankruptcy estate. (*Ibid.*, citing *In re Brace*, 566 B.R. 13, 17 (B.A.P. 9th Cir. 2017).) The Bankruptcy Appellate Panel of the Ninth Circuit affirmed, and the Braces appealed to the Court of Appeals for the Ninth Circuit. (*Ibid.*, citing *In re Brace, supra*, 566 B.R. at 16; In re Brace, 908 F.3d 531, 535 (9th Cir. 2018).) The Ninth Circuit certified a question of law to the California Supreme Court—"whether the form of title presumption set forth in Evidence Code section 662 applies to the characterization of property in disputes between a married couple and a bankruptcy trustee when it conflicts with the community property presumption set forth in Family Code section 760." (*Brace, supra,* 9 Cal.5th at 911; see also *In re Brace,* 908 F.3d at 534.) Evidence Code section 662 provides: "The owner of the legal title to property is presumed to be the owner of the full beneficial title. This presumption may be rebutted only by clear and convincing proof." Family Code section 760 provides: "Except as otherwise provided by statute, all property, real or personal, wherever situated, acquired by a married person during the marriage while domiciled in this state is community property."

The California Supreme Court, after discussing the history of community property in detail, held:

1. For property acquired in or after 1975, the presumption in Family Code section 760 that property is community property applies. This presumption applies to a dispute between one or both spouses and a bankruptcy trustee. (*Brace, supra,* 9 Cal.5th at 912, 938.)

    a. "For joint tenancy property acquired during marriage before 1975, each spouse's interest is presumptively separate in character." (*Id.* at 938.)

    b. The Supreme Court picked the year 1975 as the line of demarcation because that was when the landmark legislation that reformed the community property statutes went into effect. These reforms gave equal managerial rights to wives, and departed from the husband-dominated community property law of the past. (*See id.* at 923.)

2. The presumption in Evidence Code section 662 that the owner of the legal title is the owner of the full beneficial title does not apply when it conflicts with the community property presumption in Family Code section 760. (*Id.* at 912, 938.)

3. For property acquired with community funds in or after 1985, the titling of a deed as a joint tenancy is not sufficient to transmute the property into separate property under Family Code section 852. (*Ibid.*)

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Servicing Agreements and the Payoff

by Anita Rubeck, CSEO CEI
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Payoff demands from private-party beneficiaries have been a source of concern for the title and escrow industry for quite a while. Obtaining a demand from a private-party beneficiary requires a few more steps than obtaining a demand from an institutional lender.

Let's talk about obtaining demands to payoff a loan.

To order a payoff demand from a private-party beneficiary, the Escrow Holder will provide a form to the beneficiary to complete. The form lists several documents that are required to accompany the payoff demand when sending the payoff demand form back to the Escrow Holder.

The documents required are:

- The original Note,
- Original Deed of Trust,
- Request for Full Reconveyance executed by the beneficiary before a Notary Public

The beneficiary must also sign and complete the form by stating the unpaid principal balance, interest rate (or daily interest amount), interest paid to date, and any other costs due.

Note: Most Trustees of a Deed of Trust require the ORIGINAL documents in order to issue a Deed of Reconveyance, including the Request for Full Reconveyance having ALL beneficiary signatures acknowledged by a Notary Public.

Another note: A few Escrow Holders require that the beneficiary's signature on the Request for Full Reconveyance be acknowledged by a Notary Public that is on the Escrow Holder's approved Notary Public list.

The Seller/Borrower should review and approve the demand to affirm their agreement with the payoff demand figures.

If either the Seller/Borrower do not agree with the figures on the written demand statement, the Seller/Borrower should take care to contact the lender/beneficiary to discuss, and if the payoff figure changes, request that a written updated demand be forwarded to the Escrow Holder before close of escrow.

Now let's talk about beneficiaries who use a servicing agent.

Some private party-beneficiaries use what is commonly referred to as a servicing agent to manage the collection of the payments. Often the servicing agent wants to act as the sole communicator with the Escrow Holder by providing the figures to payoff the loan, and instructions to remit the payoff amount to the servicing agent.

Stories and lawsuits have surfaced over the issue of payoffs payable to servicing agents, when the servicing agent does not remit the funds to the beneficiary. This issue has caused the title and escrow companies to implement additional requirements.

Some Escrow Holders have taken the position that they will only communicate with the private-party beneficiary, and that the check must be payable to the private-party beneficiaries.

Other Escrow Holders may agree to accept a payoff demand prepared by the servicing agent, provided the actual private-party beneficiaries acknowledge the payoff demand. Yet, even when the private-party beneficiary provides authorization to remit the payoff payable to the servicing agent, the Escrow Holder often requires that the payment be made to the private-party beneficiaries.

Usually, when the Escrow Holder explains to the servicing agent that "No matter what, the payoff will be payable to the private-party beneficiary" the servicing agent often responds with "I've never heard of this, no other Escrow Holder does that!".

Frequently the servicing agent will want to deviate from the Escrow Holder's requirements by offering a copy of the "Servicing Agreement". Rarely has a Servicing Agreement contained adequate language to authorize the payoff to be made payable to the servicing agent. A review of the Servicing Agreement may find other issues, such as:

- The Servicing Agreement references a different property as the security for the loan
- The Servicing Agreement is dated years before the creation of the Deed of Trust
- The beneficial interest is as husband and wife, yet only one spouse signed the Servicing Agreement
- The beneficial interest in the Deed of Trust is in the name of a corporation, trust, LLC, or other entity, yet the signature is of an individual
- The Servicing Agreement is signed by someone not listed as one of the beneficiaries

When asking the servicing agent why a copy of a Servicing Agreement was provided for a beneficiary not shown in the Deed of Trust or Assignments, the Escrow Holder may be told that there is an unrecorded Assignment.

When the Deed of Trust and/or Assignments have multiple beneficiaries, it is important to add the percentages to verify that the percentages add up to 100%. The answer to why the beneficial interest does not add up to 100% may prompt more questions.

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Hindsight is 20/20

by Jeffrey Leung, SVP National Claims Manager & Dawn Weller, Claims Officer
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Hindsight is 20/20. It is a cliché that I often use when sharing about title insurance claims. We, in the claims department, have that ability to dissect the transaction and often times determine the source of the claim and the recovery when a loss is paid. However, in most instances claims are submitted months, if not years, after the policy is issued. Thus, providing guidance or lessons from specific claims is not timely. One exception is fraud. In some instances, these types of claims erupt immediately, result in tremendous losses, and leave us holding the bag chasing the recovery of the lost funds. Then there are the exceptions which why this story is so important.

Mr. P is a retired gentleman living a peaceful life in the suburbs of Los Angeles County. Mr. P is also the holder of a secured loan for property in another upper-middle class neighborhood in Los Angeles County. In mid-2019, Mr. P successfully forecloses on his secured lien and acquires the property via a trustee's deed upon sale. The property continued to be tied up in litigation between the prior owner and Mr. P over the foreclosure.

In March 2020, an order is opened by an independent escrow for title services from a title company. The order is a cash out $500,000 loan transaction. The subject property is free and clear of all liens and, although the subject litigation is not resolved, withdrawals of the Lis Pendens of record are recorded prior to the close of the transaction. On the day prior to closing, the loan proceeds are wired to the title company branch. From the loan proceeds, taxes and title services are debited and the balance of approximately $484,000 is forwarded to escrow. After the close, escrow promptly wired the balance of the funds to the bank account as per the borrower's instruction.

As part of their standard operating procedures, escrow mailed the borrower the closing statement and thank you letter to the borrower's mailing address (which was the real owner's home address). Mr. P immediately notified escrow of potential fraud as Mr. P never received the loan proceeds or agreed/authorized this loan transaction. Due to the quick actions of the escrow, the wired funds to the so-called borrower were attempted to be frozen. Within 3 days of the closing, the claims department was notified of the alleged fraud. Despite the immediate response from escrow and the claims department, obtaining information concerning a frozen account was not without substantial hurdles.

Financial institutions are leery of freezing accounts without substantial cause, and are protective of the identity of their client's information. Over the next four months, the efforts of escrow and title finally paid off with the return of over $430,000. In addition, the check for payment of property taxes was stopped and the homeowner's insurance placed by escrow at the borrower's request was cancelled allowing recovery of an additional $17,122.00.

Although many of the red flags were not present in this loan transaction, here are a few of the issues that should have raised concerns:

1. All cash out loan of a substantial sum
2. Hard money lender
3. The borrower could not provide the name of their homeowner's insurance carrier
4. The borrower provided a copy of a closing statement from a previous escrow of the foreclosed owner to clear an old deed of trust

Thankfully, because of the hard work of escrow and the claims department, the good guys prevailed with losses kept to a minimum. ▪

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BRACE YOURSELF. . .

a. "For joint tenancy property acquired with community funds *on or after* January 1, 1985, a valid transmutation from community property to separate property requires a *written* declaration that expressly states that the character or ownership of the property is being changed." (*Id.* at 938, italics added.)

b. For property acquired *before* 1985, "the parties can show a transmutation from community property to separate property by *oral or written* agreement or a common understanding." (*Ibid.,* italics added.)

c. The Supreme Court picked the year 1985 as the second line of demarcation because that is when section 852 went into effect.

Brace pointed out that title companies routinely prepare deeds for spouses in joint tenancy form without the spouses understanding the legal ramifications of doing so. (*Brace, supra,* 9 Cal.5th at 917.) "The major problem ... is the fact that husbands and wives take property in joint tenancy without legal counsel but primarily because deeds prepared by real estate brokers, escrow companies and title companies are usually presented to the parties in joint tenancy form. The result is that the parties don't know what joint tenancy is, they think it is community property, and then find out upon death or divorce that they didn't have what they thought they had all along. ..." (*Id.,* citing Assem. Interim Com. on Judiciary, Final Rep. Relating to Domestic Relations (Jan. 11, 1965) p. 124 (Domestic Relations), ellipses in original.)

It remains to be seen if the *Brace* decision will affect the title industry as much as it has affected the bankruptcy community, as it may be malpractice for an attorney to advise his/her client to file for Chapter 7 bankruptcy protection where the client owns community real property acquired after 1985 that is held in joint tenancy without advising the client that he/she should consider transmuting the nature of the property before filing bankruptcy. ▪

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Complicating matters even more is when the servicing agent:

- ✓ Can't find the original Note and Deed of Trust
- ✓ Is the trustee and won't surrender the Deed of Reconveyance, and/or original documents until after receipt of the payoff
- ✓ Declares they cannot locate a beneficiary

These potential obstacles may call for the expertise of your Escrow Advisory, and likely will cause significant delays in obtaining an adequate payoff demand before close of escrow.

The escrow industry has a variety of ways of handling payoff demands with servicing agents. Be sure to familiarize yourself with your company policy and procedures concerning this process. ▪

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