

Family Law and the **GREAT RECESSION**

by Hon. Catherine A. Gallagher (Ret.)



NO ONE EVER SAID practicing family law was boring. These days, however, the arising challenges require a crystal ball to accurately predict the outcome. Just a couple of years ago, if parties were going through a dissolution, one spouse could refinance the house, buy out the other spouse, and still be able to feed the family with maybe a little left over to cover attorney fees. With equity diminishing in homes around the Bay Area, the financial picture of many families has changed significantly. And with the economy tanking now more than ever, family law attorneys are looking for creative solutions for their clients' financial problems.

Welcome to the era of short sales, foreclosures and attempts at loan modifications. Unfortunately, the promise of easy loan modification hasn't materialized. And foreclosure, while sometimes the only option, will destroy the parties' abilities to utilize any credit, just when their families need it most. It is not unusual for credit card companies to cancel cards once they become aware of a bankruptcy.

While still reported to the credit agencies, a short sale may be a viable solution and does not have as negative an effect as bankruptcy. Understandably, banks are reluctant to accept less than what is owed on their loans and many

financial institutions hesitate to approve this pay off. However, as foreclosures on properties increase, many lending institutions realize a short sale is often more beneficial than owning a distressed property, which must be maintained and marketed. The procedure of obtaining a buyer for the property and securing bank approval obviously varies, depending on a number of factors. But approval has been slow in the past. While it generally takes at least 60 days after a buyer has obtained bank approval for the short sale, it can easily take up to 18 months.

Attorneys, however, can make all the difference by negotiating directly with the bank on their client's behalf. While specialized "short sale" negotiating firms advertise on the web and real estate brokers can handle negotiations with lending institutions, lawyers really excel at the art and science of negotiations. The object is to prevent clients from being saddled with a deficiency judgment or a promissory note to pay the difference between the amount of the sale price and what was owed on the property. If clients have a second mortgage or a line of credit on the home, the lawyer should try to work with those lenders to see what accommodations can be made.

Additionally, since the IRS has procedures for foreclosures but not for the

typical real estate short sale, a lawyer can help explain the complicated tax consequences. In foreclosure cases, the IRS generally takes the position that if a debt for which you are personally liable is canceled or forgiven, you must include the canceled amount in your income. Until the Mortgage Forgiveness Debt Relief Act of 2007 sunsets in December of 2012, however, the cancelled debt can be excluded from income if it is "qualified principal residence" indebtedness, up to a maximum exclusion of \$2 million. If the property is not a qualified personal residence, the tax consequences will depend on the terms and structure of the loans; advice of a knowledgeable attorney and/or tax accountant is essential. In addition, if your client is involved in a creative disposition of their real estate, consider requesting the court retain jurisdiction of the case to handle the tax consequences.

If the home can be saved, an alternative to consider is to defer sale for a number of years, although here again a crystal ball might be handy. While case law generally addresses the needs of the children as paramount in determining whether a home sale should be deferred, the argument is worth considering if sale of the home ought to be delayed in hopes that the real estate market will recover. While

it is best if both parties agree to the deferral, if they don't, an argument to the court might be applicable due to these economic times; especially if it can be also argued that it is in the best interest of the children to remain in the family home. Other factors highlighted in prior cases such as *IRMO Duke* (1980) 101 CA 3d 152, *IRMO Stallworth* (1987) 192 CA3d 742, and *IRMO Braud* (1996) 45 CA4th 797 should also be addressed.

Counsel should ask the court to make a threshold determination initially if deferring sale of the family home is economically feasible, including if: 1) the mortgage and property taxes will be paid, 2) insurance can be maintained, 3) the house will be properly maintained, and 4) the parents' equity in the house will be further jeopardized by deferring sale. (*Consult Family Code §3800 et seq. to fashion an appropriate order.*) If the sale of any property is deferred, title should be held as tenants in common (not joint tenants), the court order or Marital Settlement Agreement ("MSA") should specify the length of the deferral, and the court should retain jurisdiction to address such issues as maintenance and taxes. Finally, the tax consequences to the spouse not living in the residence and the loss of the \$250,000 exclusion to that individual should also be addressed.

Of course, if your client or your client's spouse is considering filing bankruptcy, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "act") should be reviewed. Child and spousal support obligations are, as a matter of law, non-dischargeable, as are most other debts to ex-spouses and financial obligations to a child. The act even provides that a debtor cannot be discharged under Chapter 13 unless support is current. Spouses must decide whether there will be a joint or separate filing in bankruptcy court, which requires careful planning and probably the services of a bankruptcy attorney. If both spouses do not file, liability after discharge might not be avoided. The bankruptcy court will independently examine the MSA and will void provisions where property transfers between spouses were made with the

intent to defraud creditors. [See 11 USC §548 and *In re Beverley* (9th Cir. BAP 2007) 374 BR 221.] In fact, a bankruptcy judge has voided pre-bankruptcy "non-dischargeability" agreements between individuals as unenforceable on public policy grounds [*In re Cole* (9th Cir. BAP 1998) 226 BR 647, 654]. Likewise, even agreements to discharge a debt contained in an MSA (mortgage debt which is part of support order) are not binding on bankruptcy courts, which independently determine if a debt is non-dischargeable [*In re Tatge* (8th Cir. BAP 1997) 212 BR 604].

When the community debts exceed the amount in the marital estate, the excess debt does not have to be equally apportioned between the spouses either. It can be assigned, as the court deems "fair and equitable," considering the parties' ability to pay so that one spouse can be saddled with most or all of the community debt [Family Code §2622(b)]. If the home is "under water" (e.g. more is owed on the residence than its present market value), the negative can be ordered by the court to be considered in the division of assets; however, most parties either agree that the asset has no value or permit the court to evaluate the home at zero.

Just in case your crystal ball is precisely tuned up and you can predict how the real estate or investment markets will perform, you might be able to utilize Family Code §2108 to force the sale of a declining asset. Under that code section, the court has the power to liquidate community property before trial if it finds that there is an unreasonable market or investment risk relative to the nature, scope and extent of the community assets.

And if indeed you do have that crystal ball, can you tell the rest of us when this recession will truly end? ♦

— *Hon. Catherine A. Gallagher (Ret.), a former Presiding Judge of the Santa Clara County Superior Court, spent the final three years of her 25-year judicial career exclusively handling family law and probate matters. She is now a full-time mediator, arbitrator, and private neutral with JAMS – The Resolution Experts.*

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