

EARLE LAW OFFICES

A PROFESSIONAL CORPORATION

19925 Stevens Creek Boulevard

Post Office Box 1925

Cupertino, California 95015

WWW.EARLELAW.COM

EARLELAW NEWSLETTER

408.786.1060

Pitfalls of Creative Real Estate Financing: An Example From the School of Hard Knocks

by Anthony F. Earle, Esq.*

August 2007

As modern society evolves and becomes increasingly more technical and complicated, many law firms and attorneys “specialize” in one area, or a select few closely related areas, of law. EARLE LAW OFFICES, on the other hand, recognizes that clients’ lives and legal needs are not organized or compartmentalized along the lines of legal practice areas. Accordingly, EARLE LAW OFFICES focuses on clients’ “real-world” legal needs by providing legal services in a number of diverse practice areas, including real estate, family law, and trusts and estates. While each of these diverse legal practice areas may appear to have little relationship with the others, the recent appellate case Ruelas v. Ruelas, 2007 WL 2358675, illustrates that legal problems do not confine themselves to discreet practice areas.

Factual Background

During 1996, Stanley Hernandez and Isabel Hernandez leased from Kathleen Bell a condominium located in Reseda, California. The lease contained an option to purchase. Ms. Bell agreed during 1998 to sell the condominium in accordance with the terms of the purchase option, notwithstanding that the option period had expired. A problem, however, arose when it was discovered that the Hernandezes were unable to obtain a purchase money loan due to their very poor credit rating.

Rafael Ruelas, a Realtor who, in 1997, had married the Hernandezes’ daughter Michelle, suggested that Michelle obtain a purchase money loan and take title to the condominium on behalf of her parents, Stanley and Isabel Hernandez. The Hernandezes agreed to this arrangement and promised to make all mortgage and impound (tax and insurance) payments. The source of the down payment was a loan Mrs. Hernandez obtained from her brother.

Rafael Ruelas, however, wrote the check for the down payment.

Michelle borrowed the balance of the funds necessary to complete the purchase and, during January 1999, while still residing with her husband Rafael Ruelas, took title to the condominium as “a single woman.”

Michelle thereafter began receiving mortgage statements for the loan which was secured by the condominium. Michelle’s father, Stanley Hernandez, opened a checking account for Michelle and, each month, deposited therein funds sufficient for Michelle to make the monthly mortgage and impound payments.

Michelle made the monthly mortgage and impound payments. The Hernandezes, who lived in the condominium, claimed the mortgage interest deduction for income tax purposes. Michelle and her husband Rafael Ruelas did not deduct the mortgage interest on their tax returns.

All apparently went well until 2003, when Rafael and Michelle Ruelas separated and filed competing petitions for dissolution of their marriage.

The California law requires each party to an action for dissolution of marriage to disclose to the other party information concerning, among other things, the existence of all community property and the disclosing party’s separate property. Michelle did not list the condominium in her disclosure documents. Rafael Ruelas, on the other hand, listed the condominium in his disclosure documents as community property.

Stanley and Isabel Hernandez filed a separate, quit title, lawsuit seeking a judicial determination that they, not their daughter Michelle and her estranged husband Rafael Ruelas, were the owners of the condominium. The court consolidated the divorce and quiet title lawsuits.

In support of his position that the condominium is a community asset that he and Michelle own, Rafael Ruelas pointed out that property acquired during marriage is presumed to be community property. Ruelas also claimed that (1) he, as a Realtor, negotiated the purchase of the condominium for himself and Michelle; (2) Michelle took title thereto as a single woman because doing so enabled Michelle to qualify for a (perhaps fraudulently-obtained) "owner-occupied" mortgage loan, (3) the Hernandezes were not parties to the escrow, and (4) the deposits the Hernandezes made into the bank account from which Michelle made mortgage payments were mere payments of rent made by the Hernandezes to himself and Michelle.

At trial, Michelle; the Hernandezes; and the seller, Kathleen Dell, all testified against Rafael Ruelas, stating that the intent had always been for Michelle to take title to the property and later quitclaim the property to her parents, the Hernandezes, because the Hernandezes could not obtain a purchase money loan.

The Courts' Decisions

The trial court found that the condominium was not Rafael Ruelas's and Michelle's community property and entered a judgment awarding title to the condominium to Stanley and Isabel Hernandez. Rafael Ruelas (but not Michelle) appealed; the appellate court affirmed the trial court's judgment.

The legal theory the trial court used to arrive at its decision is known as a "resulting trust." "When a transfer of real property is made to one person, and the consideration therefor is paid by or for another, a trust is presumed to result in favor of the person by or for whom such payment is made. 'The trust that is 'presumed to result' from this situation is termed a 'resulting trust'; its purpose is to enforce the intentions of the parties. It is distinguished from a constructive trust, which is typically imposed to rectify fraudulent behavior.' A resulting trust differs from an express trust chiefly in that (1) it arises by operation of law, without an expressed intent, and (2) the resulting trustee ordinarily has no duty other than to transfer the

property to the person entitled." Ruelas v. Ruelas, *supra*, at 2 (internal citations omitted).

Reulas also contended on appeal, perhaps anticipating he would lose on his primary claim, that ownership of the condominium should be apportioned between himself and Michelle as community property, on the one hand, and the Hernandezes, on the other hand. The basis for Ruelas' apportionment claim was the fact that \$4,230 in community property had been used to complete the purchase of the condominium. The appeal court rejected this argument and affirmed the trial court's order that Michelle, from her separate property, reimburse the community property estate in the amount of \$4,230.

Conclusion

Although the tactic used by the Hernandezes for purchasing real estate is certainly not recommended, use of this and similar tactics are probably more common than some might suspect. Further, in economic markets where mortgage money and credit are tight or tightening, use of such tactics may be the only available option for some purchasers of real property.

In order to reduce the possibility of losing one's real estate acquisition to an unscrupulous person, or simply to reduce the likelihood of future litigation to enforce one's right to title, and the significant expense associated therewith, prospective real estate purchasers who consider using a "creative financing" tactic such as that used by the Hernandezes should, before commencing the transaction, engage the services of a competent and qualified attorney to assist them in managing and reducing the risk which is inherent in such transactions.

* Anthony F. Earle, Esq. practices in the areas of business law, family law, real estate law, and trusts and estates; he represents individuals and small businesses in both litigation and non-litigation matters.

Mr. Earle is licensed to practice law in all California state trial and appellate courts, the United States Supreme Court, the United States Court of Appeals for the Ninth Circuit, and federal trial courts in the Northern District of California. He is a member of the American Bar Association and the Santa Clara County Bar Association, and is also a licensed Real Estate Broker.

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