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COMMUNITY PROPERTY LIENS – FROM DRAHOS TO SABA AND BEYOND

1. Introduction

This article regards community real estate liens applicable to sole and separate real estate interests. Generally, separate property real estate interests are acquired by the separate property holder prior to marriage, inherited, or purchased during marriage and the other spouse signed a disclaimer deed which effectively disclaimed any legal interests in the property.

Arizona cases have long held that community contributions which benefit separate property interests do not somehow transform such property to community property. In re Estate of Sims, 13 Ariz.App. 215 (1970). In earlier Arizona separate property real estate cases, the community was only entitled to reimbursement of the amount it spent on improving the property and reducing the principal balance of the mortgage loan. Hanrahan v. Sims, 20 Ariz.App. 313, 317-318 (1973). However, the Arizona Supreme Court in Honnas v. Honnas, 133 Ariz. 39, 40 (1982) rejected the reimbursement only approach and held that the community was also entitled to share in the enhanced value of such property even if the increased value was primarily due to general market conditions. The Honnas case, while establishing the basic principles, did not provide details on how to measure such contributions other than to confirm the "value at dissolution" approach. Id. at 1046.

Where the community has made principal contributions in the form of down payments for the purchase of real property and/or mortgage payments against the loan, and where the value of the home increased during the marriage, the basic formula used to measure such community liens was first addressed by the Arizona Court of Appeals in Drahos v. Rens, 149 Ariz. 248 (App. 1985) (citing In re Marriage of Marsden,130 Cal.App.3d 426, 438, 181 Cal.Rptr. 910 (1982). Such formula was later refined by the Arizona Court of Appeals in Barnett v. Jedynak, 219 Ariz. 550 (App. 2009).

Where the community made such contributions, but the value of separate property real estate decreased during marriage, the principles and formula(s) to measure the community's lien were later addressed by the Arizona Court of Appeals in Valento v. Valento, 225 Ariz. 477 (App. 2010).

The published decisions regarding real estate community liens have consistently explained that the formulas in these cases are not binding, and that courts may adopt whatever methodology they deem equitable in determining the community liens. See Saba v. Khoury, 516 P.3d 891 at ¶ 16 (2022). However, the Arizona Supreme Court's language in Saba explains that deviating from such formulas will likely require factual findings that support such deviation as discussed further in this article. Id.

The main thrust of this article is not to merely focus on the formulas applied over time with respect to community real estate liens, but to explore in more detail the principles behind the formulas, and issues that remain outside of such formulas.

The Arizona Chapter of the American Academy of Matrimonial Lawyers published a detailed Arizona divorce guide in 2023 which can be found on its website at azaaml.org. Chapter 3 of such guide provides an excellent outline regarding community and separate real property interests, and more specifically regarding community real estate liens and disclaimer deeds. To avoid unnecessary duplication, I have attached Chapter 3 of the ***Arizona Condensed Divorce Guide by the Arizona Chapter of the American Academy of Matrimonial Lawyers*** as Appendix A to this article.

2. The Basics:

A. Where Separate Property Appreciates During Marriage.

The common calculation of a community lien in separate property real estate - where the value of real estate appreciated during the marriage – is referred to as the *Drahos/Barnett* formula. However, for ease of application, one need only know the revised formula set forth in the later *Barnett* case (the application of the *Barnett* formula would have yielded the same result in the *Drahos* case.) The *Drahos/Barnett* formula, as revised, is as follows:

C + [C/B x A]

A = Appreciation during marriage
B = Value of property on date of marriage
C = Community contribution to principal

A logical adjustments must be made to such formula if the property was acquired during marriage. In such event, B would obviously equal the value of the property at the time of acquisition. See Bell-Kilbourn, 216 Ariz. 521, ¶ 12 (App. 2007). Accordingly, the further refined formula is:

C + [C/B x A]

A = Appreciation during marriage

B = Value of property on date of marriage (or acquisition if later)
C = Community contribution to principal

B. Where Separate Property Depreciates During Marriage.

When the economy suffered a recession beginning in late 2007 that negatively affected real estate values, courts were faced with issues involving real estate that was worth less at the time of divorce than it was worth at the date of marriage. The Court of Appeals in Valento v. Valento, 225 Ariz 477 (App. 2010) determined that in such cases the community should still receive at least some reimbursement for its principal contributions, but that such should be adjusted where negative equity exists. In such cases, the community shares in the downside proportionately – similar to what is provided by the *Drahos / Barnett* formula where the value increased during marriage due to market forces.

The calculation of a community lien in separate property real estate - where the community contributed to principal, but the value of real estate depreciated during the marriage - is addressed in Valento v. Valento as follows:

If positive equity still exists, the community lien equals the amount of the principle reduction of the loan paid by the community. If negative equity exists, however, the community lien is reduced proportionately as follows:

C – (C/B) x D)

B = Fair Market Value at date of marriage (or later acquisition as SP)
C = Community contributions to principal reduction
D = Depreciation in value during marriage

Although during the last 13 years Arizona has for the most part experienced appreciation in the real estate market, we have experienced recent retraction in real estate values in certain areas and neighborhoods with rumors of more potential adjustments to come. Thus, it is possible that we may see an increase in Valento cases in the future.

3. Refinancing / 2nd Mortgage / HELOC Issues.

Keep in mind that there may be some complications and necessary adjustments to the described formulas where the mortgage is refinanced with cash taken out, or a second mortgage or home equity line of credit (HELOC) is taken out during the marriage. Depending upon what the funds were used for, such may require adjustments to the data used within *Drahos / Barnett* formula.

For example, if cash taken out during the refinance was used for community purposes, it would be logical that such should *arguably* be offset against the "community contribution to principal" portion of the applicable formula. If cash taken out during the refinance was used for separate property purposes, such should not effect the *Drahos/Barnett* calculation so long as such cash-out is ignored for purposes of determining the appreciation prong of the formula

Knowing the principals behind the formulas will help the attorney apply such principals as needed when variations are present that do not fit neatly within the formulas. See Section 12.A *infra* regarding deviations from the *Drahos / Barnett* formula.

4. Community Lien Claims are Limited to Capital Contributions.

In real property cases, the analysis of community liens is 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 entitle the community to a share of any equity attributable to those efforts."). Footnote 4 of Valento explains that community payments of mortgage interest and other non-capital contributions 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 5 of Valento 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 5 of the case goes on to further articulate that improvements that have no material effect on market value are not included in determining a community lien. Valento at n.5.

The language in Valento raises interesting issues regarding non-capital community contributions when the community did not receive offsetting benefits. It makes sense that the community is not entitled to a *Drahos / Barnett* share of market appreciation associated with non-capital contributions. However, Valento should not be interpreted so narrowly as to preclude real estate related reimbursement claims in all cases.

An example may be where community funds are used to pay real estate taxes or other expenses on a rental property, but the community does not receive the rental income. Although the cited language in Valento arguably makes sense where the community receives benefits, such as occupying the marital residence or receiving rental profits, such case is distinguishable where the community does not receive such benefits. It makes common sense that a separate reimbursement claim may be made under appropriate circumstances. See Pothoff v. Pothoff, 128 Ariz. 557, 562 (App. 1981) (the community is entitled to reimbursement for its payment of a party's separate debts); Rothman v. Rumbeck, 54 Ariz. 443 (1939) (although insurance policy remained separate property, community was entitled to reimbursement of premium payments).

Such would arguably not constitute a "deviation" from the *Drahos / Barnett* formula or principles, but rather claims that fall outside such formula.

5. Capital Improvements Must Be Measured Separately.

Other issues may include improvements to the property during the marriage that increases the value of the property. As noted in Valento the cost of the improvements by itself is not relevant, but rather only the increase in value associated with such improvements is to be factored in a community lien analysis. Parties and/or their attorneys will need to ensure that competent evidence is submitted regarding the increase in value to the property attributed to the improvements at issue.

Although improvements as such are discussed in the Drahos and Barnett cases, they are not part of the *Drahos / Barnett* formula. As such, capital improvements need to be addressed separately. If one merely includes the value of improvements as part of the capital contributions in the *Drahos / Barnett* formula, the community and separate property end up sharing in the increased value even if the cost of such was paid for entirely by one or the other.

Similarly, one must also be careful not to "double dip" when the property value is affected by capital improvements. For example, a standard appraisal would normally consider any substantial improvements. If the improvements made by the community are already factored into the appraisal, it would not be equitable for the community to then receive a share of the value of such improvements separately (i.e., a double dip).

Accordingly, the data inserted into the *Drahos / Barnett* formula needs to be adjusted depending upon if the improvements are made by the community or separate property owner. If the capital improvements are provided by the separate property owner, the appreciation prong should be reduced by the value of such capital improvements. If the capital improvements are provided by the community, the appraisal should be adjusted to state a value absent such improvements, with the community to then receive separate credit for the amount of the increase in value attributable to such improvements.

One should of course apply common sense before spending substantial expert fees regarding such bifurcated analysis. For example, if the improvements at issue were made long before the divorce proceedings, there may be only nominal value attributable to such improvements, and such bifurcation may not be worth it. However, if substantial improvements were made more recently, such additional analysis may be warranted.

6. Co-Mingled Funds (that are not traced) Used to Pay Mortgage Payments or Other Capital Contributions Constitute Community Contributions.

Another issue that commonly arises is where mortgage payments are made from co-mingled funds. A common example is where separate property rental proceeds are deposited to

a community account. If not explicitly traced in accordance with Arizona law, courts are required to treat such mortgage payments as community 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).

7. Disclaimer Deeds Signed During Marriage Do Not Nullify Prior Community Contributions.

It has sometimes been argued that a disclaimer deed effectively nullifies community contributions 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. Although such argument was specifically rejected by the Court of Appeals in Saba v. Khoury, 481 [.3d 1167 (App.2021) , the published decision was subsequently vacated by the Supreme Court of Arizona in Saba v. Khoury, 516 P.3d 891 (Ariz.2022).

Such contention was, however, addressed in the Arizona Court of Appeals memorandum decision in Kadiyala v. Vemulapalli, No. 1 CA-CV 17-01111 FC (Arizona App. Div. 1 January 24, 2019).[1] 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 was no community interest. Id. at ¶14. The Kadiyala Court held that such argument ignores the reality of the community contributions stating, "[a]lthough the disclaimer deed recites otherwise, it does not trump the undisputed facts at trial for purposes of calculating an equitable lien." Id. at ¶13. The court went 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 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).

Id. at ¶14.

In short, the Court rejected the technical arguments associated with the language of the disclaimer deed and chose substance over form.

[1] 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.

8. Character of Property When Disclaimer Deeds Are Signed at Time of Acquisition

Disclaimer deeds are generally a product of mortgage requirements. Disclaimer deeds are required by lenders when the parties are married and only one party is purchasing the property (and thus only one of the parties is liable on the mortgage).

When real property is purchased prior to marriage, there is no community and thus a disclaimer deed is not applicable. In both the Drahos and Barnett cases, the properties were purchased prior to marriage, thus no disclaimer deed analysis was necessary in those cases.

The issue of disclaimer deeds arose in the context of the presumption that property acquired during marriage is presumed to be community absent clear and convincing evidence to the contrary. In Bender v. Bender 123 Ariz. 90 (App.1979), Wife argued that the trailer park at issue constituted community property because it was purchased during marriage despite signing a disclaimer deal at the time of acquisition. The Bender v. Court held that where a party signs a disclaimer deed at the time of the acquisition of this property, such effectively rebuts such presumption. Id. at 995-996.

The Bender decision was expounded upon in Bell-Kilbourn v. Bell-Kilbourn, 216 Ariz. 521 (App. 2007). In Bell-Kilbourn the parties were married 3 years before the real estate at issue was purchased. Because of Husband's compromised credit history, the parties purchased the marital residence in Wife's name alone in order to qualify for the mortgage. The parties paid off Wife's separate debts and some community debt in order to help her qualify for the loan, and the mortgage was taken solely in Wife's name. Husband signed a disclaimer deed as required by the lender. The parties used community funds to pay the mortgage throughout the marriage. Id at ¶ 2.

The trial court in Bell-Kilbourn found that under the circumstances the home should be deemed community property. The trial court found it was not the intention of either party that Husband gifted his interest in the residence to Wife, and that Husband only signed the disclaimer deed as a result of his relatively poor credit so that the parties could purchase the home together. Accordingly, the trial court found that considering the parties' intent, and to be fair and equitable, the residence should be deemed community property notwithstanding the disclaimer deed. Id. at ¶ 3.

The Arizona Court of Appeals in Bell-Kilbourn held that the trial court erred by ruling that the house was a community asset. Id. (citing Bender v. Bender, 123 Ariz. 90 (App. 1979)). The Court explained that "[p]roperty takes its character as separate or community at the time [of acquisition] and retains [that] character" throughout the marriage. Id. at ¶ 5 (citing Honnas v. Honnas, 133 Ariz. 49 (1982). The Bell-Kilbourn Court found that the disclaimer deed constituted a contract between the parties, and that because such was not set aside on the grounds of fraud or mistake, it was binding upon the parties. Id. at ¶ 11. The Court then

remanded the case for the trial court to determine the extent and amount of the community lien that was fair and equitable. Id. at ¶ 12 (citing Honnas and Drahos).

9. Femiano v. Maust

In Femiano v. Maust, 248 Ariz. 613 (App.2020) the Court of Appeals faced a somewhat different situation. In Femiano, the Wife signed a disclaimer deed similar to what took place in the Bell-Kilbourn case. However, the community in Femiano paid 100% of the down payment and mortgage payments on the home. Id. at ¶ 21.

Citing Bell-Kilbourn, the Femiano Court found that the disclaimer deed was binding upon Wife and that the home was Husband's separate property. However, Femiano overruled the trial court's calculation of the community lien and held that application of the *Drahos / Barnett* formula would be inequitable since there were no separate property financial contributions. Thus, Femiano held that even though the property was legally Husband's separate property, equitable principles supported the conclusion that the community was entitled to 100% of the equity realized during marriage since it made all the principal contributions (i.e., both the down payment and all mortgage payments). Id.

As explained in the following sections, the Femiano opinion was short lived as far as its "equitable" analysis.

10. Saba v. Khoury (Court of Appeals).

In Saba v. Khoury, 481 P.3d 1167 (Ariz. App. 2021), a different panel of the Court of Appeals (CofA) soon parted ways with Femiano decision as applied to the calculation of a community lien where, under similar circumstances, the community paid 100% of the down payment and mortgage. Although the Arizona Supreme Court subsequently vacated the CofA opinion (See Section 11 below), the CofA analysis is helpful to review for historical context.

Saba involved two rental properties purchased during marriage. The first property (Leisure Lane) was purchased during marriage in Wife's name as an "unmarried woman" (i.e., the parties "fudged" Wife's marital status to qualify for the first-time homeowner tax credit). As such, Husband did not sign a disclaimer deed at the time of purchase, but later signed a disclaimer deed when the mortgage was refinanced 2 ½ years later. The second property (30th Way) was purchased during marriage in Wife's name with a combination of community and separate property funds, and Husband signed a disclaimer deed regarding such property at the time of acquisition.

The trial court found that the disclaimer deeds regarding both properties were enforceable and applied the *Drahos/Barnett* formula in determining the community liens for both properties, including the Leisure Lane property which the community paid 100% of the down payment and mortgage payments.

Husband appealed the trial court's determination that the disclaimer deeds at issue were enforceable claiming that disclaimer deeds signed during marriage should be determined pursuant to standards applicable to post-marital agreements. In addition, Husband claimed that even if the disclaimer deeds were enforceable, the *Drahos/Barnett* formula should not apply to the Leisure Lane property for essentially the same reasons set forth in Femiano (i.e. that the community paid 100% of the down payment and mortgage payments), and that the *Drahos/ Barnett* formula is inequitable as applied to both properties because where there is still an outstanding mortgage the formula benefits the separate property owner disproportionately.

Wife cross-appealed and argued that any principal contributions made by the community prior to the disclaimer deeds should not be included in the *Drahos / Barnett* calculation considering the language of the disclaimer deeds which disclaimed all community interests up to the date of such documents. Wife also contended that the trial court erred in finding she comingled the funds used to pay the mortgages, and that the trial court thus improperly credited the community with loan payments made from her separate account. Id. at ¶ ¶1-2.

The CofA affirmed all of the trial court rulings. Id. at ¶ 6 (citing Bender v. Bender, at 93 , and Bell-Kilbourn, at ¶ 7).

The CofA rejected Husband's argument that disclaimer deeds signed during marriage should receive the same heightened scrutiny as postnuptial agreements. Id. at ¶ ¶ 8-9. The Court explained that prior courts had declined to view disclaimer deeds in such fashion, and that postnuptial agreements are distinguishable:

> Postnuptial agreements necessarily require both spouses' involvement and define each spouse's property rights in the event of death or divorce. Disclaimer deeds are unilateral and simply renounce ownership in property, effectively rebutting the presumption of community property. See Bell-Kilbourn v. Bell-Kilbourn, 216 Ariz. 521, 524 (App. 2007).

Id. at ¶ 9. The CofA went on to state "[a]bsent fraud or mistake, the disclaimer deeds must be enforced. Id. at ¶ 10.

Regarding Wife's contentions regarding the tracing issues, the CofA confirmed that Wife did not meet her burden of proof to establish that the co-mingled rental income was explicitly traced within her separate account, thus the trial court properly credited the community with the mortgage payments. Id. at ¶¶ 10-12.

The CofA rejected Husband's argument that the "Drahos formula is inequitable because it presupposes that the separate property owner has a superior interest in the property, resulting in a windfall in favor of that property." Id. at 15 (Husband contended in his appellate brief that under the *Drahos/Barnett* formula the separate property owner received credit in the

formula for the remaining loan amount regardless of who made the payments). The CofA explained that the separate property owner in fact has a superior interest in the properties, and that purpose of the formula is "to reimburse the community for its contributions and reward those contributions with a proportionate share of appreciation" (as opposed to a direct proportional division of equity based on contribution). Id. at ¶ 15. In making its determination, the CofA rejected Husband's argument that the court should adopt the reasoning set forth in Femiano v. Maust:

> We part company with Femiano. Awarding the community Leisure Lane's full appreciation ignores the reality of what the disclaimer deed represents. But for that disclaimer, Husband would be entitled to an equal interest in the full value of Leisure Lane. And an award under Femiano would ignore the fact that Wife remains solely liable for the outstanding loan balance. If the community were to receive 100% of the appreciation, then Husband would be rewarded with 50% of the property's upside with none of the risk on the downside. This result is inequitable and unreasonable.

Id. at ¶ 17. The CofA went on to explain that "the *Drahos / Barnett* formula sufficiently balances these interests and apportions the appreciation in an equitable manner." Id. at ¶ 18.

Finally, the CofA rejected Wife's argument that the community should not receive credit for its contributions prior to the disclaimer deed regarding Leisure Lane, explaining that "[t]he timing of Husband executing the disclaimer deed does not affect the application of the Drahos formula." Id. at ¶ 19.

The parties both filed petitions for review with the Supreme Court of Arizona. Because the Supreme Court of Arizona vacated the CofA decision as addressed below, the CofA decision is addressed herein only for discussion purposes, but has no precedential value.

11. Saba v. Khoury (Arizona Supreme Court).

Although both parties filed petitions for review with the Arizona Supreme Court regarding the issues addressed by the CofA, the Supreme Court limited its review to one issue, i.e., whether the *Drahos / Barnett* formula was an appropriate method to apply under the circumstances. Id. at ¶ 1. Based upon the opposing rulings in the Saba and Femiano CofA decisions, the Supreme Court "accepted review to consider how the marital community should be reimbursed for its contributions to separate property during the marriage, a question of statewide importance and likely to recur". Id. at ¶ 6.

The Supreme Court in Saba first explained:

> We hold that the trial judges should begin by using the Drahos / Barnett formula and should then adjust the calculation to account for the community's overall contribution of labor and funds to the separate property along with the market appreciation of the

property. In so holding, we do not limit trial judges' discretion to consider the value the community's contributions actually added to the value of the separate property to fairly determine the amount to which the community is entitled.

Id. at ¶ 2. The Saba Court then summarized in detail the trial court's community lien calculations based upon the *Drahos / Barnett* formula:

> Specifically, the court concluded that because the community paid 19.88% of the balance on the Lesure Lane loan, it should receive 19.88% of the appreciation in the home's value that occurred during the marriage in addition to the $39,741.29 it paid toward the principal, resulting in a lien in the amount of $68,588.02. Similarly, the court calculated the community's lien on 30th Way to be $47,539.25 reflecting the initial contribution ($25,176.70) plus the proportionate share of appreciation (14.8% of $150,999).

Id. at ¶ 4.

The Saba Court rejected Husband's argument that that because the community paid 100% of the Leisure Lane contributions it should receive 100% of the equity including appreciation. Id. at ¶¶ 5-9. The Saba Court explained that the analysis must be initially be based upon "whether a property's increase in value is due to the community's contributions or to other causes like simple market appreciation …". Id. (citing Cockrill v. Cockrill, 124 Ariz. 50 (1979)). The Saba Court went on to explain that the *Drahos / Barnett* formula is an "appropriate starting point for the courts to calculate a marital community's equitable lien on a spouse's separate property." Id. at ¶¶ 9-14. The Saba Court further distinguished that the community's contribution to capital improvements which increase the value of the property are valued separately than payments toward the mortgage which benefit but do not necessarily improve the separate property (i.e., pursuant to which the *Drahos / Barnett* formula is used). Id. at ¶ 15.

The Saba Court explained that it is not "mandating' that the *Drahos / Barnett* formula apply to every case, and that trial courts "may select whichever (method) will achieve substantial justice between the parties." Id. (citing Cockrill, 124 Ariz. at 54). The Saba Court, however, went on to explain:

> But the *Drahos / Barnett* formula is useful insofar as it provides trial courts with a consistent starting point. The formula is a baseline from which courts can evaluate whether the facts of a specific case warrant a modification of or a departure from the formula. If the equities do warrant such a departure, the trial court may measure the lien using a different method, but only if the equitable lien amount reflects – at a minimum – the amount of the community contribution and division of equity reflecting the increase in value due to the community contribution consistent with a market rate of return on that contribution.

Id. at ¶ 16. The Saba Court went on to clarify that Husband's objection to the *Drahos / Barnett* formula was based upon an "erroneous premise" that the objective regards the division of community property, whereas a community real estate lien analysis is a separate property analysis subject to the equitable reimbursement of the community contributions. Id. at ¶ 17 In reaching its conclusions, the Saba Court explicitly rejected the Femiano Court's analysis and conclusion explaining that the Femiano analysis "treats separate property as community property, giving no credit for the separate ownership of the property." The Saba Court explained:

> Again, the object is a fair *reimbursement of community funds,* not an *equitable division of property.* The holding in Femiano assumes that the community's contributions are the sole cause of the property's increase in value and fails to credit the separate property owner with any increase in value due to simple market appreciation. We disapprove Femiano.

Id. at ¶ 19. The Saba Court concluded that the trial court did not error in applying the *Drahos / Barnett* formula to calculate the community's reimbursement as such formula provides for a proportional appreciation in property value. Id. at ¶ 20.

The Saba Court ultimately vacated the Court of Appeals' opinion and affirmed the trial court's judgment. Id. at ¶ 21. The Saba Court did not explicitly state why it vacated the Court of Appeals' decision.

12. Additional Issues – Saba and Beyond

A. What Circumstances Support a Deviation from the Drahos / Barnett Formula?

As set forth in Section 3, *supra*, cashing out a portion of the home equity during marriage pursuant to a refinance, 2nd mortgage or HELOC may present a basis for adjusting the *Drahos / Barnett* formula depending upon whether the cash received was used for separate property purposes or to benefit the community. However, these are formula based adjustments affecting the overall community contributions or what is included as appreciation. In such instance, one is still using the formula and adjusting the data.

When I presented at For Better or For Worse in 2020, I submitted my article titled *Beyond Bell-Kilbourn and Drahos – Disclaimer Deeds and Community Liens in Real Estate Cases.* One of my propositions submitted in the past regarding community real estate liens has since been answered (in the negative) by the Arizona Supreme Court in the Saba case. Similar to the Femiano Court, I contended that trial courts should consider providing equal treatment to community and separate property contributions in calculating a community lien, which the *Drahos/Barnett* formula does not do where there is an existing mortgage. The Supreme Court's decision in Saba has put such issue to bed by making it abundantly clear that in real estate community lien cases, the community's claims are treated as reimbursement cases with a

proportionate return on the community's principle contributions as provided by the *Drahos / Barnett formula*, as opposed to a division of the increased equity proportionate to community versus separate contributions as set forth in Femiano.

Although the Saba Court explained that the *Drahos / Barnett* formula is a "consistent starting point" or "baseline" in determining a community lien, it went to great lengths to exclude a direct division of the equity based upon separate versus community contributions. Thus, while Femiano found that such a division was "equitable", the Saba Court explicitly disapproved such analysis. Saba at ¶19. Thus, pursuant to Saba, it appears that any "equitable" division must give credit to the separate property holder for the amount of the remaining unpaid mortgage.

To get a better understanding of how this works, one can reverse engineer the mathematics. Even if the community pays 100% of the down payment and mortgage, under the *Drahos / Barnett* formula the separate property holder will continue to receive more of the overall equity where there is a mortgage. If you carry out the math to the end, the community could eventually become entitled to 50% of the overall equity pursuant to a *Drahos / Barnett* calculation, but only if the mortgage is paid off in its entirety during the marriage, and of course assuming that all principal contributions were made by the community.

The Barnett formula as applied to such facts:

C + [C/B x A]

A = Appreciation During Marriage
B = Appraised Value of Property on Date of Marriage (or acquisition)
C = Community Contribution to Principal

Home was purchased during marriage for $500K (= appraised value at time of acquisition)
Community funded $100K as down payment
Mortgage was $400K
Community paid entire mortgage during marriage
Home is worth $800K at time of divorce.
Thus appreciation during marriage = $300K

$500K + [$500K/$500K = 1 x $300K] = $800K community lien

Thus, one can see that anything short of paying 100% of the mortgage by the community results in a superior share of the equity going to the separate owner. The Saba Court explained that this is appropriate as the Court is not dividing community property, but reimbursing the community for its principal contributions plus a proportionate return on such contributions.

So, the question becomes what facts give rise to a deviation from the *Barnett / Drahos* formula? Does this require an analysis similar to Toth v. Toth or In re Marriage of Flower? See Toth v. Toth, 190 Ariz. 218 (1997); In re Marriage of Flower 223 Ariz. 531 (App.2010). In Flower, the Court held that even though Husband gifted his interest in real property to the community pursuant to a joint tenancy deed, there were ample facts of record that supported an equitable deviation from the applicable presumption. Id. at ¶¶ 17-21. However, Saba stopped short of declaring that the *Drahos / Barnett* formula as a "presumption", thus the question remains what facts support a deviation?

There are of course factual scenarios that one can attempt to argue in support of a deviation from the *Barnett / Drahos* formula outside of what took place in Femiano. Perhaps the non-owner spouse contributed properties to the community as what took place in Flower. Perhaps the case involves the dissipation of assets or other facts that support the community's claims. What we do know from Saba is that the community's payment of all or the substantial portion of the principal contributions toward the home in question is not by itself a basis to deviate from the *Drahos / Barnett* formula.

The deviation question does not just apply to whether the community should receive more than what the *Drahos / Barnett* formula provides, but also applies to whether the court should reduce the community lien or recognize a community lien at all. Earlier cases suggest that certain equities may limit or negate a community lien, however, such cases were decided prior to Drahos and Barnett. Moreover, such argument would appear to contradict the language in the Saba v. Khoury decision regarding what the community should receive "at a minimum" as addressed further below.

In Tester v. Tester, 123 Ariz. 41 (App. Div. 2 1979), the parties lived in 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. Husband did most of the improvements and repairs to the home himself. Id. at 42. Husband sought reimbursement for the community financial contributions as well as for his repairs and labor. The key concept applied by the Tester 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 Tester 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." Id. 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 Wife's separate estate. Id. at 197. See also Hanrahan v. Sims, 20 Ariz.App. 313 (App. 1973) (equitable claim by community subject to equitable defenses such as benefits of living in separate property

home); Pownall v. Pownall, 197 Ariz. 577 ¶¶ 24-25 (App. 2020) (nominal community lien offset by benefits of non-owner spouse residing in home post-service);

The crux of the Tester case is that a community lien is an equitable remedy subject to potential equitable defenses. This is emphasized in footnote 7 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 at n.7 (Ariz. App. 2010).

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 prior to marriage and the mortgage payment may have been substantially less than fair rental value. Although Drahos set forth a formula that the trial court in that case and subsequent courts have found equitable, Tester and similar cases that pre-date Drahos have not been expressly 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 regarding separate property businesses. For example, 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 (i.e., the separate property share of the profits) 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?

On the other hand, in Saba v. Khoury, the Supreme Court of Arizona states:

> But the *Drahos / Barnett* formula … is a baseline from which the courts can evaluate whether the facts of a specific case warrant a modification of or a departure from that formula. If the equities do warrant such a departure, the trial court may measure the lien using a different method, but only if the equitable lien amount reflects – at a minimum the amount of the community contribution and a division of equity reflecting the increase in value due to the community contribution consistent with a market rate of return on that contribution.

Id. at ¶ 16 (emphasis added). Thus, a strict reading of Saba suggests that any equitable reduction to the community lien is limited. The contrary analysis is that the court must first determine what the community lien is and then may offset separate property equities against such lien after the fact. What the Saba Court intended by such language will likely be vetted in future cases. As one can see, the higher courts by their language may give clarification to certain issues, but often give rise to other issues at the same time.

B. Are Disclaimer Deeds Always Enforceable as a Contract?

In discussing disclaimer deeds in Sections 7 and 8 *supra*, I limited my discussion to the Court decisions as applied to the facts in those cases.

One of the additional issues that I addressed in my prior article regards whether all potential contract defenses should apply to disclaimer deeds as opposed to only "fraud and mistake" as addressed in Bender and Bell-Kilbourn. Because Bender and Bell-Kilbourn provided a contract analysis to disclaimer deeds, it seems as though all contract defenses should be available regarding disclaimer deeds signed at the time of the acquisition of the property as addressed more thoroughly below.

Another issue I addressed in my prior article was my proposition that a post-marital agreement analysis should apply to a disclaimer deed where the property at issue is initially community property, but later disclaimed by one of the parties pursuant to a subsequent disclaimer deed. An example may be where the married parties initially purchase a property jointly (i.e., with both parties as joint obligors on the mortgage), but one of the parties is no longer credit worthy at the time of a later refinance. In short, a disclaimer deed that purports to transform community property to separate property should *arguably* be subject to the more strict standards of a postnuptial agreement as addressed more thoroughly below.

Neither one of these issues was specifically addressed by the Supreme Court in Saba, or other Arizona published opinion, thus such will likely continue to be disputed until further clarification is provided by the higher courts.

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

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

Many practitioners believe that the Bender and Bell-Kilbourn cases created a Pandora's box of issues, and that disclaimer deeds are unfairly treated differently than other agreements entered into during marriage (such as post-marital agreements). A closer review of the caselaw shows that Bender and Bell-Kilbourn do not do anything quite so dramatic and that basic community and separate property concepts are still intact.

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 its character as separate or community at the time of acquisition and retains that character throughout the marriage." Id. at 523. A valid disclaimer deed signed at the time of acquisition 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 *arguably* applies to disclaimer deeds signed at the time of acquisition as opposed to disclaimer deeds signed after acquisition if the property was initially community (Note: disclaimer deeds signed after acquisition are generally signed pursuant 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. See Bell-Kilbourn at Id.; Bender v. Bender, 123 Ariz. at 997. Because these are the only two defenses mentioned, subsequent cases continue to suggest that these defenses are exclusive. Nothing in Bell-Kilbourn and Bender v. Bender expressly state that these are the only two contract defenses available, nor does such a restrictive interpretation 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 by the other spouse, and was such bargained for?

The counterargument is that courts should ignore the language in Bender and Bell-Kilbourn that a disclaimer deed is construed pursuant to regular contract principles, but rather that a disclaimer deed is merely a written confirmation of ownership at the time of acquisition. The defenses of fraud and mistake would still be available to challenge enforcement without inviting other "regular contract" defenses.

D. A Disclaimer Deed Executed After Purchase *Arguably* Requires a Post-Marital Agreement Analysis.

If property is community at the time of acquisition and a disclaimer deed is later signed during marriage, the analysis should *arguably* not be limited to contract principles alone. As confirmed by the Arizona Supreme Court in Honnas v. Honnas at 1046, “[p]roperty takes its character as separate or community at the time of acquisition and retains that character throughout the marriage.” See also Bell-Kilbourn at ¶ 5 (citing Honnas v. Honnas, 133 Ariz. 49 (1982). 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.

One can see the distinction by making a deeper dive into the language of the Bender and Bell-Kilbourn decisions. Bender explains that where the disclaimer deed is signed at the time of acquisition, the disclaimer deed is not a “[c]onveyance between the spouses”. Bender at 94. But if the property were initially community, wouldn’t a subsequent disclaimer deed logically constitute a purported transmutation or conveyance between the spouses, i.e. from community to separate property? Similarly, in Bell-Kilbourn, the Court states “[b]ecause Husband never had an interest in the house at the time of acquisition, he had nothing to convey to Wife …”. Bell-Kilbourn at ¶ 10. But if the property was community prior to the disclaimer deed, the disclaiming party did in fact have an interest in the house prior to the disclaimer deed, thus creating a clear distinction.

The distinction made in Bender and Bell-Kilbourn seems reasonable. A party can certainly purchase separate property during marriage with separate funds. Taken to the next level, a party can purchase separate property during marriage pursuant to their separate credit. In either case, the community claim is for reimbursement plus a proportionate return. However, where a property is purportedly transmuted from community to separate pursuant to a disclaimer deeds, the fundamental principles of Bender and Bell-Kilbourn no longer apply.

In Austin v. Austin, 237 Ariz. 201 (App.2015), Wife signed various agreements during the marriage which if enforceable would have affected her separate and community property interests. Husband argued to the Court that regular contract principles should apply to the documents Wife signed pursuant to Bell-Kilbourn and other cited cases. Id. at 206. The Austin Court rejected Husband’s contentions, 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 signed by 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. The Austin Court explained that 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 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)).[3]

Thus, where a disclaimer deed is signed during marriage and purportedly changes what previously constituted community property, the Bell-Kilbourn and Bender analysis and facts do

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[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.

[3] Austin v. Austin makes the distinction between a post-marital agreement and a separation agreement as whether the documents were signed when separation or divorce was not imminent or contemplated. Austin at ¶17. Such distinction arguably reflects the parties' fiduciary duty to the community and when such duty arguably ends. The distinction whether a document is in effect a post-marital agreement or separation agreement pursuant to A.R.S. § 25-317(B) may be substantial as to which party has the burden of proof and what factors should be applied regarding enforceability.

not apply and the disclaimer deed should *arguably* be addressed under the heightened scrutiny and burden of proof applied to post-marital agreements.

It should be noted that the Court of Appeals in Saba v. Khoury attempted to distinguish disclaimer deeds from post-nuptial agreements in its since vacated decision. See Saba, 481 P.3d at ¶ 9. However, the issue of whether the disclaimer deed converted community property to separate property, as opposed to a time of acquisition contractual analysis applied in Bell-Kilbourn, was not addressed in the opinion. Because the Saba Court of Appeals' decision was vacated, its analysis has no precedential value.

13. Post-Service of Process Issues.

A. Schickner Claims Probably Do Not Apply to Rental Properties that Generate a Profit.

In my recently updated article regarding separate property businesses, I discussed the proposition that the community may have a claim to a portion of a separate property business post-service profits proportionate to its community lien. *A Long and Winding Road "Untangling the Knots in Business Valuation and Apportionment Issues*, Section VI pgs. 42-50 (2023) . The article is available on the AAML Arizona Chapter website (Resources section) at azaaml.org. In short, community liens applicable to a separate property business have been treated as "equity" interests. Cockrill v. Cockrill, 124 Ariz. 50, 52 (1979) ("[t]he profits of separate property are either community or separate" depending upon the circumstances; Rueschenberg v. Rueschenberg, 219 Ariz. 249, ¶ 31 (App. 2008) ("In essence, our community property laws transform the community into an equity partner with the sole and separate property owning spouse to the extent the community's effort have generated net earnings, increased the value, or otherwise increased the net worth and/or market value of the company") (emphasis added). Thus, the contention is that pursuant to the logical application of *Schickner v. Schickner*, 237 Ariz. 194 (App. 2015), the community should receive its share of any post-service business profits (above the owner's reasonable compensation) proportionate to its equity interests.

Although community liens regarding separate property businesses and separate property real estate share the same foundational principles (the major cases often cite to one another), they part company with one another with respect to the nature of the property at issue.

In Saba v. Khoury, the Supreme Court of Arizona makes the distinction between property or "equity" interests versus an equitable lien (i.e., a security interest). The Saba Court explains, in no uncertain terms, that a community's real estate lien claim is a "reimbursement" claim plus a return on investment proportionate to the community contribution. Saba v. Khoury at ¶¶ 1, 8. The Saba Court explains that community principal payments on the mortgage do not "enhance the value" of the real estate, however, the community should receive a fair return on the

amount it paid to reduce the principal balance of the mortgage. The Saba Court explained that the *Drahos / Barnett* formula accounts for this return. Id. at ¶¶ 15 – 19.

The distinction between an "equity claim" and a "reimbursement claim" may be important with regard to rental real estate interests (such as the properties at issue in the Saba case). Where rental real estate generates a profit, it at first seems logical that the community should share in such post-service profits proportionate to its community lien until the community lien is satisfied. However, in light of the clarification made by Saba v. Khoury, such would not make sense if the community lien is not in the nature of an equity interest.

One may ask why the Supreme Court of Arizona has characterized community business liens as an "equity interest" and community real estate liens as a "reimbursement" claim. The answer to such question appears to be implicit from the language in Saba that community payments of a mortgage obligation does not enhance the value of the real estate, whereas, in separate property business cases, the main issue generally regards the portion of the increase in value of the business during the marriage associated with community contributions. The Saba Court explains that the increase in value to real estate is generally associated with market increases, i.e. an inherent return on investment. Such market increases would also remain separate property in a business apportionment case. An easy illustration of the distinction can be seen in a pie-chart analysis. In a real estate case, the pie (i.e. the real estate) does not get any bigger because of the community contributions (unless additions to the structure are added, which are addressed separately). In a business case, we are dealing with the community's share of the increase in value pursuant to community contributions. In such case, the pie has become larger. Thus, while the corpus and the inherent increase in value of the separate business remains separate, the portion of the expanded pie attributable to community contributions has been treated as community property or community equity.

There of course may be hybrid real estate facts to which the language in Saba v. Khoury arguably allows for deviations. For example, if the community has paid for improvements and additions to rental real estate that led to increased profits, it is conceivable that the court may deem it equitable that the community should receive an equitable portion of such profits (i.e., in addition to its *Drahos / Barnett* share of the increase in value.) There is also the scenario where a real estate business owns properties itself, and the owner-operator commits community efforts in managing and increasing the value of such business beyond the value of the properties themselves. In such instance, there may be a blend of separate property business and real estate lien issues. Community lien issues are of course equitable in nature, thus your analysis may need to be adjusted when unique facts such as these are presented.

B. Post-Service Bobrow / Reimbursement Issues.

Since we are discussing post-service issues, keep in mind the principles set forth in Bobrow v. Bobrow, 391 p. 3d 646 (Ariz. App. 2017) and its progeny. Where real estate is community property and mortgage payments are made post-service, Arizona case law has held

that a party that pays the mortgage from post-service separate property funds is entitled to reimbursement from the other spouse for their equal share of such payments absent an "ouster". Bobrow at ¶ 8; Ferrill v. Ferrill 514 p.3d 292 at ¶ 11 (App. 2022).

In a separate property real estate case, such principles of course do not apply as there is no community mortgage in play. However, what if the non-owner spouse continues to reside at the property post-service without contributing to the expenses? Should the non-owner reimburse the owner a portion of the fair rental value. How about utilities and other expenses? Such raises counter reimbursement and/or equity arguments that the non-owner spouse should contribute to such expenses under the circumstances even if such are not technically community obligations.

14. Conclusion:

The issues addressed in this article, while extensive, clearly do not exhaust all potential issues which may arise regarding community liens, equitable adjustments, deviations to the established formulas, and other ancillary issues regarding separate property real estate interests.

The Supreme Court of Arizona in Saba v. Khoury makes it clear that while the application of *Drahos / Barnett* is not based upon a presumption per se, it is the "baseline" for measuring the community's lien associated with community principal contributions toward the purchase and mortgage. Saba at ¶ 16. However, as discussed, there are instances that adjustments should be made, equitable offsets applied and deviations argued pursuant to unique facts as real estate liens and other reimbursement claims are "equitable" in nature.