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Hiding a Mortgage Too Well

Roger Bernhardt

The concept of a hidden mortgage is easy enough to understand, as far as the motivation for creating one is concerned, but its actual operation is often far more difficult to grasp. *Garcia v Roberts* (2009) 173 CA4th 900, 93 CR3d 286, reported at p 132, is a good illustration of that (which I will get to after a short introductory digression).

Mortgage law starts with the idea that there may be superior equities in the transaction that can often trump the actual language in the document, and that those equities cannot be waived by further fancy language in the document. When a mortgage is involved, a court will “look through” the form of the transaction to get to its substance and, consequently, not pay much attention to the literal language of the actual provisions in it. (The best illustration of this principle is the statement in CCP §744 that a mortgage “*whatever its terms*” always has to be foreclosed.)

The doctrines of superior equities and rules against clogging (prohibiting the inclusion of provisions that impair the borrower’s right of redemption) are often frustrating for those whose income comes from negotiating deal terms, as well as for those who believe in freedom of contract even when it allows a lender to collect its pound of flesh, if that was what the deal called for. Mortgage creditors can be quite upset to discover that they spent a lot of money and time demanding and drafting provisions they were later unable to enforce.

One way for a creditor to avoid the inconveniences of mortgage law is to take advantage of the fact that ordinary contracts that do not amount to mortgages are not subject to those same principles. A simple contract is interpreted according to its terms and the intention of the parties, except in special cases such as fraud or adhesion. That means that if a clever attorney can blindside a court into thinking that it has before it an ordinary contract transaction rather than a mortgage transaction, he or she may be able to get away with a far better result for the client. (After all, for over 75 years, California courts were fooled into thinking that deeds of trust were not mortgages, thereby allowing lenders a good long time to avoid otherwise unpleasant mortgage rules.)

There is no doubt in my mind that the deal in *Garcia v Roberts* was, in fact, a hidden mortgage. But it was so well concealed that I am not sure that anyone—neither lawyers nor the judges, nor even the parties—realized it. The positions taken and the rulings made—whether the deal involved an oral loan agreement or a written lease option, whether a cause of action for one could be added to the other at a later time, whether one of those theories could complement or supersede the other, whether and how the parol evidence rule and the statute of frauds had an impact, the effect of the expiration of the option date, an optionor’s duty of good faith and fair dealing, plus many other rather bizarre twists and turns in the case—all arose because everyone attempted to analyze the transaction as it had been literally concocted by the parties. Because of that approach, I do not believe that the opinion makes much sense or is likely to ever be cited by

another court or relied on by another attorney; the opinion and the “actual facts” on which it relies are just too complicated to be useful.

A Camouflaged Purchase Money Loan

From my perspective, however, the case is an intriguing one, with useful cautions for those who borrow or loan money. The deal was simply a camouflaged purchase money loan transaction. Garcia, the borrower, started out having an option to purchase property that he had been renting, but lacked the \$132,500 necessary to exercise that option and complete the purchase. This led him to seek to borrow that amount from his friend, Roberts. In an ordinary transaction, Roberts might have merely advanced that money to Garcia directly for Garcia to buy the property, and then taken back a deed of trust on it when Garcia acquired title to it. Instead, Roberts gave the money directly to the seller and took title himself, giving Garcia a two-year lease on the property together with an option to purchase it from Roberts when that lease ended. Since the monthly payments Garcia had to make to Roberts during the lease period were expressly stated to amount to 12 percent of the purchase price that Roberts had paid the seller, there was no doubt that they were interest payments on the loan rather than rent payments under a lease. This sale and leaseback was a mortgage arrangement, with the added twist that title to the property went to the lender from a third party seller rather than from the borrower—a twist that makes this mortgage transaction one of purchase money rather than a refinance.

If the judges had appreciated that this was a mortgage loan, they would have said that Roberts held title to the property both in trust and as security for a loan to Garcia. The trust is a resulting trust because Garcia was really the one who paid the price (by way of using funds he had borrowed from Roberts). But while Roberts held his title only in trust, he was nevertheless entitled to have his loan to Garcia repaid out of the property, making that trust a security device or equitable mortgage securing his loan. That was the real deal, rather than the phony paperworked or oral versions the parties bickered about.

If, in fact, this was a mortgage loan between Roberts and Garcia, it would not matter whether it was structured as an oral agreement or a written lease and option. In any case, Garcia would be entitled to assert his equity of redemption and pay his debt late, *i.e.*, after the date stated in the lease option or the date for payment declared in the loan agreement had passed. Mortgage debtors always get extra time to “redeem” themselves.

Remedies

Characterization as a mortgage would also bear on the remedies issues, now awaiting a new trial. The traditional remedy would be to allow Garcia to assert his right of redemption (*i.e.*, exercise the original option) and obtain title to the property by repaying Roberts the \$133,027 (including closing costs) he had borrowed from him. The earlier trial court judgment had instead awarded damages to Garcia of \$367,000, based on a breach of contract theory. That result appears premised on the assumption that Roberts keeps the title he has and Garcia recovers the benefit of the bargain he would have obtained by purchasing property worth \$500,000 for only \$133,000. (Fraud was also found, but that finding did not appear to have been used to increase Roberts’s liability.) The alternate recoveries work out the same way economically, given a debt of \$133,000 and a market value of \$500,000. Ordinarily, Roberts would not be able to elect to keep the property and pay Garcia damages, since that would amount to a strict foreclosure combined with a damage kicker. But I suppose that Garcia can elect to treat Roberts’s behavior

as constituting a wrongful foreclosure and choose to take his recovery as damages rather than as rescission and restitution. As I say, the numbers work out the same either way.

Before I read this decision, it had never occurred to me that an unintended virtue of deciding that a contract transaction constituted a mortgage in disguise was that it could save the lawyers and the judges from the near-impossible task of attempting to literally interpret or enforce that otherwise incomprehensible contract language. This whole case would have been a lot simpler if that fact had only been appreciated.

Garcia v Roberts (2009) 173 CA4th 900, 93 CR3d 286

The published portion of this decision discusses whether the trial court abused its discretion by granting a substituted plaintiff's motion to amend the complaint (to conform to the proof) by adding a breach of written contract claim. The breach of written contract claim conflicted with the deposition testimony of plaintiff Johnny Garcia, who died before trial. The substituted plaintiff (his wife, Omega Garcia) prevailed at trial on all causes of action, including a claim of fraud. The court of appeal vacated that part of the judgment awarding damages to plaintiff on the cause of action for breach of written contract, but affirmed the other orders and judgment of the trial court.

The dispute arose out of Johnny Garcia's attempt to purchase real property, including a mobilehome, that he had been renting for \$500 per month from the Sasashima Family Trust. Garcia lived in the mobilehome and operated from there a modest business as a backhoe operator. In 2001, Garcia reached an agreement with the Trustee of the Trust for an option to purchase the property for \$140,000. Under the agreement, Garcia paid \$7500 to the Trust and had two years to come up with the balance. The \$7500 would be treated as a downpayment and Garcia would continue paying the \$500 monthly rent until the purchase concluded. When Garcia had difficulty obtaining financing, he asked defendant Ronald Roberts, a plumbing contractor for whom he occasionally worked, if he would be willing to lend the money. Roberts orally agreed to pay \$132,500 for the property to the Family Trust as a loan; title to the property, however, would be put in Roberts's name and Garcia would pay 12 percent interest (about \$1325 per month) for a period of two years, at the end of which Garcia would have to secure independent financing to pay off the loan and receive title. Although the closing costs raised the final price to \$133,027, Roberts closed escrow on September 26, 2002. Shortly thereafter, Roberts invited Garcia and his wife, Omega, to his home to sign paperwork. Roberts's wife filled out (and the parties signed) a form contract entitled "Lease with Option to Purchase," which Mrs. Roberts read and explained, since Johnny Garcia spoke some English but could not read it and Omega Garcia did not understand English at all. In 2004, with the assistance of a mortgage broker, Garcia cleaned up his credit history and took steps to obtain home insurance while the mortgage broker applied for financing and ordered an appraisal. In late August or early September, the mortgage broker called Roberts, who confirmed the terms of the sale. The mortgage broker also informed Roberts that escrow had been opened and attempted to arrange a meeting for signing a purchase agreement required by the lenders. Roberts delayed action pending his vacation. On his return, although Roberts eventually met with Garcia and the mortgage broker, he postponed signing the purchase agreement until the next day at the title office. The next day, Roberts refused to sign the agreement but requested no changes. Roberts

continued to complain that he did not like the papers and would not sign. On October 26, 2004, Roberts told Garcia that he had lost his opportunity to purchase the property.

Garcia filed suit on December 16, 2004. At the time of trial, on June 25, 2007, the operative complaint was premised on the breach of an oral loan agreement. Although Roberts's pleadings originally referred to a written contract, by the time of trial, his position was that there was no enforceable or valid oral or written contract. During discovery, Johnny Garcia insisted that the only agreement he had with Roberts was the oral agreement; Garcia denied knowing anything about a written lease option agreement. On February 7, 2007, Johnny Garcia died; his wife was substituted into the case as successor-in-interest and personal representative. At the beginning of trial, during the discussion of in limine motions, Garcia's counsel announced the motion to amend to add a breach of contract claim. Thereafter, the motion was formally made, a brief filed in support, and substantial oral argument held. Garcia's counsel acknowledged that Johnny Garcia had refused to allow any reference to the written contract. Roberts's counsel argued that the motion was unduly prejudicial because defendants had relied on Johnny Garcia's repeated denials. The trial court granted the motion to amend.

The court of appeal focused on "the crucial fact that at the time of trial plaintiff was deceased and so could not be questioned further on any issues relevant to the lease option agreement." The court of appeal ruled that the trial court abused its discretion in permitting the amendment because Roberts was unfairly prejudiced by the reversal of position on plaintiff's part.