Equitable subrogation award among coowners: Kenney v U.S., 2006

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On sale of house, equitable subrogation award was to be calculated by crediting all of joint tenant’s mortgage payments against net proceeds before dividing balance into equal shares. *Kenney v U.S.* (9th Cir 2006) 458 F3d 1025

George Kenney (Kenney) and his former wife, Donna, held title as joint tenants on a house they purchased in 1978. They permanently separated in 1989. By oral agreement with Donna, from 1989 until the house was sold in 2002, Kenney assumed and made all the payments on the house loans, a total of $166,826 in principal and interest. Between 1995 and 1997, the government filed tax liens against Donna. Donna quitclaimed her interest in the house to Kenney; thereafter, to sell the house, Kenney entered into a substitution-of-proceeds agreement, agreeing that the liens would attach to the sale proceeds to the same extent as to the house itself.

The net proceeds on sale of the house were $307,244. The government asserted liens against one half of those proceeds. Kenney sued to quiet title in the sale proceeds. The parties filed cross-motions for summary judgment. Kenney contended that because of his mortgage payments, under the oral agreements with Donna, Donna’s interest in the house (and thus her proceeds) had diminished to zero when the government’s liens attached. Alternately, Kenney contended that he was entitled to equitable subrogation against Donna’s interest for the payments he had made on Donna’s share as well as interest on the payments. The government agreed Kenney was entitled to equitable subrogation, but disagreed about its method of calculation and denied he was entitled to interest on the payments. The district court rejected Kenney’s diminishing interest theory. However, it adopted Kenney’s calculation of equitable subrogation, but did not include interest on his payments.

The Ninth Circuit affirmed in part and reversed in part. The diminishing interest theory was foreclosed by *Marriage of Benson* (2005) 36 C4th 1096, 32 CR3d 471, reported in 28 CEB RPLR 190 (Nov. 2005), which required agreements to assume loan obligations to be in writing.

The district court had divided the net proceeds ($307,244) into equal shares for Kenney and Donna, and applied equitable subrogation to credit Kenney half of the mortgage payments he made between 1989 and 2002 ($83,413) from Donna’s share. The remainder of Donna’s share ($70,209) was available to satisfy the government liens.

The government argued that Kenney’s $83,413 should be taken from the total net proceeds, leaving a balance to divide between Kenney and Donna, of which Donna’s half ($111,915.50) would be available to satisfy the liens. The government contended that because equitable subrogation only allowed Kenney to stand in the shoes of the lenders, he should be paid from the net proceeds as a lender, before his and Donna’s shares were divided.

The government’s method would have forced Kenney to take his subrogation award from proceeds in which he had a half interest, effectively forcing him to pay for half of the amount to which he was entitled. Several California cases established that Kenney should be credited from
the total net proceeds for all the principal and interest payments that he made ($166,826) before the balance was equally divided.

The district court reached the correct result in its calculation, but it erred in giving the government all of the escrow interest on Donna’s share of the net proceeds. Kenney’s award of $83,413 was 54 percent of the $153,622 in controversy, so he should have received 54 percent of the escrow interest on the $153,622.

The district court did not abuse its discretion in denying interest on the payments Kenney made for Donna. It was free to consider that Kenney’s payments on Donna’s behalf enabled him to protect his own half interest in property, and that the property had appreciated.

**THE EDITOR’S TAKE:** Kenney had three theories to support his claim that his payment of Donna’s share of the mortgage should give him priority over the tax liens held by the government, but only the weakest one worked.

The best theory (i.e., best for him) was “diminishing interest”—that half of every payment he made on their joint mortgage worked a partial, proportional transfer of Donna’s equity in the security. (He might have made that theory even more lucrative by claiming only half the payments on the first mortgage, but 100 percent of his payments on the second mortgage, because those funds went entirely to Donna, but perhaps he was concerned about looking too greedy.) This theory lost only on a statute of frauds ground, which means that it can be much bolstered in future cases: If you fear that your client’s spouse’s creditors may come after the shared assets, have the parties execute a joint agreement that any excess payments by your client are partial purchases rather than loans. (I proposed a variation of that arrangement some years ago for spouses to execute mutual deeds of trust to protect recovery for excess contributions from creditors in Bernhardt, *Secretly Severing Joint Tenancies*, 19 CEB RPLR 125 (May 1996); either one should work.) This gets more complicated when title is held as community property rather than in joint tenancy, since some creditors of either spouse can then reach the entire asset and not just the share of one of them.

The next best theory was to credit Kenney both for what he paid and also for interest on those payments. (That would have been a handsome amount, being calculated from the date each payment was made.) The court rejected that theory on the ground that the interest wasn’t equitably, and I think it was probably also not economically, required: A junior creditor should be subordinate to the same existing senior liens whether they were still held by the original lenders or paid off by Kenney. (It also looks like Kenney got credit for the full amount of each mortgage payment, not just for how much it reduced principal, which may or may not be a windfall, since the liens themselves accrued additional interest each month when not paid.) Unlike the first theory, this one is unlikely to be made any stronger because of an agreement between the spouses concerning it: The United States would have to sign the agreement, too.

Finally, the theory accepted by the court was that Kenney should have subrogation rights for the payments he made on the senior liens against the property that Donna and he owned that was subject to levy by the government for her debts. That was obviously fair, since his
paying off those mortgages increased Donna’s equity, and therefore the amount the government could reach. (And, of course, fairness would have it come off the top rather than out of Kenney’s own share, as the government contended.) But, with regard to that theory, Kenney was lucky in two respects: First, that he had paid off the mortgages in full, since subrogation does not work for only partial payments. This rule does not seem particularly just, since partial reductions of principal on senior liens still benefit junior creditors, but any other rule has too many complications. (That consideration makes Kenney’s first theory—of diminishing interest—much more attractive, and essential, since the mortgage has been only partially paid.) Second, Kenney apparently was not aware of the government’s tax liens when he paid the mortgages, since knowledge can kill the right to subrogation. While this rule seems based more on a confusion between torts and property principles rather than on economic logic, it is the rule and can cause real harm to those who too readily agree to pay other’s debts. See Bernhardt, *Paying the Wrong Debt*, 19 CEB RPLR 212 (Oct. 1996). If your client does know of tax liens against his spouse, don’t make those mortgage payments too readily.—*Roger Bernhardt*