

## Question 6

Herb and Wendy, residents of California, married in 2001. Herb worked as an accountant. Wendy was an avid coin collector who hoped someday to turn her hobby into a profitable business. Prior to marriage, they had entered into a prenuptial agreement providing that each spouse's wages would be his or her separate property.

On Wendy's birthday in 2002, Herb gave Wendy a drawing by a famous artist. Herb paid for the drawing with \$15,000 that his parents had given him. Wendy hung the drawing in their bedroom.

In 2003, Wendy opened CoinCo, a shop specializing in rare coins. She capitalized the business with a \$10,000 inheritance that she had received when her grandfather died. Wendy worked at the shop alone every day. Customers appreciated her enthusiasm about coin collecting and her ability to obtain special coins at reasonable prices. Over time, Wendy learned that she had acquired a number of highly valuable coins. There was also a renewed interest in coin collecting due to the discovery of several boxes of old coins found buried in the area.

Although Wendy's services at the shop were worth \$40,000 per year, she took an annual salary of \$25,000. She also paid \$5,000 in household expenses from the business earnings each year.

In 2008, Herb and Wendy separated, and Wendy filed for dissolution of marriage. At that time, CoinCo was worth \$150,000, and the drawing was worth \$30,000.

In 2009, before trial of the dissolution proceeding, Wendy was disabled by a serious illness and had to be hospitalized. She closed CoinCo while she was in the hospital, and the value of the business fell to \$100,000 by the time of trial. Her hospital bill was not covered by health insurance.

In the dissolution proceeding, Wendy claims that the prenuptial agreement is valid and Herb claims that it is not.

What are Herb's and Wendy's respective rights and liabilities in:

1. The drawing? Discuss.
2. CoinCo? Discuss.
3. The hospital bill? Discuss.

Answer according to California law.

## Answer A to Question 6

California is a community property state. All property acquired during marriage is community property (CP). Property acquired prior to marriage or after permanent separation, and any property received during the marriage by gift, bequest, or devise, is separate property (SP). In order to determine the character of property, we must trace back to the funds used to acquire the property, then apply any special exceptions or conditions under the law. Both spouses are entitled to a one-half share of CP. At divorce, the CP is divided equally unless there are special considerations that apply.

### 1. The drawing

To determine the character of a piece of property we trace back to the funds used to acquire it. Here, we are told that H paid for the drawing with \$15,000 that his parents gave him as a gift. Property acquired during marriage as a gift to one spouse is SP; therefore the \$15,000 was SP, and by tracing we determine that the drawing was SP at the time it was purchased.

### Transmutation

Prior to 1985, the character of property could be more easily changed or transmuted from SP to CP or vice versa. After 1985, however, any transmutation of property had to be in writing to be valid. An exception to this is where a spouse gives the other spouse a gift of relatively insubstantial value, in which case the gift between spouses can be transmuted from CP to SP or from SP to CP or even from one spouse's SP to the other spouse's SP.

Here, we are told that the drawing was by a famous artist, and that H purchased it in 2002 in honor of W's birthday for the substantial sum of \$15,000. We are also told that Wendy hung the drawing in the couple's bedroom. Under these facts, the drawing was of substantial value and would not ordinarily come within the transmutation exception for gifts of insubstantial value. But we are also told that it was bought on Wendy's birthday, H gave it to her, and W hung it in their bedroom. Those facts appear to show an intent

that the painting was either given to the community from H's SP, or possibly even given to W as her SP, but hanging the painting in their bedroom looks more like a potential transmutation from H's SP to CP. However, because the drawing was clearly valuable and there was no writing, no transmutation occurred. The painting remained H's SP at the time of permanent separation.

End of economic community upon permanent separation.

A marriage ends upon dissolution/divorce, but the economic community of a marriage ends upon permanent separation, where the couple separates with the intent to not reconcile and to stay permanently separated and dissolve the marriage. Here, we are told that H and W separated in 2008, and W filed for dissolution of marriage at that time. Therefore, the economic community ended in 2008. We are also told that in 2008 the painting was worth \$30,000. Because there was no transmutation, the painting was still H's SP, and now worth \$30,000.

## 2. CoinCo

Separate property business enhanced by community labor. Where a SP business is enhanced by community labor during marriage, for the purposes of dissolution the courts will use one of two formulas in order to determine the CP's interest and share in the SP business.

Pereira: Where the SP business growth is due predominately to the spouse's labor and abilities, the Pereira method is used. Under Pereira accounting, the SP business spouse is entitled to the original principal value of the business, plus an annual rate of return calculated at 10%, both of which are SP. The remaining value of the business is CP.

Van Camp: Where the value of the SP business derives mostly from the character and nature of the business itself, the Van Camp method of accounting is used. Under Van Camp, the community is entitled to the reasonable salary value of the spouse's labor,

minus any amount received by the community, and minus any community expenses paid. All else is SP.

Pereira analysis:

Here, we are told that we can trace the beginning of CoinCo in 2003 to W using a \$10,000 inheritance. This inheritance is SP; therefore CoinCo is a SP business belonging to W. We are also told that W had prior to marriage been an avid coin collector, therefore she had skill and expertise used to increase the value of the business. We are also told customers appreciated her enthusiasm about coin collecting and her ability to obtain special coins at good prices and had in fact obtained highly valuable coins. We are also told that after permanent separation with W became ill, the value of CoinCo fell from \$150,000 in 2008 to \$100,000 in 2009, because W was not available to lend her skills to the business. All of these factors point to W's skill and expertise as being the reason for CoinCo's success, and point to a Pereira analysis. Under Pereira, the initial value of CoinCo of \$10,000 is SP, and 10% per year from 2003 when it started to 2008 upon permanent separation is \$1,000 per year or \$5,000. Therefore \$15,000 would be W's SP, and the remainder would be CP. At permanent separation CoinCo was worth \$150,000, so \$135,000 was CP, and H would be entitled to half of that. We are told that in 2009, CoinCo's value fell to \$100,000. If that figure is used, then we deduct the \$15,000 SP and the \$85,000 remaining is CP.

Van Camp analysis:

On the other hand, we are also told that there was a renewed interest in coin collecting due to the discovery of old coins found buried in the area. This would point to CoinCo being inherently valuable because of the type of business it was, and not entirely due to W's expertise skill and labor. If a court decided that was the predominant factor, then under Van Camp analysis we are told the W's services at CoinCo were worth \$40,000 per year. Over five years that is \$200,000. We are told that W took an actual salary of \$25,000 per year, and W also paid \$5,000 per year of household community expenses. So the community already received \$125,000 of salary over five years from 2003 to 2008 and \$25,000 in expenses totaling \$150,000. Under Van Camp, the community is

still entitled to \$50,000, the difference between the \$200,000 value and the \$150,000 actually received. The initial \$10,000 investment is W's SP. We are told that by the time of 2009 divorce trial the value of CoinCo fell to \$100,000. Thus \$50,000 of that is CP and the rest is SP.

Prenuptial agreement:

A prenuptial agreement is valid so long as it is in writing. Here we are told that prior to marriage W and H entered into a prenuptial agreement providing that each spouse's wages would be his or her SP. The agreement is valid; therefore W's wages from CoinCo are her SP and the community is not entitled to them. Therefore, the above Van Camp analysis is altered by the prenuptial agreement. The \$125,000 in salary will not be credited to the community, but the expenses (which are not mentioned in the prenup) will still be credited. Thus under Van Camp and under the prenup wages of W are not credited to the community.

This does not affect the Pereira analysis which is not based on wages. Overall, the facts show that the increase of value of CoinCo was due primarily to W's skill so because Pereira does not take wages into the analysis there is no change under Pereira. H will want Pereira used, and W will want Van Camp used, because it is based on her wages, which are SP under prenup. But a court is likely to apply Pereira.

### 3. The hospital bill

Debts after permanent separation

After permanent separation the economic community ends. Any debts that are incurred by either spouse post-separation are SP debts, and creditors will have to go after the SP of the spouse who incurred the debt. An exception exists, however, for debts related to the necessities of life, such as food, clothing, shelter, and, arguably, health care expenses. In that event, a creditor may go after the debtor spouse's SP, the CP, and also the SP of the other spouse.

Here, we are told that in 2009, after the permanent separation but before the divorce trial, W was disabled by a serious illness and in hospital, and that her hospital bill was not covered by insurance. Because the hospital bill is for a necessity of life and they are not divorced yet, the hospital can go after W's SP, the CP, and H's SP for this necessity of life debt.

## **Answer B to Question 6**

California is a community property state. In California, property acquired during marriage is presumed to be community property (CP). Property acquired before marriage and after legal separation is deemed separate property (SP). Additionally, property acquired by gift, bequest and devise is also SP.

The name of the title is not determinative of the property's characteristics. Courts may trace the funds used to acquire the property to determine the characteristics of the property. With these things in mind, we can understand how a court will assess the distribution of the following assets.

### Prenuptial agreement

The determination of the distribution of assets at the divorce of Wendy and Herb all depend on the validity of the prenuptial agreement. A prenuptial agreement is an agreement that allows [a] party to contract out of California community property law. To be valid, there must be a writing signed by both parties, each of whom are represented by independent counsel, there must be a valid waiver in writing, a full disclosure of all assets, and a minimum of 7 days before the parties sign the agreement. Additionally, the parties must have the capacity to enter such [an] agreement, including no undue influence from either party. Also, it must be voluntary. Here the only facts we are given was that in 2001, Herb and Wendy married in California. Prior to their marriage a prenuptial agreement was entered into. The agreement stated that wages of each spouse would be his or her separate property. However, at the divorce proceedings, Wendy claims that the agreement is valid while Henry argues it is not. Without facts demonstrating the validity of the agreement, the following distribution analysis will show the results of the distribution with or without a valid prenuptial agreement.

### 1. The drawing

Items acquired during marriage are presumed to be CP unless tracing the assets or actions of the parties shows otherwise. Here, on Wendy's birthday in 2002, she

acquired a drawing from a famous artist. Wendy acquired this painting from her husband Herb. Herb paid \$15,000 dollars for the painting using money his parents gave him. As stated above, property and money received as a gift is the SP of the party receiving the gift. When Herb acquired the painting, tracing shows that it was his SP. However, in 2002, as a birthday present, Herb gave the painting to Wendy. Wendy will argue that since she received the property as a gift, it is presumed that gifts become the SP of the receiver.

However, in 2008 the painting was worth \$30,000 dollars. Herb will argue that the property should still be his property because it was an invalid transmutation of his SP to Wendy's SP.

### Transmutation

Transmutation is the doctrine of transferring one person's SP into another person's SP. After 1985, stricter requirements were necessary for property to be validly transmuted. After 1985, in order to successfully transmute the property a party needed to show there was 1) a writing, 2) signed by the party who is giving up the SP and 3) expressively states the transmutation of the property. Under these facts we do not see a valid transmutation under the 1985 documents.

Here, in 2002, Herb gave the drawing as a birth gift. We are not given any other facts. If Wendy can show that she was given the drawing and was given a birthday card, that said possibly "I know you love this drawing, now it's yours! Love, Herb" we may have a valid transmutation. The card in itself is a writing, as would be his statement explaining the gift. Additionally, people usually sign birthday cards. Since we do not get the facts stating this or anything like this happened, the painting was invalidly transmuted and Herb will be able to trace the drawing back to the Parents' \$15K gift. Also, the actions of the parties, Wendy hanging the drawing in the bedroom does not show the property was SP. Wendy will have to return the painting.



## Pre-nup?

Since this drawing was not purchased using either party's earnings, the pre-nup has no effect on the distribution of the drawing.

## **2. CoinCo**

The next issue is the distribution of the CoinCo business. Since, under California law, earnings acquired through the effort, intelligence, and skill of either part is deemed CP, the validity of the pre-nup is vital to the distribution of Coinco.

### Invalid pre-nup

The following analysis presumes that a court will believe Hank and find that the 2001 pre-nup is invalid.

The courts use two tests to determine the property interests of a self-employed company owned and worked out by a spouse during marriage. A court may use either the Pereira analysis while Wendy would desire the Van Camp if it is shown that the pre-nup is invalid.

### Pereira Analysis

Under Pereira, courts conclude that the company's value is based upon the effort, hard work, and skill of the working spouse. Since we are working with the assumption of an invalid pre-nup, the earnings by a spouse during marriage are presumed CP. Under Pereira, the working party keeps their SP and receives a reasonable rate of interest on the investment (10%) multiplied by the years worked. Here, the company was capitalized by a \$10K inheritance of Wendy that she received when her grandfather died. As described above, in heritance is SP.

Herb will argue that her business thrived because of her work, enthusiasm and her ability to collect special coins as reasonable prices. If the court believes this to be true,

under Pereira, Wendy would be entitled to her initial \$10K + 10% of \$10K multiplied by her years worked, which look to be 5 (2003 – 2008). This number would go to Wendy's SP and the rest would go to the CP estate.

### Van Camp

Under Van Camp, courts conclude that it was not the work of the spouse, but certain circumstances outside their control resulted in the increase of the business value. Here, Wendy will argue that because of a discovery of boxes of old coins, a renewed interest in coin collecting caused her business to boom. She will argue that she was lucky since she always wanted to start a coin business but fortunately came in at the right time. If a court believes this to be the reason why the business flourished, a court uses a different formula than the one used above. Under Van Camp, the community receives a reasonable salary minus whatever was already received minus household expenses multiplied by the number of years worked. The rest would go to the SP of the working spouse.

Under these facts, a reasonable salary would be about \$40K per year. Wendy only took out \$25K per year and also spent \$5K in household expenses per year. So \$10K would be multiplied by the 5 years she worked, resulting in \$50K going to CP. Since at the time of dissolution the company was worth \$100K, Wendy would receive \$50K as SP and her half of CP resulting in her receiving \$75K.

### Court Discretion

Although Wendy will argue for a Van Camp analysis and Herb will argue for a Pereira analysis, a court has the discretion to choose whichever one they like. Courts will look to whichever method is intrinsically fair to both parties in making their determination.

## Valid pre-nup

If the court finds that the pre-nup is valid, as Wendy claims, the property will be distributed differently. Since the pre-nup rebuts the presumption that the earnings during marriage are CP, Herb may not recover anything under either test.

Presumably, income derived from one's SP is deemed to also be SP.

Under Pereira, courts conclude that the company increases based upon the skill and effort of the other party. Here, since the skill and effort are considered earnings, Herb would not receive anything under Pereira. Both the initial down payment as well as the earnings acquired during Wendy's years working would be her SP and would result in her obtaining the full \$100K. Since Wendy would be able to argue that income from the company is both her earnings and investment, Herb would acquire nothing.

Also, under Van Camp, Herb would get nothing. Just like the analysis above, since the company was financed by SP and her earnings under the Pre-nup are SP, the entire \$100K would be characterized as SP.

## Goodwill

Herb's last ditch effort is to argue that goodwill is a community asset. Goodwill is a community property interest that increases customer retention in a business. Here Herb will argue through her enthusiasm Wendy created goodwill for the community. However, goodwill is created by the skill and effort of the working party. As stated above this is deemed part of one's earnings. Under the pre-nup, earnings are one's SP. Herb has no valid claim on receiving CP money for goodwill.

If the pre-nup is valid, Herb has no claims of CoinCo.

### **3. The Hospital Bill**

Traditionally, a party has no financial obligations after legal separation and/or divorce. Legal separation is defined as the mutual intent to no longer continue marital relations with a physical separation. Here, the facts stated that in 2008, Herb and Wendy did separate. Without other facts, it is presumed that their separation had the required intent.

An exception to the statement above states that a spouse's SP and CP is liable for necessities acquired by the other spouse. Here, in 2009, Wendy became disabled and had to be hospitalized. The facts also state that this occurred before the dissolution proceeding. Because Herb and Wendy are not divorced, Herb retains some liabilities as it pertains to Wendy's hospital bills.

Since Wendy's bill was not covered by insurance, 3 types of property may be used for fulfill the hospital obligations. First, Wendy's SP may be used. Additionally, since medical bills are deemed a necessity by California law, both the CP and Herb's SP may be used to fulfill this obligation. If in this instance Wendy is not able to use her SP to pay the bill Herb is liable to use his own property.