

## Question 2

Hank and Wendy are residents of California. Hank is a teacher and Wendy is an accountant.

In 2008, Hank and Wendy married. After their wedding, Wendy's mother deeded them a house as joint tenants. They moved into the house and used their earnings to furnish it in a lavish style, including an antique mirror in the entryway. One day, Hank gave the mirror to a friend who had admired it on a visit to the house.

In 2012, Wendy purchased a small office building where she established her own accounting practice. She paid for the building with funds saved from her earnings during her marriage and took title in her name alone.

In 2013, Hank and Wendy separated. Hank told Wendy that the house was henceforth her separate property and she said, "O.K."

After the separation, Wendy's income from the accounting practice tripled and she remodeled the office building with her increased earnings. Without Hank's knowledge, she then sold the building to Bob, who did not know that she was married.

In 2014, Wendy initiated dissolution proceedings.

1. What are Wendy's rights, if any, as to the antique mirror? Discuss.
2. What are Hank's and Wendy's rights, if any, as to the following:
  - a) The house? Discuss.
  - b) The accounting practice? Discuss.
  - c) The office building? Discuss.

Answer according to California law.

## **QUESTION 2: SELECTED ANSWER A**

### **Community Property Generally**

Since Hank and Wendy are residents of California, the law of California will be applied in their divorce proceeding. California is a community property (CP) state. The general presumption is that all property acquired by either spouse during the marriage, real or personal, is CP. On the other hand, all property that is acquired by gift, bequest, devise or descent is considered separate property (SP) of the spouse who received it. In this case, the ownership of each of the assets will depend on whether the CP presumption controls, or the actions of the parties or some other presumptions have changed the character of the property. Each asset will be discussed separately below.

### **The Mirror**

The first issue is whether Wendy has any rights in the antique mirror that Hank gave away to his friend. In this case the mirror was acquired during the marriage, and was purchased using the earnings of both parties; therefore the mirror is considered CP. There are no facts to indicate that the parties changed the character of the mirror and therefore the CP presumption is controlling.

### **Gift To the Friend**

The issue here is whether Hank has fully disposed of the mirror by giving it away to his friend. After 1-1-1975, both spouses to the marriage acquired the rights to equal management and control of the marital assets. Under the rules regarding the rights of equal management and control, one spouse may not make a gift of CP without the consent of the other spouse.

Here, Hank gave the friend the mirror, and there is no indication that he asked for Wendy's permission before doing so. Hank may argue that although spouses may not

make gifts of CP without the other spouse's permission, the general rule is that the parties can dispose of personal property. On the other hand, the general rule is that spouses may not dispose of personal property without the consent of the other spouse, for less than fair market value. Here, the facts indicate that the parties decorated their house in a "lavish style" and that the mirror was an antique; therefore it is reasonable to assume that this antique mirror was fairly valuable. Since Hank merely gave the mirror to a friend, and received no consideration for the gift, he has breached his spousal fiduciary duty owed to Wendy. The gift to the friend was improper.

When one spouse makes an improper gift, the other spouse has a right to set aside the gift. In this case, if Wendy were trying to contest the gift during the marriage, she could set aside the entire gift. However, at divorce, a spouse only has a right to set aside one-half of the gift, because the parties each have a one-half interest in all CP. In this case, Wendy would be able to set aside one-half of the gift at divorce. Since the gift was of personal property and a mirror cannot be physically divided, the court will probably value the mirror and award Wendy one-half of its value through another source of money during the dissolution.

### **The House**

Next, the court must determine how to characterize the house that was given to Wendy and Hank sometime after 2008. Since the parties were married in 2008 and the house was acquired afterwards, it is presumed to be CP. However, in this case, the house was received as a gift. The facts indicate that Wendy's mother deeded it to them as joint tenants. As discussed above, gifts during the marriage are considered to be SP of the spouse receiving the gift. In addition, when parties own property in Joint Tenancy, during the marriage it is classified as two SP halves. Therefore, during the marriage, this house would be considered two SP halves owned by each spouse.

### Actions By the Parties

The issue here is whether the discussion between Hank and Wendy in 2013 changed the character of the house. Here, the facts indicate that Hank told Wendy that the house was "henceforth her SP" and that Wendy said "ok." This is an attempt at a transmutation. A transmutation is an action by the spouses to change the character of the property that the spouses already own.

Prior to 1985, transmutations could be of the most informal character, including orally. Here, there was an oral agreement to transfer the house to Wendy's SP at the couple's separation in 2013. If this was prior to 1985, this would be valid. However, modernly a transmutation is not valid unless it is in writing, indicates that there is a change in the character of the property, and is signed by the adversely affected party. In this case, Hank would be the adversely affected party because he would be abandoning his one-half interest in the property and giving it to Wendy. However, since there was no signed writing, this oral promise to change the character of the property to Wendy's SP is unenforceable.

### Anti-Lucas Legislation

Since the transmutation was ineffective, the court must now determine how to divide the property at dissolution. Here, the property is held in joint tenancy, which is inconsistent with the basic CP presumption that all property acquired during the marriage is CP. However, under the Anti-Lucas Legislation, for purposes of dissolution only, all property held jointly is treated as CP. This presumption can only be overcome by a statement in the deed that the parties intend to hold title differently or a written companion agreement. In this case, the mother merely deeded the property to the spouses as a gift. It is unlikely that they literally intended for the property to be owned one-half by each of them as their SP. In addition, there is no written agreement indicating otherwise. Therefore, the house will be treated as CP. Since the house is treated as CP at dissolution, both Hank and Wendy have a one-half interest in the property.

The general rule is that at divorce, CP should be divided equally in kind. However, the court can fashion other relief if necessary. In this case, since Hank evidenced an intent to give the house to Wendy, the court may allow Wendy to keep the house, and just award Hank the value of one-half of the house.

### **The Accounting Practice**

Next, the court will address the accounting practice of Wendy's. Although Wendy was an accountant prior to the marriage, the facts indicate that she established her own practice in 2012 during the marriage. Since the work of a spouse is considered CP labor, the earnings a spouse earns from work are CP funds.

### Calculating the Value Of the Business

When there is a spouse that has a SP business, the court must determine how to allocate the business and the earnings from the business. The court does this by applying one of two formulas, each of which will be discussed below.

### Pereira

Under the Pereira formula, the court takes the initial investment of the spouse, multiplies it by a simple and arbitrary interest rate (typically 10%) and then multiplies that by the number of years the spouse worked in the business during the marriage. That figure is considered to be a rate of return on the initial investment, and is awarded to the spouse who started the business with her SP, the remaining amount is considered CP.

### Van Camp

Under the Van Camp formula, the court will calculate a reasonable rate of earnings for the working spouse, and multiply that by the number of years the spouse worked during the marriage. This figure would then be awarded to the community as CP. The

remaining funds would be considered SP of the spouse, and attributable to standard increases in value to the business due to the market.

In general, the court will use the Pereira formula when the increased value of the business was attributable to the work of the spouse in the business. In contrast, the courts will use Van Camp when the increase in value of the business is due to the overall market economy.

In this case, however, it does not appear that the court would use either approach. The facts indicate that the business was opened during the marriage, using money that Wendy had earned during the marriage. Because the money was earned during the marriage, the business itself is considered CP and not Wendy's SP. Therefore, the accounting business as of 2013 should be considered CP and should be divided equally between the parties at dissolution.

#### Post-Separation Earnings

In this case, the facts indicate that the earnings of the accounting practice tripled after the separation. The general rule is that marital community ends when there is physical separation of the parties with no intent to rekindle the relationship. Here, the facts indicate that the parties separated in 2013. It is unclear whether there was physical separation, but since Hank told Wendy that the house was her SP, it is likely that he moved out of the house at that time. If the court finds that 2013 was the date the marital community ended, then no CP could be established after that time, and all of the increased earnings in the accounting practice would be Wendy's SP. If the court finds that there was no true separation until 2014 when Wendy filed for divorce, then the accounting practice value as of 2014 would be divided equally between the parties as CP earned during the marriage. But, under these facts, it is most likely that the court will find that 2013 was the date that the marital community ended, and award the increased profits to Wendy as her SP.

## **The Office Building**

Last, the court must determine the character of the office building in order to determine if Hank has any interest in it, notwithstanding the fact that Wendy sold it to Bob.

The property was acquired during the marriage using funds from Wendy's earnings; therefore the office building is initially characterized as CP.

### Actions Of the Parties

The issue here is whether the general CP presumption can be rebutted since Wendy took title to the property in her name alone. Under California law, there is a form of the title presumption, which holds that the holder of record title to a property is presumed to be the true owner. In this case, Wendy will argue that the property is hers because she took title in her name alone, and therefore the form of the title prevails.

However, in order for the form of the title presumption to apply, the title must itself have evidentiary value. In this case, the title may not prevail, because there are no facts to indicate that Hank agreed to her taking title in her name alone. Wendy may argue that since the office was purchased with CP earnings, the community made a gift to her and she could take the property as her SP. However, there are no facts to support this. There is no evidence to show that Hank knew that she took title in her name alone, let alone that he agreed for her to do so. Therefore, the title will not be controlling. Since the property was acquired with CP funds, the property will be considered CP.

### Post 2013 Actions

Although the property will be classified as CP, the court must determine how to handle the fact that Wendy remodeled the business with her increased earnings after the date of separation. As discussed above, all property that is acquired after the date of

separation is considered to be SP of the acquiring spouse. In this case, Wendy's earnings from her accounting practice post 2013 are characterized as her SP.

### SP Improvements To CP

Since the money used in the remodel was Wendy's SP, the court will treat this as a SP improvement to a CP asset. Historically, if a spouse contributed SP to a CP asset, it was considered a gift. However, modernly the general rule is that if a spouse contributes SP to a CP asset, he can be reimbursed for SP down payments, loan reductions, and improvements. Here, Wendy remodeled the office building and therefore this will be characterized as an improvement. Wendy will then be entitled to reimbursement to her SP for either the cost of the improvement, or the increased value to the building because of the improvement.

### The Sale to Bob

In this case, the classification of the office building is slightly complicated by the fact that Wendy sold the property to Bob. The general rule is that when disposing of CP real property, both spouses must participate in the sale and sign the appropriate documents. However, in this case, the facts indicate that Wendy sold the house without Hank's knowledge, which means he clearly did not participate in the sale. Here, it was easier for Wendy to do this, because the house was titled in her name alone and therefore Bob was unaware that she was married.

When a spouse disposes of real property without the consent of the other spouse, the injured spouse can set aside the sale if it is done within one-year of the sale. In this case, the facts are not clear when exactly the sale took place, but it was sometime between 2013 when they separated and 2014 when Wendy initiated divorce proceedings; therefore one year has not passed. Hank may be able to set aside the sale once the court makes the determination that the office building was in fact CP. On the other hand, since Bob did not know that Wendy was married and he bought the



building for consideration, he is considered a bona fide purchaser. The court may not want to injure Bob by voiding the sale, so the court may instead award Hank the value of one-half of the building.

### Spouse's Obligations to Each Other

As discussed above, spouses have equal management and control of the CP assets. In addition, spouses are in a reciprocal fiduciary relationship with each other, and therefore owe each other a duty to act fairly and honestly with each other. If the court finds that Wendy acted fraudulently when she took title in her name alone and when she sold the property to Bob without Hank's knowledge, then the court could penalize her for this fraudulent behavior for breaching her fiduciary duty to Hank. Since the fiduciary duty continues until the assets have been fully divided in dissolution proceedings, Wendy still owed Hank this duty as of the date that she sold the property. However, absent a showing of fraud, the court will divide all of the assets as discussed in detail above.

## QUESTION 2: SELECTED ANSWER B

California is a community property state and all property acquired during a marriage and before permanent separation is presumed to be community property ("CP"). Any property acquired by either spouse before marriage or after permanent separation is presumed to be separate property ("SP"), as is any property acquired by either spouse by gift, devise or bequest. At divorce, a court generally will award each spouse one-half of the CP in kind.

1. What are Wendy's rights, if any, as to the antique mirror?

The issue to be considered in determining Wendy's rights, if any, in the antique mirror, is whether the antique mirror is CP and whether Hank had a right to give the mirror to his friend.

The mirror is CP. Any property acquired during Hank and Wendy's marriage with CP is presumed CP. Earnings of either spouse are considered CP. Because the mirror was purchased with Hank and Wendy's earnings, it will be CP.

Under California law, both spouses have equal rights to manage and control CP. Thus, one spouse may not dispose of a piece of CP without the permission of the other spouse. Because Hank did not seek Wendy's permission in making a gift of the mirror, the gift is invalid and Wendy may try to rescind the gift and reclaim the mirror as CP. In the alternative, if the mirror is not recoverable, Hank may be required by the court to reimburse the community for the value of the mirror. Thus, in any event, unless Wendy consented to the gift, Wendy will retain her one-half interest in the antique mirror.

2. What are Hank's and Wendy's rights, if any, as to the following:

a) The house?

To determine Hank's and Wendy's rights, if any, in the house, we must determine whether the house is CP and whether any subsequent action altered that characterization.

The house was deeded to Hank and Wendy after their marriage as joint tenants. Under California law, any property held by husband and wife as joint tenants is presumed to be CP as holding in joint tenancy is antithetical to SP status; however, if the property is purchased or improved with SP, the SP is entitled to reimbursement from the community on divorce. (In contrast, on death, Lucas holds that any contribution by SP to property held in joint tenancy is a gift and there is no right to reimbursement.) The fact that Wendy's mother deeded the house to Hank and Wendy will not overcome the presumption that property held in joint tenancy will be considered to be CP. Although property given as a gift to one spouse (as one might have assumed Wendy's mother would have done) will be presumed to be SP, here Wendy's mother explicitly deeded them the house as joint tenants. Hence, it will be presumed to be CP as discussed above. Thus, prior to separation, each of Hank and Wendy had a one-half in kind interest in the house.

After the separation (which I presume for purposes of this question is a permanent separation as there are no facts to the contrary indicated in the question), Hank told Wendy that the house was henceforth her separate property and she said "O.K." In order to effectively transmute property that is CP to SP, and vice versa, under California law a valid transmutation agreement is required. Prior to 1985, an oral agreement could be effective to transmute property. However, after 1985, a transmutation must be in writing to be valid. As the purported agreement to cause the house to be SP occurred in 2013, it will be invalid. Thus, the house will remain CP and each of Hank and Wendy have a one-half in kind interest in it.

b) The accounting practice?

To determine Hank's and Wendy's rights, if any, in the accounting practice, we must determine whether the accounting practice is CP and whether any subsequent action altered that characterization.

Wendy established her accounting practice during the marriage with her labor. Any property acquired during Hank and Wendy's marriage with CP is presumed CP. Labor and earnings of either spouse are considered CP, and any goodwill created during the marriage and before permanent separation is CP. Although California allows the value of a business to be divided between SP and CP where the business was originally SP and appreciated during marriage, those rules (e.g., *Pereira* and *Van Camp*) will not apply here as the practice was established during the marriage. Thus, the value of the accounting practice that accrued until permanent separation is CP, and each of Hank and Wendy will be entitled to a one-half in kind interest therein.

However, here the facts state that Wendy's income from the accounting practice tripled after the separation. All property acquired after permanent separation is SP, including labor and wages of each spouse. Thus, Wendy's increased income post-separation and the post-separation increase in value to the accounting practice (because attributable to Wendy's labor) will be Wendy's SP and Hank will not have any interest therein.

c) The office building?

To determine Hank's and Wendy's rights, if any, in the office building, we must determine whether the office building is CP and whether any subsequent action altered that characterization.

The office building was purchased by Wendy in 2012 with funds from her earnings during marriage and she took title in her name. Under California law, all property acquired during marriage is presumed to be CP even if titled in one spouse's name. Here, we know that Wendy purchased the office building with her earnings during the

marriage. Under California law, such earnings are CP. Thus, because the office building was purchased with CP it will be CP notwithstanding that title is in Wendy's name alone, the presumption that the office building is CP will not be overcome, and as of separation each of Hank and Wendy have a one-half in kind interest in it.

After separation, there are two issues to consider to establish Hank and Wendy's respective rights with respect to the office building.

After permanent separation, Wendy's earnings become SP. The issue is whether Wendy's. Under California law, when CP is improved with SP, the property remains CP but the SP is entitled to a right of reimbursement from the community. Here, after separation when Wendy remodeled the office building with her increased earnings, she was entitled to reimbursement from the community for any increased value to the office building that resulted.

Wendy subsequently sold the office building to Bob, who did not know she was married. The issue is whether that sale is valid or whether it can be rescinded. Under California law, both spouses have equal rights to manage and control CP. Thus, one spouse may not dispose of a piece of CP without the permission of the other spouse. Where, as here, one spouse sells CP without the consent of the other, the sale may generally be rescinded within the first year, unless the sale is made to a bona fide purchaser. A bona fide purchaser ("BFP") is a purchaser for value who takes without notice of the claims of any other person. In the context of community property, to be a BFP a purchaser must not know that a seller is married. Here, we know that Bob did not know Wendy was married and the deed was in her name alone. Thus, he did not have notice of Hank's interest in the property and will be a BFP. Because Bob is a BFP, the sale cannot be rescinded. Even so, Wendy will be required to reimburse the community for the purchase price (although, as noted before, she will herself be reimbursed for the value of her SP improvements).

Thus, although neither Hank or Wendy will have an interest in the office building itself, Hank will have a one-half interest in the purchase price of the office building (less the value of the remodeling, if any) and Wendy will have a one-half interest in the purchase price of the office building and a right to be reimbursed for the costs of the remodeling.