

Question 6

Husband and Wife married in 1997 in California. Neither of them brought any significant assets to the marriage, and they were both employed. Husband and Wife agreed that Husband should go to law school after they had saved up some money. Husband put his earnings in a savings account in his name alone. Wife deposited her earnings into a joint checking account in both of their names, which was used for their living expenses. Husband had a child support obligation from a previous marriage. Every month, Husband paid his child support by check from the joint checking account.

Husband began law school in 1998. Wife continued to work to support the couple. Husband took out a student loan to pay his tuition. Husband graduated in 2001 and obtained his law degree. He passed the bar exam and got a position with a large law firm.

In 2004 Husband became a partner in the firm. Husband's partnership earnings were substantial. He paid off his student loan using these earnings. Although the actual value of Husband's share of the firm's goodwill was substantially greater, the partnership agreement provided that its value was \$3,000 for purposes of valuation as marital property in the event of a dissolution of a partner's marriage.

In 2006, Husband and Wife filed for dissolution of marriage.

1. Is the community entitled to reimbursement for
 - (a) The child support? Discuss.
 - (b) The payments on the student loan? Discuss.

2. Does the community have an interest in
 - (c) Husband's law degree? Discuss.
 - (d) The goodwill in Husband's law firm and, if so, is the community bound by the firm's valuation? Discuss.

Answer according to California law.

Answer A to Question 6

California is a community property state. All amounts earned through the community labor of married California residents are presumptively community property, which means that they are owned together, equally, by the husband and wife (or by the domestic partners). All items earned through gift, bequest or devise to an individual spouse remain that spouse's separate property. Community property continues to accrue until the end of the economic community, which occurs with physical separation and an intent not to resume the marriage. Certain presumptions arise from form of title, and CP may be transferred to separate property and vice versa.

Community's Reimbursement Claims

Child Support

The community remains liable for all credit obligations of each individual spouse, whether acquired before or during the marriage. Thus, Husband's ("H") child support obligations, although they arose before marriage, may still be satisfied from the community property jointly owned by the couple. However, by statute, the community is entitled to reimbursement for child support payments that arise from a prior marriage of one of the spouses, if that spouse's separate property was available at the time to satisfy the obligation. Here, H and W married when neither of them had any significant assets, although they were both employed. If H had no available separate property at the time he made the child support payments, those obligations were legitimately paid out of community funds, and the community has no right to reimbursement. The payments were made from H and W's joint checking account, which is funded entirely with W's earnings. Since W's earnings are CP, the payments on the child support were made with CP (by H writing checks drawing on the joint checking account).

Savings account in H's name alone

The fact that H opened a savings account in his name alone does not defeat the presumption that his earnings remain community property. Title in one spouse's name, if the name on the bank account can be considered title, does not prohibit tracing to the source of the funds. It may, in certain circumstances, be evidence of a gift from the community to that spouse. However, when the spouse takes title in his or her own name, no inference of a gift will arise. Also, it may serve as a bar to the other spouse's premarital creditors, if the non-debtor spouse's CP earnings are placed in the separate account and the debtor spouse has no access to it. However, here it is H who has the obligation. Thus, because the separate savings account was funded only with H's earnings, it will be deemed to be community property, since the earnings of one spouse through labor are community property. And, because any profit from community property remains community property, whatever interest H has earned will remain CP. Of course, the facts do indicate that H and W were both employed when they entered the marriage. Thus, it is possible that some of the earnings H used to fill the savings account were his premarital earnings. H might attempt to trace some of the value of the savings

account to those funds. However, where assets have been commingled, they are presumptively community property and W will have a hard time asserting the amount of separate property in H's account. If she were able to trace, the community would be reimbursed to the extent that those separate property funds (if any) were available to pay for the child support.

Transmutation and the savings account

In order for the separate account to constitute a transmutation of CP to H's separate property, the agreement would need to be in writing, with W (as the adversely affected) spouse expressly conveying the interest to H and signing the writing. Here, H's name on the bank account does not constitute a transmutation.

Thus, community property was properly used to pay for the child support payments, even if they were a premarital obligation of H. Because H had no apparent separate property available when the payments were made, the community is not entitled to reimbursement.

Payments on student loan

A loan constitutes community property to the extent that the lender relied on community property in making it. Here, H decided to go to law school and take out loans while he was married to W. The lender presumably relied on the future earnings of H and W's current income, all community property at the time. Thus, the "intent of the lender" makes this a community loan. Moreover, H used his earnings as a lawyer to pay off this loan, thus it was paid for entirely with community property. By statute, the community is entitled to reimbursement, with interest, when community funds are used to pay for the education of one spouse which greatly enhances that spouse's earning capacity. Here, H's law degree has resulted in him becoming a lawyer at a large law firm, with a presumably generous salary. Thus, the degree has greatly enhanced H's earning capacity. The community is therefore entitled to reimbursement for the amount of the student loan used for the education itself (not for the amount used for ordinary living expenses), with interest. However, if H can establish an equitable defense, reimbursement will not apply.

Equitable defenses to community reimbursement

Where the community has already substantially benefited from the increased earnings due to one spouse's education, there will be no reimbursement to the community at divorce. Substantial benefit is presumed where the community has benefited from the increased earnings for 10 years. Here, H began working in 2001, as an associate presumably, and became a partner in 2004. The couple is now seeking a divorce in 2006. Thus, at most, it has benefited from H's earnings for 5 years, which does not constitute a substantial benefit.

Also, where community funds have been used to pay for an education for the other spouse as well, the community is not entitled to reimbursement. Here, W worked the entire time H was in law school, and did not benefit from an education. Thus, this

defense will not apply.

Finally, where the degree has lessened the obligations of one spouse to pay for support of the educated spouse post-divorce, reimbursement may not apply. Here, it is unclear what W's earning capacity is. If she is extremely well paid (a CEO perhaps) then she might still be under an obligation to pay spousal support to H post-divorce, and this obligation might be lessened by H's ability to earn a lawyer's salary. However, there are no facts indicating what W makes, so this defense presumably does not apply.

Community's Interest in H's Law Degree and the Goodwill of H's Law Firm

Law degree

By statute, professional degrees earned by one spouse during the marriage are not community property, although as noted above the community may be entitled to reimbursement for the cost of acquiring that education. That one spouse worked to pay for the education is irrelevant to the ownership of the degree. The reimbursement interest does not amount to a community interest in the degree itself – meaning an interest in the present discounted value of the future earnings attributable to the degree. Thus, the law degree remains H's separate property going forward, and the community is entitled only to reimbursement with interest for the cost of acquiring the degree.

Goodwill

Goodwill is the value of a business over the expected normal rate of return on the capital invested in that business. In essence, it constitutes the intangible value of the business' reputation above and beyond the raw liquidation value of the business. When the goodwill is generated by community labor, it is a community property asset. Here, H's share of the goodwill was earned entirely while he was married to W. Thus, the goodwill itself is a community property asset.

Valuation and the Partnership Agreement

The valuation of goodwill occurs by one of two methods. First, it can be valued by capitalizing the future stream of income to a present fixed sum (according to varying calculations). Second, it can be valued by looking to the "market price" of the interest. The latter is established by bona fide offers to purchase the business or concern. Here, the partnership agreement of H's firm specifies that the value of H's share in the firm's goodwill is valued at \$3,000, but only "in the event of a dissolution of a partner's marriage." However, the community is not bound by this valuation, because it does not constitute a valid market valuation of H's goodwill interest. Buy/sell options in a partnership agreement created by the relevant spouse's firm will not control the valuation of that spouse's interest at divorce. This is because of the obvious risk of abuse inherent in such a valuation. The partner-spouse could agree with his or her other partners to create a very low valuation only for purposes of divorce, in order to deprive the non-partner spouse of his or her rightful share of the partner spouse's interest. Here, that seems to be exactly what has occurred, especially given that the agreement expressly provides that it only applies when one of the partners gets divorced. Thus, the \$3,000

valuation will not control, and the court will apply the capitalization (or some other) method.

Valuation of a SP business

The Van Camp and Pereira doctrines would not apply here, since H did not enter into the marriage with a SP business interest. Thus, to the extent the law firm is considered a business, and H considered an owner, H's interest will be entirely community property, as noted above.

Answer B to Question 6

Community Property

California is a community property state. All property acquired during marriage is presumed to be community property (CP). All property acquired before marriage or after legal separation is considered separate property (SP). Further, all property acquired by either spouse during marriage by gift, bequest or devise is that spouse's separate property. Upon dissolution of marriage, all community property assets are subject to equal division in kind unless statute or policy requires otherwise.

(1)(a) Is the community entitled to reimbursement for the child support payments?

Child Support

Child support obligations from a previous marriage are considered the separate property obligation of the acquiring spouse. However, during marriage, community funds may be reached to satisfy any payments. Upon divorce, the community is entitled to reimbursement for any child support payments made with community property funds when separate property funds were available.

Here, H had a child support obligation from a previous marriage. Every month he paid his child support by check from the joint checking account held in both H and W's names. The checking account contained W's earnings during marriage; thus the checking account contained community property, because all earnings during marriage are considered community property. The issue is whether H had separate property funds available at the time the payments were made.

Bank Account titled in H's name alone – transmutation?

The fact that a bank account is titled in one spouse's name alone does not automatically rebut the community property presumption. Any change to the character of a community property asset after 1985 is required to be in a signed writing, specifically indicating that the nature of the asset is being transmuted.

Here, H opened a bank account in his own name in 1997; however, he deposits into that account his earnings. All earnings during marriage are presumed to be CP. There is no indication that there was a written transmutation of these funds from CP to H's SP; thus the CP presumption cannot be rebutted and all of H's earnings in his savings account will be considered CP.

Also, neither H nor W brought any significant assets to the marriage. Thus, it does not appear that H had any SP assets available at the time the CP funds were used to pay the child support payments. As such, the community will not be reimbursed for any payments made.

(1)(b) Is the community entitled to reimbursement for the payments on the student loan?

Debts

Generally, all debts acquired during marriage are considered community property. However, if it was the intent of the lender to only look to satisfaction of the debt by one spouse's SP, then the debt will be a SP debt.

Here, H took out educational loans to obtain a law degree. Any educational debt acquired during marriage is CP; however, upon divorce, it will be assigned to the acquiring spouse. Thus, it is likely that the lender only looked to H's SP to satisfy the debt knowing that if H and W were divorced, only H would be liable on the debt. However, there are no specific facts to support this argument.

Education

Any education acquired during marriage is the SP of the acquiring spouse. However, upon dissolution of marriage, the community is entitled to reimbursement for any payments made to finance the education if the education substantially increased the spouses' earning capacity unless (1) the community has already substantially benefited from the education; (2) the other spouse also received a community funded education; or (3) obtaining the education offset the need for spousal support.

Here, H obtained a law degree. H began law school in 1998 and W continued to work to support the couple. H took out a student loan to pay his tuition. H graduated in 2001, passed the bar and got a job with a big law firm. Being a lawyer substantially enhanced his earning capacity because in 2004, he became a partner and his earnings were substantial. H paid off his student loan using these earnings. Because H used his earnings during marriage to pay off the loan, the loan was paid off with community funds. Thus, the community financed H's education. As such, the community is entitled to reimbursement unless an exception applies.

Has the community already benefited?

If the spouse has had the education for more than 10 years, there is a presumption that the community has already benefited from the education and no reimbursement is required. Here, H got his law degree in 2001 and H and W filed for dissolution in 2006. Thus, H has only had the job for 5 years at the time of dissolution and the presumption will not apply.

On the facts, no other exception applies. W did not receive a community funded education, and there is no indication that without the education, H would have needed substantial child support. Thus, the community is entitled to reimbursement of the community funds spent to pay off H's student loan.

(2)(c) Does the community have an interest in H's law degree?

Education

Any education acquired during marriage is the SP of the acquiring spouse. As discussed above, the community is only entitled to reimbursement for any community funds spent to finance the education if the education substantially enhanced the spouses' earning capacity. Further, educational debt remaining at the time of dissolution is assigned to the acquiring spouse.

Here, there is no debt remaining on H's education. The community will take no interest in H's education, but as explained above, will be reimbursed for the funds expended to pay off H's loans.

(2)(d) Does the community have an interest in the goodwill of H's law firm and, if so, is the community bound by the firm's valuation?

Goodwill

All assets acquired during marriage by the labor and efforts of a spouse are community property, and goodwill is no exception. The goodwill of a professional practice is a community asset. Goodwill is the value of the continued patronage to the practice. It is the value of the business that is not derived from personal skill or the value of the assets of the business. It can be valued by expert testimony or by capitalizing the excess earnings of the practice.

Here, H will argue that no valuation is necessary because the partnership provides that its value was \$3000 for purposes of valuation as marital property in the event of a dissolution of a partner's marriage. However, this argument is likely to fail. In a similar case, the California Supreme Court held that any valuation provided for in a partnership agreement may be considered in valuing the goodwill of a professional practice, however, it is not conclusive as to the value. Further, the court indicated an unwillingness to let partners contract with each other in order to defeat the community property system.

Thus, the court may consider the agreement as evidence of value, but ultimately will allow W to put on evidence of an expert to explain what the goodwill of the business is really valued at. This will be considered CP and subject to equal division in kind.