

Question 3

In 2007, while married to Hank and residing in California, Wendy inherited \$150,000. Wendy used the money to purchase \$50,000 worth of Chex Oil stock and a restaurant that cost \$100,000. Hank managed the restaurant and, solely through his own efforts, it prospered and is now worth \$300,000.

In 2008, Hank inherited an unimproved lot in California worth \$75,000. Hank and Wendy obtained a construction loan from a bank for the purpose of building a rental house on the lot. In making the loan, the bank relied upon the salaries earned by both Hank and Wendy and, in addition, required that Wendy pledge the Chex Oil stock. A rental house was constructed on the lot. The present market value of the property, as improved, is \$500,000.

In 2011, Cathy, a customer at the restaurant, tripped and fell over a box carelessly placed in the entryway by Hank. She obtained a judgment against Hank for injuries suffered in the fall.

Hank and Wendy have now decided to dissolve their marriage.

1. What are Wendy's and Hank's respective rights in:
 - a. The Chex Oil stock? Discuss.
 - b. The restaurant? Discuss.
 - c. The rental property? Discuss.
2. To satisfy her judgment, may Cathy reach the community property, Hank's separate property, and/or Wendy's separate property? Discuss.

Answer according to California law.

SELECTED ANSWER A

Community Property

California is a community property (CP) state. All property acquired during marriage is community property. Separate property (SP) includes property owned before marriage, property acquired by gift, will, or inheritance during marriage, rents, issues, and profits from SP, and earnings after separation.

Characterization of property as either CP or SP depends on: (1) the source of the property; (2) any legal presumption affecting the property; and (3) any actions of the parties that may have changed the character of the property.

With these principles in mind, each item of property will be analyzed.

The Chex Oil Stock

Source

In 2007, while married to Hank (H), Wendy (W) inherited \$150,000. Wendy used the \$150,000 inheritance to purchase \$50,000 of Chex Oil stock and a \$100,000 restaurant. Thus, the source of the Chex Oil stock was W's inheritance, which is W's SP.

Presumptions

All property acquired during marriage is presumed CP. This presumption can be rebutted by tracing to a SP source or by an agreement to the contrary. Here, W can trace the \$50,000 used for acquisition of the Chex stock to her \$150,000 inheritance. W's inheritance is her SP. Thus, the general CP presumption is rebutted by tracing the funds used to purchase the stock to a SP source, the inheritance.

Actions

The only action taken by the parties with respect to the Chex stock was to pledge it as collateral for the loan to build the rental property.

Parties may transmute property from SP to CP and vice versa, which is a change in character of the property. After 1/1/1985, any transmutation must be in writing, clearly state the change in character of the property, and be signed by the spouse whose interest is adversely affected.

Here, there was no agreement between H and W that the Chex stock be transmuted from W's SP to CP. The fact that the bank required H and W to pledge the Chex stock as collateral for the bank loan to build the rental property is not sufficient evidence of a transmutation because it does not state any intent that W is transmuting her SP to CP.

Thus, the pledging of the Chex stock as collateral does not change the character of the stock.

Disposition

Because the stock can be traced to a SP source, the general CP presumption is rebutted, and has had no change in character; the Chex stock is W's SP. Now that H and W are seeking dissolution of their marriage, the Chex stock will be awarded solely to W as her SP.

The Restaurant

Source

In 2007, while married to H, W inherited \$150,000. Wendy used the \$150,000 inheritance to purchase \$50,000 of Chex Oil stock and a \$100,000 restaurant. Thus, the source of the restaurant was W's inheritance, which is W's SP.

Presumptions

All property acquired during marriage is presumed CP. This presumption can be rebutted by tracing to a SP source or by an agreement in writing to the contrary.

Here, W can trace the \$100,000 used for acquisition of the restaurant to her \$150,000 inheritance. W's inheritance is her SP. Thus, the general CP presumption is rebutted by tracing the funds used to purchase the restaurant to a SP source, the inheritance.

Actions

Hank managed the restaurant during the marriage.

CP Contribution to SP Business

A spouse's effort, skill, and industry during marriage is a CP asset. Where a spouse contributed his or her effort, skill, and industry during marriage to his or the other spouse's SP asset, and the asset increases in value, the community receives an interest in the asset. There are two different accounting methods to determine the value of the respective SP and CP interests in the business at dissolution.

Here, H contributed his effort, skill, and industry, which is a CP asset, to the restaurant, which is W's SP asset, during marriage.

The court is not required to use either formula and may choose, or may use whichever formal the parties provide evidence in support of.

Pereira

The Pereira formula is used where the major factor contributing to the increase in value is the spouse's personal effort. Under Pereira, the value of the SP portion of the asset is equal to the value of the SP asset at the time of marriage or the time of acquisition during marriage, plus a reasonable rate of return, usually 10% per annum. The residual value belongs to the community.

Here, managing a restaurant takes personal effort and industry. The facts state that "solely through [H's] own efforts, it prospered." Thus, it appears that Pereira would be the more appropriate formula to use in this circumstance.

Here, the restaurant was purchased in 2007 for \$100,000. Now, in 2013, H and W seek dissolution of marriage. Assuming that the purchase price was the fair market value of the restaurant at the time, the SP portion of the restaurant will be equal to \$100,000 plus \$10,000 per year for six years, or \$160,000. The residual value, of \$140,000 (\$300,000 - \$160,000) is the community's interest in the restaurant.

Thus, under the Pereira formula, the restaurant will be \$160,000 CP and \$140,000 SP.

Van Camp

The Van Camp formula is typically used where the SP business is valuable and increases in value due to the existence of the business and market forces, and not the personal effort or industry of the spouse. Under Van Camp, the community receives a reasonable salary in return for the spouse's contribution of time and effort, reduced by the amount of community expenses paid by the returns from the business. The residual is the owning spouse's SP.

Here, as explained above, the restaurant in value because of H's contribution of effort and industry, not because of market forces. Thus, the Van Camp formula is probably not the more appropriate formula.

Under Van camp, the community would be credited with a reasonable salary for the 6 years that H spent managing the restaurant, less any community expenses paid by the returns from the restaurant. The balance will be W's SP.

Disposition

Since Pereira is probably the better formula, the restaurant will be \$160,000 CP and \$140,000 SP.

The Rental Property

Source

In 2008, H inherited an unimproved lot worth \$75,000. Inheritance during marriage is the inheriting spouse's SP. Thus, the source of the lot is H's SP.

Regarding the construction loan, the personal credit of either spouse during marriage is a community asset. Here, a loan was obtained from the bank for the construction of the rental property. The loan was obtained in both spouses' names and the bank relied upon the salaries earned by both H and W. The bank also required W's Chex stock as collateral.

Since the bank relied on the personal credit of both spouses, the bank loan is CP.

Presumptions

All property acquired during marriage is presumed CP. The presumption can be rebutted by tracing to a SP source or a written agreement to the contrary. Here, the lot was acquired in 2008, during the marriage. However, the lot can be traced to H's inheritance, which is SP. The bank loan is presumed CP because it was acquired during marriage. There are no facts that can rebut this presumption. W may argue that her pledge of collateral of the Chex stock makes the bank loan her SP, but this argument will be rejected because the bank specifically relied on the salaries earned by both H and W.

Actions

Improvement of Separate Real Property with CP

Here, the bank loan (CP) was used to improve an SP asset (H's lot).

Where CP is used to improve a SP asset, the community is entitled to an interest. The formula used for calculating such an interest is from *In re Marriage of Moore*. The community is entitled to reimbursement for the value of the contributions for down payment, improvements, and payment of principal, plus a pro rata share of the appreciation.

Here, the community will receive reimbursement of the principal payments made on the bank loan, plus a pro rata share of the appreciation calculated by dividing the CP contribution by the total contribution of SP and CP. The facts do not give enough details to make such a calculation, but it will be some portion of the \$500,000 present market value.

Disposition

The rental property is part CP and part SP as discussed above. The CP portion will be divided equally upon dissolution.

What Can Cathy Reach to Satisfy Her Judgment?

Liability of CP and SP for Tort Judgment

CP is liable for all debts incurred by either spouse before or during marriage. Where a judgment results from a tort committed by one spouse, the order of satisfaction of the judgment depends on whether the tortfeasor spouse was acting for the benefit of the community at the time the act giving rise to the judgment was committed. If the tortfeasor spouse was acting for the benefit of the community, the judgment may be satisfied first by CP and then by the tortfeasor spouse's SP. The non-tortfeasor spouse's SP is not liable. If the tortfeasor spouse was not acting for the benefit of the community, the judgment may be satisfied first from the tortfeasor spouse's SP and then from CP. The non-tortfeasor spouse's SP is not liable.

Here, H placed a box in the entryway of the restaurant, presumably while working at the restaurant. Cathy, the customer, obtained a judgment against Hank. If Hank was working at the restaurant and placed the box in the entryway negligently, in the course of his work, he was acting for the benefit of the community because the community had an interest in the restaurant and H's wages from the restaurant were CP. Alternatively, if H placed the box there and injured Cathy intentionally, or did not place the box there as part of his work at the restaurant, he was not acting for the community. Here, it is probably more likely he was acting for the benefit of the community.

As such, Cathy must first satisfy her judgment from CP, which includes a portion of the restaurant and a portion of the rental property. Once CP is exhausted, and if it is, Cathy must satisfy the balance of her judgment from H's SP, which includes a portion of the rental property. Cathy cannot reach the portion of the restaurant that is W's SP and cannot reach the Chex Oil stock, which is also W's SP.

SELECTED ANSWER B

California is a community property state. In California, there is a community presumption. Under the community presumption, property obtained during marriage by the spouses is presumed community property. There are also areas of separate property. Property obtained by either spouse before or after the marriage is typically separate property. Additionally, any property obtained by gift, will, or inheritance by either spouse is that spouse's separate property. Property that is obtained using separate property also remains separate property. With these considerations, Hank and Wendy's respective rights will now be considered.

1. Hank and Wendy's Rights in Property

Chex Oil Stock

While married to Hank and residing in CA, Wendy inherited \$150,000. As described above, an inheritance by a spouse is separate property of that spouse despite the community presumption. Wendy used \$50,000 of this money to buy the Chex Oil stock. The use of separate property to obtain other property results in that other property remaining separate property. Therefore, the Chex Oil stock was separate property when it was bought by Wendy.

Hank may argue that Wendy intended to make the stock a gift to the community when she used it as part of the collateral for the loan obtained by the couple in 2008. Since 1985, however, a transmutation of property from separate property to community property must be in writing and show the intent of the separate property holder to effectuate a gift to the community. Because Hank would not be able to produce such a writing, he will not be able to show that Wendy made a gift to the community.

The Chex Oil stock is Wendy's separate property.

Restaurant

While married to Hank and residing in CA, Wendy inherited \$150,000. As described above, an inheritance by a spouse is separate property of that spouse despite the community presumption. Wendy used \$100,000 of this money to buy the restaurant.

As described above, the use of separate property to purchase other property results in that property remaining separate property. Therefore, the restaurant was separate property when it was bought by Wendy.

The restaurant has increased in value because of Hank's efforts. Hank's labor is considered community property. The use of community property to enhance the value of a spouse's separate property is analyzed by the court in different ways.

When the separate property is the separate property of one spouse and then other spouse uses community property to enhance the value of the first spouse's separate property, courts in CA may sometimes consider this a gift by the second spouse to the first spouse. Here, Hank used community property assets (his labor) to increase the value of the separate property owned by Wendy (her restaurant). Some courts may interpret this as a gift by Hank to Wendy.

The gift interpretation, however, is more likely to be used when a monetary or similar transfer of community property is made to enhance the separate property's value. Here, Hank worked for at least 4 years (depending on when they seek dissolution of the marriage – it could be 6 years) at the restaurant. It is unlikely he intended these years of work to be a gift to Wendy's separate property. Some courts will refute the presumption that the community property going to the other spouse's separate property was a gift and instead hold that the portion is community property.

In determining what portion is community property, courts will apply analysis either from the *Pereira* case or the *Van Camp* case.

The *Pereira* formula is often applied when the labor of the spouse has resulted in the increase in the value of the business. This is the case here, where the facts state that the restaurant has prospered "solely through his own efforts" as manager of the restaurant. The *Pereira* formula considers the value of the property at the time it was acquired (or time of the marriage if that comes after), and gives the spouse owning the separate property a fair return on the investment, which would be 10% per annum. Based on this analysis, and assuming 6 years have passed, Wendy would get 10% of the restaurant's initial value, or \$10,000, each year. This would result in \$60,000 of

increase. So \$160,000 of the property remains Wendy's separate property and the other \$140,000 is community property.

The fact that Hank was working instead of Wendy does not change this analysis. Typically the owning spouse may work on her own separate property. Regardless, community property (Hank's labor) was put towards the business to make it grow, and so the *Pereira* formula would view the fair investment return to be community property.

The *Van Camp* formula applies when the property increases in value because of its inherent worth. This does not apply here because the property increased due to Hank's efforts, not the restaurant existing itself. This formula would look at the reasonable rate of compensation for the spouse and deduct the expenses of the couple. The remaining value of the salary would be community property, and the remaining value of the business would be separate property of the spouse. As mentioned above, it does not apply here because the restaurant increased in value due to Hank's efforts and because it was Hank working on the property rather than Wendy.

Their respective rights in the property should be \$160,000 separate property of Wendy and \$140,000 community property, which the couple would split upon divorce.

Rental Property

While married to Wendy and residing in CA, Hank inherited an unimproved lot worth \$75,000. As described above, an inheritance by a spouse is separate property of that spouse despite the community presumption. The unimproved lot, therefore, was separate property of Hank.

The community then obtained a loan to improve the property into a rental property. Whether a loan is considered community property or separate property depends on what the creditor looked at for satisfaction of the loan.

Here, the creditor looked at the salaries of each and the value of the Chex Oil stock. Because of the inclusion of the Chex Oil stock, Wendy may argue that the loan should be considered her separate property that then went into the rental property. The value of the stock, however, was only \$50,000. In order to go from an unimproved lot to a rental property worth \$500,000, the creditor likely made a substantial loan and relied

primarily on the salaries of each spouse. The salaries of each spouse at that time, and therefore their creditworthiness, is a community asset. The loan, therefore, should be considered a community asset.

As above, this involves the use of community property to enhance the value of separate property of a spouse. Hank may argue that Wendy intended her use of community property to enhance the value of his separate property to be a gift. Courts have analyzed this in different ways, as described above. Here, it is unlikely that a court would determine this to be a gift and instead hold that the community has some interest in the property.

Wendy may argue that Hank intended a gift to the community by using the community loan to build up his property. As explained above, however, a transmutation requires a clear writing by the party giving the gift. Here, there is no writing showing that Hank intended a gift. The court would determine that Hank did not gift the entire property to the community.

Instead, the court must then determine what percentage of the property is community property. The land went from unimproved and worth \$75,000 to improved and worth \$500,000.

Wendy may argue that the increase should all be considered community property, potentially subject to a reasonable increase in the original investment. This would essentially be like an argument that *Pereira* should apply because it is now a business and community assets went into it to increase its value. If this were used, the property would receive a fair 10% increase per annum and the community would receive the remaining value of the property.

Alternatively, the court looks at the amount of the loan that was received. The court could then compare this amount to the original value of the land to do a proration analysis. Under this theory, the court would look at the original \$75,000 value of the land and compare it to the value of the loan (I'll assume \$125,000 for basic calculation and demonstration purposes). If the loan were \$125,000, then the total value going into the property would be \$200,000 (75,000 + 125,000). The court would then prorate the proportion of separate property and community property to the value of the property

today, which is \$500,000. The proportions of the separate property (3/8 in assumption) and the community property (5/8 in assumption) would be prorated to the \$500,000 value to determine amounts of separate property and community property.

The court may also alternatively look at the amount of the loan and view this as the community property and merely require a reimbursement for the amount of money that went into the undeveloped land.

Because of the increase in the property value due to the improvements, some form of proration would likely be better for the court to apply to afford a more fair split of the property value.

2. Cathy's Judgment

Cathy, a patron at the restaurant, has received a judgment against Hank for his negligence. Based on the facts, it appears that the judgment is only against Hank individually and not against the restaurant itself. The analysis below will assume that Hank is individually liable and the restaurant is not vicariously liable for the judgment.

Because Hank is personally liable for the judgment, his separate property is subject to Cathy's judgment. Cathy may therefore go after Hank's portion of the rental property that is his separate property. She may also go after any other separate property owned by Hank.

The tort liability of one spouse can affect the community assets. Cathy would be allowed to go after the community assets to satisfy her judgment. The order in which she obtains her judgment, however, depends on whether the spouse was acting for the benefit of the community at that time or for his own separate benefit. Here, Hank was working at the restaurant for the benefit of the community when the tort liability was incurred. Because Hank was acting for the betterment of the community, Cathy may go after the community property before she is forced to go after Hank's separate property for the judgment. To the extent that Wendy's community property interest is infringed by Cathy's judgment, she may be able to seek reimbursement from Hank at the divorce because she is not personally liable for the tort.

Wendy's separate property is not subject to the tort liability of Hank. Wendy is not individually liable for the tort (again, assuming that the restaurant is not vicariously liable). Additionally, community property of Wendy, such as wages, kept in a separate account that the other spouse cannot access could not be reached by a creditor unless for the necessities of the other spouse. Here, Hank is liable for a tort, not a contract for necessities, so the necessities exception would not apply. Additionally, Cathy's Chex Oil stock that she keeps separate is separate property rather than community property that she keeps separate, so it could not be reached by Cathy.

Therefore, Cathy may go after Hank's separate property and the community property to satisfy her judgment. She may not go after Wendy's separate property.