

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.

Question 6

Community Property

Herb and Wendy, residents of California, married in 2001. (There are no quasi-community, i.e., out of state or quasi-marital, i.e., putative spouse, issues) Herb worked as an accountant. Wendy was an avid coin collector who hoped someday to turn her hobby into a profitable business. (It could be argued that Wendy actually started her business prior to marriage) Prior to marriage, they had entered into a prenuptial agreement providing that each spouse’s wages would be his or her separate property. (There are no facts to determine whether the prenuptial agreement is valid)

(This entire paragraph relates to call 1. concerning the drawing) On Wendy’s birthday in 2002, Herb gave Wendy a drawing by a famous artist. (Since Wendy acquired the drawing during marriage, it is presumptively community property. However, that presumption will be rebutted by evidence that Herb intended to make a “gift” to Wendy) Herb paid for the drawing with \$15,000 that his parents had given him. (The source of the funds came from Herb’s separate property) Wendy hung the drawing in their bedroom. (The fact that the drawing is in “their” bedroom is not a valid written transmutation)

(This paragraph and the next one relate entirely to call 2. in regards to CoinCo) In 2003, (CoinCo was opened two years after marriage) 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. (Property acquired by inheritance is separate property) 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. (It is Wendy’s efforts and labor that is helping her business succeed) 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. (Wendy’s investment capital and the favorable conditions under which the business was conducted show that the “character” of the business is part of the reason for its success)

Although Wendy’s services at the shop were worth \$40,000 per year, (This is the reasonable value of her services) she took an annual salary of \$25,000. (Wendy is not being adequately compensated by CoinCo) She also paid \$5,000 in household expenses from the business earnings each year. (Relevant only to Van Camp accounting)

In 2008, Herb and Wendy separated, (This likely refers to permanent physical separation) and Wendy filed for dissolution of marriage. (Filing for dissolution is a clear indication that the couple has no intent to resume marital relations) At that time, CoinCo was worth \$150,000, and the drawing was worth \$30,000. (Because the economic marital community has ended, the assets will be valued at this time. However, the value of the drawing is immaterial because it is Wendy’s sole separate property)

(This paragraph relates to call 3. about the hospital bill) 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. (Herb is personally liable for the hospital bill as it is a debt incurred for common “necessaries” of life even though they might be living separately. But he is entitled to reimbursement)

In the dissolution proceeding, Wendy claims that the prenuptial agreement is valid and Herb claims that it is not. (Because there are no facts demonstrating whether the agreement was properly executed, a legal discussion, as compared to a factual inquiry, is warranted)

Insight Within

This was a relatively straightforward community property essay. It posed little difficulty and was a nice way for applicants to end the essay portion of the February 2010 California bar exam. While most essays require a strong factual application, this essay contained no facts about the premarital agreement. Thus, it was up to the student to know and understand the law in California concerning premarital agreements. It was a legal based discussion. Call of the question 2. concerning CoinCo could have been discussed numerous ways. It appears, like always, that there is no one correct answer. Thus, an essay should thoroughly demonstrate your ability to think, discuss, and analyze the facts in front of you in a clear, lucid manner.

Model Answer by One-Timers ©

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

In order to determine both Herb and Wendy's rights in each item, it is first necessary to discuss the validity of their prenuptial agreement.

Premarital Agreement

A premarital agreement is an agreement between prospective spouses made in contemplation of marriage that alters the statutory property rights of husband and wife. It must be in writing and signed by both parties. It is enforceable without consideration.

Under California Family Code §1615, a premarital agreement is not enforceable if it was executed involuntarily or the agreement was unconscionable when it was executed.

A premarital agreement is executed voluntarily if the contesting party: was represented by independent legal counsel or expressly waived such representation; had at least seven calendar days between the time the agreement was first presented and signed; **and** if unrepresented by counsel, was fully informed of the terms and basic effect of the agreement as well as the rights and obligations he or she was giving up by signing the agreement, and was proficient in the language in which the explanation of the agreement was written. The court may also consider any other factors it deems relevant.

A premarital agreement is not unconscionable if the contesting party was provided a fair, reasonable, and full disclosure of the property or financial obligations of the other party or did not voluntarily and expressly waive, in writing, any right to disclosure of the property. This issue shall be decided by the court as a matter of law.

On these facts, Herb and Wendy entered into a prenuptial agreement prior to marriage. The agreement provided that each spouse's wages would be his or her separate property. However, in the dissolution proceeding, Herb claims that the prenuptial agreement is not valid. Without additional facts, it is not possible to determine if all the above elements have been satisfied. Therefore, the analysis below will discuss each item affected by the agreement as if it was valid and if it is void. *Note:* The agreement is really only relevant to Herb and Wendy's rights and liabilities in CoinCo.

1. The drawing

Despite the validity of the premarital agreement, Wendy owns the drawing as her separate property as Herb intended to make a gift.

California Community Property Maxim

California is a community property state. All property acquired during the course of a marriage is presumed to be community property. All property acquired before marriage or after permanent physical separation is presumed to be separate property. In addition, any property acquired by gift, devise or bequest is presumed to be separate property.

In order to determine the character of any asset, courts will trace back to the source of the funds used to acquire the asset.

Here, Herb gave Wendy a drawing by a famous artist during their marriage. It is presumptively community property. However, Wendy will easily be able to overcome this statutory presumption.

Gift Between Spouses – Separate Property

Under §770, separate property of a married person includes all property acquired by gift, bequest, or devise. On these facts, Herb gifted the drawing to Wendy for her birthday. It is customary for people to give gifts on such an occasion. The money is from a separate property source since the drawing was purchased from funds Herb's parents had given him. However, that does not change the result as Herb intended to make a gift of his separate property to his spouse on her birthday. It is therefore Wendy's separate property.

Not a Valid Transmutation

Herb may try and argue that the drawing is community property since there is no written agreement changing the character of the drawing. This argument will fail.

Under §852, married persons may transmute separate property of one spouse to separate property of the other spouse. A transmutation of such property must be made in writing by an express declaration that is made and consented to by the spouse whose interest is adversely affected.

Here, Wendy only hung the drawing in their bedroom. At no time did she execute a written agreement changing the character of the asset. The fact it was worth \$30,000 in 2008 and has doubled in value does not change this result.

For those reasons, Wendy owns the drawing as her separate property. Herb has no interest in it.

2. CoinCo

Assuming the premarital agreement is valid, Wendy owns CoinCo as her sole separate property with no reimbursement or apportionment to Herb. However, assuming the agreement is not valid, the court will likely apply *Pereira* accounting to value the business.

Determining the End of the Marital Economic Community

The economic marital community is at an end when spouses are *living separate and apart* and their conduct and actions show an *intent not to resume* the marital community. Living separate and apart refers to when spouses have come to a parting of the ways with no present intention of resuming marital relations. The fact that a husband and wife may live in separate residences is not determinative. The question is whether the parties' conduct evidences a complete and final break in the marital relationship. *In re Marriage of Baragry*, 73 Cal.App.3d 444 (1977).

Here, the facts state that in 2008 Herb and Wendy separated. This likely means they are living separate and apart from each other. Thus, the couple has permanently physically separated. Furthermore, Wendy filed for dissolution of marriage. Filing for dissolution is probably the most obvious and clear indication of one's intent to end the marriage. As such, the economic marital community has likely ended in 2008.

Community Labor that Enhances a Separate Property Business

In 2003, Wendy opened and capitalized CoinCo with a \$10,000 inheritance that she had received when her grandfather died. This startup capital and the business is undoubtedly Wendy's separate property. However, in order to determine how the court should divide the remainder of the business, it will apply one of two accounting formulas.

Pereira Accounting

When a separate property business's success is due to the skill and management as well as the energy, ability, and capacity of a spouse, that part of the business is community property. Thus, when a spouse's efforts and labor are the primary source of the appreciation of the separate property business, courts will use *Pereira* accounting. *Pereira v. Pereira*, 156 Cal. 1 (1909).

Pereira allows the owner-spouse to receive a reasonable rate of return on her initial investment to the business. The value attributable to the community is the balance after the owner-spouse obtains a fair rate of return. This accounting formula is applied most often to a labor intensive business and generally favors the community.

Here, Wendy was an avid coin collector and in 2003, she opened CoinCo with an initial \$10,000 separate property investment. Wendy worked at the shop alone every day. This shows that the principal part of her income was due to her personal efforts, energy, ability, and capacity to run the shop. This is further supported because the facts state that her customers appreciated her enthusiasm about coin collecting and her ability to obtain special coins at reasonable prices. Moreover, CoinCo was not a losing business but a very profitable one.

Because CoinCo was successful due to the skill and ability with which Wendy conducted the business, the community estate should be accredited with all the profits derived therefrom in excess of a reasonable rate of return upon her capital which she had invested. Wendy's initial investment of \$10,000 will be assigned a reasonable rate of return similar to that of a long-term investment well secured. The economic marital community of the business lasted from 2003-2008, which is five years. Thus, \$10,000 plus \$5,000 equals \$15,000, which will be apportioned as Wendy's separate property. At the time of dissolution, CoinCo was worth \$150,000. Therefore, the remaining \$135,000 is community property.

It is worthy to note, that a court, in the interest of justice and fairness, will most likely determine the worth of CoinCo as of the time of trial. Under §2552, the court shall value the assets and liabilities as near as practicable to the time of trial. Thus, the amount of \$100,000 may be a proper alternative valuation date due to the extenuating circumstances of Wendy's serious illness.

Van Camp Accounting

When a separate property business's success is in large part due to the investment of the capital and the favorable conditions under which the business was conducted, courts apply *Van Camp* accounting. A successful venture which produced large returns indicates that the "character" of the business was the primary cause of its productivity. *Van Camp v. Van Camp*, 53 Cal. App. 17 (1921).

When applying *Van Camp*, the community is entitled to fair compensation for the services rendered in running the business comparable to that of other individuals in the same or similar line of business. Then the community living expenses must be deducted from community property income to determine the community interest. Any remaining increase in the value of the separate property business is the owner-spouse's separate property. A court will apply *Van Camp* usually when the business could not have carried on without the initial capital investment.

Here, it can be presumed that some of the profits of CoinCo were justly due to Wendy's initial \$10,000 capital investment. Without the investment of her capital in the business, she likely could not have opened CoinCo and it would still be a hobby and a dream of hers to one day turn her coin collecting into a profitable business. Additionally, over time there became a renewed interest in coin collecting due to the discovery of several boxes of old coins found buried in the area. This supports the fact that the character of CoinCo was subject to favorable conditions which led to its success.

However, there are sufficient facts showing that the business was successful more so due to Wendy's efforts and ability. And while CoinCo would likely still be a hobby to Wendy without her initial investment, she devoted substantial time, energies, and personal efforts to making CoinCo a success. Therefore, a court will likely apply *Pereira*.

Conclusion

Of course, no fixed rule can be laid down which would be equitable in all cases, but this seems to be the most evenhanded result. The above analysis obviously assumes, for apparent reasons, that the premarital agreement was not valid. If the prenuptial agreement is valid, the entire value of CoinCo is Wendy's separate property.

3. The hospital bill

Herb and Wendy are both liable for her medical necessities despite the fact that they are separated. But, Herb is likely entitled to reimbursement.

Division of Property for Debts and Liabilities

Under §914(a)(2), a married person is personally liable for a debt incurred for common "necessaries" of life of the person's spouse while the spouses are living separately.

Here, Wendy was disabled by a serious illness and had to be hospitalized. This incident took place after they separated but before dissolution. Still, Wendy's hospital bill is a medical necessity of life and both parties are equally liable to pay it.

Reimbursement

The court has jurisdiction to order reimbursement in cases it deems appropriate for debts paid after separation but before trial. Here, if Herb's separate property is used to pay Wendy's hospital bill, Herb should be reimbursed. Wendy has separate property funds available as she owns CoinCo and a \$30,000 drawing. Therefore, Herb is entitled to reimbursement if his separate property pays her bill.

Organization and structure: Following the order of the calls of the question and numbering according to how the examiners furnish it. Answering each call of the question specifically and addressing each issue within it by IRAC'ing. Making logical coherent arguments supported by the law and facts **7%**

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

Premarital Agreement **17%**

1. The drawing **19%**

California Community Property Maxim

Gift Between Spouses – Separate Property

Not a Valid Transmutation

2. CoinCo **42%**

Determining the End of the Marital Economic Community

Community Labor that Enhances a Separate Property Business

Pereira Accounting

Van Camp Accounting

Conclusion

3. The hospital bill **15%**

Division of Property for Debts and Liabilities

Reimbursement

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