11-2015

His, Hers, or Theirs?

Roger Bernhardt
Golden Gate University School of Law, rbernhardt@ggu.edu

Christine Tour-Sarkissian
Golden Gate University School of Law

Recommended Citation
38 Real Prop. Law Rptr. 145 (Cal CEB Nov. 2015)

Category: **Articles & Columns**
Created on Wednesday, 25 November 2015 13:47
Hits: 76

His, Hers, or Theirs?

Roger Bernhardt

Christine Tour-Sarkissian

A Family Law or a Real Estate Case?

Marriage of Brandes (2015) 239 CA4th 1461 is not technically a real estate case because the major asset fought over in that dissolution action was an investment advisory business that the husband had founded before marriage, but which had grown enormously during the marriage. Because investment advising is not a real estate activity, *Brandes* has been omitted from traditional coverage in this Reporter. (It was reported in CEB's Estate Planning and California Probate Reporter; see 37 CEB Est Plan Rep 69 (Oct. 2015).) But since the opinion has so much to say to lawyers about community and separate property—real as well as personal—we wanted to devote a column to its implications.

Brandes is a case of first impression in California, with wide implications not for only family law attorneys drafting pre- or post-nuptial agreements or litigating about community and/or separate business interests, but also for real estate attorneys structuring deals for their clients. As far as we know, no state court had ever before adopted a "hybrid" approach to the application of two major but contrasting family law doctrines, as happened here.

The Marriage and the Business

Charles Brandes founded BIP, a business of selling investment advice to clients, in 1974. At first, BIP was only marginally successful. When Charles and Linda met in 1983, BIP was managing $8.2 million in assets and Charles's annual income was $44,148. When they married in 1986, BIP's managed assets had increased to $20 million. When their marriage ended 18 years later, in 2004, the business was managing assets worth $85 billion. (This was in addition to other community property they had, worth $208 million, as well as $100 million of separate property held by Linda, none of which was involved in this appeal.)

The business growth from $8 million to $20 million in the premarital period clearly all belonged to Charles, having arisen before the marriage, but how much of the growth from $20 million to $85 billion was also his separate property, rather than his and Linda's community property? The trial court attributed the increase between 1986 and 1992 (from $20 million to $213 million) to Charles's efforts, but found that after 1991 (1992 to 2004), factors *other* than those personal efforts were more important.

For the first marital period (1986 to 1992), Charles was sole manager, responsible for BIP's investing philosophy; his track record attracted investors and he had a hands-on approach to the business. Based on that, the trial court allowed him a reasonable return on his initial separate property investment and treated the rest of the growth during that period as community property income resulting from his efforts, following a calculation known as the *Pereira* formula (see *Peirera v Pereira* (1909) 156 C 1), typically applied when the profits from an activity or asset are derived from the community efforts expended on it.

The logic of this formula is that in California, because it is a community property state, all income received by the family during a marriage is regarded as community property. But wealth brought into the marriage by either spouse remains the separate property of that spouse, not losing its original character because of the marriage. Fam C §770(a). California then treats the income subsequently produced by that separate property as itself separate property, even though it was earned during the marriage, unlike some other community property states that characterize rents and profits from separate property as community rather than separate property. California is also to be distinguished from noncommunity property common law jurisdictions, which can treat *all* property as marital property even when it belonged entirely to one of the spouses before marriage, then dividing it accordingly.

Allocating Income Between a Spouse and the Community

This California combination of rules presents a problem when part of the income from a separate property asset arose because of the personal efforts of that spouse in managing the asset during the marriage (rather than the passive generation of income from the asset itself), which portion should in all fairness be treated as community income rather than as rents and profits from separate property. The *Pereira* formula, by first calculating a proper return on the separate property investment (say, 3 percent per year, like a bond or passive rental income) and then attributing the balance of the income to community efforts of the spouses in managing the property, permits the court to measure and give the other spouse her fair share of the community income, even though it arose out of an asset separately owned by the other. The efforts of either spouse are community and compensable under this formula, whether by him or by her.

This *Pereira* treatment covered only the first part of the Brandes marriage, from 1986 through 1991. For the remaining years of the marriage (1992 to 2004), although BIP grew bigger and more successful (from $213 million to $85 billion), its success, according to the trial court, was chiefly attributable to factors *other* than Charles's personal effort. This led to the court's employing a different method of estimating—the *Van Camp* formula (see *Van Camp v Van* **[146]** *Camp* (1921) 53 CA 17)—an approach said to be applied when the business profits are due to the "character of the separate asset" even though community effort was "more than minimally involved" (*In re Marriage of Dekker* (1993) 17 CA4th 842)—a rather unhelpful-sounding yardstick. Under the *Van Camp* math, a court, instead of reimbursing the separate property first and giving the residue to the community, begins by first adequately compensating the community (*e.g.,* seeing that Charles received a fair salary as would be paid to a property manager for those same efforts). Only after that calculation is the balance of the growth or income of the property treated as separate and awarded to the spouse who owns it. Although *Van Camp* may seem to benefit the community at the expense of the separate property owner, the outcome in real dollars can be dramatically different.

Pereira and *Van Camp* typically produce different results. If the business (or the real estate) has not done well, then it may be better to be the first claimant rather than the second. But if the enterprise was profitable, then the residuary claimant is likely to do best.–If a housing bubble causes an apartment building to generate $100,000 in net rents as against a separate return on the original investment of only $1000, that leaves the remaining $99,000 of profit for the community; whereas, if a reasonable compensation to the community—of, say, $15,000 for services—were to be calculated first, that leaves $85,000 as the return on capital. Spouses probably cannot plan their activities during marriage so as to come under *Pereira* rather than *Van Camp* (or vice versa), but on divorce their attorneys can estimate the probable outcomes under both theories and then argue for the one more helpful to the respective clients. If the property value has risen significantly during the marriage (and mostly independently of efforts), the spouse who owns the asset will most likely argue for the *Van Camp* formula–because it awards more to him (without asking how much he deserved this return on investment); whereas the nonowning spouse would probably prefer *Pereira*, which gives the greater windfall to the community (regardless of how hard it worked for it). If the asset's growth was unimpressive, then the owner may be the one to want *Pereira*, since he will at least be reimbursed off the top. (We don't yet have a theory that works out a ratio between return on separate investment and compensation for community effort and uses them both in a single formula, thank heavens!)

Choosing between two formulas that produce such different results is not easy.–Nor had our supreme court helped matters by telling trial courts to "select whichever formula will achieve substantial justice," as it did in *Beam v Bank of America* (1971) 6 C3d 12. The formulas apply after the fact, when a divorce is in progress rather than when the business is being operated, and they do not appear readily receptive to direct agreements made during the marriage. Spouses can, while married, transmute an asset from separate to community (Fam C §850(b)), but can they also agree that a judge will apply *Pereira* or *Van Camp* to that income if they later do get divorced?

Another complicating factor is that, under either *Pereira* or *Van Camp*, family living expenses are charged against community property income, on the assumption that the spouses would have paid their bills that way rather than from the separate funds of either. In *Brandes*, that family expense deduction consumed all of the community income during the second period, which caused Linda to be the big loser: While she got $3.6 million for the growth during the first period, she received nothing for the second period because family expenses during that 13-year period exceeded the community income.

The New Hybrid in *Brandes*

What *Brandes* added to all this complexity was that both the *Pereira* and *Van Camp* formulas can be applied to the same asset: The trial court was upheld in its use of the *Pereira* formula during the 1986–1991 period and then in switching over to the *Van Camp* calculation for 1992–2004, based on the changing nature of Charles's role in the company. That could certainly happen in a real estate situation. For example, our markets behaved quite differently before 2005 than after 2008, and individual efforts (aka community property) played different roles in impacting values at one time rather than the other. In a bubble, it does not take much effort for values to inflate. So far, at least, under both *Pereira* and *Van Camp*, growth is aggregated rather than dealt with on a year-by-year basis; imagine the complexity of carrying over and netting out this year's losses against last year's gains.

It would have been easier for the rest of us had Charles's business had been a community asset throughout.–That would have made all of its growth community growth and all of its income community income; there would be no separate property claim. Had either Charles or Linda put separate funds into that community business, their contributions would have been treated as either (nonreimbursable) gifts or interest-free, nonrecourse loans (Fam C §2640), but such contributions would not have led to any separate property ownership acquisition in favor of the contributor.

Ironically, community property states enacted many of their rules to protect women, who frequently did not own the assets managed by their husbands. However, in those states, the preservation of premaritally owned property as separate has often worked against them. In noncommunity common law jurisdictions, where all property is treated as marital and equitably apportioned, the spouse who owned a premarital asset loses much of the advantage of that situation—it all may be divided anyway. Preservation of the concept of separate property in a community property state means that the wealthier spouse can retain much of what he had before the marriage (and its later rents and profits, in California). If taking **[147]** an impoverished mate does not make you any poorer, marrying a wealthy one does not automatically make you any richer.

Although the poorer spouse cannot change many of the above rules, she can take steps to get the assets in question out from under some of them. She can persuade her fiance to retitle assets into tenancy in common or joint tenancy by conveying fractional interests to her. She can also persuade him (after the marriage) to transmute his assets from separate to community, although under those circumstances she will have to comply with all of the rules concerning fiduciary duties inherent in every marital relationship. Fam C §§721(b), 1100(e). If an asset is recharacterized, its subsequent income may not be subject to a *Pereira* or *Van Camp* accounting. Careless asset handling can also have the same effect—separate property that was too commingled with community property may have lost its separate character. (Linda also made a commingling claim, based on the phenomenal growth of the company, but the trial court's answer was that the growth alone did not alter the nature of the business, nor did nondistribution of its profits mean that separate and community income were commingled or transmuted.)

The Stock Purchase

Linda's one claim that did somewhat succeed concerned Charles's purchase (during the marriage) of the outstanding stock in his company. He did so pursuant to an option that he had acquired from a partner before the marriage, and which he exercised during the marriage by signing a promissory note, making a downpayment and thereafter paying the balance of the option price out of the subsequent earnings of the business. Since his option arose before marriage, it came under the "*inception of title*" doctrine, which classified those particular shares–as separate property even though he acquired them during the marriage.

Relying on Fam C §2581, which provides that property acquired by the parties during marriage in joint form is presumed (on divorce) to be community property, Linda claimed that since those shares had been paid for with funds held in joint bank accounts, they were presumptively purchased with community funds. The court of appeal rejected that argument, holding Fam C §2581 inapplicable because a more specific statute, Prob C §5305, controlled and allowed Charles to trace his separate property contributions into joint accounts to preserve their separateness (and also to show that there were no community funds then available because of the parties' high-spending lifestyle).

On the other hand, Linda's argument that the trial court erred in rejecting her claim that the stocks were community property under the *"lender's intent doctrine,"* because they were purchased on credit during the marriage, succeeded. In general, there is a rebuttable presumption that property acquired on credit during a marriage is community. The presumption applies in the absence of evidence that the creditor was relying mainly on the purchaser's separate property. Charles had not shown that there was a lender-purchaser relationship between him and the seller of the stocks and thus had not rebutted the community property presumption. Nor was there any evidence that the seller relied on the value of Charles's separate property in extending that credit.

This error led to a remand of the case to determine whether the credit was extended to Charles alone or to both spouses. A contrary finding on this issue the next time around could well make some part of the stock community rather than separate property. That would mean that, since this segment of the purchase price was paid solely by Charles (Linda having admitted that there were no community funds available to pay it), Charles would have a right of reimbursement for those payments, but would not under the recharacterization of that stock as community property. Fam C §2640.–The community would be compensated directly for this ownership interest acquired by extending its credit and then also awarded some of the profits attributed to the community efforts expended by Charles on the separate property stock (under *Van Camp* or *Pereira*), and then Charles would be reimbursed for the separate funds he had contributed to pay the community debt.

Community Investment or Community Effort?

Linda made one other argument that we wish had received more attention from the court of appeal, as it is often used when dealing with real property assets. Under what is called the "*Moore/Marsden*" approach in family law (see *In re Marriage of Moore* (1980) 28 C3d 366 (*Moore*) and *In re Marriage of Marsden* (1982) 130 CA3d 426 (*Marsden*)), investments of community property funds in separate property give the community a pro tanto interest in the separate asset. Linda contended that the community had earned $3.6 million by the end of the first (*Pereira*) period, which amounted to 80 percent of the business's value at that time, and since it had not been distributed, it had therefore been commingled with Charles's separate property, giving the community pro tanto ownership of 80 percent of the business.–The court rejected that argument, saying that it would convert the community's right to postmarital apportionment (per *Pereira* or *Van Camp*) into a right to transmutation that existed during the marriage (239 CA4th at 1477):

California law does not require apportionment of community efforts devoted to separate property on an ongoing basis, upon pain of transmuting that separate property into community property. Courts account for community efforts towards separate property through equitable apportionment after the marriage, not transmutation during the marriage.

But that distinction means we have one rule governing treatment of a separate asset that is improved by community *funds*—the community owns a share of it—and another rule governing treatment of a separate asset that is improved by community *efforts*—in which case there is an equitable apportionment of its income rather than any transmutation of its ownership.–The court of appeal said that Linda presented no cogent argument for applying this *Moore/Marsden* fund **[148]** investment rule to investment of community efforts, but it is hard to see a cogent argument for two such different rules for such similar situations.

CROSS-REFERENCES: For discussion of the *Pereira* and *Van Camp* approaches to allocating a business interest between separate and community property, see Business Succession Planning: Strategies for California Estate Planners and Business Attorneys §20.15 (Cal CEB) and Crossover Issues in Estate Planning and Family Law §3.63 (Cal CEB).