

Comments

California's Characterization of Credit Acquisitions During The Post-Separation Period

In California, the community property is liable for debts incurred during separation. However, proceeds from these debts may be characterized as separate property of the acquiring spouse. Thus, the community, even though suffering the risks of liability, is disallowed the benefits of such risks. This Comment examines both credit acquisitions and debt liability during separation. This Comment argues that the current lender's intent analysis applied upon credit acquisition should be discontinued in favor of the exposure analysis. Further, the Comment argues that community property debt liability during separation arises only if the debt is related to the community which occurs a) if the liability benefits the community; or b) if the loan was obtained in exchange for community property.

I. INTRODUCTION

Property acquired during separation is presumed to be the separate property of the acquiring spouse.¹ This presumption may persist even though the property was acquired via a credit transaction.

1. CAL. CIV. CODE § 5118 (West 1985), which states "[t]he earnings and accumulations of a spouse and the minor children living with or in the custody of, the spouse, while living separate and apart from the other spouse, are the separate property of the spouse."

However, the community is presumed to be liable for all debts incurred during marriage.² Thus, while a single spouse may obtain the acquisition for his or her own separate property, the community may be liable for the debt upon default.

This Comment propounds that credit acquisition should be characterized in an equitable fashion in accordance with the debts incurred while obtaining the property. Accordingly, debts incurred during separation should be characterized as community debts only if the debt incurred is in exchange for community property or is related to community property. As such, if the property is acquired on credit during separation, the character of such property is either community or separate in accordance with the liabilities incurred while obtaining the loan. The following is an introductory hypothetical fact pattern to assist the reader in understanding the issue.

Husband and Wife were married for eight years, after which each became disenchanted with the another and separated. During the two and one-half years of separation, Husband continued to work. Neither spouse had any separate property prior to marriage. However, while married, from both their efforts, they established A.B. Research Corp., of which Husband held the controlling interest. The corporation was extremely successful and had a fair market value of \$10 million. Husband's interest in the corporation was deemed entirely community property.

During the separation period, Husband made a large investment of approximately \$1 million. The \$1 million came from a loan by the local bank. The application for credit was signed by Husband alone; however he stated he was married, not separated. The basis upon which Husband claimed the bank relied in granting the loan included:

- (1) repayment from Husband's income, expected to be approximately \$200,000 for the year;
- (2) Husband's net worth of approximately \$6 million, centered primarily in A.B. Research stock and real estate;
- (3) Husband's controlling interest in A.B. Research, which has a \$1 million unsecured working capital line of credit at the local bank; and
- (4) a letter from A.B. Research assuring repayment in the event Husband defaulted.

2. CAL. CIV. CODE § 5120.110(a) (West 1985 & Supp. 1988), which states [e]xcept as otherwise expressly provided by statute, the community property is liable for a debt incurred by either spouse before or during marriage, regardless which spouse has the management and control of the property and regardless whether one or both spouses are parties to the debt or to a judgment for the debt.

However, Husband did not default on the loan. In fact, the investment was turned over within the separation period prior to dissolution, reaping a \$400,000 net profit. The questions that arise are: Who receives the proceeds from this post-separation loan? Is Husband entitled to the proceeds as his separate property, or are the proceeds community property to be shared by Wife?

By codification California has attempted to clarify issues of characterization of property as community or separate. However, the codification, which is supplemented by case law, not only leaves gaps in several areas but also appears to contradict itself, resulting in confusion and inequitable results.

This Comment reviews the statutes and case law addressing the characterization of property acquired on credit and the liabilities incurred during separation. In doing so, the Comment discusses the lender's intent analysis, currently applied in California to determine the property characterization of credit proceeds acquired throughout the entire marriage, including the separation period, and its evidentiary and equitable problems. This Comment also examines the exposure analysis which characterizes credit acquisitions in accordance with debts incurred, and its application in determining the characterization of property acquired on credit during separation. This Comment then will explore credit liability during separation and the qualification of California Civil Code section 5118 which, on its face, should control all earnings and accumulations during separation. The author advocates that not all property acquired during separation should be the separate property of the acquiring spouse. Suggestions for the separated debting spouse in avoiding the possibility of his or her separate credit purchase from becoming the property of the community are provided, as well as suggestions for statutory amendments and new legislation to deal with this problem.

II. LENDER'S INTENT ANALYSIS

California Civil Code section 5110 states a presumption that all property acquired during marriage is community property.³ This presumption is fundamental to the community property system.⁴ However, California recognizes the right of either spouse to hold property separately while married⁵ which enables the spouse to hold

3. CAL. CIV. CODE § 5110 (West 1985).

4. *Wilson v. Wilson*, 76 Cal. 2d 119, 125-26, 172 P.2d 568, 572 (1945).

5. CAL. CIV. CODE §§ 5107, 5108 (West 1985).

not only both community and separate property assets, but also to have individual assets which are a combination of both community and separate property.⁶

Loan proceeds, and thus the property acquired with credit during marriage, follow the fundamental presumption of community property.⁷ This presumption is rebuttable by evidence that the lender relied on the separate property of the acquiring spouse when extending the loan.⁸ However, reliance upon separate property does not necessarily mean that the loan is secured with separate property.⁹

The lender's intent analysis is essentially an application of tracing, which allows the spouse to characterize the loan proceeds as separate property if the spouse can trace the acquisition of the property to a separate property source.¹⁰ The question which arises, and which has resulted in considerable litigation, is to what level must the tracing extend? Must the lender rely solely on the spouse's separate property, or is primary reliance sufficient?

Initially, California required proof that the lender relied entirely on the existing separate property of the acquiring spouse prior to characterizing the loan proceeds as separate property.¹¹ However, in 1953, in *Gudelj v. Gudelj*,¹² the California Supreme Court relaxed the standard, stating that "[i]n the absence of evidence tending to prove that the seller *primarily* relied upon the purchaser's separate property in extending credit, the trial court must find in accordance with [the section 5110] presumption."¹³

In recent years courts, under the pretext of the *Gudelj* standard, have found evidence of lender's intent in (a) reliance on or hypothe-

6. See Bruch, *The Definition and Division of Marital Property in California: Towards Parity and Simplicity*, 33 HASTINGS L.J. 771 (1982). The simplest example of an asset which contains both community property and separate property is a bank account held during marriage. The spouses may place within the account a) their earnings from a salary during marriage which unless expressed otherwise is generally community property; and also b) earnings from a separate property investments which would generally be separate property of the spouse who owns the investments. The account becomes commingled during marriage. However, upon dissolution, via tracing, the spouses can generally recoup their separate property portion prior to the division of the community asset.

7. *Gudelj v. Gudelj*, 41 Cal. 2d 202, 210, 259 P.2d 656, 661 (1953).

8. *Id.*, 259 P.2d at 661.

9. See, e.g., *Bank of California v. Connolly*, 36 Cal. App. 3d 350, 375, 111 Cal. Rptr. 468, 485 (1972).

10. Cummings, *The Division of Property Purchased On Credit Under California Community Property Law: A Proposal For Reform*, 17 PAC. L.J. 129, 141 (1985) (citing H. VERRALL, CASES AND MATERIALS ON CALIFORNIA COMMUNITY PROPERTY 264-65 (1977)).

11. *In re Marriage of Grinius*, 166 Cal. App. 3d 1179, 1186, 212 Cal. Rptr. 803, 807 (1985) (citing *Estate of Molbert*, 57 Cal. 257, 259 (1881); *Estate of Ellis*, 203 Cal. 414, 416, 264 P. 743, 744 (1928)).

12. 41 Cal. 2d 202, 259 P.2d 656 (1953).

13. *Id.* at 210, 259 P.2d at 661 (emphasis added).

cation of separate property,¹⁴ or (b) sole reliance on separate property,¹⁵ or (c) extension of the loan on the faith of existing property belonging to the acquiring spouse.¹⁶

As a result of the continuously inconsistent application of the lender's intent analysis, California's Fourth District Court of Appeals in *In re Marriage of Grinius*¹⁷ conducted an extensive review and held:

[W]e restate the applicable standard: Loan proceeds acquired during marriage are presumptively community property; however, this presumption may be overcome by showing the lender intended to rely *solely* upon a spouse's separate property and did in fact do so. Without satisfactory evidence of the lender's intent, the general presumption prevails.¹⁸

III. THE PROBLEMS WITH THE LENDER'S INTENT ANALYSIS

The *Grinius* standard may restate the rule, but it fails to clarify the confusion or resolve the inequities. The problem is twofold. First, from an evidentiary standpoint, the courts rely upon the subjective intent of the lender, a third party, to determine the characteristics of the proceeds.¹⁹ Additionally, the lender's intent is assessed at the moment the loan is executed rather than at the date of trial. As a consequence, the lender's intent may be difficult to ascertain because the loan may have been approved years prior to the trial.

Second, from an equitable standpoint, the *Grinius* standard is too harsh, since any evidence indicating that the lender relied on any source but the separate property results in characterizing the property as community property. However, if the court is inclined to revert to the *Gudelj* standard, it is also inequitable, for it is too arbi-

14. *Grinius*, 166 Cal. App. 3d at 1187, 212 Cal. Rptr. at 808 (citing *Bank of California v. Connolly*, 36 Cal. App. 3d 250, 375, 111 Cal. Rptr. 468, 485 (1973); *Ford v. Ford*, 276 Cal. App. 2d 9, 13-14, 80 Cal. Rptr. 435, 438-39 (1969); *Somps v. Somps*, 350 Cal. App. 2d 328, 336-37, 58 Cal. Rptr. 304, 310 (1967); *Hicks v. Hicks*, 211 Cal. App. 2d 144, 153, 27 Cal. Rptr. 307, 313 (1962)).

15. *Grinius*, 166 Cal. App. 3d at 1187, 212 Cal. Rptr. at 808 (citing *Howard v. Howard*, 128 Cal. App. 2d 180, 186, 275 P.2d 88, 92 (1954)).

16. *Grinius*, 166 Cal. App. 3d at 1187, 212 Cal. Rptr. at 808 (citing *In re Marriage of Aufmuth*, 89 Cal. App. 3d 446, 455-56, 152 Cal. Rptr. 668, 674 (1979); *In re Marriage of Stoner*, 147 Cal. App. 3d 858, 863-64, 195 Cal. Rptr. 351, 354-55 (1983)).

For a more in depth review of the inconsistencies in the lender's intent application prior to *Grinius*, see generally Young, *Community Property Classification of Credit Acquisition in California: Law Without Logic?*, 17 CAL. W.L. REV. 173 (1981).

17. 166 Cal. App. 3d 1179, 212 Cal. Rptr. 803 (1985).

18. *Id.* at 1187, 212 Cal. Rptr. at 808 (emphasis added).

19. Young, *supra* note 16, at 175. Even though Young's analysis confronted the *Gudelj* lender's intent rule, the same holds true for the *Grinius* lender's intent rule.

trary to assess which assets were primarily relied upon. Furthermore, and most importantly, a spouse, as part of the community, shares the debt liability incurred by the borrowing spouse before or during marriage;²⁰ but the non-borrowing spouse is disallowed any benefits of the acquisition regardless of the fact that it was the community's line of credit that made the acquisition possible.²¹

A closer review of *Grinius* reveals the extent of these problems. In *Grinius*, shortly after marriage, the husband and wife acquired a restaurant.²² To purchase the restaurant they obtained two loans including an \$80,000 Small Business Administration Guaranty lent by California First Bank (hereinafter SBA loan).²³

At trial, the husband claimed that the restaurant real property was his sole separate property. However, the husband failed to produce any direct evidence of the lender's intent and relied entirely upon circumstantial evidence to prove that the lender relied solely on the husband's separate property in extending the SBA loan.²⁴ The husband claimed that "the SBA loan guaranty was premised solely on [his] posting of collateral consisting of his entire separate property."²⁵ The court disagreed with his assertion, apparently following the principle that the most probative evidence of intent of an actor is the objective evidence of what happened, "[f]or normally the actor is presumed to have intended the natural consequences of his deeds."²⁶ Thus, the court reviewed the SBA loan conditions outlined in the loan guaranty authorization,²⁷ believing this objective evidence best identified the subjective intention of the lenders. The evidence refuted the husband's contentions, since only two of the nine required conditions of the SBA loan necessitated hypothecation of his separate property.²⁸

In reviewing the evidentiary problems of the *Grinius* test, a spouse's inability to present direct evidence of a lender's intent, like the husband in *Grinius*, is not unusual. As a practical matter it is extremely difficult, if not impossible, to present evidence of actual subjective intent. To do so, the spouse with the burden of proving sole intent of the lender must either subpoena the lender or present a written agreement between the parties identifying the lender's intent. To subpoena the lender, the spouse initially must identify the lending officer or officers who executed the loan and then locate their where-

20. CAL. CIV. CODE § 5120.110(a).

21. CAL. CIV. CODE § 5118.

22. *Grinius*, 166 Cal. App. 3d at 1184, 212 Cal. Rptr. at 806.

23. *Id.*, 212 Cal. Rptr. at 806.

24. *Id.* at 1187, 212 Cal. Rptr. at 808.

25. *Id.*, 212 Cal. Rptr. at 808.

26. *Washington v. Davis*, 426 U.S. 229, 253 (1976) (Stevens, J., concurring).

27. *Grinius*, 166 Cal. App. 3d at 1187, 212 Cal. Rptr. at 808.

28. *Id.*, 212 Cal. Rptr. at 808.

abouts. The difficulty of this request is compounded by the passage of time, which in *Grinius* exceeded six years.²⁹ Likewise, a written agreement expressing the parties' intent is also unlikely to exist, since at the time the loan was executed it is doubtful that the parties anticipated a divorce so as to be concerned with the division and characterization of marital property. Therefore, the likelihood that the parties would have executed an agreement expressing their intentions is remote.

Thus, in *Grinius*, circumstantial evidence was all that remained for the husband to prove his case. The circumstantial evidence consisted solely of the assets pledged and the lender's guidelines in authorizing the loan. This evidence was somewhat unpredictable and inconsistent. In *Grinius*, the SBA loan approval required: (a) a third deed of trust on husband's improved real property, which was already subject to prior liens; (b) the husband's assigning his separate property stock to the lender; (c) the wife's signature on the promissory note and all other instruments of hypothecation; (d) the community acquiring and assigning an \$80,000 life insurance policy on the husband to the lender; and (e) a second deed of trust on the restaurant real property and improvements.³⁰ However, the decisive factor which the court relied upon to rebut the husband's contention was a clause in the SBA loan guidelines which restricted the extension of a small business loan to only those individuals with ability to repay and manage the small business.³¹ The court concluded that it was the community, not the husband alone, who had the repayment and management ability.³² As a result, the loan was not traceable solely to the husband's separate property. Therefore, the proceeds were deemed community property.

Apart from the evidentiary problems of the *Grinius* standard, the courts have also consistently failed to reach equitable solutions. This easily can be demonstrated by a slight alteration to the *Grinius* facts. For instance, even if the husband had presented evidence that his separate real property on which the SBA loan was secured had a fair market value of \$200,000 at the time of the loan was executed, and if the wife had no prior restaurant management experience, the court still would have been inclined to rule that the proceeds were

29. *Id.* at 1185, 212 Cal. Rptr. at 806-07. The facts given fail to reveal the date of marriage. There is evidence, however, that they were married at the time the husband paid a portion of the SBA loan principal in 1975, and that they separated in 1980.

30. *Grinius*, 166 Cal. App. 3d at 1187, 212 Cal. Rptr. at 808.

31. *Id.* at 1189, 212 Cal. Rptr. at 809-10.

32. *Id.*, 212 Cal. Rptr. at 810.

community property. To do otherwise would disregard the *Grinius* requirement that the lender rely *solely* on separate property of the acquiring spouse to characterize the asset as separate. For even in these amended facts, there still exists evidence that the lender relied on the community life insurance or other community property, since both the husband and the wife signed the promissory notes. Furthermore, it is unrealistic in a modern commercial transaction to assume that a lender will not try to secure the loan with all possible resources.

If the courts felt inclined to reinstate the California Supreme Court's *Gudelj* standard,³³ the inequities nevertheless would persist since it is impossible to accurately determine on which sources the lender primarily intended to rely. For instance, in *Grinius* the husband's real property already was encumbered, but the value of the property was unknown. Likewise, his stocks were not valued.³⁴ Furthermore, the life insurance had no value until the husband's death, and the other community property assets which would become assessable by both the husband's and the wife's signature on the promissory note were undisclosed. Even so, having only been married a relatively short period prior to obtaining the loan, the community assets undoubtedly would not be extensive.³⁵ Finally, the wife's experience in the restaurant business may have been overshadowed by the husband's business experience acquired elsewhere. Therefore, with a multitude of possible assets to rely upon, and each having a variance in value, it becomes impossible to consistently and equitably state which assets, in fact, primarily were relied upon.

A solution to both the evidentiary and equitable downfalls of the lender's intent analysis exists, whether it is the sole or primary reliance standard. This solution may be found in the exposure analysis.³⁶

IV. THE EXPOSURE ANALYSIS, A POSSIBLE SOLUTION TO THE CHARACTERIZATION PROBLEMS

The exposure analysis used in the community property states of Texas³⁷ and Washington³⁸ allows for "the benefits of credit acquisi-

33. *Gudelj*, 41 Cal. 2d 202, 259 P.2d 656 (1953). In *Gudelj*, the court required a showing that the lender relied *primarily* on the spouse's separate property in extending the loan.

34. *Grinius*, 166 Cal. App. 3d at 1187-88, 212 Cal. Rptr. at 808.

35. *See, e.g.*, *Hicks v. Hicks*, 211 Cal. App. 2d 144, 155, 27 Cal. Rptr. 307, 314 (1962).

36. This argument has been presented by both Richard L. Young in his article, *see Young, supra* note 16, at 255, and by Timothy J. Paris in his article, *Credit Acquisitions During Marriage*, 9 L.A. LAW NO. 3, 11, 16 (1986).

37. *See generally* *Goodloe v. Williams*, 302 S.W.2d 235 (Tex. Civ. App. 1957);

tions to be allocated in accordance with the legal exposure of the indebted parties."³⁹ With this approach, the evidentiary problems are resolved because the parties avoid having to present evidence of subjective lender's intent at the time the transaction was entered, and instead, can rely upon direct evidence by presenting the promissory notes and all other instruments of hypothecation. These documents will reflect the exposed assets available to the lender upon default.⁴⁰

From an equitable standpoint, it is far more appropriate to allocate the benefits of a credit transaction to the parties who may suffer due to default. Under a lender's intent analysis, the acquired property may be characterized as the separate property of the borrowing spouse. Nevertheless, upon default, the lender, regardless of his or her initial intent, can pursue the community property for repayment, even though the community property gained absolutely no benefit

Dillard v. Dillard, 341 S.W.2d 668 (Tex. Civ. App. 1960). In *Dillard*, the husband claimed that property acquired during marriage on credit was his separate property. He claimed it was acquired by promising his separate property. However, an officer of the lending bank testified that if it became necessary to collect the note, the bank would have levied on any property, community or separate. Presented with this evidence, the *Dillard* court relied upon *Goodloe v. Williams*, 302 S.W.2d 235 (Tex. Civ. App. 1957), and stated, "property purchased during marriage by either spouse on credit is community property unless an agreement exists that the *separate estate of the vendee only* shall be looked to by the vendor for satisfaction of the credit extended." *Dillard*, 341 S.W.2d at 671 (emphasis added). Thus, the *Dillard* court held the property acquired on credit was community in character. See also Young, *supra* note 16, at 243-45 (indepth review of Texas cases addressing the exposure analysis).

38. See generally *Finley v. Finley*, 47 Wash. 2d 307, 287 P.2d 475 (1955); *Katterhagen v. Meistor*, 75 Wash. 112, 134 P. 673 (1913). In *Katterhagen*, the trial court found that the title to the property involved was taken in the name of George Meistor and Mary Meistor. The purchase price was \$6,500, and \$1,600 was paid from separate funds of George Meistor. The remainder of the purchase price came from a promissory note and mortgage which was signed by George and Mary Meistor. But, the note and mortgage were paid by George Meistor out of his separate funds. From these facts, the trial court concluded that the property was the sole and separate property of George Meistor. However, the Washington Supreme Court modified the judgment saying:

[George Meistor] paid \$1,600 upon the purchase price from his separate funds. To that extent the property was separate. The remainder, or \$5,050, was paid by the community. *When the husband and wife united in the promissory note, the debt created was a community debt, and the money borrowed upon the note belonged to the community.*

Id. at ___, 134 P. at 674 (emphasis added).

The court held that 1600/6500 of the property was the husband's as separate property; thus the court reimbursed George Meistor for his separate property contribution. The remaining 5050/6500 was community property; thus the court allowed the community to benefit from the risks of the debt. See also Young, *Credit Acquisitions, supra* note 16, at 245-51 (additional review of Washington case law confronting the exposure analysis).

39. Paris, *supra* note 36, at 16.

40. *Id.*

from such liability. Under the exposure analysis, regardless of which spouse borrows the money to purchase the property, the acquired property is characterized totally in accordance with the risk allocation that will arise upon a default.

However, one commentator is quick to point out that some areas in the exposure analysis still require the discretion of the court.⁴¹ First, the exposure analysis will always result in a community property characterization if the lender insists upon both spouses signing the promissory note or other instruments of hypothecation. However, a recent federal regulation forbids lenders from requiring both spouses' signatures and from asking questions about a non-borrowing spouse if the borrowing spouse states that the loan is sought based solely on his or her separate property or personal use.⁴²

Second, in many cases the separate property collateral may vastly outweigh the pledged community property, and it would be unfair to characterize the proceeds as community property when as a practical matter the lender, in all likelihood, will pursue only the separate property for repayment.⁴³ In these cases, it may be appropriate to characterize the proceeds in accordance with the proportion of separate to community liabilities, instead of a unitary characterization.

Finally, there may be situations where a party used separate funds to pay the down payment or loan payments. Here, the approach taken by California Civil Code section 4800.2⁴⁴ appears appropriate. The legislature allows the contributing spouse to be reimbursed for his or her traceable separate property contribution.⁴⁵ However, the

41. *Id.*

42. See generally *Anderson v. United Fin. Co.*, 666 F.2d 1274 (9th Cir. 1982); *United States v. ITT Consumer Fin. Corp.*, 816 F.2d 487 (9th Cir. 1987). In *Anderson*, the Ninth Circuit held it was a violation of the Equal Credit Opportunity Act (ECOA) when a creditor required an applicant's spouse to co-sign the promissory note if the applicant individually qualified under the lender's standards of creditworthiness. *Anderson*, 666 F.2d at 1276-77. However, in *ITT Consumer Fin. Corp.*, the Ninth Circuit held that lenders, in equal management community property states, such as California, did not violate the ECOA when they sought the signature of the applicant's spouse on the promissory note if the spouse's future earnings were considered in determining the creditworthiness of the applicant. *ITT Consumer Fin. Corp.*, 816 F.2d at 490-93. The distinguishing point between *Anderson* and *ITT Consumer Fin. Corp.* is that in *Anderson* the applicant individually met the lender's credit worthiness standard, while in *ITT Consumer Fin. Corp.*, the applicant did not. As a result, *ITT Consumer Fin. Corp.* does not remove the restrictions upon the lenders which would enable them to require both signatures even if the applicant's spouse individually meets the lender's creditworthiness standard. *ITT Consumer Fin. Corp.*, 816 F.2d at 493.

43. Paris, *supra* note 36, at 16.

44. *Id.*

45. CAL. CIV. CODE § 4800.2 (West 1988) provides in pertinent part: In the division of community property under this part unless a party has made a written waiver of the right to reimbursement or signed a writing that has the effect of a waiver, the party shall be reimbursed for his or her contributions to the acquisition of the property to the extent the party traces the contribution to a separate property source.

contributing spouse is not allowed compensation for the appreciation in the value of the proceeds, nor is he or she penalized for depreciation.⁴⁶

V. THE APPLICATION OF THE EXPOSURE ANALYSIS TO DETERMINE THE CHARACTERIZATION OF PROPERTY ACQUIRED ON CREDIT DURING SEPARATION

Marriage continues throughout the separation period and, with that in mind, one may expect the laws accompanying marriage to remain consistent throughout separation. In some instances they do, and in others they do not. First, it appears the community property remains liable for all debts of either spouse throughout marriage.⁴⁷ At the same time, the separated spouses are allowed to retain their earnings and accumulations acquired during separation as their separate property.⁴⁸

With these conflicting principles in mind, California's Second District Court of Appeals in *In re Marriage of Stephenson*⁴⁹ confronted the characterization of property acquired on credit during separation. In *Stephenson*, the husband, during separation, purchased real property using \$172,000 in funds from loans which he borrowed from the pension plan at Stephenson and Son, Incorporated.⁵⁰ The pension was comprised largely of community property.⁵¹

The court's initial analysis followed the normal lender's intent inquiry. While citing *Gudelj*,⁵² the court stated that "proceeds of a loan acquired during marriage are community property . . . [this] presumption is rebuttable upon a showing that the loan was extended

46. CAL. CIV. CODE § 4800.2 provides in pertinent part: "The amount reimbursed shall be without interest or adjustment for change in monetary values and shall not exceed the net value of the property at the time of division."

47. CAL. CIV. CODE § 5120.110(a), which states:

Except as otherwise expressly provided by statute, the community property is liable for a debt incurred by either spouse before or during marriage, regardless which spouse has the management and control of the property and regardless whether one or both spouses are parties to the debt or to a judgment for the debt.

48. CAL. CIV. CODE § 5118 which states in pertinent part: "The earnings and accumulations of a spouse . . . while living separate and apart from the other spouse, are the separate property of the spouse."

49. 162 Cal. App. 3d 1057, 209 Cal. Rptr. 383 (1984).

50. *Id.* at 1084, 209 Cal. Rptr. at 401.

51. *Id.* at 1085, 209 Cal. Rptr. at 402.

52. *Id.* at 1084, 209 Cal. Rptr. at 401 (citing *Gudelj v. Gudelj*, 41 Cal. 2d 202, 210, 259 P.2d 656, 661 (1953)).

on the faith of existing property belonging to the acquiring spouse.”⁵³

After making this initial statement, the court acknowledged that the analysis applies to post-separation loans, and not solely to loans extended during marriage prior to separation,⁵⁴ since during separation the lender still can recover against the community. However, concern over which assets are liable in the event of a default is the principle of the exposure analysis, not that of a lender’s intent analysis. Furthermore, with this relationship in mind, the court stated: “Accordingly, the proceeds of a post-separation loan will be the separate property of the borrowing spouse if it is not obtained in exchange for community property and is, therefore, unrelated to the community.”⁵⁵

Conversely stated, the proceeds of a post-separation loan will be community if they are obtained in exchange for community property and are, therefore, related to the community. This is precisely the rationale of the exposure analysis. If a spouse’s assets become subject to liability, then he or she will enjoy the assets which this indebtedness acquires.

The issues which arise from *Stephenson* are: (a) Which circumstances create community liability during separation and (b) Why was this real property not a post-separation “accumulation,” and therefore per se separate property of the acquiring spouse in accordance with California Civil Code section 5118?⁵⁶ These two issues are discussed in the following two sections.

VI. CREDIT LIABILITY DURING SEPARATION

Currently, California statutes fail to distinguish between the liabilities for debts incurred before and after marital separation. The statutes instead simply espouse a single principle concerning the period covering the entire marriage. The governing statute, California Civil Code section 5120.110(a) states:

Except as otherwise expressly provided by statute, the community property is liable for a debt of either spouse incurred before or during marriage, regardless which spouse has the management and control of the property and regardless whether both spouses are parties to the debt or to a judgment to the debt.⁵⁷

53. *Stephenson*, 162 Cal. App. 3d at 1084, 209 Cal. Rptr. at 401.

54. *Id.* (citing 1 C. MARKEY, CALIFORNIA FAMILY LAW: PRACTICE AND PROCEDURE, COMMUNITY PROPERTY § 5.71 [4] (1984)).

55. *Stephenson*, 162 Cal. App. 3d at 1085, 209 Cal. Rptr. at 401.

56. This section provides that earnings and accumulations of a spouse while living separate are considered separate property. *See infra* notes 82-93 and accompanying text.

57. CAL. CIV. CODE § 5120.110(a). California, like most community property states, employs a system that is most favorable to creditors. The general rule, which is subject to certain exceptions, allows for creditors to satisfy their debts out of property

Continuous liability throughout marriage is claimed to rest on California family law recognizing marriage and the incidents of marital status continuing until divorce or the death of one spouse.⁵⁸ However, in reviewing the case law, there appears to be a consistent limitation placed upon the creditor's reach for loans received after separation.

*A. Case Analysis of Creditor's Rights on Post-Separation
Loans Since the Enactment of the
Family Law Act*

In the 1977 case of *In re Marriage of Hopkins*,⁵⁹ the wife incurred certain liabilities after separation, namely, miscellaneous department store charges.⁶⁰ The then current California statute, Civil Code section 5116,⁶¹ called for the community to be liable for any debt incurred by either spouse during marriage.⁶² However, in *Hopkins* the Second District Court of Appeals chose to limit the statute's scope, holding that because the debts had occurred after separation and were not *related* to the community, the community should not be liable for such debts.⁶³ In arriving at this decision, the court recognized that the earnings and accumulations of each spouse after separation were the separate property of that spouse,⁶⁴ and thus reasoned that debts incurred after separation also should be separate.⁶⁵ The court assessed whether the indebtedness benefited the community. In this case, the indebtedness did not benefit the community

over which the debtor spouse has management and control. Thus in California, where there is equal management and control over the community property, a creditor can pursue both the separate property of the debtor spouse and all the community property. CALIFORNIA LAW REVISION COMM'N, LIABILITY OF MARITAL PROPERTY FOR DEBTS, (Jan. 1984) [hereinafter CALIFORNIA LAW REVISION COMM'N].

58. Only death or a final judgment of dissolution or nullity terminates marriage. CAL. CIV. CODE § 4350 (West 1983). Accordingly, an informal separation, an interlocutory judgment of dissolution, or a decree of legal separation does not affect a party's status as a spouse. See, e.g., *In re Estate of Devigia*, 162 Cal. 51, 121 P. 320 (1912) (woman held entitled to family allowance from decedent's estate as his widow despite earlier entry of an interlocutory decree of divorce).

59. 74 Cal. App. 3d 591, 141 Cal. Rptr. 597 (1977).

60. *Id.* at 600, 141 Cal. Rptr. at 602.

61. *Id.* See CAL. CIV. CODE § 5116 (repealed 1969). The substance of former Civil Code § 5116 is continued in CAL. CIV. CODE § 5120.110(a), see 17 CAL. L. REV. COMM. REPORTS 1, 30 (1984).

62. CAL. CIV. CODE § 5116.

63. *Hopkins*, 74 Cal. App. 3d at 600, 141 Cal. Rptr. at 602.

64. *Id.* (relying on CAL. CIV. CODE § 5118).

65. *Hopkins*, 74 Cal. App. 3d at 600, 141 Cal. Rptr. at 602.

since the debts were incurred for the wife's personal use and thus, were not "related" to the community.⁶⁶

The "relatedness test" was applied five years later in *In re Marriage of Munguia*.⁶⁷ The debt involved a fee for private investigator services that was incurred by the husband during separation. The wife had secreted the children in Europe, and the husband hired the investigator to locate and return them to the United States.⁶⁸ In *Munguia*, the First District Court of Appeals held that the debt was unrelated to the community and thus should be deemed separate.⁶⁹ The court based its relatedness conclusion on a statement made by the husband's attorney which described the obligation as "perhaps rash and indiscreetly [and possibly not] prudently" incurred.⁷⁰ However, the court appeared to imply that if the safety of the children had been truly in jeopardy, the liability incurred by the husband for investigative services would be attributed to the community. Thus, since both spouses are liable for the well-being of their children, any liability incurred while procuring their safety would be related to the community.

A year later, in the *Stephenson*⁷¹ case, the Second District Court of Appeals considered the concept of relatedness for a second time. To repeat the facts, the husband, after separation, borrowed \$172,000 from Stephenson and Son, Incorporated Pension Plan Trust which was a community property asset.⁷² The court stated: "If a post-separation loan is 'unrelated' to the community, then the courts have uniformly held the borrowing spouse solely liable for the debt."⁷³ The court determined that the loan was related to the community since it was obtained in exchange for community property.⁷⁴

The final case in the series of post-separation loans is *American Olean Tile Co. v. Schultze*.⁷⁵ In *American Olean Tile*, the First District Court of Appeals placed additional limitations on creditors' rights. The court reviewed creditor's rights on a loan incurred after the husband and wife had not only separated but also executed a marital settlement agreement dividing their property.⁷⁶ The husband received as his separate property the prior community property of H & S Tile, which later became indebted to American Olean Tile

66. *Id.*, 141 Cal. Rptr. at 602.

67. 146 Cal. App. 3d 853, 195 Cal. Rptr. 199 (1983).

68. *Id.* at 861-62, 195 Cal. Rptr. at 203.

69. *Id.* at 862, 195 Cal. Rptr. at 203.

70. *Id.*, 195 Cal. Rptr. at 203-04.

71. 162 Cal. App. 3d 1057, 209 Cal. Rptr. 383 (1984).

72. *Id.* at 1084, 209 Cal. Rptr. at 401.

73. *Id.* at 1085, 209 Cal. Rptr. at 401 (emphasis added).

74. *Id.*, 209 Cal. Rptr. at 401.

75. 169 Cal. App. 3d 359, 215 Cal. Rptr. 184 (1985).

76. *Id.* at 364, 215 Cal. Rptr. at 187.

Company. The wife, on the other hand, received some undisclosed assets. Soon thereafter, the husband defaulted on the loan to American Olean Tile Company, which in turn sought relief against the wife.⁷⁷ The court, relying on an obscure interpretation of California Civil Code section 5118, stated that "income earned and obligations incurred after separation in the operation of a separate property business are not community in nature."⁷⁸ Thus, the court held that the wife was not liable for the husband's debts incurred while the spouses were separated.⁷⁹

The court's interpretation is obscure because California Civil Code section 5118 mentions nothing about obligations incurred, but solely addresses the earnings and accumulations of a separated spouse while separated.⁸⁰ The First District Court interpreted Civil Code section 5118 to encompass that if the earnings and accumulations are to be the separate property of the separated spouse, then equitably, the debts incurred by the separated spouse which are unrelated to the community then should be the debts of that indebted, separated party.⁸¹

77. *Id.* at 363, 215 Cal. Rptr. at 186.

78. *Id.* at 364, 215 Cal. Rptr. at 187 (citing Civil Code section 5118 which states in pertinent part: "The earnings and accumulations of a spouse . . . while living separate and apart . . . are the separate property of the spouse." CAL. CIV. CODE § 5118).

79. *American Olean Tile Co.*, 169 Cal. App. 3d at 364, 215 Cal. Rptr. at 187.

80. CAL. CIV. CODE § 5118.

81. Additionally, in *American Olean Tile Co.*, the court was confronted with the issue of whether a valid transmutation of community property assets from community property to separate property of each spouse could then immunize the assets from subsequent debts incurred by a separated spouse. The court held that the valid transmutation effectively will immunize the prior community property assets which had become separate property; thus the only manner for the creditor to satisfy the debt is to pursue the separate property of the debtor spouse. *American Olean Tile Co.*, 169 Cal. App. 3d at 364, 215 Cal. Rptr. at 187.

The court mentioned exceptions to this general rule, holding that the community property remains liable if the transmutation agreement is entered into to defraud an existing creditor of either spouse, or if the creditor is misled to its detriment by the failure of the spouses to inform it that by virtue of an agreement between the spouses, the supposed community assets on which the creditor relied were in fact separate assets. *Id.* at 364, 215 Cal. Rptr. at 187.

The enforcement of a valid transmutation agreement thereby shielding the nondebtor spouse from incurring liability was reiterated in *Kennedy v. Taylor*, 155 Cal. App. 3d 126, 201 Cal. Rptr. 779 (1984). In *Kennedy*, the court stated: "Third party contract creditor[s] can easily avoid the risk of unknown interspousal transfer (and the embarrassment or burden of inquiring about them) by obtaining both spouses' signatures on notes Obtaining both spouses' signatures is a reasonable burden to place on creditors." *Id.* at 130, 201 Cal. Rptr. at 781.

This argument could be applied regardless of the existence of a valid transmutation agreement, for it may be more reasonable for a creditor to require both signatures rather than "a separated and noncontracting spouse . . . to police the financial dealings of his

B. Summary of Creditor's Rights

The courts, when regarding post-separation loans, strictly have limited the application of California Civil Code section 5120.110(a) or its predecessor, California Civil Code section 5116, which have held the community property liable for debts incurred by either spouse during the entire marriage. Prior to assessing liability on the community property or to either spouse's separate property for post-separation debts, the courts initially look to see if the loan relates to the community. If so, the community is liable. Conversely, if the loan is unrelated to the community, then it becomes the separate liability of the debtor spouse.

Relatedness entails two circumstances. The first is whether the liability incurred benefits the community; the second is whether the loan is obtained in exchange for community property. If either circumstance exists, then the liability is related to the community, thus creating a community property liability.

VII. THE QUALIFICATION OF CALIFORNIA CIVIL CODE SECTION 5118 — EARNINGS AND ACCUMULATIONS ACQUIRED AFTER SEPARATION

California Civil Code section 5118 was written to enable the separated spouse to become self-sufficient after the break-up of the community. It states in pertinent part: "The earnings and accumulations of a spouse . . . while living separate and apart from the other spouse, are the separate property of the spouse."⁸² The area of inquiry for this Comment concerns the qualification of the terms of "earnings" and "accumulations" within section 5118,⁸³ since adherence to the plain meaning of the statute would require all property acquired on credit during separation to be characterized as the sole property of the acquiring spouse.

Earnings under section 5118 have been construed broadly to encompass virtually any form of compensation for a spouse's time and efforts, including any income derived from the fruits of labor and

or her contracting spouse and to remain ever vigilant to notify prospective creditors of the true status of their marital relationship and respective assets." *Id.* A problem arises, however, with the legality of a creditor requiring both spouses to sign a promissory note. See *Anderson v. United Fin. Co.*, 666 F.2d 1274 (9th Cir. 1982); *United States v. ITT Consumer Fin. Corp.*, 816 F.2d 487 (9th Cir. 1987). See generally *supra* note 42. For further discussion of liability after division of property, see CALIFORNIA LAW REVISION COMM'N, *supra* note 57, at 9-11.

82. CAL. CIV. CODE § 5118.

83. Discussion of "living separate and apart" within CAL. CIV. CODE § 5118 is beyond this Comment. For a discussion of "living and apart" within Cal. Civ. Code § 5118 see Comment, *Living Separate and Apart Under section 5118 of the Family Law Act—Effects and Implications of the Bargaining Decision*, 6 W. ST. U.L. REV. 183 (1979).

services.⁸⁴ However, earnings exclude income derived with the aid of capital.⁸⁵

Accumulations have received a similarly broad interpretation. In 1910, the California Supreme Court,⁸⁶ applying Civil Code section 169,⁸⁷ defined accumulation as "any property which a person acquires and retains . . . [except where] . . . acquired by . . . [a] purchase with community funds, or in exchange for other community property."⁸⁸ Relying upon this definition, courts have found as accumulations under section 5118, the temporary support payments received by a spouse after separation;⁸⁹ real property previously held in joint tenancy by both spouses and subsequently purchased by a single spouse after separation at a foreclosure sale with funds advanced by a third party;⁹⁰ and damages received for wrongful death of a child of the marriage while in the custody of a spouse after separation.⁹¹ The property in these cases, the temporary support payments, the real property, and the wrongful death award, were items neither acquired in exchange for community property nor purchased with community funds, and thus are within the meaning of section 5118.

Conversely, in *Stephenson*,⁹² the court recognized that the real property acquired by the spouse using a loan pledged against the

84. See, e.g., *In re Marriage of Behrens*, 137 Cal. App. 3d 562, 573, 187 Cal. Rptr. 200, 206 (1982), in which the court held a corporation's post-separation contributions to a spouse's profit-sharing account were intended to be a form of compensation, and thus were separate property under section 5118.

85. See, e.g., *In re Marriage of Imperato*, 45 Cal. App. 3d 432, 438, 119 Cal. Rptr. 584, 590 (1975), in which the court held the earnings of a corporation are not, generally speaking, the earnings of the individual stockholder or stockholders, but are "profits" of the corporation to be distributed usually in the form of dividends.

86. *Union Oil Co. v. Stewart*, 158 Cal. 149, 110 P. 313 (1910).

87. CAL. CIV. CODE § 169 (repealed 1969). CAL. CIV. CODE § 169 stated: "The earnings and accumulations of the wife . . . while she is living separate from her husband, are the separate property of the wife." *Id.* The Family Law Act which became operative January 1, 1970 recodified CAL. CIV. CODE § 169 to CAL. CIV. CODE § 5118. The text of the statute remained the same. It was not until 1971 that Civ. Code § 5118 was amended and now states: "The earnings and accumulations of a spouse . . . while living separate and apart from the other spouse, are the separate property of the spouse." CAL. CIV. CODE § 5118. See also Bruch, *The Legal Import of Informal Marital Separations: A Survey of California Law and a Call for Change*, 65 CALIF. L. REV. 1015 (1977).

88. *Union Oil Co.*, 158 Cal. at 156, 110 P. at 316.

89. *In re Marriage of Wall*, 29 Cal. App. 3d 76, 79, 105 Cal. Rptr. 201, 203 (1972).

90. *Richardson v. Superior Court*, 101 Cal. App. 638, 644, 281 P. 1077, 1080 (1929).

91. *Christiana v. Rose*, 100 Cal. App. 2d 46, 56, 222 P.2d 891, 897-98 (1950).

92. 162 Cal. App. 3d 1057, 209 Cal. Rptr. 383 (1984).

community assets was in essence an exchange for community property. Thus, the property was not an accumulation within the meaning of section 5118.⁹³

In summary, when property is acquired on credit during separation and the loan is obtained in exchange for liability on community assets, then this accumulation is not governed by California Civil Code section 5118. Therefore, the property is not per se the separate property of the acquiring spouse.

VIII. SUGGESTIONS FOR THE SEPARATED BORROWING SPOUSE TO AVOID THE POSSIBILITY OF HIS OR HER SEPARATE CREDIT PURCHASES BECOMING THE PROPERTY OF THE COMMUNITY UNDER THE CURRENT CALIFORNIA LAW.

Under the present California lender's intent rule, it is important for the borrowing spouse to obtain written statements from lenders specifying exactly what the lender relied upon in extending the loan and to insure that the lender does in fact do so. The borrowing spouse should specify to the lender that the loan is solely for his or her separate use and, therefore, his or her signature alone is required on the promissory notes and other instruments of hypothecation. The borrowing spouse should insist that only separate property assets are to be used as collateral and method of repayment. Furthermore, he or she should inform the lender of the separation, thus establishing the uncertainty of separate property rights on the community property assets. The borrowing spouse should propose an agreement with the nondebting spouse stating that all post-separation debts are the liability of the debting spouse and the community property is free from any such liability. Finally, if possible, the spouse should enact and record a valid transmutation agreement for all community property and present this to the lender for his or her records.⁹⁴

Additionally, to alleviate the uncertainties, the legislature should both amend current legislation and enact new legislation. A few suggestions are presented in the remaining part of this Comment.

A. Proposed Amendments to Existing Statutes

1. Civil Code Section 5118 Earnings of Separated Spouse as Separate Property

Section 5118 states that earnings and accumulations acquired during separation are the separate property of the acquiring spouse. However, "accumulations" currently is not defined. Thus, an addi-

93. *Id.* at 1085, 209 Cal. Rptr. at 402.

94. *See, e.g.,* Bruch, *supra* note 87, at 1026-27.

tional subsection should be added to the statute. The following is a proposed definition of "accumulations" within section 5118:

(b) Accumulations within this section include all property acquired and retained except where acquired by a purchase with community funds, or in exchange for other community property.

This amendment not only would define accumulations but also would limit the current all-inclusive use of accumulations to only that property that was not purchased with community funds, or in exchange for community property. As a result, accumulations during separation are the separate property of the acquiring spouse only if acquired by his or her earnings, skill and time during the separation period, or in exchange for separate property of the separated acquiring spouse.

2. *Civil Code Section 5120.110: Community Property Liability for Debt of Either Spouse*

Section 5120.110(a) presently states that the community property is liable for all debts incurred by a spouse before or during marriage. This statute should be amended to require a distinction between debts incurred by a spouse during marriage but prior to separation and those debts incurred after separation. A proposed amendment reads as follows:

(a)(i) Except as otherwise expressly provided by statute, the community property is liable for a debt incurred by either spouse before or during marriage up until the point of separation, regardless of which spouse has the management and control of the property and regardless of whether one or both spouses are parties to the debt or to a judgment for the debt.

(ii) During the period between separation and dissolution of marriage, the community property is liable for debts incurred by either spouse which are related to the community. Debts incurred during this period which are unrelated to the community are the separate debt of the indebted spouse.

This amendment would leave unchanged the current credit liability of the spouses during marriage up until separation. However, during separation only those debts incurred to benefit the community will become liabilities of the community. Such an amendment would correspond with Civil Code section 5118. Thus, if the accumulation was to benefit the community, then the community would become liable for such a debt; however, the accumulation would be classified as a community property asset following the exposure analysis.

*B. Proposed New Legislation:
Credit Acquisitions During Marriage*

Currently, the California legislature has yet to address credit acquisitions during marriage. This area requires codification which should resolve both the inconsistencies and inequities in the present case law. There is no need to distinguish between acquisitions made prior to or after separation; since, in either case, the property characterization is determined by the liabilities incurred. The suggested section should read:

The proceeds of credit acquisitions during marriage are determined by the character of the assets exposed upon incurring the liability to acquire such assets. If both separate and community property assets are exposed upon incurring the debt, then the proceeds should be apportioned by the proportion of liability incurred by the exposed assets.

This proposed new legislation would remove California's current lender's intent analysis and statutorily impose the exposure analysis currently used in the community property states of Texas and Washington.⁹⁵

IX. CONCLUSION

The courts, in characterizing proceeds and property acquired on credit during separation, appear to have adopted the exposure analysis. To avoid further confusion and inequitable results, this Comment recommends an across-the-board adoption of the exposure analysis for all characterizations of credit acquisition throughout the marriage.

To apply the exposure analysis, knowledge of the parties' potential credit liability is required. In California, the community becomes liable for a post-separation debt if the loan relates to the community. The loan will relate to the community if either the liability incurred benefits the community, or the loan is obtained in exchange for community property.

Furthermore, during the separation period, not all accumulations are the separate property of the acquiring spouse. Accumulations which are obtained in exchange for liability on community assets are not governed by California Civil Code section 5118, and thus are not per se the separate property of the acquiring spouse. Both these principles are advanced within the proposed amendments to current legislation and suggested new legislation.

In the introductory hypothetical, a post-separation loan was extended to Husband which resulted in an accumulation during separa-

95. For discussion concerning the exposure analysis, see *supra* notes 37-55 and accompanying text.

ration of \$400,000. Adhering to the principles propounded by this Comment, first, Civil Code section 5118 automatically does not require the accumulation as the separate property of the acquiring spouse, since only accumulations that were acquired without exchanging liability on community assets are separate property of the acquiring spouse. Additionally, the proceeds should not be characterized by the lender's intent analysis, but instead by the exposure analysis. Thus, reviewing the assets exposed reveals that both Husband's separate property and community property assets were exposed when extending the loan. In such a case, the court should have discretion to apportion the proceeds in the proportion of separate to community liability. In addition, the court should give weight to the likely avenue of recovery.

In the introductory case, the community assets vastly outweigh the separate assets. In addition, upon default, the lender in all likelihood would seek repayment from the pledged community assets of A.B. Research, instead of attempting to collect on Husband's prospective salary. Considering these factors, the community should benefit from the potential liability. Thus, the proceeds should be entirely community property, and as such, shared between Husband and Wife.

WM. CURTIS BARNES, JR.

