Arizona's All-or-Nothing Approach to the Classification of Gain from Separate Property: High Time for a Change

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This Article** concerns the familiar situation where a married person owns separate property upon which he or she expends community labor, producing profits. The gain is logically attributable to two factors: (1) the return on the capital investment in the property and (2) the labor of the owner-spouse.[1] In all community property jurisdictions, gain attributable to the labor and skills of either spouse belongs to the community.[2] In five of the community property states, including Arizona, the return accruing during marriage on separate capital investment is classified as separate property.[3] The clash of these basic principles in the five "American rule"[4] states raises the perplexing problem of how the gain resulting from the application of community labor to separate capital should be classified: all community, all separate, or a mixture of the two. This problem arises in three basic types of cases: divorce, decedents' estates, and creditors' rights.

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1. Of course, the other spouse may also expend labor upon the property and this labor will have to be considered along with that of the owner-spouse in determining the amount of the gain owing to the community.

2. W. REPPY & W. DE FUNIAK, COMMUNITY PROPERTY IN THE UNITED STATES 1 (1975) [hereinafter cited as W. REPPY & W. DE FUNIAK]; W. DE FUNIAK & M. VAUGHN, PRINCIPLES OF COMMUNITY PROPERTY § 66, at 140 (2d ed. 1971) [hereinafter cited as PRINCIPLES].

3. W. REPPY & W. DE FUNIAK, *supra* note 2, at 248; PRINCIPLES, *supra* note 2, § 71, at 162 n.1. The relevant statutory provisions are as follows: ARIZ. REV. STAT. ANN. § 25-213 (1976); CAL. CIV. CODE §§ 5107, 5108 (West 1970); NEV. REV. STAT. § 123.130 (1975); N.M. STAT. ANN. § 57-4A-2(C) (Supp. 1975); WASH. REV. CODE § 26.16.020 (1976).

4. This is the term employed by Professors Reppy and de Funiak to denote the deviation made by these five states from the Spanish principle that the fruits, rents, and profits of separate property belong to the community. W. REPPY & W. DE FUNIAK, *supra* note 2, at 248.

Four of the five "American rule" states divide the gain between the community and the separate estate of the owner-spouse by means of one or more methods of apportionment. Arizona stands alone in refusing to adopt a system of apportionment.[5] The Arizona courts have long adhered to the assumption that it is impossible to accurately apportion the gain between the community and the spouse's separate estates, and have thus continued to classify the gain as either all community or all separate.

This Article takes the position that the "all-or-nothing"[6] approach presently utilized by the Arizona courts should be abandoned in favor of a system of apportionment. The Arizona case law is examined initially, followed by a brief look at the various systems of apportionment employed in the other jurisdictions. The Article then considers the unfairness which results from the application of the all-or-nothing approach, and advances a proposal for a new approach designed to effectuate "substantial justice"[7] between the community and the owner-spouse's separate estates. A discussion of the classification problem as it arises in "reverse" form (separate labor applied to community capital) follows next. The Article concludes with some thoughts on why a shift by the Arizona courts to the apportionment of gain would not be unfair to creditors in that state.

I. ARIZONA'S ALL-OR-NOTHING APPROACH

A. The Origins of the Problem

Under Spanish law, the rents, issues and profits of a spouse's separate property were classified as community property.[8] The Arizona legislature codified this principle in 1865 when it adopted a comprehensive community property act.[9] But in the *Charauleau-Woffenden* cases, the Arizona Supreme Court repudiated the Spanish principle and classified these items as the separate property of the owner-spouse.[10] At the present time, the rents, issues, and profits of a

5. W. REPPY & W. DE FUNIAK, *supra* note 2, at 261-62. For a discussion of the Arizona case law on this subject, see text accompanying notes 13-27 *infra*. Texas also employs an all-or-nothing system, *see* W. REPPY & W. DE FUNIAK, *supra* note 2, at 282-83, but because it is not an "American rule" state, its law on this subject is not discussed herein.

6. This is the shorthand employed by Professors Reppy and de Funiak to describe the Arizona approach to the problem. W. REPPY & W. DE FUNIAK, *supra* note 2, at 261.

7. The phrase "substantial justice" was adopted by the California courts in reference to the choice to be made by them in a given case between the two systems of apportionment utilized in that state. *See, e.g.*, Beam v. Bank of America, 6 Cal.3d 12, 18, 490 P.2d 257, 261, 98 Cal. Rptr. 137, 141 (1971); Logan v. Forster, 114 Cal. App.2d 587,599-600, 250 P.2d 730, 738 (1952). The term is also found in New Mexico case law. *See* Laughlin v. Laughlin, 49 N.M. 20, 35, 155 P.2d 1010, 1019 (1945). *See also* text accompanying notes 47-50 *infra* for a discussion of the California approaches to apportionment of gain from the separate property of one of the spouses.

8. W. REPPY & W. DE FUNIAK, *supra* note 2, at 247; PRINCIPLES, *supra* note 2, § 71, at 160; Lyons, *Development of Community Property Law in Arizona*, 15 LA. L. REV. 512, 514 (1955).

9. Arizona Laws 1865, c. XXXI, § 9, p. 61; *see* Lyons, *supra* note 8, at 514 n.17.

10. *See* C. SMITH, SUMMARY OF ARIZONA COMMUNITY PROPERTY LAW 39 (1977 ed.); Ly-

spouse's separate property are classified as separate property by statute.[11]

In Arizona, as in the other community property states, gains due to the labor of either spouse during the marriage are generally considered community property.[12] Thus, the clash of basic principles and the resulting problem of classifying the gain from applying labor to separate property have confronted the courts of Arizona since the latter part of the last century.

B. Cases Illustrating the All-or-Nothing Approach

In *Rundle v. Winters*[13] the Arizona Supreme Court followed the rule then existing in Nevada[14] in announcing an all-or-nothing approach to the classification of gain from a spouse's separate business:

> Where either spouse is engaged in a business whose capital is the separate property of such spouse, the profits of the business are either community or separate in accordance with whether they are the result of the individual toil and application of the spouse, or the inherent qualities of the business itself.[15]

In *Rundle* the husband owned and operated a pool hall business. The court considered this to be the type of business in which profits would result "primarily" from the spouse's labor rather than from the inherent qualities of the business.[16]

In *In re Estate of Torrey*[17] the court noted that the all-or-nothing formula was easy to state, but difficult to apply to the facts in a given case.[18] Yet, relying upon the leading Nevada case on the subject,[19] the

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ons, *supra* note 8, at 514. The first of this line of cases, Charauleau v. Woffenden, 1 Ariz. 243, 260-61, 25 P. 652, 657 (1876) held that the classification of rents, issues and profits as community property had been impliedly repealed by *An Act Relating to the Separate Property of Married Women*, No. 2, 1871 Ariz. Acts 18 (1871) (current version at ARIZ. REV. STAT. ANN. § 25-214(A) (1976)). In repudiating the Spanish rule, the court relied in part upon the philosophy of the California Supreme Court in George v. Ransom, 15 Cal. 322, 76 Am. Dec. 490 (1860). *See* 1 Ariz. at 260, 25 P. at 657. The court adhered to this position in the second case, Woffenden v. Charauleau, 1 Ariz. 346, 353, 25 P. 662, 664 (1876), but then returned to the Spanish rule in the third. Woffenden v. Charouleau, 2 Ariz. 44, 48-49, 8 P. 302, 304 (1885). It finally repudiated the Spanish rule in the fourth case. Woffenden v. Charouleau, 2 Ariz. 91, 93, 11 P. 117, 118 (1886).

11. ARIZ. REV. STAT. ANN. § 25-213 (1976) provides: "All property, real and personal, of each spouse, owned by such spouse before marriage, and that acquired afterward by gift, devise or descent, and also the increase, rents, issues and profits thereof, is the separate property of such spouse."

12. ARIZ. REV. STAT. ANN. § 25-211 (1976) provides: "All property acquired by either husband or wife during the marriage, except that which is acquired by gift, devise or descent, is the community property of the husband and wife." This does not mean, however, that gain accruing from a spouse's labor after separation must necessarily be considered community property. See text & notes 98-133 *infra* for a discussion of the status of the "living separate and apart" doctrine in Arizona.

13. 38 Ariz. 239, 298 P. 929 (1931).

14. Lake v. Bender, 18 Nev. 361, 392, 4 P. 711, 728 (1884), *modified*, 18 Nev. 361, 411-12, 7 P. 74, 80-81 (1885).

15. 38 Ariz. at 245, 298 P. at 931.

16. *Id.* at 246-47, 298 P. at 931-32.

17. 54 Ariz. 369, 95 P.2d 990 (1939).

18. *Id.* at 375, 95 P.2d at 993.

19. Lake v. Bender, 18 Nev. 361, 392, 4 P. 711, 728 (1884), *modified*, 18 Nev. 361, 411-12, 7 P.

court summarily rejected any attempt at apportionment:

> And in this or any other case, if profits come mainly from the property, rather than the joint efforts of the husband and wife, or either of them, they belong to the owner of the property, although the labor and skill of one or both may have been given to the business. On the contrary, if profits come mainly from the efforts or skill of one or both, they belong to the community. *It may be difficult in a given case to determine the controlling question, owing to the equality of the two elements mentioned, but we know of no other method of determining to whom profits belong.* In the use of separate property for the purpose of gain, more or less labor or skill of one or both must always be given, no matter what the use may be; and yet the profits of property belong to the owner, and in ascertaining the party in whom the title rests, *the statute provides no means of separating that which is the product of labor and skill from that which comes from the property alone.*[20]

In *Torrey* the separate business was a restaurant. The court felt that this, like the pool hall in *Rundle*, was the type of business in which profits were attributable "mainly" to the spouse's labor.[21]

In *Anderson v. Anderson*[22] the court applied the all-or-nothing test in holding that real estate purchased by a husband after marriage from the earnings of his cleaning establishment was community property. Again, the court looked at the *type* of business involved and classified the gain accordingly.[23] In *Lawson v. Ridgeway*[24] the court held that the profits of a country general store were attributable to the personal efforts of the husband and not to the return on the capital investment.[25]

Finally, In *Porter v. Porter*[26] the court provided a list of the various types of businesses which had previously been held by the courts of Arizona and other jurisdictions to fall within one or the other of the two categories:

> [I]ncome from pool and billiard halls, restaurants, cleaning establishments, lumber mills, bakeries, liquor and cigar stores, saloon and gambling parlors, farms, drayage and forwarding businesses, and the

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74, 80-81 (1885).

20. 54 Ariz. at 375-76, 95 P.2d at 993, (quoting Lake v. Bender, 18 Nev. 361, 392, 4 P. 711, 728 (1884), *modified*, 18 Nev. 361, 411-12, 7 P. 74, 80-81 (1885)) (emphasis added).

21. We think the inherent nature of the restaurant business is such that if it is a success it is generally, if not always, due to the management. Proper food properly prepared and served are the things that attract and hold the trade. These services were rendered by the deceased and whatever accrued therefrom belongs to the community.

54 Ariz. at 376, 95 P.2d at 993.

22. 65 Ariz. 184, 177 P.2d 227 (1947).

23. "There can be no doubt that the inherent nature of the clothes cleaning business is like the restaurant business. Its success is due to the management and requires the attention of the owner of it." *Id.* at 187, 177 P.2d at 229.

24. 72 Ariz. 253, 233 P.2d 459 (1951).

25. *Id.* at 261, 233 P. 2d at 464.

26. 67 Ariz. 273, 195 P.2d 132 (1948).

> income of a practising physician have all been held to be community in character . . . [w]hile on the other hand income from hotels and toll roads, farming and nursery operations, farm rentals have been held to constitute separate income.[27]

C. The Segregation Test—A Slight Deviation from the All-or-Nothing Approach in Arizona

In a small number of cases, the Arizona courts have applied a test by which the gain from the separate property *is* subjected to a limited form of apportionment.[28] Where the owner-spouse withdraws from the business an amount for his salary which, within a broad range of fairness, reflects the value of his labor, the court will designate that salary as the amount of the gain owing to the community. The remainder of the gain from the enterprise will be designated as the amount owing to the owner-spouse's separate estate.[29] The courts have made it very clear that they will not utilize the segregation test unless they deem the salary designated by the owner-spouse to be an adequate payment for the services that he has rendered. Where the court does not deem the salary to be adequate, the usual all-or-nothing rule will be applied, and no apportionment will be made.[30]

D. Intention of the Parties as the Controlling Factor

The segregation cases recognize that the parties may themselves provide a method by which the gain from the separate property will be classified.[31] In a number of other cases the courts have classified the gain in accordance with the intent of the parties, even though there had been no formal "segregation" of a community property salary.[32] For example, in *Spector v. Spector*[33] the parties entered into an antenuptial contract which established that the earnings received by each spouse resulting from the separate ownership of income-producing assets would be separate. The court upheld this arrangement, noting that it

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27. *Id.* at 280-81, 195 P.2d at 136-37 (citations omitted).

28. *See* Nelson v. Nelson, 114 Ariz. 369, 371, 560 P.2d 1276, 1278 (1977); Porter v. Porter, 67 Ariz. 273, 284, 195 P.2d 132, 139 (1948); Lincoln Fire Insurance Co. v. Barnes, 53 Ariz. 264, 270, 88 P.2d 533, 535 (1933). See text accompanying notes 69-77 *infra* for a critique of the court's application of the segregation test in *Barnes* and *Porter*.

29. See W. REPPY & W. DE FUNIAK, *supra* note 2, at 262-63 for a discussion of the segregation test. See also text accompanying notes 51-55 *infra*.

30. In the absence of a clear showing that a fair salary for the husband's efforts has been set, Arizona decisions have followed an 'all or none' rule, placing the earnings either all in the community, or all in the separate estate, depending upon the nature of the property, with every presumption being in favor of the community.

Nace v. Nace, 6 Ariz. App. 348, 354, 432 P.2d 896, 902 (1967), *vacated on other grounds*, 104 Ariz. 20, 488 P.2d 76 (1968). *See also* Evans v. Evans, 79 Ariz. 284, 287, 288 P.2d 775, 777 (1955); Lawson v. Ridgeway, 72 Ariz. 253, 260-61, 233 P.2d 459, 464 (1951). All three cases stand for the proposition that the salary of a manager of separate property does not *ipso facto* measure the gain attributable to his services.

31. *See* Evans v. Evans, 79 Ariz. 284, 286, 288 P.2d 775, 777 (1955).

32. For a discussion of the importance of intent as a factor in the classification of property as either community or separate, see text accompanying notes 112-26 *infra*.

33. 23 Ariz. App. 131, 531 P.2d 176 (1975).

avoided "the confusion in ownership arising from 'mixed income.' "[34] And in *Noble v. Noble*,[35] the court held that the parties' mistaken belief that all gain from separate property belonged by law to the community was tantamount to an implied "transmutation"[36] contract on such terms.[37]

Although the intent of the parties may thus be a significant factor for classification purposes, in the absence of clear evidence as to the proper division, the entire gain will be deemed to belong to the community in any case where it does not appear that the separate business is of a type producing primarily a return of capital.[38] The burden is upon the party asserting the separate interest to overcome the presumption that all earnings during coverture are community in nature.[39]

E. Recent Cases—Do They Indicate that a Change is Forthcoming?

Two recent cases decided by the Arizona Court of Appeals may appear upon an initial reading to call for an abandonment of the all-or-nothing approach and the adoption of an apportionment system. In *Everson v. Everson*[40] the appellate court remanded the case to the trial court with the directive to determine what portion of the gain was due to the management of the owner-spouse and what portion to the inherent nature of the business.[41] However, rather than make an apportionment, the trial court was apparently directed to determine which factor

34. *Id.* at 138, 531 P.2d at 183.

35. 26 Ariz. App. 89, 546 P.2d 358 (1976).

36. "Transmutation" merely refers to a change in the characterization of property (*i.e.*, separate to community or vice versa). The term is employed most often to refer to the change in characterization which results from an implied or express agreement between the spouses. *See* W. REPPY & W. DE FUNIAK, *supra* note 2, at 421-26.

Normally, of course, the Arizona court faced with a case involving the application of community labor to separate capital would employ the all-or-nothing rule in order to determine whether the profits of the business were separate or community. In *Noble*, however, the court gave effect to the spouses' understanding that all gain from the separate property belonged to the community. Thus the gain, which might conceivably have been held to be separate property, was "transmuted" into community property in accordance with the spouses' understanding. For a discussion of "transmutation" agreements, both express and implied, under California law, see Bruch, *The Legal Import of Informal Marital Separations: A Survey of California Law and a Call for Change*, 65 CAL. L. REV. 1015, 1026-27 (1977). See also text accompanying notes 110-33 *infra* for a discussion of transmutation agreements under Arizona law.

37. 26 Ariz. App. at 93-94, 546 P.2d at 362-63.

38. *See* Stauss v. Stauss, 82 Ariz. 268, 270, 312 P.2d 148, 150 (1957) (when no "intelligent guide" is furnished to the court to segregate the portion of the income which may be attributable to the inherent nature of the separate business, all income will be treated as community property). Apparently then, in any situation in which it is doubtful how to apply the all-or-nothing test, the Arizona courts resolve the problem by falling back upon the presumption that all property acquired during marriage is community property. *See* note 39 *infra*.

39. [W]here doubts exist as to whether the proceeds represent the product of skill, labor, or management, as opposed to inherent return on investment, they are generally resolved in favor of finding the former, there being a strong presumption, rebuttable only by clear and convincing evidence, that all earnings during coverture are community in nature.

Barr v. Petzhold, 77 Ariz. 399, 409, 273 P.2d 161, 167 (1954). For a discussion of the community property presumption, *see* C. SMITH, *supra* note 10, at 27-28.

40. 24 Ariz. App. 239, 537 P.2d 624 (1975).

41. *Id.* at 243, 537 P.2d at 628.

was predominant, and then to classify the entire gain accordingly.[42] In *Nelson v. Nelson*[43] the court did cite the California apportionment case of *Van Camp v. Van Camp*.[44] However, the court appears to have cited *Van Camp* not with an intent to adopt the system of apportionment established in that case, but rather to support its conclusion that the husband's salary was sufficiently adequate so that the segregation test could be employed.[45]

Thus, although no change seems to be indicated by recent cases, the courts of Arizona are now aware that there are indeed methods available to apportion the gain from a spouse's separate property. A brief overview of the various methods of apportionment follows.[46]

II. MAJOR SYSTEMS OF APPORTIONMENT EMPLOYED IN THE OTHER COMMUNITY STATES

A. The Pereira Approach

In *Pereira v. Pereira*[47] the California Supreme Court applied a reasonable interest rate[48] to the capital investment component of the separate capital/community labor endeavor. The resulting figure was held to be the amount of the gain attributable to the inherent nature of the business and hence was the amount due the separate estate. The remainder of the gain was allocated to the community.[49]

B. The Van Camp Approach

In *Van Camp v. Van Camp*[50] the court computed a fair salary for the community labor expended upon the separate property over the years. This amount was allocated to the community. The remainder of the gain was allocated to the separate estate of the owner-spouse.

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42. W. REPPY, SUPPLEMENT TO COMMUNITY PROPERTY IN THE UNITED STATES 13 (1977), states that it is possible to read *Everson* as adopting an apportionment approach like that of the California Supreme Court in Beam v. Bank of America, 6 Cal. 3d 12, 17, 490 P.2d 257, 261, 98 Cal. Rptr. 137, 141 (1971) (see the discussion of *Beam* in text accompanying notes 60-62 *infra*). The Arizona court, however, made no direct reference to apportionment and stated the all-or-nothing rule in its opinion. *See* 24 Ariz. App. at 243, 537 P.2d at 628.

43. 114 Ariz. 369, 560 P.2d 1276 (App. 1977).

44. 53 Cal. App. 17, 28, 199 P. 885, 889 (1921). See text accompanying note 50 *infra* for a discussion of the *Van Camp* apportionment test.

45. 114 Ariz. at 371-72, 560 P.2d at 1278-79. As Professor Reppy notes, the Arizona court remarked that "the law in California differs somewhat from our own." W. REPPY, *supra* note 42, at 13.

46. *See generally* W. REPPY & W. DE FUNIAK, *supra* note 2, at 261-64; King, *The Challenge of Apportionment*, 37 WASH. L. REV. 483, 485-93 (1962).

47. 156 Cal. 1, 103 P. 488 (1909).

48. The interest rate applied by the court was seven percent, the legal interest rate in California at the time. *Id.* at 11-12, 103 P. at 492-93. This figure has been the rate most often applied by courts utilizing *Pereira*. *See* King, *supra* note 46, at 489. *See also* Jones v. Jones, 67 N.M. 415, 419-20, 356 P.2d 231, 235 (1960) (court rejected argument that ten percent rate should be used).

49. See text accompanying notes 85-87 *infra* for a discussion of some of the problems inherent in the *Pereira* approach.

50. 53 Cal. App. 17, 199 P. 885 (1921). See text accompanying notes 85 & 88 *infra* for a discussion of the problems inherent in the *Van Camp* approach.

C. *The Segregation Test*

As has already been seen, a few Arizona cases have applied this test to apportion the gain between the community and the manager's separate estate.[51] Washington, after initially utilizing the all-or-nothing approach,[52] adopted this system and has applied it in a much more extreme fashion than have the Arizona courts.[53] Where the spouse's separate business is unincorporated, where he or she works on separately owned real estate, or where he or she buys and sells separately owned securities, failure to segregate a salary will result in a holding that the entire gain belongs to the community.[54] And where the business is incorporated, the amount which the corporation pays the spouse *ipso facto* establishes the amount due the community, with the remainder of the profits going to the separate estate.[55]

D. *The Compromise Model*

This method, which is a compromise between the *Pereira* and *Van Camp* approaches, has been utilized in only two reported cases, both involving taxation.[56] Under this system, the court computes a fair return on the capital investment (as under *Pereira*), and also a fair salary for the services rendered by either or both spouses (as under *Van Camp*). If the former amount is represented by "a" and the latter by "b," $\frac{a}{a+b}$ will be the separate component of the gain and $\frac{b}{a+b}$ will be the community component.[57]

E. *The "Substantial Justice" Approach*

California, Nevada, and New Mexico purport to use both the *Pereira* and *Van Camp* formulas for apportionment; the problem in these states is how to decide which test is the appropriate one in a given

51. See cases cited in notes 28-30 *supra*.

52. *In re* Buchanan's Estate, 89 Wash. 172, 180-81, 154 P. 129, 132 (1916).

53. See text accompanying note 30 *supra* for a discussion of the limits imposed by the Arizona courts on the application of the segregation test. Despite these self-proclaimed limits on the test, the Arizona courts have occasionally applied it without determining whether the designated salary was adequate. See text accompanying notes 69-77 *infra* discussing the *Barnes* and *Porter* cases.

54. *See, e.g., In re* Estate of Smith, 73 Wash.2d 629, 630-31, 440 P.2d 179, 180-81 (1968); Pollock v. Pollock, 7 Wash. App. 394, 401, 499 P.2d 231, 237 (1972).

55. *See, e.g.*, Hamlin v. Merlino, 44 Wash.2d 851, 858-59, 272 P.2d 125, 129 (1954). Michelson v. Michelson, 89 N.M. 282, 287-88, 551 P.2d 638, 643-44 (1976), provides another illustration of a mechanical application of the segregation test. Presumably, proof of a deliberate attempt to set an unreasonably low salary to benefit the spouse's separate estate would result in relief from this automatic approach employed by the Washington courts.

56. Todd v. Commissioner, 153 F.2d 553, 555 (9th Cir. 1945); Todd v. McColgan, 89 Cal. App.2d 509, 512, 201 P.2d 414, 417 (1949).

57. This is the description of the compromise method provided in W. BROCKELBANK, THE COMMUNITY PROPERTY LAW OF IDAHO 174-75 (1962). See note 89 *infra* for a discussion of the pros and cons of the compromise method.

case.[58] In California and New Mexico, a pro-*Pereira* bias had developed through numerous cases[59] until the California decision of *Beam v. Bank of America*[60] established a case-by-case approach whereby the equities are examined:

> In applying this principle of apportionment the court is not bound either to adopt a predetermined percentage as a fair return on business capital which is separate property . . . nor need it limit the community interest only to [a] salary fixed as the reward for a spouse's service . . . but may select [whichever] formula will achieve substantial justice between the parties.[61]

However, because it provided no guidance to trial judges as to which formula would achieve "substantial justice" under which circumstances, the *Beam* decision is highly unlikely to end the *Pereira-Van Camp* debate.[62]

III. THE UNFAIRNESS OF THE ALL-OR-NOTHING APPROACH AND THE NEED FOR AN APPORTIONMENT SYSTEM

A. Unfairness of the All-or-Nothing Rule

None of the systems of apportionment described above can *precisely* measure the amount of gain which is due to the return on capital on the one hand or to community labor on the other. Nonetheless, this is no reason to refuse to make an attempt at apportioning the gain. Certainly it will be a rare case in which the gain can accurately be attributed wholly to one factor as opposed to the other. The failure of the Arizona courts to apportion, then, must necessarily result in repeated instances of unfairness to either the separate estate or the community at the behest of the other. Nevada, the latest "American rule" state to abandon the all-or-nothing approach in favor of apportionment, was well aware of this inequitable effect:

> The rule we announce today [adopting the *Beam* approach] is necessary in order to prevent the inherent injustice of denying the owner

58. Actually, in New Mexico, the segregation test, as well as *Van Camp* and *Pereira*, has been approved for use in apportionment cases, so the courts there must select which of these three approaches is appropriate. *See* Gillespie v. Gillespie, 84 N.M. 618, 623, 506 P.2d 775, 780 (1973).

59. *See, e.g., In re* Estate of Neilson, 57 Cal. 2d 733, 740, 22 Cal. Rptr. 1, 4-5, 371 P.2d 745, 748-49 (1962); Laughlin v. Laughlin, 49 N.M. 20, 31, 155 P.2d 1010, 1017 (1944). In *In re* Marriage of Lopez, 38 Cal. App. 3d 93, 106, 113 Cal. Rptr. 58, 66 (1974), it was said (speaking in the context of a very successful separate-capital, community-labor business) that *Pereira* was the preferred test but *Van Camp* was the appropriate formula when the spouse's labor "had a minor influence" on the occurrence of the gain. Clearly, the *Lopez* test would not have endorsed *Van Camp* had the gain been very modest while labor had such a "minor influence." See text accompanying note 81 *infra* for a discussion of which test should be chosen under which circumstances.

60. 6 Cal. 3d 12, 490 P.2d 257, 98 Cal. Rptr. 137 (1971).

61. *Id.* at 18, 490 P.2d at 261, 98 Cal. Rptr. at 141.

62. See text accompanying notes 78-81 *infra* for the author's guidelines as to when a court should choose one formula over the other in order to effectuate substantial justice between the parties. For an idea of the confusion spawned by the coexistence of the two apportionment formulas, see Comment, *Apportionment of Income from a Spouse's Separately Owned Property*, 51 CAL. L. REV. 161, 187-95 (1963).

> of separate property a reasonable return on the investment merely because the increase in value results 'mainly' from the labor, skill or industry of one or both spouses.[63]

The injustice and unfairness inherent in the all-or-nothing approach are perhaps best demonstrated by the "laundry list" of businesses contained in the *Porter* case.[64] What assurance is there, for example, that the gain derived from hotels or from farming and nursery operations must be mainly a result of the return on capital rather than of the labor expended thereon, or that the gain derived from a lumber mill or a liquor store is always a result primarily of the labor expended rather than the return on capital? This attempt by the Arizona Supreme Court to make some sense of the previous cases applying the all-or-nothing rule strongly indicates that it is no easier for a court to determine whether the gain is due mainly to labor or return on capital than it is to choose between the *Pereira* and *Van Camp* formulas in the states that attempt to make an apportionment.[65] As noted previously, the court in *In re Estate of Torrey* admitted that the all-or-nothing rule was often difficult to apply to the facts of a given case.[66] Clearly, then, simplicity of application or relieving the courts from a burdensome litigation issue cannot justify Arizona's refusal to attempt apportionment.

B. Apportionment in Arizona: What System Should Be Adopted?

In order to ensure that both the community and the separate estate of the owner-spouse are accorded a fair share of the gain, it is clear that a system of apportionment should be adopted. It remains to be decided which system can best effectuate substantial justice between the parties.

1. *The Segregation Test Should Not Be Adopted.*

As noted previously, some Arizona cases have utilized the segregation test to apportion the gain.[67] However, this test is not the one most likely to effectuate substantial justice. The Arizona courts have recognized this fact to the extent that they have declined to apply the test where the salary segregated by the owner-spouse appeared to be inadequate to fairly compensate the community.[68] Despite this stated policy

63. Johnson v. Johnson, 89 Nev. 244, 246-47, 510 P.2d 625, 626 (1973).
64. Porter v. Porter, 67 Ariz. 273, 280-81, 195 P.2d 132, 136-37 (1948).
65. *See* W. REPPY & W. DE FUNIAK, *supra* note 2, at 262.
66. 54 Ariz. at 375, 95 P.2d at 993.
67. *See* text & notes 28-30 *supra*.
68. See text and note 30 *supra*. In *Lawson v. Ridgeway* the court stated:
> The suggestion that the drawing or salary account of a partner is in every instance the extent of the contribution of the community of which he is a member to the partnership business, in the absence of proof to the contrary, is to suggest that such drawings or salaries from a partnership are usually set by the partners with the thought that the amount drawn fairly represents the value of the personal services rendered. We believe it to be a matter of common knowledge that such drawing accounts are normally deter-

of limiting the application of the test, in two cases the court applied it with the result that the community was not credited with its fair share of the gain.

In *Porter v. Porter*[69] the husband worked for a corporation, of which he was a one-third owner, that manufactured and sold leather goods. The corporation paid him a "salary" which the court acknowledged to be "at all times inadequate for the maintenance of the community expenses."[70] The corporation also paid him $96,696.21 in "dividends" during fourteen years of marriage. The court, emphasizing that the success of the corporation was not a result of any unusual talents, skill or management on the part of the husband, since he was merely "an employee, performing ordinary duties which could have been performed by other individuals not possessing any unusual qualifications,"[71] held that all of the husband's gains except his "salary" were separate property, despite its admission that the "salary" was clearly inadequate to compensate the community. The result was plainly unfair to the community.

In *Lincoln Fire Insurance Co. v. Barnes*[72] the wife made a downpayment of $45,000 on a long-term lease of hotel property. The downpayment consisted solely of the wife's separate property. The remainder of the $185,000 purchase price was evidenced by a note secured by a chattel mortgage. The payments on the note were made largely out of the earnings of the hotel, and those earnings were due mainly to the labor of the spouses, as opposed to the return on the capital investment. The plaintiff, husband's community creditor, argued that by virtue of these payments the community had acquired an interest in the lease. Therefore, he contended that when the leasehold was subsequently sold, part of the proceeds belonged to the commu-

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mined by other factors such as the amount that can be drawn out of the business regularly without financially embarrassing the business and by the criterion of how much is needed for normal and regular living expenses of the partners. It would certainly be a rare case when such drawing accounts were determined upon the basis of the value of the personal services rendered with the thought that anything over and above that would be a return from capital investment.

72 Ariz. at 260, 233 P.2d at 464. In W. BROCKELBANK, *supra* note 57, at 177-78, the same concern is echoed:

> It is often said that the community must be satisfied with the salary or wage taken from the business by the husband. The trouble here is that such a salary is not set on a competitive basis. The husband is at both ends of the bargain. He runs the business and hires himself as manager. . . . The husband, on the one hand, acting like an owner, and wishing to spend as little as possible and build up as big a surplus as possible in the business, will take out of the business a very small amount, much less than any fair estimate of the worth of his services. On the other hand if he owns only 51% of the stock, he has control and may wish to abuse it by allotting to himself a salary much larger than his services are worth. In both cases, this basis for the part that is to be given the community is unrealistic.

69. 67 Ariz. 273, 195 P.2d 132 (1948).
70. *Id.* at 277, 195 P.2d at 134.
71. *Id.* at 281, 195 P.2d at 137.
72. 53 Ariz. 264, 88 P.2d 533 (1939).

nity. The court held that the community had no interest, since property takes its character as community or separate at the time it is acquired; here, the lease was acquired with the separate property of the wife and hence was impressed with that character.[73] The only interest the community might conceivably have would be a lien on the proceeds of sale for the amount contributed by it to the payments on the note. Since, as noted above, the earnings of the hotel were due primarily to the spouses' labor, the community appeared to be entitled to a reimbursement. Under the all-or-nothing test the earnings would be classified as wholly community property. However, the evidence showed that the spouses had been paid for their services out of the earnings of the hotel. The court held that this "salary" was the only portion of the profits that belonged to the community; the remainder belonged to the separate estate of the wife as the return on the capital she had invested.[74] Because it chose to apply the segregation test rather than the all-or-nothing test, the court necessarily concluded that the community did not have a lien on the proceeds of sale.[75]

The court's use of the segregated salary test in *Barnes*, as in *Porter*, dictated a result which was unfair to the community. This is generally so, unless the segregation is the result of an agreement between husband and wife that the salary (also agreed upon) will be the sole remuneration for community labor. Where (s)he has entered into such an agreement the spouse who does not own the seperate capital cannot complain that marital property law would, absent the agreement, have given the community a greater return.

The mechanical application of the segregation test in *Porter* and *Barnes* is similar to the rigid approach taken by the Washington courts,[76] and the result reached in both cases conflicts with that which

73. *Id.* at 269, 88 P.2d at 535. The court relied here upon the inception of title rule of Horton v. Horton, 35 Ariz. 378, 380-81, 278 P. 370, 371 (1929).

74. [I]t is urged by plaintiff that it is obvious that the income of the hotel was mainly the product of the individual toil and application of the two spouses rather than of the inherent qualities of the business itself. If it were not for one fact there might be some merit to this contention of plaintiff, but the undisputed evidence shows that both Mr. and Mrs. Barnes were paid for their services out of the income of the hotel, the one by a salary and the other by a drawing account. Under these circumstances, we think the trial court was justified in concluding that the parties themselves considered their personal services, which, of course, belonged to the community, were compensated by the salary and the drawing account and that the profits in excess of that came out of the inherent qualities of the business itself.

53 Ariz. at 270, 88 P.2d at 535.

75. It is true that Mrs. Barnes testified she paid a considerable portion of her drawing account on the mortgage, but this would not affect the conclusion that the income of the hotel above the drawing account and salary of her husband was the earnings of the business and the amount paid on the loan from the drawing account is not fixed with sufficient definiteness to establish any lien of the community upon the property for such payments under the doctrine of *Horton v. Horton* . . . .

Id. at 270-71, 88 P.2d at 535.

76. Text & notes 54-55 *supra*. In Hamlin v. Merlino, 44 Wash.2d 851, 272 P.2d 125 (1954), the husband had the corporation which he controlled pay him an annual average salary of $1,858

would be reached if the presumption in favor of the community were applied.[77] The segregation test clearly has not worked substantial justice between the parties in past cases and holds no promise of doing so in the future unless confined to cases of proven antenuptial or postnuptial contract.

2. *A Proposed System of Apportionment*

Arizona should follow the lead of the California Supreme Court in the *Beam* case and apportion the gain from separate property so as to achieve substantial justice between the parties. However, the *Beam* court did not provide any meaningful guidance to trial courts with respect to the choice between the *Pereira* and *Van Camp* systems.[78] Therefore, the courts of Arizona should employ the following criteria in making the choice between these systems of apportionment. First, the court should determine whether the amount of labor expended upon the separate property was high or low. This step in the analysis involves an inquiry very much like that now used in the all-or-nothing cases. Labor is "high" if the court believes that labor contributed more than the separate capital to producing whatever gains accrued. It is "low" if the capital is viewed as the chief contributing factor in producing the gain. Second, the court should determine whether the gain realized from the endeavor was high or low. Comparison at this step of the analysis is to gains enjoyed nationally (or state-wide, perhaps) by similar businesses in view of the amount of capital, hours of labor and type of labor invested. For example, if $100,000 of capital and eight hours per week of labor are invested, a total gain over one year of $5,000 is manifestly *low*, while a gain of $100,000 is *high* (even if the labor is that of a skilled professional such as a veterinarian or lawyer). Some cases will involve rather clear examples of high or low gain.[79] In others, the choice of the high or low label will involve close line drawing which must be entrusted to the discretion of the judge,[80] who may, if the par-

between 1929 and 1945. The court noted that this salary "was rather small" and was completely consumed by family expenses. However, the court stated that the fairness of the salary depended upon the amount of earnings of the corporation. Since it had not been established what those earnings were, the salary was held to be conclusive as to the community's portion of the gain. *Id.* at 860, 272 P.2d at 129-30.

77. "In order to simplify the determination of the character of property, Arizona has repeatedly resorted to a presumption that all property acquired during marriage is community property." C. SMITH, *supra* note 10, at 27 and cases cited therein. The presumption is codified in ARIZ. REV. STAT. ANN. § 25-211 (1976).

78. *See* text accompanying notes 60-62 *supra*.

79. *Beam v. Bank of American*, 6 Cal. 3d 12, 16, 490 P.2d 257, 260, 98 Cal. Rptr. 137, 140 (1970), was a case where the court was able to declare readily from the facts before it that the gain was "modest", *i.e.*, *low*. *See* note 82 *infra*.

80. Even if the apportionment issue arises in a jury trial case, the high-low determination should be treated as a question of law.

ties wish, be guided by expert testimony or take judicial notice of commonly known economic conditions.

Third, armed with the data drawn from steps one and two, the court can determine which formula should be applied. The matrix of combinations and the appropriate formula to be used with each combination looks like this:

Labor	Gain	Formula
High	High	Pereira
High	Low	Van Camp
Low	High	Van Camp
Low	Low	Pereira

In the first situation, where the amount of labor expended is high and the gain is also high, *Pereira* is the appropriate formula, since this will ensure that the community receives the greater share and at the same time ensure that the separate estate receives something. In the second situation, where the amount of labor is high and the gain is low, *Van Camp* is the appropriate formula. The community will thereby be assured of receiving something, whereas if *Pereira* were utilized, the community interest would lose out almost entirely.[81] In the third situation, where the amount of labor is low and the gain is high, *Van Camp* should be employed. This will ensure that the community receives a small portion of the gain, while the majority of the gain goes to the separate estate. The separate estate, of course, deserves the majority of the gain since the labor was the less significant factor in producing it as compared to the return on capital. Finally, in the fourth situation, where both the amount of labor and the gain are low, *Pereira* is the proper system. This will ensure that the separate estate receives something, while the community, which expended little effort in producing the gain, receives the remainder, if any.

Under this scheme, the courts would determine which factor (labor or return on capital) made the major contribution, as has been done under the all-or-nothing rule. But instead of allocating the entire gain to one interest or the other, an apportionment would be made, with the choice of formula dependent upon which factor made the larger contribution and is therefore entitled to the larger share of the gain. Under

81. For example, suppose that 50 hours of labor a week is expended upon the business and that the capital investment is $20,000. After one year, the gain from the business (before paying husband any salary) is only $1,500. If *Pereira* is utilized and the interest rate applied is seven percent, the resulting apportionment will be $1,400 to the separate estate and only $100 to the community. Clearly, the community has received far less than its appropriate share of the gain in view of the considerable amount of labor expended. If *Van Camp* were utilized instead, the fair salary allocated for the 50 hours of labor per week would have to be more than $1,500. The resulting "apportionment" of $1,500 to the community and nothing to the separate estate would certainly be more reasonable than the apportionment under *Pereira*.

this system, the unfairness of the all-or-nothing rule would be avoided. The only situation in which one estate would receive the entire gain at the expense of the other is where the gain is *very* low. In that case,[82] the primary contributing factor does receive all the gain.

Where it appears that either the community or the separate estate has not received an adequate share of the gain under the proposed scheme, interest could be calculated on the amount allocated. This provides added flexibility, allowing the court to account for any special factors. *Pereira* is by its very nature a highly flexible test since it depends on proof of the appropriate interest rate.[83] *Compounding* the interest would increase the separate return; for example, compound interest might be utilized to fairly compensate the separate estate for the increase in the value of the property due to inflation.[84] *Van Camp* can be made more flexible by two variations: either simple or compound interest could be calculated on that portion of the salary that has not been withdrawn from the business. The full range of formulas available to the court now looks like this:

Regular Pereira (selected after determination of appropriate rate).

Pereira with compound interest

Van Camp with compound interest

Van Camp with simple interest

Regular Van Camp

82. *Beam v. Bank of America*, 6 Cal. 3d 12, 490 P.2d 257, 98 Cal. Rptr. 137 (1971), provides an example of this situation. Prior to and during the early years of his marriage, the husband inherited $1,629,129 in cash and securities. At the time of the parties' divorce 29 years later, Mr. Beam's separate estate enjoyed only a "very modest increase," to $1,850,507.33. The trial court (which was upheld by the California Supreme Court) utilized Pereira, employing the then legal interest rate of seven percent. The entire gain was accordingly distributed to the separate estate of Mr. Beam. *Id.* at 19, 490 P.2d at 262, 98 Cal. Rptr. at 142.

83. In one group of cases, the prevailing legal interest rate has been utilized. In another, the courts have referred to the original language of *Pereira* and determined that the "usual interest on a long term investment well secured" should be utilized. *See* Comment, *supra* note 62, at 193:

> Neither of these two rates is very closely related to practical reality. The use of the rate on a well secured investment does not give consideration to the risk factor, which is of primary importance in determining the return on any investment. The separate capital in the husband's business is an equity investment rather than a loan, and is unsecured rather than "well secured." Similarly, the use of the legal interest rate ignores the possibility that the husband may have made a better or worse than average investment.

Id. The test suggested is that "the amount to be attributed to the separate investment should be the usual rate of return on investments in similar enterprises operating in generally the same environment." *Id.*

In *Gillespie v. Gillespie*, 84 N.M. 618, 506 P.2d 775 (1973), the New Mexico Supreme Court took yet another approach. The amount due the separate estate was determined by applying a rate of return equal to the *prime* rate prevailing during the marriage plus two percentage points. The court reasoned that had the business capital been borrowed, this would have been the interest rate required to be paid. *Id.* at 621-22, 506 P.2d at 778-79.

84. *See generally* W. REPPY & W. DE FUNIAK, supra note 2, at 261. In a recent California case, however, the court rejected the husband's contention that compound interest should be utilized to "beef-up" the amount allocated to the separate estate under *Pereira*. *See In re* Marriage of Folb, 53 Cal. App. 3d 862, 873-74, 126 Cal. Rptr. 306, 314 (1975).

The proposed system of apportionment is not without its imperfections. Neither *Pereira* nor *Van Camp* purports to measure the amount that would be due to each factor if an arms-length agreement between "labor" and "separate capital" could have been struck.[85] There are also problems of proof peculiar to each method. For example, there is the difficult question as to the proper interest rate to be applied in using *Pereira*.[86] Should interest on the capital investment be calculated from the date of the marriage or only during those years in which the property was productive?[87] When *Van Camp* is used there is the problem of determining what is a reasonable salary for the services rendered.[88]

Despite these imperfections, the proposed system would provide both the community and the separate estate with an amount that, at the very least, is reasonably related to the contribution each has made to the gain. Certainly this is a major improvement over the all-or-nothing system. Furthermore, the guidelines provided to the courts to facilitate the choice between *Pereira* and *Van Camp* will ensure a degree of predictability that has been lacking in the California experience both prior to and after *Beam*. Furthermore, the courts can adjust for any deficiencies in the amounts allocated to the community or to the separate estate by utilizing an interest rate on top of the system chosen.[89]

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85. *See* King, *supra* note 46, at 489-90.

86. *See* note 83 *supra*.

87. *See* King, *supra* note 46, at 489 n. 37.

88. One approach to this problem would be for the court to make an inquiry into the salaries paid by comparable businesses to employees holding similar positions. W. BROCKELBANK, *supra* note 57, at 176-77, states that "the cases talk about what one would have to pay to employ a manager to perform the services supplied by the husband." He criticizes these cases as undervaluing the services of many spouses who expend labor upon a business which they own:

> This is not realistic. The employed manager watches the clock. He is interested in what he can get out of it. In contrast the husband puts his whole being into the enterprise. . . . At least it is certain that the wages one would pay a hired manager is not the fair value of the vigilant and extraordinary services of the spouse.

Id.

89. Several proposals for an apportionment system appear in the literature on the subject. Included among them are the following:

(1) King, *supra* note 46, at 497, proposes the following system:

> The community would be given a reasonable salary and the separate property would receive reasonable interest. While neither salary nor interest would represent an exact measure of contribution, each would be subject to practical determination by the court by resort to comparable commercial situations. . . . In cases where the facts may show that one or each should receive less than the amounts computed, the returns should be reduced accordingly. . . . For policy purposes, the system might be modified to provide for a minimum salary for the community.

King also suggests that any surplus remaining after the reasonable salary and reasonable interest are calculated should be divided between the community and the separate estate "as the particular facts might dictate . . . . Thus the court could consider any unique factors, such as extraordinary attributes of the personal labor, or the separate property, or external factors . . . ." *Id.* Finally, he notes that the court should take into account whether the community or the separate estate has consumed a portion or all of its share. *Id.* This last factor, which is discussed in Cross, *The Community Property Law in Washington*, 49 WASH. L. REV. 729, 768 (1974), would have to be considered by the Arizona courts after they had determined the amounts owing to each interest by use of the system proposed in this Article.

(2) The court might compute the respective shares under both *Pereira* and *Van Camp* and then choose the result more favorable to the community. W. REPPY & W. DE FUNIAK, *supra* note

IV. THE CLASSIFICATION PROBLEM IN "REVERSE" FORM

A. How The Reverse Situation Arises—The Imperato Case

Thus far, this Article has considered the problem of classifying the gain from a spouse's separate property where community labor has been expended upon that property. In *In Re Marriage of Imperato*[90] the California Court of Appeals considered the reverse situation. There, the husband became the sole shareholder, president, and manager of a community-owned corporation during the course of the marriage. The parties eventually separated and Mr. Imperato continued to operate the corporation. In the proceedings instituted for dissolution of

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2, at 264. While this approach would be in line with the presumption in favor of the community, it is questionable whether that presumption compels the application of the formula resulting in the larger community share. The system proposed in this Article would protect the community's interest in the gain, but would not favor it at the expense of the separate estate where the latter is entitled to the greater share of the gain.

(3) The "compromise" method of apportionment, text & notes 56-57 *supra*, has been advocated by W. BROCKELBANK, *supra* note 57, at 178-79. *See also* LeSourd, *Community Property Status of Income from Business Involving Personal Services and Separate Capital*, 22 WASH. L. REV. 19, 34 (1947) (claiming that the compromise method is "the closest approach to achieving the intent of the law"). As Professor Brockelbank has noted, the *Pereira* approach tends to favor the community, especially during a period of inflation, while *Van Camp* favors the separate estate in cases where there has been substantial gain. The compromise method, by taking into account both interest and salary, balances the inaccuracies of *Pereira* and *Van Camp* and thus should produce a more equitable division of the profits. *But see* Comment, *supra* note 62, at 185 (criticizing the compromise method as an amplification of the deficiencies of *Pereira* and *Van Camp* and as being "arbitrary"). Despite this, the system proposed in this Article is preferable to the compromise method because it promises a more accurate apportionment of income. As stated in the text accompanying this note, the formula chosen as a result of the court's inquiry into the amount of labor expended upon the business and the amount of gain realized will produce an apportionment that accurately reflects the relative contributions of labor and capital. Moreover, interest is available to the court to increase the amount allocated to either the community or the separate estate if any special factors indicate that this is called for. *See* text & notes 83-84 *supra*.

(4) Other commentators have called for the courts to make a broad-based inquiry into all factors bearing upon the amount due each interest, with the burden placed upon the party asserting the separate interest to prove what factors entitle him to what share of the gain. *See, e.g.*, Knutson, *California Community Property Laws: A Plea for Legislative Study and Reform*, 39 S. CAL. L. REV. 240, 265 (1966); Comment, *supra* note 62, at 195-200. Again, this is a proposal consistent with the presumption in favor of the community. Under the present all-or-nothing system in Arizona, the burden is upon the party asserting the separate interest to prove that the gain is due primarily to the return on capital; otherwise, the entire gain will be allocated to the community. Text & notes 38-39 *supra*. In a recent case, the Court of Appeals indicated that since, by statute income from separate property is itself to be characterized as separate property, the burden should be placed on the other spouse to establish that part of the increase which is the result of the personal services of the spouse who owns the separate property. Percy v. Percy, 115 Ariz. 230, 232, 564 P.2d 919, 921 (App. 1977). This allocation of the burden of proof runs directly counter to the strong presumption in favor of community property which has long dominated Arizona case law and which has been consistently applied in cases of the type under discussion. *See* text & notes 38-39 *supra*.

Under the proposal advanced in this Article, in deference to the statutory presumption in favor of the community, the party asserting the separate interest should have the burden of proof on the following issues: (a) that he deserves *some* portion of the gain, rather than that he deserves all of it, as under the present system; (b) that the predominant factor in producing the gain was the return on capital, *i.e.*, that the labor expended was low. If this burden is carried, the court will employ whichever formula best protects the separate interest, according to whether the gain was high or low; (c) whether the gain was high or low; and (d) any factors showing that the share allocated to the separate estate is too low, and hence, requires "beefing up" via application of an interest rate (plus what that interest rate should be).

90. 45 Cal. App. 3d 432, 119 Cal. Rptr. 590 (1975).

the marriage, the problem presented was how the post-separation gain should be classified. Under California law applicable to this case, the postseparation labor was the husband's separate labor rather than the community's; any return on capital belonged to the community rather than to the husband's separate estate.[91] The Court of Appeals remanded the case to the trial court, calling for the application of the *Beam* substantial justice test.[92] It noted that the use of *Pereira* (fixed return on capital) would result in the allocation of a fair return on the capital to the community, with the remainder of the gain going to the husband's separate estate.[93] The use of *Van Camp* (fixed return on labor), on the other hand, would result in the allocation of the reasonable value of the husband's post-separation labor to his separate estate, with the remainder going to the community.[94]

If the apportionment system proposed in this article were adopted in Arizona, a court faced with this "reverse" situation would undertake an analysis similar to that outlined above[95] for the situation where community labor has been expended upon separate property. Again, the court would determine whether the labor expended and the gain realized from the property were high or low and then employ the appropriate formula. The only difference from the "normal" situation would be the resulting classification of the gain, as noted by the court in *Imperato*.[96]

The "reverse" situation arises at separation in California because that state has a statute which provides that the earnings of a spouse while living separate and apart are his or her separate property.[97] Arizona has no such statute. Therefore, the "reverse" situation can only arise in Arizona if its courts will recognize a non-statutory living-separate-and-apart doctrine.

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91. As the Court of Appeals put it:
> In those [*Beam* type] cases, the husband owned separate property but devoted his community time after marriage to managing and preserving the property. Here, we have community property acquired during marriage, and if the facts justify apportionment we seek to allocate increases of the community property occurring after separation into separate property.

Id. at 439, 119 Cal. Rptr. at 594.

92. *Id.* at 439, 119 Cal. Rptr. at 595.

93. *Id.* at 439, 119 Cal. Rptr. at 594.

94. *Id.*

95. See text accompanying note 81 *supra*.

96. *In re* Marriage of Imperato, 45 Cal. App. 3d 432, 439, 119 Cal. Rptr. 590, 594 (1975). See note 91 *supra*.

97. CAL. CIV. CODE § 5118 (West Supp. 1977) provides:
"The 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." Consideration of what circumstances amount to "living separate and apart" in California is outside of the scope of this Article. For a discussion of the confusion engendered by § 5118, see Bruch, *supra* note 36, at 1022-1025. Section 5119 of the California Civil Code provides that earnings are separate property following a judgment of legal separation. CAL. CIVIL CODE § 5119 (West Supp. 1977).

B. *The Status of the Living-Separate-and-Apart Doctrine in Arizona*

In *Neal v. Neal*[98] the Arizona Supreme Court stated that even though the parties may be living separate and apart, the community continues to exist.[99] *Neal* followed the decision of the court of appeals in *Guerrero v. Guerrero*,[100] in which it had been held that the earnings of the husband while he is living separate and apart from his wife are community property.[101] Although it was formerly provided by statute that earnings of the wife while living separate and apart from her husband were her separate property,[102] these provisions were repealed[103] as part of the broad 1973 reform to remove sex discrimination from Arizona law. Despite *Neal* and the repeal of these statutory provisions, a form of the living-separate-and-apart doctrine does exist in Arizona, and the facts of a given case may call for its application.

1. *The Forfeiture Theory of Pendleton v. Brown*

In *Pendleton v. Brown*[104] the Arizona Supreme Court established the rule that under certain circumstances a spouse may forfeit his or her community interest in future acquisitions due to misconduct involving or leading to separation of the spouses. Thomas and Mary Ellen Brown were married in Michigan in 1875. In 1878 the Browns moved to Texas. Shortly thereafter the couple separated. The wife deserted the house, taking the couple's infant daughter and $800 of her husband's separate property, and moved to Tombstone, Arizona. She lived there with another man, although she had not divorced her husband. Thomas Brown moved to Tombstone shortly after his wife did so and apparently attempted to achieve a reconciliation. The attempt

98. 116 Ariz. 590, 570 P.2d 758 (1977).

99. *Id.* at 593, 570 P.2d at 761.

100. 18 Ariz. App. 400, 502 P.2d 1077 (1972).

101. *Id.* at 402, 502 P.2d at 1079. In the two recent cases considering this issue, the Arizona Court of Appeals has reached a result consistent with the holdings in *Neal* and *Guerrero*. In *In re* Estate of Messer, 118 Ariz. 291, 293, 576 P.2d 150, 152 (App. 1978), the court held that the earnings of a spouse even after a decree of legal separation are community property. In Flowers v. Flowers, 118 Ariz. 577, 579, 578 P.2d 1006, 1008 (App. 1978), the court ruled that recovery of damages for a personal injury are community property even if the damages are recovered after divorce. Neither decision considered the fact that both husband and wife likely "treated" the earnings as separate property, and therefore, neither precludes the adoption of the limited living-separate-and-apart doctrine set forth in the text accompanying notes 110-130 *infra*.

102. "All property acquired by either husband or wife during the marriage, except that which is acquired by gift, devise or descent, *or earned by the wife and her minor children while she lives separate and apart from her husband*, is the community property of the husband and wife." This was the text of former ARIZ. REV. STAT. ANN. § 25-211(a); the italicized portion was deleted by the 1973 amendments. The text of former § 25-213(C), also deleted by the 1973 amendments, read as follows: "The earnings and accumulations of the wife and minor children in her custory while she lives separate and apart from her husband are the separate property of the wife." An Act Relating to Equal Rights; Providing for Equal Rights for Males and Females, ch. 172, 1973 Ariz. Sess. Laws, 1655, at 1694.

103. The text of present ARIZ. REV. STAT. ANN. §§ 25-211 & 25-213 (1976) appear in notes 12 and 11 *supra*, respectively. *See also* the discussion in C. SMITH, *supra* note 10, at 41.

104. 25 Ariz. 604, 221 P. 213 (1923).

failed when he found out that she was living in adultery. The separation after this was definite and permanent, and the parties reached a separation agreement in 1880. Mary Ellen subsequently went back to Michigan and never returned to Arizona, while Thomas stayed on in Arizona. In 1900 he purchased some property in Nogales. He retained title to the property until November of 1917, at which time he conveyed it to his daughter, Abbie Pendleton, by deed of gift. Mary Ellen brought an action seeking to set aside the conveyance on the ground that, as the marital community had never been dissolved, the property acquired by the husband in 1900 was community property, and community realty could not be conveyed unless both husband and wife joined in the deed.[105] The Arizona Supreme Court held that the plaintiff-wife had forfeited all rights she might otherwise have had in Thomas' post-separation acquisitions during marriage because of her abandonment of her husband: "The evidence leaves no question as to plaintiff's adultery and abandonment. So far as it was possible for her to do so, she renounced and repudiated her marriage relation with Brown in 1880, and never afterwards indicated any change of purpose."[106]It is not clear at the present time whether the recently enacted no-fault divorce legislation in Arizona[107] will undercut the forfeiture-for-misconduct theory of *Pendleton*.[108] Even if the forfeiture theory is

105. This statement of facts is drawn from the *Pendleton* court's opinion, 25 Ariz. at 606-07, 221 P. at 214-15. The present statute disallowing a conveyance of community realty by only one of the spouses states, in pertinent part:

> C. Either spouse separately may acquire, manage, control or dispose of community property, or bind the community, except that joinder of both spouses is required in any of the following cases:
>
> 1. Any transaction for the acquisition, disposition or encumbrance of an interest in real property other than an unpatented mining claim or a lease of less than one year.

ARIZ. REV. STAT. ANN. § 25-214(C)(1) (1976). This statute coexists with ARIZ. REV. STAT. ANN. § 33-452 (1976) which states: "A conveyance or incumbrance of community property is not valid unless executed and acknowledged by both husband and wife, except unpatented mining claims which may be conveyed or incumbered by the spouse having the title or right of possession without the other spouse joining in the conveyance or incumbrance."

106. 25 Ariz. at 611, 221 P. at 216. The court elaborated upon the role of the wife's misconduct in barring any claim she might have had upon the post-separation acquisitions of her husband:

> We have, then, the well-recognized rule, which the courts of all jurisdicitions have followed, that the rights of the husband and wife are affected by the misconduct of one or the other, and that the remedy for such wrong is not limited to an action of divorce. . . . No instance has been cited, and it is safe to say that none exists, where the wife who wrongfully renounces and repudiates the marital relation is adjudged entitled to the subsequent gains of the husband. By such repudiation the community is at an end so far as property subsequently accumulated is concerned.

Id. at 616, 221 P. at 218.

107. At present, the sole ground for dissolution of marriage in Arizona is that "the marriage is irretrievably broken." ARIZ. REV. STAT. ANN. § 25-312(3) (West Supp. 1977-78).

108. *See* W. REPPY & W. DE FUNIAK, *supra* note 2, at 55-56, where the authors question whether a court can ever "fairly conclude that separation resulted because one spouse was guilty of fault while the other was entirely innocent," and whether the no-fault divorce statute will undercut the misconduct-resulting-in-forfeiture ground of *Pendleton*. Professor Smith does not discuss the potential impact of the no-fault legislation, and apparently believes that the forfeiture theory is still valid in Arizona. *See* C. SMITH, *supra* note 10, at 113-115.

ultimately held to be abrogated by this legislation, the living-separate-and-apart doctrine enunciated in *Pendleton* rests upon another ground: an implied contract between the spouses that the future acquisitions of each shall be his or her separate property.[109]

2. *The Implied Contract Theory*

The *Pendleton* court noted that it had reached its conclusion on the basis of *two* factors: "Defendant was entitled to judgment, *because of the settlement of the property rights and agreement of separation between Brown and the plaintiff, and because plaintiff forfeited all right to the property in dispute* by abandonment of Brown, and by laches in bringing this suit."[110] The separation agreement, which contained a division and partition of the parties' community property, was held by the court to be evidence of their intention to abolish the marital community. The agreement did not explicitly state that the subsequent acquisitions of each spouse were to be that spouse's separate property. But by going their separate ways, the parties had necessarily intended this to be the case:

> By this agreement plaintiff covenants that she will never molest Brown or come where he was. She places an impassable barrier between herself and Brown which makes communication impossible, and the consideration of property agreements out of the question. . . . This property was gained by Brown after the separation, and during the time when she had agreed to leave him unmolested and make no pecuniary demand upon him. *She could not have taken this property from Brown then without violating this agreement.* She has no greater claim upon it now than she had then.[111]

Further support for the theory that the spouses may impliedly contract that their postseparation earnings will be separate property comes from the long line of Arizona cases giving effect to the intentions of the

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109. 25 Ariz. at 623-24, 221 P. at 220.

110. *Id.* at 628, 221 P. at 221 (emphasis added).

111. *Id.* at 623, 221 P. at 220 (emphasis added). In support of its conclusion that the parties had impliedly contracted that their post-separation acquisitions were to be separate property, the court relied upon Corrigan v. Goss, 160 S.W. 652, 654-55 (Tex. Civ. App. 1913), another case involving a separation agreement which contained a permanent division of the spouses' property. The court noted that the Texas court had employed precisely the same reasoning in reaching its conclusion:

> It will be noted that the basis of the court's finding that subsequently acquired property should belong to the parties who severally acquired it is upon the fact of the partition and division made between them. The express terms of the agreement are nowhere recited in the opinion. The conclusion of the court . . . seems to be based, not upon the explicit statement in the writing that such should be the result, but upon the fact found that there had been a division of all the property accumulated up to that time, and that because such division was complete, just, and equitable, and the separation permanent and continued, it logically and legally followed that all property subsequently acquired should belong to the one who acquired it. It is difficult to see how a different conclusion could be arrived at.

Id. at 624, 221 P. at 220.

parties as to the classification of their property.[112] In *Lawson v. Ridgeway*[113] and *Rundle v. Winters*[114] the Arizona Supreme Court held that where the parties had treated income from their separate property as community property and it was their intention that it should belong to the community, the character of the income changed in accordance with this intention. In *Babcock v. Tam*,[115] the Ninth Circuit also relied upon the intent of the parties in classifying the property in dispute. The court held that a transmutation of the subject property from separate to community had occurred due to the parties' informal understanding concerning it over a period of years since their marriage in October, 1930.[116] This conclusion was reached by the court despite the existence of a written "Community Agreement" which was executed on June 30, 1939, during the trial which had been instituted by the plaintiff for the injuries she had incurred in an automobile collision with Mr. Tam.[117] Two cases decided after *Babcock* further illustrate the ease with which transmutation may occur in Arizona. In *Sellers v. Allstate Insurance Co.*,[118] the court held that a husband's testimony that after marriage he "considered" a Cadillac which he had owned before marriage to be community property was sufficient to constitute a triable issue as to whether he "intended" it to be.[119] And in *Noble v. Noble*[120] the court classified the subject property as community in accordance with the parties' mistaken belief that by law all increase of separate property was community.[121]

The "intent" cases discussed to this point all involve transmutations from separate to community property. The courts are not hesitant to find transmutations moving in this direction, because such a finding is consistent with the presumption that all property acquired after mar-

112. See text accompanying notes 31-37 *supra*, for a preliminary discussion of the importance of the parties' intent in the classification of their property.

113. 72 Ariz. 253, 261, 233 P. 2d 459, 464 (1951).

114. 38 Ariz. 239, 245, 298 P. 929, 931 (1931).

115. 156 F.2d 116 (9th Cir. 1946).

116. The district court found "that said Community Agreement dated June 30, 1939, had its inception at the time of the marriage of the parties thereto, in October, 1930, and was their understanding and agreement at all times subsequent to the date of said marriage, and both parties treated the properties mentioned in said Community Agreement as community property and both contributed their time and efforts in improving said property with funds derived from the use and operation of said property . . . ." We find no error in this finding.

Id. at 121.

117. The holding in *Babcock* appears to fly in the face of the parol evidence rule. It would seem that the existence of the written "Community Agreement" dating the transmutation in 1939 should have precluded any evidence of an oral transmutation occurring prior to that date. *See* W. REPPY & W. DE FUNIAK, *supra* note 2, at 426. In any event, *Babcock* is a prominent example of the ease with which transmutation may occur in Arizona. For a discussion of the application of the all-or-nothing approach to debt characterization in *Babcock*, see text accompanying notes 143-46 *infra*.

118. 113 Ariz. 419, 555 P.2d 1113 (1976).

119. *Id.* at 422, 555 P.2d at 1116.

120. 26 Ariz. App. 89, 546 P.2d 358 (1976).

121. *Id.* at 93-94, 546 P.2d at 362-63.

riage is community.[122] However, courts are also willing to find transmutations moving in the other direction, from community to separate property. Two cases, both involving written evidence of the parties' intention to transmute their property, illustrate this point. In *In re Estate of Harber*,[123] the court upheld a postnuptial agreement which provided that subsequent acquisitions during marriage would be the spouses' separate property.[124] The court cited with approval a Washington case[125] in which the existence of an oral agreement to the same effect was inferred from evidence showing that the spouses had always conducted their businesses separately. In *Spector v. Spector*[126] the court upheld an antenuptial agreement which established that the earnings of each spouse arising from separately owned assets would be separate property.[127]

The courts of both Washington[128] and California[129] have held that the parties may impliedly contract that their post-separation earnings will be separate property. These non-Arizona cases, taken together with the Arizona "intent" decisions, establish strong support for a non-

122. *See* note 77 *supra*.

123. 104 Ariz. 79, 449 P.2d 7 (1969).

124. *Id.* at 88, 449 P.2d at 16.

125. Union Securities Co. v. Smith, 93 Wash. 115, 118-19, 160 P. 304, 305 (1916), *cited in*, 104 Ariz. at 87, 449 P.2d at 15.

126. 23 Ariz. App. 131, 531 P.2d 176 (1975).

127. *Id.* at 138, 531 P.2d at 183.

128. *See, e.g.*, MacKenzie v. Sellner, 58 Wash. 2d 101, 105, 361 P.2d 165, 167 (1961); *In re* Armstrong's Estate, 33 Wash. 2d 118, 125, 204 P.2d 500, 504 (1949); Togliatti v. Robertson, 29 Wash. 2d 844, 852, 190 P.2d 575, 579 (1948). In *Togliatti*, John and Lulu Morello separated in 1928. Lulu obtained an interlocutory decree of divorce during the same year. While no final decree was obtained, the parties never resumed marital relations. In 1929, Lulu, acting in good faith, according to the court, entered into a void marriage with another man. John died in 1946, and Lulu claimed a community property interest in bonds purchased with John's post-separation earnings. The court rejected Lulu's argument:

> Here, from the entry of the interlocutory decree, the parties lived separate and apart. Neither, thereafter, contributed to the support of the other, or otherwise accounted to the other for any income received by either of them, and neither asserted any claims to any subsequent property accumulated by the other during his lifetime, and each managed his individual business and affairs free from any interference or direction by the other during this time. . . . *True, there was no formal agreement between these parties making any subsequently acquired property the separate property of each. But for eighteen years each went his separate way. By their conduct during these years, they recognized the separate ownership of all property thereafter accumulated by either of them.*

29 Wash. 2d at 852, 190 P.2d at 578-79 (emphasis added). *See also* text accompanying note 125 *supra*. However, these "shell of a marriage" cases are distinguished where a "will to union" is found to still exist. *In re* Estate of Nikiporez, 19 Wash. App. 231, —, 574 P. 2d 1204, 1208-09 (1978).

129. *See* Durker v. Zimmerman, 229 Cal. App. 2d 203, 206-07, 40 Cal. Rptr. 227, 229 (1964). In *Durker*, some of the factors relied upon by the court to infer the existence of a contract between the parties to live separate and apart were: (1) the parties had divided their property at the time of their separation; (2) they did not live thereafter as husband and wife or contact each other except for the three occasions on which the husband paid the wife's rent; (3) neither party had previously asserted any right in the post-separation property or earnings of the other; (4) although they filed tax returns stating that they were married, they indicated that their returns were separate. *Id.* at 206, 40 Cal. Rptr. at 229. *See also* Bruch, *supra* note 36, at 1026-27, calling for the repeal of California's living separate and apart statute, and its replacement by a non-statutory doctrine as exemplified in the California cases recognizing transmutation agreements between the spouses.

statutory living-separate-and-apart doctrine in Arizona.[130]

Apparently, it is a very common situation for a business to be acquired during marriage (community capital), with one of the spouses continuing to work on it (separate labor) after separation has occurred. Because many, if not almost all, separations where future divorce is contemplated include the type of implied agreement discussed above, the "reverse" apportionment problem is likely to turn up frequently in Arizona.

3. *Transmutation by Express Agreement*

The parties can, of course, provide explicitly that their post-separation earnings will be separate property.[131] Such provision could be included in a separation agreement, subject to the approval of the court,[132] or in an agreement wholly independent of any separation agreement.[133] These cases, too, would present a situation of post-agreement separate labor applied to pre-agreement community capital.

C. *The Apportionment Problem in Reverse Form in the Context of an Ex Parte Divorce*

There is one further factual situation which presents a type of "reverse" apportionment classification problem. Suppose the spouse of an Arizona married person obtains an ex parte divorce decree in a foreign jurisdiction in which the plaintiff spouse has recently taken up domicile but which does not have personal jurisdiction over the other spouse.

130. Of interest is the fact that appellant's counsel in Guerrero v. Guerrero, 18 Ariz. App. 400, 502 P.2d 1077 (1973), did not attempt to argue that the parties had impliedly entered into a contract which would have transmuted the husband's post-separation earnings into his separate property. Had he done so, the court may well have been less inclined to summarily characterize the husband's social security disability benefits as community property.

131. California recognizes that agreements as to post-separation acquisitions may be express as well as implied. *See* Durker v. Zimmerman, 229 Cal. App. 2d 203, 206, 40 Cal. Rptr. 227, 229 (1964). As for Arizona, the reasoning of the cases finding implied agreements is obviously applicable to cases involving explicit agreements.

132. ARIZ. REV. STAT. ANN. §25-317 (1976) provides:

> Separation agreement; effect.
>
> A. To promote amicable settlement of disputes between parties to a marriage attendant upon their separation or the dissolution of their marriage, the parties may enter into a written separation agreement containing provisions for disposition of any property owned by either of them, maintenance of either of them, and support, custody and visitation of their children.
>
> B. In a proceeding for dissolution of marriage or for legal separation, the terms of the separation agreement, except those providing for the support, custody and visitation of children, are binding upon the court unless it finds, after considering the economic circumstances of the parties and any other relevant evidence produced by the parties, on their own motion or on request of the court, that the separation agreement is unfair.

133. Whether such an agreement could be oral is unclear. A statute now provides that the parties, after fair disclosure, may waive rights to the property or estate of the other spouse by a written contract signed either before or after marriage. ARIZ. REV. STAT. ANN. § 14-2204 (1975). *In re* Estate of Harber, 104 Ariz. 79, 449 P.2d 7 (1969), dealing with a postnuptial agreement, was decided before passage of this statute. Spector v. Spector, 23 Ariz. App. 131, 135-36, 531 P.2d 176, 180-81 (1975), cited the new statute and the *Harber* case in upholding antenuptial agreement as to the characterization of the earnings of the spouses derived from their separately owned assets.

Without personal jurisdiction, the foreign court is unable to divide the community property of the spouses, such as a community owned business.[134] Such a business can, however, be divided in a subsequent Arizona court proceeding.

It is provided by statute in Arizona that any jointly held property for which no provision is made in a divorce decree shall thereafter be held by the parties as tenants in common.[135] Whether this provision encompasses foreign divorce decrees as well as Arizona decrees is not clear. A number of California cases have held, without the benefit of a statute, that the community property must be converted into a tenancy in common where the divorce court made no provision for the jointly held property in the first instance.[136] A similar conversion appears to occur, then, in Arizona, although it seems clear that the precise fractional cotenancy shares of the former spouses will not be known until a court, obtaining personal jurisdiction over the stay-at-home Arizona spouse as well as the plaintiff in the divorce suit, decides how the community would have been divided had property rights issues been before a divorce court judge.[137]

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134. This factual situation was presented in White v. White, 83 Ariz. 305, 320 P.2d 702 (1958). The husband obtained a divorce decree in Colorado. The Arizona Supreme Court held that the effect of the divorce decree in Arizona was as follows:

> The decree of divorce in question could not, nor did it purport to, determine more than the in rem marital status of the parties as that was the limit of the jurisdiction of the Colorado court. To that extent only we accord it full faith and credit. However this ex parte decree cannot affect the economic and property rights of the parties in Arizona.

Id. at 307, 320 P.2d at 703. The Arizona court accordingly permitted the wife to bring an action in that state for separate maintenance. See Note, *Foreign Divorce and Texas Community Property*, 28 BAYLOR L. REV. 425 (1976), for a discussion of the property issues involved in the ex parte divorce situation.

135. "The community, joint tenancy and other property held in common for which no provision is made in the decree shall be from the date of the decree held by the parties as tenants in common, each possessed of an undivided one-half interest." ARIZ. REV. STAT. ANN. § 25-318 (Supp. 1977).

136. *See, e.g.*, Taylor v. Taylor, 192 Cal. 71, 83, 218 P. 756, 761 (1923); Calhoun v. Calhoun, 81 Cal. App. 2d 297, 302, 183 P.2d 922, 925 (1947); Lorraine v. Lorraine, 8 Cal. App.2d 687, 697, 48 P.2d 48, 52 (1935). In the *Calhoun* case, the court stated:

> It has been repeatedly held that where a divorce is obtained in a foreign state upon substituted service, and there remains community property within this state not disposed of by the parties or any court of competent jurisdiction, the parties thereafter hold such property as tenants in common, if the divorce is granted for any cause other than adultery or cruelty [at the time of this decision a California divorce court could make an unequal division of community property if divorce was granted on this ground], and each becomes the owner of an undivided one-half interest in such property, and if not estopped, the respective rights of the parties may be enforced in an independent action.

81 Cal. App.2d at 302, 183 P.2d at 925 (emphasis in original deleted).

137. Clearly, if Arizona law were to apply to the property division issues (this surely would be the case if the property rights suit were brought in an Arizona court—one former spouse still retained his Arizona domicile, and the situs of any tangible property was not elsewhere), the tenancy in common found to exist after divorce would not have to be a 50-50 cotenancy; or it *could* be 50-50 until the Arizona court obtaining jurisdiction in a property division suit assigns appropriate shares to the former husband and wife. ARIZ. REV. STAT. ANN. § 25-318(A)(Supp. 1977) provides that a divorce court "shall also divide the community, joint tenancy and other property held in common *equitably, though not necessarily in kind*, without regard to marital misconduct." (emphasis added). Even where state law prohibits a divorce court from disturbing rights in separately owned property (which include an ordinary tenancy in common), but allows an equitable division of community property at divorce, an unequal division of the former com-

Whatever the division of the property, the "reverse" classification problem is presented. After the divorce, the labor expended by a party upon the formerly community business should generate gain to be owned solely by the laboring spouse. And, assuming the community property has become a tenancy in common, the return on capital should belong to the tenancy (formerly the community). As is the case with respect to the "normal" situation, where separate capital is mixed with community labor, and with respect to the *Imperato* situation, where community capital is made productive by separate labor, the just and equitable approach to the classification of gain in the ex parte divorce situation is the approtionment system proposed in this Article.[138]

V. WHY APPORTIONMENT OF GAIN WOULD NOT BE UNFAIR TO ARIZONA CREDITORS

A shift by the Arizona courts from the all-or-nothing approach to an apportionment system for the classification of gain raises the question of whether creditors of either spouse would be prejudiced thereby. In answering this question, one must start with the proposition that one who either loans a portion of the operating capital or sells items on credit to a spouse operating a business which are to be used in that business to help produce profits should, in collecting on his claim to be paid, be able to reach all sources of gain derived from that endeavor. Apportionment of gain would not be unfair to creditors under this criterion for two reasons: (1) If the present all-or-nothing system of debt characterization is retained, the application of basic agency principles would make it possible for a creditor to reach all sources of gain from the property; or in the alternative (2) the present system of debt characterization could be abandoned in favor of an approach which would apportion the debt in line with the apportionment of the gain.

A. The Present System of Debt Characterization in Arizona

As is the case with respect to the classification of gain from separate property businesses,[139] the present Arizona system of debt characterization is an "all-or-nothing" approach.[140] The debt is characterized by the court as either a "separate debt" or a "community debt." As a general rule,[141] only the separate property of the spouse incurring the

munity property would be proper. *Cf.* Note, *supra* note 134, at 431 ("The court of the situs of the property would have the power within its discretion to make an unequal division of the property when the nature of the case might deem it equitable.").

138. *See* text accompanying notes 78-89 *supra*.

139. For a description of the all-or-nothing approach to classification of gain from separate property, see text accompanying notes 13-27 *supra*.

140. *See generally* W. REPPY & W. DE FUNIAK, *supra* note 2, at 380-383. The authors refer to the Arizona system as the "community debt" system.

141. The major modifications of this general rule are as follows: (1) separate property of a spouse contracting a community debt or obligation is liable if the obligation cannot be satisfied

debt *or* only the community property can be reached by the creditor, depending upon the characterization chosen by the court.

In making this characterization the courts apply *respondeat superior* principles.[142] The community is treated as the principal, while the husband and wife are treated as its agents. If either spouse incurs a contractual debt or commits a tort which was not intended to protect or benefit the community, the spouse will be deemed to have acted outside the scope of his or her authority as agent for the community so that only that spouse's separate property can be reached to satisfy the obligation. On the other hand, if the obligation is incurred with the intent to benefit the community, the spouse will be deemed to have acted within the scope of the agency; community property can accordingly be reached to satisfy the obligation.

The Ninth Circuit case of *Babcock v. Tam*[143] provides a good illustration of the all-or-nothing approach to debt characterization and the difficulties encountered by the courts in deciding whether an activity was undertaken in order to benefit the community. In 1938 Edwin Tam set out in his separately owned automobile on a trip from his home in Yuma, Arizona. At the time, he had information that certain persons in Los Angeles might be interested in purchasing a portion of his separate real estate in Arizona. He drove first to San Diego, where his wife was recovering from an illness, and continued on to Los Angeles a few days later. In Los Angeles, he was unable to contact the persons with whom he wished to speak about his property. In order to obtain some information, Mr. Tam then drove to Huntington Park, California, the home of a Mrs. Sparks, an acquaintance who had possessed real estate in Arizona close to his holdings. Mrs. Sparks wished to go to Venice, California, so she accompanied Mr. Tam on his return trip, planning to stop in Venice while he continued along the coastal route to San Diego. Before reaching Venice, Mr. Tam's automobile collided with the automobile of Alice Babcock. Suit was subsequently instituted by Mrs. Babcock against Mr. Tam for the injuries she had sustained in the collision.[144] The Ninth Circuit upheld the lower court's finding that the negligent act of Mr. Tam occurred while he was

from the community property, ARIZ. REV. STAT. ANN. § 25-215(D) (1976); and (2) *premarital* separate debts and other liabilities incurred after September 1, 1973, can be collected from community property, but only to the extent which that spouse's contribution to the community would have been separate property if he or she had been single. ARIZ. REV. STAT. ANN. § 25-215(B) (1976). For a discussion of these modifications see C. SMITH, *supra* note 10, at 82-86. *See also* the discussion of § 25-215(B) in Comment, *Community Assets and Separate Debts: Increased Community Vulnerability in Arizona*, 1975 ARIZ. ST. L.J. 797, 806-07.

142. W. REPPY & W. DE FUNIAK, *supra* note 2, at 380; Note, *Community Liability for the Tortious Acts of One of the Spouses*, 6 ARIZ. L. REV. 268, 276 (1965).

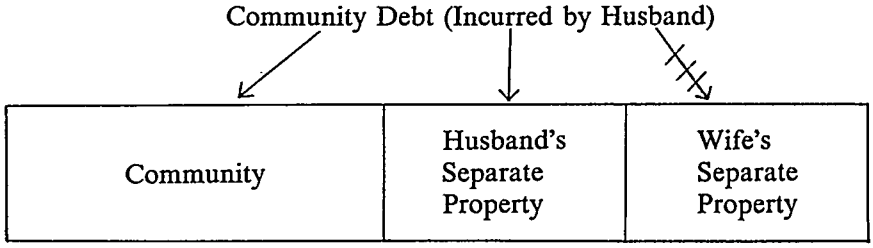
143. 156 F.2d 116 (9th Cir. 1946).

144. The foregoing statement of facts is drawn from the *Babcock* court's opinion, 156 F.2d at 118.

engaged in an activity which was not intended in any way to benefit the community, but rather was undertaken for the purpose of pursuing his separate business concerns. The court held that Mr. Tam's trip to Venice with Mrs. Sparks did not take him outside of the scope of his separate business.[145] It did not consider as legally controlling the evidence showing that part of the reason for Mr. Tam's trip was to visit his ailing wife in San Diego, despite the fact that this evidence militated strongly against the court's conclusion that the trip was undertaken *solely* for his separate business purposes.[146] Given that the court felt bound to label Tam's activities at the time of the tort wholly separate or wholly community, perhaps one cannot quibble with the result. Nevertheless, it seems obvious that elements of both community and separate activities were involved in leading to Tam's presence in California at the scene of the accident.

B. The Application of Agency Principles to Prevent Prejudice to Creditors Under the Present System of Debt Characterization

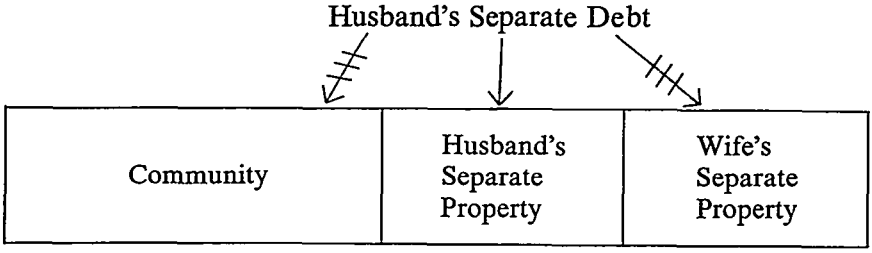
If the gain from separate property in the "normal" situation or from community property in the "reverse" situation were apportioned, the portions of the gain which could be reached by a creditor of a postnuptial debt under the present system of debt characterization would be as follows:[147]



145. So far as the conveyance of Mrs. Sparks is concerned, it would seem that compliance with her request to be taken to Venice was a personal courtesy to one who had assisted him in his dealings with his separate property. Tam was still well within the zone of his separate business at the time of such act, his conduct being far more reasonably suited to the promotion of his separate business than that of the community. . . . Any mere detour which he may have made was properly found to be insufficient to take him outside the scope of his separate business.
156 F.2d at 119.

146. The type of fact pattern seen in *Babcock* calls for an apportionment of debt, part community and part separate, to replace the present all-or-nothing analysis. See text accompanying notes 156-59 *infra*.

147. The boxes in the diagram in the text represent the community's share of the gain, the husband's separate share, and the wife's separate share. These diagrams assume that both spouses have contributed some capital (in the "normal" situation) or some labor (in the "reverse" situation) to the endeavor. An unbroken arrow means that the creditor can reach that component of the gain, while a broken arrow means that he or she cannot reach that component. The diagram showing which components can be reached where the debt is the husband's separate debt would, of course, be applicable if it were the wife's separate debt; the only changes would be an unbroken arrow going to the WSP component and a broken arrow to the HSP component. The same is true in regard to the first diagram; if it were the wife who had incurred the community debt, there would be a broken arrow going to the husband's separate property and an unbroken arrow to the wife's separate property.



In the diagram labeled "Community Debt," the community property is liable, of course, due to the characterization of the debt. The husband's separate property is liable by statute where the community property is insufficient to satisfy the obligation.[148] In the diagram labeled "Husband's Separate Debt," the husband's separate property is liable, again due to the characterization of the debt. Because we are dealing with a postnuptial separate debt, the community property is not liable under the statute.[149]

By the application of basic principles of agency law, the other components of the gain (those not liable under marital property law) should also be available to creditors, provided there is to be an apportionment of gain. First, consider the case of the wife's separate property capital, using the "normal" situation to illustrate the point. By contributing her separate capital to a husband-managed business, the wife as principal has impliedly vested her husband with authority to act as her agent.[150] Certainly, she is using him as her agent if the business produces some separately owned gain for her.[151] Therefore, any debts he incurs as her agent may be satisfied out of her separate property—both the capital and any share of the gain that is the wife's sepa-

148. ARIZ. REV. STAT. ANN. § 25-215(D)(1976) and *see* note 136 *supra*.

149. ARIZ. REV. STAT. ANN. § 25-215(B) (1976) and *see* note 141 *supra*.

150. Several Arizona cases have discussed and applied the concept of implied agency authority in other contexts. *See, e.g.*, Pacific Guano Co. v. Ellis, 83 Ariz. 12, 16, 315 P.2d 866, 868 (1957); Canyon State Canners v. Hooks, 74 Ariz. 70, 72-73, 243 P.2d 1023, 1024-25 (1952). Both of these cases state that implied authority of an agent to bind a principal may be founded upon the principal's acquiescence in the agent's course of conduct. Such acquiescence justifies the reasonable conclusion that actual authority was given, even though not in express language.

See also RESTATEMENT, SECOND, OF AGENCY § 26 (1958):

> Except for the execution of instruments under seal or for the performance of transactions required by statute to be authorized in a particular way, authority to do an act can be created by written or spoken words *or other conduct of the principal which, reasonably interpreted, causes the agent to believe that the principal desires him so to act on the principal's account*. (emphasis added).

Section 43, Comment c, states: "In the absence of other evidence as to the agent's authority, the fact that the principal acquiesces in the conduct of the agent is sufficient evidence to prove authorization or ratification." In the discussion in the text, this acquiescence arises from the wife's provision of her separate capital to her husband's business.

151. This would almost always be the case under the apportionment of gain system proposed herein and sometimes the case under present all-or-nothing law.

rate property.[152] Second, consider the case of the community property capital, this time using the "reverse" situation to illustrate the point. Here, the community has contributed the capital to the business. In so doing, it has impliedly vested the husband with authority to act as its agent in conducting the business; at least it should be found to have done so where the separate labor applied produced some community-owned gain. Therefore community property should be liable for debts incurred by the husband in running the business.[153]

The illustrations set forth above demonstrate that with the application of basic principles of agency, a shift to an apportionment of gain system will not prejudice the rights of creditors. Whether the debt is classified as separate or community, all of the gain and capital of the business can be reached by a creditor. Moreover, there is one very common business situation in which application of the present all-or-nothing approach is most unfair to creditors. Suppose John gives Harry a loan (after Harry's marriage)[154] which Harry needs to run his separately owned business. If a court later declares all of the profits of the business to be community property, John, a "separate"[155] creditor,

152. The point under discussion is well illustrated by the Texas Supreme Court's decision in Cockerham v. Cockerham, 527 S.W.2d 162 (Tex. 1975). In that case, the wife opened a dress shop using approximately $4,000 of the husband's separate capital. In addition to advancing the initial capital, the husband acquiesced in the wife's practice of writing checks on his account to pay for merchandise for the store, borrowed $5,000 to pay off some of the dress shop debts, and himself signed a check in the sum of $1,400 which was used to pay operating expenses of the shop. Although the husband never took any part in the conduct or operation of the business, the court held that "his actions were consistent with an implied assent" to the establishment of the dress shop liabilities. 527 S.W.2d at 172. Accordingly, the court permitted creditors of the business to reach his separate property.

In Texas, which is not an "American rule" state, the rents and profits of the husband's separate property are community property. Therefore, *Cockerham* is not as strong an agency case as our hypothetical situation in Arizona, where Mr. Cockerham would have enjoyed separate property income as well as one-half the community property income.

153. In connection with this agency argument for holding the community liable, one could also assert a theory of unjust enrichment. The community has utilized the separate labor of the husband to acquire a portion of the gain from the business. Therefore, to hold the husband's portion of the gain liable and the community's portion not liable is to unjustly enrich the community at the expense of the husband's separate estate.

154. If Harry acquired a separate debt before marriage, community property would be liable to the extent of the value of Harry's contribution to the community. This is so because of a 1973 amendment to § 25-215: "The community property is liable for the premarital separate debts or other liabilities of a spouse, incurred after September 1, 1973 but only to the extent of the value of that spouse's contribution to the community property which would have been such spouse's separate property if single." ARIZ. REV. STAT. ANN. § 25-215(B) (1976).

155. In *Malich v. Malich*, 23 Ariz. 423, 429, 204 P. 1020, 1022-23 (1922), the Arizona Supreme Court stated that "A personal obligation or debt created by the husband during marriage is prima facie common, and necessarily property acquired in exchange for that obligation assumes a like character." The court indicated that this presumption could be rebutted by proof that the property purchased on credit was "acquired upon a pledge or mortgage of separate property," *Id.* at 429, 204 P. at 1022, (citing Heney v. Pesoli, 109 Cal. 53, 41 P. 819 (1895)). Thus, the court apparently signified its agreement with California on this issue. In Ford v. Ford, 276 Cal. App. 2d 9, 12, 80 Cal. Rptr. 435, 438 (1969), the California Court of Appeals stated a test which is a bit broader than that of *Malich*: "If money for the purchase of property is obtained on the credit of the community estate, the result is a community purchase. The *intent of the lender* with respect to the credit upon which the loan was made is determinative." (emphasis in original). In the hypothetical situation posed in the text, it is assumed that the lender was influenced in making the loan primarily by the existence of a large amount of separate capital owned by Harry from which

will be unable to reach any of the profits. This is true despite the fact that Harry could not even have operated his business without John's loan. If the gain were apportioned, on the other hand, John's rights would not be prejudiced, for some of the profits would be classified as separate property.

C. Apportionment of Debt as a Means of Preventing Prejudice to Creditors

Apportionment of the debt is a superior and alternative way to achieve the end of allowing a creditor to reach all sources of gain derived from the business. The *Babcock* case[156] provides a striking illustration of the difficulties faced by a court in attempting to determine whether a debt is entirely a community obligation or entirely a separate obligation. Moreover, the all-or-nothing debt characterization system is not designed to effectuate the goal of fully protecting a creditor's right to have his or her judgments satisfied. In *Babcock*, for example, the court's characterization of the tort as a separate obligation was tantamount to denying the plaintiff any recovery on her judgment.[157] In view of this fact and the fact that Mr. Tam was in California to see his wife as well as to conduct his separate business,[158] it appears that the more equitable solution would have been to characterize the tort as half community, half separate.[159]

Where the income from a business is to be apportioned between the community and the separate estate of one or both of the spouses, there is no reason why the debts of the business should not be apportioned as well. Just as the income is a result of more than one factor, more than one factor is responsible for the debts of the business. Additionally, if the debts are apportioned in the same ratio as the income, the creditors of the business will be able to reach all components of the

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repayment could be made. Under the "intent of the lender" test, this would make the proceeds of the loan separate property. If the proceeds of the loan are separate property, it follows that the debt must be "separate." The "intent of the lender test" appears to have gained acceptance in a number of the community property states. *See generally* W. REPPY & W. DE FUNIAK, *supra* note 2, at 229.

156. Babcock v. Tam, 156 F.2d 116 (9th Cir. 1946).

157. *See* W. REPPY & W. DE FUNIAK, *supra* note 2, at 382. The authors question whether the *Babcock* court should have determined whether the defendant's separate property was sufficient to satisfy the judgment in deciding how to classify the tort (a consideration apparently not taken into account by the court).

158. *See* text accompanying note 146 *supra*.

159. *See* W. REPPY & W. DE FUNIAK, *supra* note 2, at 382, suggesting this solution. There has been to date apparently only one case in all the community property jurisdictions in which the court has apportioned a debt. Weinberg v. Weinberg, 67 Cal. 2d 557, 563, 432 P.2d 709, 712, 63 Cal. Rptr. 13, 16 (1967). While the facts in *Weinberg* did not call for an apportionment, *see* Reppy, *Retroactivity of the 1975 California Community Property Reforms*, 48 S. CAL. L. REV. 977, 1094 n. 404 (1975), the theory that a debt or obligation may be apportioned is a much needed improvement upon the present all-or-nothing approach and should be applied in future cases presenting a fact situation similar to *Babcock*.

income in satisfying their judgments, without recourse to implied agency principles.

Conclusion

It is high time that Arizona join the rest of the "American rule" states in apportioning the gain from a spouse's separate property between the community and the spouse's estate. Although the all-or-nothing test is a difficult one to apply, this is not its major fault. Rather, the problem lies in the inequity to the community or to the separate estate which is an inherent result of its application to a given set of facts. "Substantial justice" can only be achieved between these two estates if an apportionment system is adopted to replace the present system. The system proposed in this Article is designed to allocate to each estate a fair amount of the gain for which it has been responsible. The Arizona courts should also be aware that the classification of gain problem may arise in "reverse" form. In this situation, too, the just solution is an apportionment of the gain along the guidelines suggested. Finally, the adoption of an apportionment system for the classification of gain would not prejudice the rights of creditors in Arizona due to the application of basic principles of agency. However, the more logical approach would be for the courts to adopt an apportionment system for the classification of debts in line with that adopted for the classification of gains.