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## **Community Liens Applied to Separate Property Post-Service Profits**

### **1. Does a Schickner Post-Service Profit Claim Apply to a Community Lien?**

An issue that Arizona case law has not ‘directly’ addressed in a published opinion (or memo decision to my knowledge) is whether the community may be entitled to a portion of the post-service income from a separate property business, real estate, or other separate asset to which the community has established a community lien. It is my opinion that it may, depending on upon the circumstances.

In Schickner v. Schickner, 237 Ariz. 194 (App. 2015), the Arizona Court of Appeals addressed a community business operator’s post-service income including salary and profit distributions. The Court of Appeals explained that while the income resulting from the owner-operator’s post-service labor constitutes separate property, the profits that exceed reasonable compensation for such labor is community. Id. at 199-200, citing Rueschenberg v. Rueschenberg, 219 Ariz. at 249, 257 (App. Div. 1 2008) (“...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.”) (quoting Rundle v. Winters, 38 Ariz. 239 (1931)). Thus, while the spouse operating the community business should receive post-service income associated with his or her labor as separate property pursuant to A.R.S. §§ 25-211 and 25-213, any excess income constitutes community property.

Although Schickner addresses a community property business, there is no case law that holds such analysis would not also apply to a community lien. It is

logical that such should apply to a community lien if the community has not been compensated for its community lien interests during the pendency of the proceedings. A simplified example can be derived from real property. For illustrative purposes assume a home is deemed separate property because of a disclaimer deed, but the community paid 100% of the purchase price, mortgage payments and other capital contributions. If the home is rented post-service, the rental proceeds should logically be community as it would be inequitable for the title owner party to retain the same under community property principles. See generally, Famiano v. Maust, No. 1 CA-CV18-0582FC (App. 2020) (although the real estate at issue was technically separate property due to a disclaimer deed, the community made 100% of the capital contributions). The same analysis arguably applies to a business that derives profits due to community efforts and/or capital contributions. At least a portion of the post-service profits of the separate property business or other asset may be a result of prior community contributions.

Regarding a community lien claim to post-service profits there is an additional factor to consider. If a portion of the post-service profits are attributable to the separate property's pre-marriage inherent characteristics (i.e., not a result of community contributions), it follows that the separate property claimant should receive a percentage of the post-service profits in addition to reasonable compensation before calculating the community interest. Thus, the separate property interest would receive the percentage of the post-service profits attributable to the inherent qualities of the business as of the date of marriage (or date of acquisition if later) as well as post-service profits attributed to the party's post-service labor.<sup>1</sup> This is relatively simple as applied to real

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<sup>1</sup> Cockrill and Schickner focus on two distinct issues. A Cockrill apportionment analysis of a separate property business focuses upon the inherent qualities of the business as of the date of marriage to determine the separate property apportionment of the increased value. On the other hand, a Schickner analysis focuses on the community's contribution/ownership portion of post-service profits.

estate interests but becomes more complicated when applied to separate property business profits. The following simplified examples are illustrative:

Example 1 Real Estate:

Total Value of Rental Real Estate:	\$1,000,000
Community lien ( <u>Drahos et al.</u> ):	\$ 400,000
Community percentage:	40%
Post-Service Profits:	\$ 30,000
Community portion \$30K x .4	\$ 12,000

(Example assumes that there was no material post-service labor to manage the rental real estate.)

Example 2 Business Interests:

Applying such analysis to a separate property business is based upon the same principles, but more complicated if the separate property claim to post-service profits applies to the front and back ends.

Total Value of Separate Property Business:	\$1,000,000
Separate Property Apportionment ( <u>Cockrill et al.</u> ):	30%
Community percentage:	70%
Owner total post-service compensation:	\$500,000
Owner post-service normalized compensation:	-\$200,000
Difference	\$300,000
x .30 separate / pre-marriage inherent qualities	-\$90,000
Community portion of post-service income:	\$210,000

An initial reaction to this analysis is “why should the community receive any portion of post-service profits associated with a separate property business?” If a community claim were merely a reimbursement analysis, such reaction would be valid. However, pursuant to Arizona case law, a community lien if successfully established is a community property equity interest. Such is a pro-rata community interest in the equity of the asset itself. Thus, while the law states that the nature of property is determined at the time of acquisition, the portion of the increase in equity attributable to community efforts or capital contributions was acquired during marriage.

Pursuant to Cockrill v. Cockrill, 124 Ariz. 50 (1979) “[t]he profits of separate property are either community or separate” depending upon the circumstances. Id. at 52 (emphasis added). According to Rueschenberg,

In essence, our community property laws transform the community into an equity partner with the sole and separate property-owning spouse to the extent the community’s efforts have generated net earnings, increased the value, or otherwise increased the net worth and/or market value of the company.

Id. at 257 (emphasis added). The analysis that a community lien is a “community interest” is confirmed in Famiano v. Maust, No. 1 CA-CV 18-0582 FC (App. Div.1 April 23, 2020) ¶ 17 (“the capital contributions made with community funds create a community interest in the separate asset that may be vindicated through an equitable lien”) (emphasis added).

A simplified way of describing such property is that the corpus of the property remains separate property, but a portion of the after-acquired equity is community property to the extent that a community lien is established. This increased equity may be due in part to community efforts, community capital contributions, improvements or otherwise. One can view the asset by way of a pie chart showing the corpus as separate property with the remaining portion of the pie divided between separate and community property based upon equitable

principles (i.e., Drahos, Cockrill, etc.). In essence, the community is a shareholder to the extent of its equity interest and is thus entitled to its proportionate share of the post-service profits.

## 2. Burden of Proof.

An additional issue is the burden of proof regarding the community versus separate property portion of such post-service income.

According to Schickner v. Schickner, 237 Ariz. 194 (App. 2015),

Because property acquired during marriage is presumed to be community property, the spouse seeking to overcome the presumption has the burden of establishing the separate character of the property by clear and convincing evidence.

Id. at ¶22 (citing Brebaugh v. Deane, 211 Ariz. 95, 98, ¶6 (App. 2005)).

Schickner goes on to state:

As to the rest of Husband's compensation because it is derived from a community asset, Husband bears the burden of establishing the separate nature of all the distributions he received.

Id. at ¶27 (emphasis added). Schickner further explained:

Nor does the record show that the trial court placed the burden on Husband of providing by clear and convincing evidence that the distributions he received from both businesses over the three-year period should be deemed his sole and separate property.

Id. at ¶29.

Because the husband in the Schickner case failed to establish what portion of the post-service income was attributable to his post-service labor by clear and convincing evidence, the Court of Appeals remanded such issue for the trial court to determine the amount of compensation based upon Husband's post-

service toil and labor with the remainder deemed community property. Id. at ¶30.

Arizona cases have held that the community has the initial burden of proof to establish that the community has a lien (or equity claim) regarding a separate property asset. Hefner v. Hefner, No. 1 CA-CV 18-0404 FC (App. Div. 1 (filed 12-10-2019)). Once it is established that a community lien exists (i.e., whether by capital contributions and/or community labor), it is the separate property claimant's burden to establish what portion of the equity and/or profits remain separate property. Cockrill v. Cockrill, 124 Ariz. at 52. A fair assessment after reading Schickner and the other cited cases in harmony is that this separate property burden of proof also applies to post-service income where a community lien (i.e., community equity) has been established.

### 3. Conclusion.

As practitioners our analysis does not stop at establishing a community lien / equity interest in the separate property asset. We should also assess whether the community has a claim to a portion of the profits, rental proceeds or other income received after service of process that flow from the community's lien (equity interest) in the property. Like Schickner, such claim to a portion of the profits arguably continues until such point that the community lien is satisfied.