EAST WEST FAMILY LAW COUNCIL

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NUTS & BOLTS OF LITIGATING A BUSINESS ASSET

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Minyard Morris

Ms. Rana is a Certified Family Law Specialist and Partner at Minyard Morris, an exclusively family law firm located in Newport Beach, California.

Ms. Rana is experienced in handling high income and complex asset divorce and paternity proceedings involving issues of child and spousal support, business valuation, property division, custody, and attorney fees.

Leena Hingnikar, CFLS

Hingnikar Family Law

Ms. Hingnikar is a Certified Family Law Specialist. She has been practicing exclusively family law since 2008 in Los Angeles County.

Ms. Hingnikar has significant experience with complex financial and property issues, including business valuations, high earner income/support issues, prenuptial and postnuptial agreements, and trusts.

Kristen L. Gillespie, CPA/ABV, CFF

Gursey | Schneider LLP

Kristen is a Partner in the firm's Litigation Services Department, specializing in the area of forensic accounting in family law litigation matters.

She has testified as an expert witness in Los Angeles, Santa Clara, Orange, and San Bernardino County Superior Courts.

She has performed a wide range of litigation accounting services including business appraisals, determining gross cash flow available for support, lifestyle analyses, quantification of tracing and reimbursement claims, and pension plan and real property allocations.

Complete bios are included after resource materials.

CASE ROADMAP
FOR LITIGATING A BUSINESS ASSET

Obtain preliminary understanding of issues

Intake with client

Obtain client responses to questionnaire

Retain your CPA

Conduct second-round of information gathering

Formal & informal discovery; exchange of disclosures

Depositions, subpoenas

Site visits, informational meetings

Work through draft reports with CPA

Expert demands & depositions

Trial preparation & Trial

HOW TO OBTAIN A PRELIMINARY UNDERSTANDING OF THE BUSINESS ASSET

BUSINESS ASSET TYPE – PRELIMINARY CONSIDERATIONS

Determine the FORM of the business.

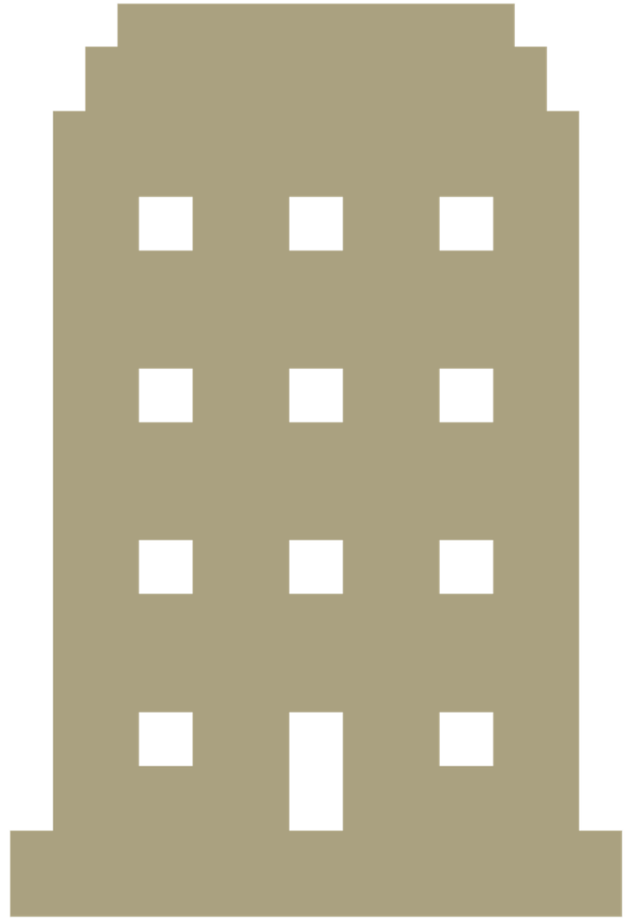
Determine the PERCENTAGE of the ownership interest.

Does one spouse own 100% of the asset, or less than 100%?

Some ownership interests may not need to be formally valued.

It may not be appropriate to spend time and fees formally valuing an ownership interest, e.g., significantly minority interests, pass-through investment interests, etc. Early retention of a qualified family law CPA can help the lawyer make appropriate decisions.

TYPES OF BUSINESS ASSETS YOU MAY ENCOUNTER



BUSINESS ASSET TYPES

- Sole proprietorships – An unincorporated business owned/operated by a single person. No separate return required, income/expenses can be reported on Schedule C of a personal tax return, so there are pass-through tax advantages. It is easy to create and is inexpensive to maintain. Generally, for new entrepreneurs or a one-person shop, such as contractors and consultants.
- Partnerships – Formed by two or more partners who contribute money, labor, skill, and share in profits/losses of the business. They file annual partnership returns and pass through profits/losses to partners in amount proportional to the partner's ownership interest.
- Corporations – Owners are called shareholders, and they exchange money or property for shares of stock in the business. They are separate tax paying entities that must file separate returns to show income/expenses. They distribute profits to shareholder owners. Profits of the corporation are taxed to the corporation when earned, then taxed to shareholders when distributed to them as dividends.
- S-Corporations – Technically not a business entity, but a rather a tax classification that allows entities to pass income, losses, deductions and credits through to its shareholders, so shareholders of S-Corps report income and losses on their personal returns, which are then taxed at individual income tax returns, allowing the S-Corp to avoid double taxation. S-corps must qualify to file as such by having, among other things, fewer than 100 shareholders, only one class of stock, and only certain types of shareholders (e.g., people, not other corporations).
- Limited Liability Companies (LLCs) – LLCs generally exist to offer small-business owners protection from personal liability in business obligations. Owners of LLCs are known as members, and LLCs are taxed similarly to sole proprietorships and partnerships but can elect a different taxation method.

THE CLIENT INTAKE

- What questions do you want to ask the client during the initial interview? Why?
  - Name, location(s), product/service
  - Formation year & form of business (is business a franchise)
  - Did you found, purchase, or acquire business through gift/otherwise
  - % ownership interest, responsibilities, and approx. compensation for all owners
  - Gross revenue & net income after expenses - roughly
  - Major assets, income sources, competitors, loans, debts
  - Does business have CPA? Books?

  Consider developing a standard questionnaire for clients. A sample is provided.

UNDERSTANDING WHAT COMES NEXT

Your client's business asset will be:

- **CHARACTERIZED** (as either community or separate), and
- The community interest will be **VALUED**.

CHARACTERIZATION

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As community property

Family Code § 760:

If the business asset was formed or acquired *during* the marriage, or if the ownership interest was acquired during the marriage, then it is presumed to be a community asset that may be valued and allocated to one spouse, typically the operating spouse.

As separate property

Family Code § 770:

If the business was formed *prior to* the marriage, or if the ownership interest was acquired prior to the date of marriage, then it is presumed a separate property asset of the owner spouse.

However, to the extent that the business appreciated in value during the marriage, then the increase in value may be *apportioned* between the separate and community estates. That is because the community might be owed a reimbursement to the extent community services or efforts increased the value of the business.

CHARACTERIZATION

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APPORTIONMENT OF THE SEPARATE PROPERTY BUSINESS

Why do we apportion? To attribute to the community any value derived from community efforts, and to make sure the community has been fairly compensated for the services rendered during marriage by the business owner spouse to the separate property business.

APPORTIONMENT METHODS

Pereira v. Pereira (1909)

When the personal efforts of a spouse were the primary driver of the increased value in a separate property marriage, the Pereira approach provides the owner spouse with a fair rate of return on the business investment, and then allocates any additional increase in value to the community. The rate of return can vary and can be either simple or compound.

Marriage of Brandes (2015)

A hybrid approach that includes a Pereira analysis AND a Van Camp approach. Typically requires a market change or capital infusion later in the marriage.

Van Camp v. Van Camp (1921)

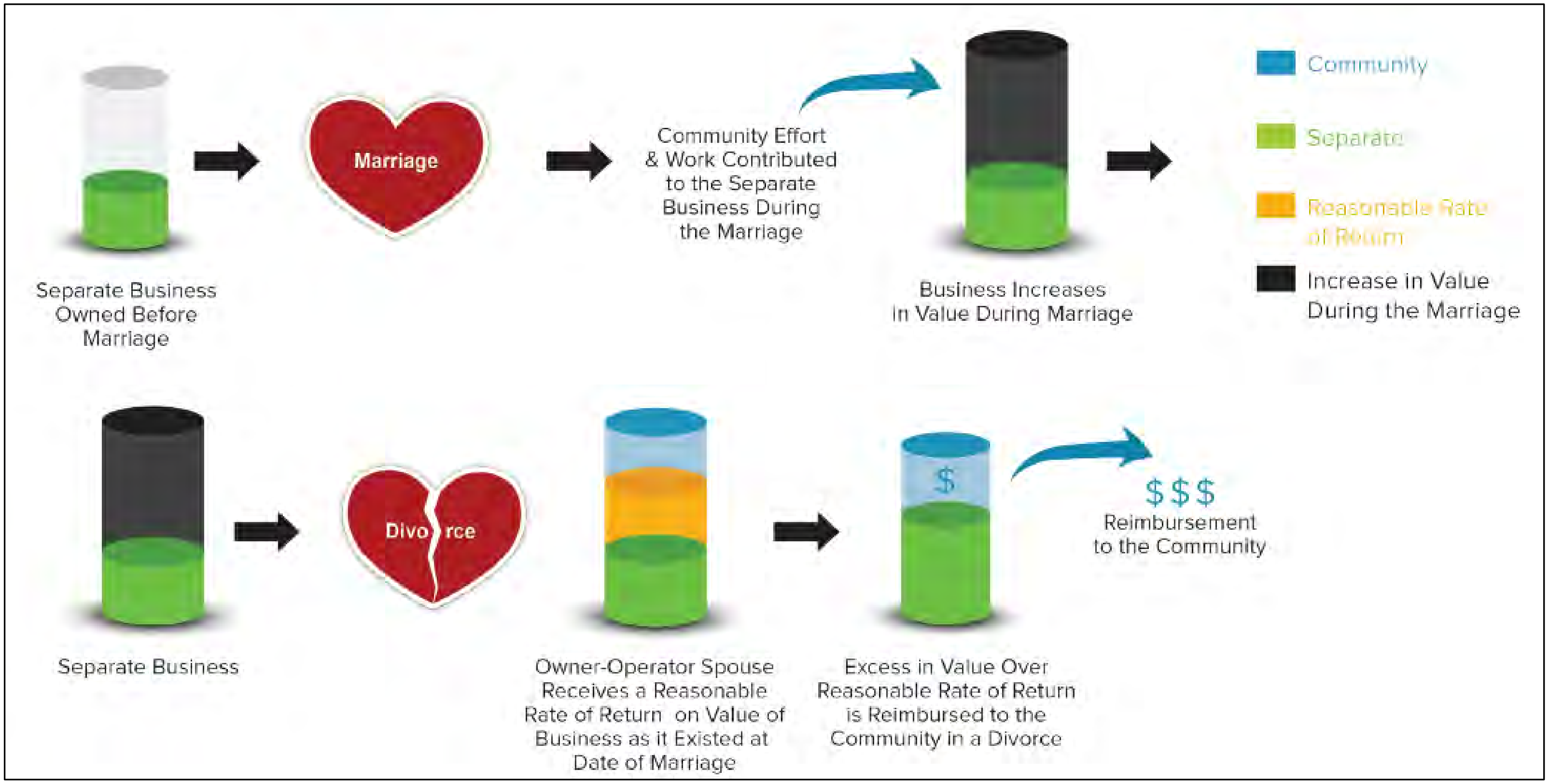
The Van Camp approach is utilized when the increase in the business value is due primarily to factors other than the efforts of the owner spouse.

Examples would be where the business is more capital intensive, where the increase in value is market driven, where there has been an infusion of capital, a franchise restaurant or hotel with many general manager/operators that the owner merely supervises, etc.

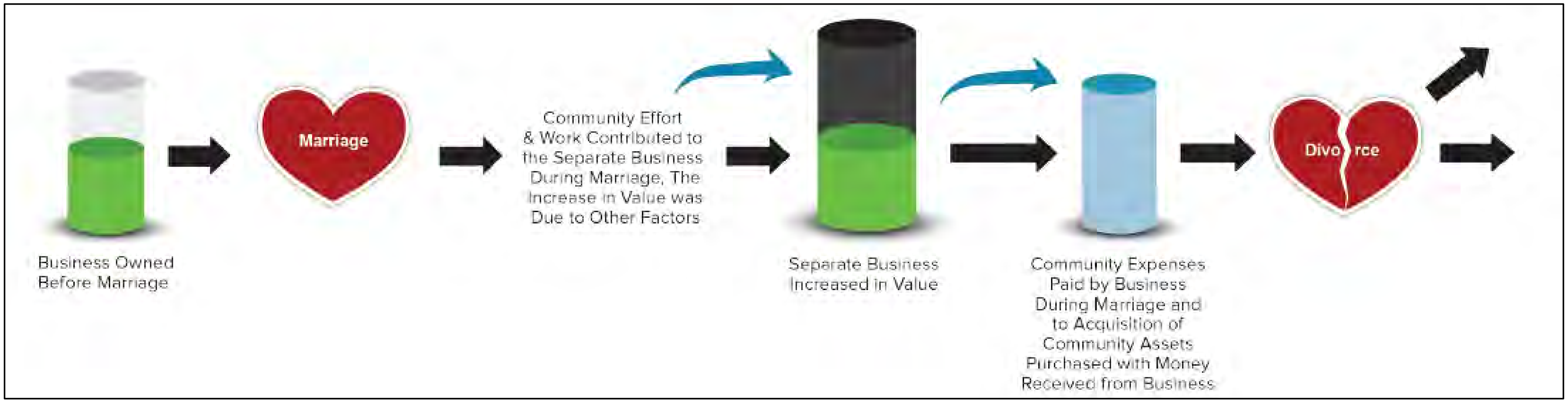
In this approach, the focus is on whether the spouse's efforts during the marriage were reasonably and adequately compensated. If not, the community needs to be reimbursed for the under compensation.

The Court can use any apportionment method that provides equity and accomplishes "substantial justice".

PEREIRA APPORTIONMENT



VAN CAMP APPORTIONMENT



VALUATION

AS OF WHAT DATE IS A BUSINESS ASSET VALUED?

Typically, closest to the date of trial as is practicable.

(*Family Code* 2552)

Why does this matter?

During the period between the date of separation and the entry of a final Judgment, the business might continue to appreciate in value, in part due to the efforts of the owner/operator spouse.

Either party may request an ***alternate date of valuation*** (e.g., date of separation for a sole proprietor who continues to work in the business post-separation, such as a lawyer.) Provide notice under F.C. § 2552b.

Or, consider a stipulation that provides both parties with the right to present evidence as to his/her proposed dates of valuation at time of Trial.

Samples are included in the resource materials.

RETAINING THE EXPERT

- Joint retentions –when are they appropriate?
- Do you need a Court order or a Stipulation?
- What specifics should be included in the Order/Stipulation?
- How far in advance to retain the expert?
- Legal issues to consider

VALUATION APPROACHES

1. **Income-based approach**

   - Looks to normalized earnings of the business

   - Applies an appropriate capitalization rate to these normalized earnings

2. **Asset-based approach**

   - Looks to underlying assets & liabilities of the business, including goodwill

3. **Market approach**

   - Looks to comparable businesses & sales of comparable businesses

NORMALIZING NET EARNINGS

STEP ONE

Adjust the expenses of the business by adding back to the net earnings of the business those expenses that a family court would not permit.

STEP TWO

Adjust the owner(s)' total compensation (from all sources, including salary, dividends, distributions, perquisites, etc.) back to what a non-owner could reasonably expect to receive for performing the same services.

ADJUSTMENTS TO OWNER COMPENSATION

INCOME BASED APPROACH CAPITALIZATION OF EARNINGS

5YA Net Earnings of Business after Expenses, Compensation to Spouse, Etc.	$300,000
Make Adjustments to Normalize Net Earnings of Business:	
Add Back Total Compensation of Operating Spouse (5 years average)	$250,000
Add Back Perquisites (5 years average)	$50,000
Subtract Spouse's Reasonable Compensation	<$150,000>
Total adjustments necessary to normalize net earnings of business	$150,000
Normalized Net Income of Business (5YA) ($300,000 + $150,000)	$450,000
Apply a Multiplier/CAP Rate	x 3
Business Equity Value***	**$1,350,000**
*** The FMV of any non-operating assets plus any excess working capital are added to the FMV figure above.	

ASSET BASED APPROACH, CAPITALIZATION OF EXCESS EARNINGS

(REVENUE RULING 68-609)

Calculate Adjusted Book Value:		
Book Value (Assets on the Corporate Books After Depreciation)	$200,000	
Adjustment of assets to FMV	+ 100,000	
Adjusted Book Value	$300,000	$300,000 (A)
Calculate Goodwill:		
Normalized Net Income of Business (5YA)	$450,000	From previous example
Return on adjusted book value (5% x $300,000)	– $15,000	
Excess Earnings	$435,000	
Multiple	× 2	
Goodwill	$870,000	$870,000 (B)
Business Equity Value		**$1,170,000 (A) + (B)**

INFORMATION GATHERING

INFORMAL DISCOVERY

FORMAL DISCOVERY

DEPOSITIONS

SUBPOENAS

TRIAL PREPARATION

- REVIEW DRAFT REPORTS WITH YOUR CPA
- OBTAIN THE OTHER SIDE’S REPORT
- DEPOSING EXPERTS
- PREPARE YOUR “STORY”

THANK YOU!

Please feel free to contact your presenters with any questions.

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