FAMILY LAW CORNER

JANANI S. RANA and ROBERT (BOB) O. WATTS

What Every Business Owner Should Know About Divorce in Orange County

As of today, Orange County is home to more than 100,000 small businesses (defined as 0-500 employees), and that number grows by about 4.75% annually. Cal. Emp. Dev. Dep't (2016), https://data.edd.ca.gov/. Accordingly, there is an increasing likelihood that one or both spouses in an Orange County divorce will be a business owner. This article offers a preliminary overview of strategic considerations relative to the characterization and valuation of a business owned by either spouse (or ownership interest in a business) during a divorce in Orange County.[1] It is intended for business owners, divorce lawyers, and lawyers who work with business owners.

Business valuation is a complex and case specific area that generally requires the retention of one or more financial experts, including a family law forensic certified public accountant (CPA). Business owners who opt to use their own personal or business CPAs often face difficulty when the CPA must be qualified as an expert, or when issues regarding objectivity and credibility are raised. The personal or business CPA may not have a thorough understanding of pertinent caselaw and statutes or their strategic application. Both parties should also consider early in the case whether additional experts are required— e.g., specific appraisers to opine on the value of real estate, machinery, computers, intellectual property or other tangible or intangible property, tax experts, compensation experts, and industry-specific experts to address working capital requirements, reasonable rates of return, and a myriad of other issues.

Each of the topics addressed here could be the subject of its own lengthy article. Early retention of a family law forensic CPA can make a significant difference in the outcome of a case.

Basic Rules of Characterization

A business (or business interest) must first be characterized as either community property or separate property.

Community: If the business was formed *during* the marriage, or if the ownership interest was acquired during the marriage, then the business is presumed to be a community asset that will be valued and awarded to the operating spouse. Cal. Fam. Code § 760. An equalizing "buyout" payment will then be paid to the non-operating spouse.

Separate: 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 to be a separate property asset of the owner spouse. Cal. Fam. Code § 770. However, to the extent that the business appreciated in value during the marriage, the increase in value may be apportioned between the separate and community estates. *See Beam v. Bank of Am.*, 6 Cal. 3d 12 (1971). The community may be owed a reimbursement to the extent community services or efforts increased the value of the business during marriage. *Id.* However, the community does not acquire an *interest* in the business or become an *owner* of the business. The character of a separate property business does not change, absent a transmutation that satisfies Family Code section 852. A separate property business that increases in value during the marriage remains a separate property business. The community may simply have an equitable reimbursement right that may be determined in the divorce.

Valuation Date

Typically, the community business will be valued as close to the date of trial as practicable. Cal. Fam. Code § 2552. However, the duration between the date of separation and trial may be months or years, and during that time, the business may either decrease or increase in value for any number of reasons, such as efforts of the operator spouse, market changes, or an owner's breach of fiduciary duty or misappropriation. Simply accepting a date of trial valuation without proper consideration of the reasons for the post-separation increase or decrease can result in substantial injustice. Perhaps the operating spouse should be penalized for acts that constitute misappropriation of a community asset. Perhaps the operating spouse should be compensated for post-separation efforts that increase the value of the business. *See Marriage of Imperato*, 45 Cal. App. 3d 432 (1975).

A separate property business may require an equitable apportionment analysis pursuant to the methods set forth in *Pereira*,[2] *Van Camp*,[3] *Brandes*,[4] or another method that accomplishes substantial justice.[5] If this analysis is to be completed, it will be necessary to determine the date through which it should take place. Where an alternate valuation date issue exists, lawyers should raise the issue early with the CPA and the other side, determine if the date of valuation should be bifurcated and resolved early, and/or consider a stipulation permitting each party to present evidence as to his/her proposed date of valuation(s) at trial, without prejudice.

Valuation Approaches

Generally speaking, there are three valuation approaches in family law in Orange County.

The first is an income-based approach that (1) normalizes the net earnings of the business by determining excess compensation of the business owner and other non-business expenses (e.g., perquisites, discretionary expenses, non-recurring expenses, depreciation, and other adjustments that would be made if the business were run by a third-party manager rather than the owner), (2) applies an appropriate capitalization rate, and (3) adjusts for any non-operating assets and excess working capital. Owners should therefore expect to justify their decisions to acquire non-operating assets and to retain cash beyond historical working capital needs.

The second approach typically used in Orange County is a hybrid asset-based approach often referred to as the "Excess Earnings Method." It adds the (1) book value of the business adjusted to fair market value (which may require appraisers and analysis of accounts receivable and bad debts), to (2) goodwill. Goodwill is the intangible value of a business—the expectation of continued patronage (Cal. Bus. & Prof. Code § 14100) or the expectation that the business will continue to generate earnings greater than what is necessary to simply survive. *See Marriage of Foster*, 42 Cal. App. 3d 577 (1974). Goodwill in family law is calculated by applying a multiplier to the business' normalized net earnings (after adjusting for reasonable compensation, perquisites, and non-recurring/discretionary expenses) and deducting a reasonable rate of return on the adjusted book value. Valuing only the tangible assets of the business without valuing goodwill may only be appropriate for forced liquidation events, non-operating businesses, or holding entities.

During a divorce, both parties are entitled to all books and records of the business, so detailed and accurate record-keeping is one of the keys to a successful outcome.

The third approach is a market approach that evaluates the sale of comparable businesses. It may be difficult to convince a court that true comparable businesses exist.

Normalizing Expenses: A business owner must be able to justify business expenses as reasonable, recurring, and/or non-discretionary to avoid having the expenses adjusted (i.e., added back to the business' earnings) to the business' income. The following is a non-exhaustive list of typical expenses paid through a business that may be permitted by the IRS for tax purposes, but are likely to be added back, in part or whole, to the business' earnings during a divorce: personal health insurance, car expenses (payments, insurance), disability insurance, garage/storage fees, travel, entertainment, "faux" employees—children and spouses on payroll, cellphone, and legal/accounting fees for the divorce. Non-cash expenses that may be added back are depreciation and capital expenditures.[6] Repairs after a natural disaster, flood or fire, loss of a product line, and leasehold or certain improvements may be adjusted as well. *Hein v. Hein* made it clear that Uncle Sam does not have the last word when it comes to whether certain expenses will be adjusted in a divorce. 52 Cal. App. 5th 519 (2020).

Reasonable Compensation: Determining reasonable compensation of the owner and/or any non-working or over-compensated employees can be some of the most difficult decisions to make in the valuation process. Higher compensation for the owner (or others) can have the effect of lowering the goodwill of the business. Selecting a CPA that is qualified to render an opinion on reasonable compensation issues is crucial. Parties may need to retain an additional compensation expert. To adjust an owner's compensation to a reasonable compensation, the expert will look to an employee of comparable experience, productivity, expertise, education, age, hours, services, etc. The key word is "commensurate." Professional compensation surveys can be used if for a "similarly situated professional practice or practitioners."[8] National surveys may not be a proper basis for determining reasonable compensation of someone in Southern California, at least absent the proper geographic adjustments. *Id.* There will be a difference between reasonable and actual compensation in most cases.

Divorce Preparation

During a divorce, both parties are entitled to all books and records of the business, so detailed and accurate record-keeping is one of the keys to a successful outcome. Handwritten records should be organized and easy to understand.[9] All business owners should expect to produce five years of tax records, QuickBooks files, financial statements, general ledgers, accounts receivable and payable inventories, payroll records, bank and credit card statements, cancelled checks, and asset and supply inventories. Formation documents may be necessary to prove separate property character—stock certificates, incorporation documents, operating agreements.

For business owners who face equitable apportionment issues, additional records may be necessary. As an example, any *Pereira*

analysis will require a valuation of the business on (at least) two dates—date of marriage and date of separation. If records are unavailable, the business owner should consider if exceptions are available.[10] The court may also rely on "reasonable, well-supported, and non-speculative testimony" from a family law CPA and/or the owner.[11]

Generally, business owners should consider preparing for a divorce as if it were a sale. If the business owner and/or family members routinely mix personal and business income or expenses, consider separate accounts and reduced commingling. Determine how to handle uncollectable accounts receivable, pending transactions of stock sales to employees, and pending capital expenditures or improvements. If pending/anticipated transactions will require the consent of an acrimonious or litigious spouse, consider the Standard Family Law Restraining Orders, fiduciary obligations, and what might need to be done prior to the commencement of the divorce.

It is also important to determine how/whether a recent acquisition, sale, buy-in, or buy-out will impact valuation. The business owner should know that, generally, the court will view buy/sell agreements as intended to compensate owners upon withdrawal, *not* to determine fair market value of the business in a divorce.[12] However, buy/sell agreements can be used in valuation of professional service firm interests.[13] Spousal consents are generally not relevant to business issues in a divorce[14] unless perhaps the non-operating spouse was represented by an attorney at the signing. The business owner who intends to rely on a buy/sell agreement should review the considerations set forth in *In re Marriage of Nichols.*[15]

Family-owned businesses give rise to unique considerations. How does a spouse prove the business was gifted by a family member? How does the non-operating spouse prove that funds necessary to acquire the business from family were community in nature? Business owners should evaluate the merits of keeping family members who do not perform any services for the business on payroll. Obvious over-compensation will result in an addback of income to the net earnings of the business. The operating spouse should also discuss with a family law attorney or CPA the implications of firing a spouse who may or may not perform services.

Careful estate planning and a well drafted premarital agreement can obviate many of the logistical difficulties associated with business *characterization*. However, keep in mind that *valuation* issues can arise even with a separate property business.

The most common estate planning pitfall for business owners is likely the well-intentioned but legally invalid transmutation. Transmutations, governed by Family Code section 852(a), require an express declaration via a writing that states on its face that character or ownership of an asset (e.g., a business) is being changed.[16] The specific language of the writing (e.g., the word "grant" may be ambiguous[17]) as well as the underlying document may impact the outcome (e.g., a trust transfer deed[18] versus a grant deed[19]). The business owner may also need to overcome the rebuttable presumption of undue influence.[20] Therefore, where transmutation is an issue, consultation with family law counsel, including prior to execution of estate planning documents, may make significant financial sense. Transmutation case law is extensive and complex.

Conclusion

The Family Code and related caselaw provide significant incentive for parties to share books and records and make family law CPAs available for meet and confer. Games of "hide the ball" generally play out poorly and result in unnecessary fees—the costs for multiple experts, discovery motions, subpoenas, and depositions will quickly eat up the estate. The suggestions included here are intended to prepare business owners and their lawyers for a cooperative and cost-effective divorce.

ENDNOTES

(1) Owning an interest in a business is not the same as owning a business. There are substantial differences that this article does not address, and it is not always wise to spend time and fees valuing every ownership interest of the parties (e.g., significantly minority interests, pass-through investment interests, etc.). Early retention of a qualified family law CPA can help a lawyer or party make educated, cost-effective, and appropriate decisions.

(2) *Pereira v. Pereira*, 156 Cal. 1 (1909).

(3) *Van Camp v. Van Camp,* 53 Cal. App. 17 (1921).

(4) *In re Marriage of Brandes*, 239 Cal. App. 4th 1461 (2015).

(5) *See In re Marriage of Dekker,* 17 Cal. App. 4th 842 (1993) and *In re Marriage of Brooks,* 33 Cal. App. 5th 576 (2019).

(6) *See* Cal. Fam. Code § 4058 and *In re Marriage of Rine*, 18 Cal. App. 4th 953 (1993) which holds that deductions from income are specific and should be narrowly construed. The most significant depreciation caselaw includes *Asfaw v. Woldberhan*, 147 Cal. App. 4th 1407 (2007), *In re Marriage of Rodriguez*, 23 Cal. App. 5th 625 (2018), and *Hein v. Hein*, 52 Cal. App. 5th 519 (2020).

(7) *In re Marriage of Ackerman*, 146 Cal. App. 4th 191 (2006).

(8) *In re Marriage of Rosen*, 105 Cal. App. 4th 808 (2002). *See also In re Marriage of Iredale & Cates*, 121 Cal. App. 4th 321 (2004).

(9) *See* Cal. Fam. Code §§ 721(b), 1100(e), 2100(c), 2102, 2105, and Cal. Corp. Code §§ 16403, 16404.

(10) *See Beam v. Bank of Am.*, 6 Cal. 3d 12 (1971) (finding that, in an equitable apportionment analysis, a business owner spouse's inadvertent or reasonable failure to maintain certain records may be excused).

(11) *In re Marriage of Ciprari*, 32 Cal. App. 5th 83, 97 (2019).

(12) *In re Marriage of Fenton*, 134 Cal. App. 3d 451 (1982).

(13) *In re Marriage of Iredale & Cates*, 121 Cal. App. 4th 321 (2004).

(14) *In re Marriage of Slater*, 100 Cal. App. 3d 241 (1979).

(15) *In re Marriage of Nichols,* 27 Cal. App. 4th 661 (1994). *See also Iredale & Cates, supra* note 13.

(16) *Estate of MacDonald*, 51 Cal. 3d 262, 272 (1990).

(17) *See Estate of Bibb*, 87 Cal. App. 4th 461 (2001).

(18) *In re Marriage of Begian and Sarajian*, 31 Cal. App. 5th 506 (2018).

(19) *In re Marriage of Barneson,* 69 Cal. App. 4th 583 (1999).

(20) *In re Marriage of Haines*, 33 Cal. App. 4th 277 (1995).

Janani S. Rana *is a Certified Family Law Specialist at Minyard Morris in Newport Beach. She exclusively handles Orange County family law matters. She can be reached at jrana@minyardmorris.com.*
Robert (Bob) O. Watts *is a Partner at Gursey Schneider LLP. He specializes in litigation support relating to financial issues. He can be reached at rwatts@gursey.com.*

This article first appeared in Orange County Lawyer*, June 2023 (Vol. 65 No. 6), p. 52.*
The views expressed herein are those of the author. They do not necessarily represent the views of Orange County Lawyer *magazine, the Orange County Bar Association, the Orange County Bar Association Charitable Fund, or their staffs, contributors, or advertisers. All legal and other issues must be independently researched.*