The Practitioner Family Law

Work Rules

Valuation of a Community-Property Business After Separation

By Mitchell A. Jacobs
and David L. Marcus

It is common for a spouse to continue working at a community-owned business after separation. Often, the business will increase in value after separation. Determining whether the increase in value is community property or the separate property of the spouse working at the business implicates competing rules of community-property law: On the one hand, community assets are to be valued as of the date of trial, and on the other hand, a spouse's post-separation work should be separate property.

If the success of the business is sufficiently dependent on the skill and efforts of the working spouse, then this dilemma is resolved in favor of the working spouse, with all increase in value of the business from the date of separation to the date of trial being confirmed as the working spouse's separate property.

The most recent case to address this issue is *In re Marriage of Duncan*, 2001 DJDAR 7212 (Cal. App. July 11, 2001). The parties were married for about four years. Shortly after marriage, the husband and wife formed a firm that invested assets of pension funds. This role is known as a pension-fund "adviser." A pension-fund "consultant" selects an adviser on behalf of the pension fund.

The husband had a national reputation as an adviser, which he had developed over 20 years prior to the marriage. Firms that perform the service of pension-fund advisor are hired based on their past record of investments. Success of the firm depends on having a better record that other advisers. Pension-fund consultants have a fiduciary duty to select the best advisers.

Pension-fund consultants will interview several advisers before selecting one. Also, the adviser's performance is continually monitored. If the performance of the adviser is unacceptable, then at any time a different adviser can be hired.

During the marriage, a marketing specialist was hired by the firm and received 21 percent of the stock. (All but one other share was community property.) This person managed marketing and client services and was president and chief administrative officer. The husband was chairman, chief executive officer, chief investment officer and solely managed at least 97 percent of the assets that the firm managed. He assisted in managing the other 3 percent. He also completely controlled the management and operation of the firm and was the only member of the board of directors. The husband was also primarily responsible for approving all professional hiring decisions and employee compensation. Finally, he initiated the firm's investment strategy and policy when the firm began and supervised the ongoing application of that strategy.

At separation, the firm employed 19 people and was managing $1.086 billion in assets. The husband's income was $5.8 million per year.

The court ruled that the community-property interest in the firm should be valued as of the date of separation pursuant to Family Code Section 2552(b). That section allows for a date of valuation other than the trial date for "good cause." This requirement is met where a business's value "devolves largely from the personal skill, industry and guidance of the operating spouse, rather than the business' capital assets."

The court found that the firm had all the attributes of a professional practice, which has traditionally been valued as of the date of separation: It performed services for a fee; it offered specialized knowledge and experience dependent almost exclusively on the husband's skill and expertise and post-separation work; it was licensed and regulated; and its assets consisted largely only of office equipment, accounts receivable and work in progress.

The wife argued that in order to value the firm as of the date of separation, the value of the firm must solely depend on the work and effort of the spouse. The court rejected this argument, finding that other factors may cause the business to increase in value.

She next argued that much of the post-separation increase in the value of the firm resulted from fees paid pursuant to contracts entered into prior to separation. However, after separation, the husband continued to manage 97 percent of the assets. His investment decisions were directly related to the firm's revenue and its ability to retain and attract clients. He also attended every final interview with prospective new clients.

> **The court ruled that the community-property interest in the firm should be valued as of the date of separation, pursuant to Family Code Section 2552(b).**

The wife reasoned that the increase was also due to the growth of the funds under the firms control. The court, however, held that this argument likewise ignored the reality that the firm's success and growth was directly related to the husband's success or failure in managing the investments.

The growth of the stock market was also advanced by the wife as an argument that the post-separation increase in the value of the firm was not related to the husband's efforts. The court responded that the success of the firm did not depend on the stock market in general because sometimes the husband's performance was better than the market in general, and sometimes it was worse. The success of the firm depended on the husband's decision to buy, sell or hold each individual stock.

The wife asserted that the firm was marketed as a "team effort." However, the "team" aspect was with respect to the "support" functions of the staff. These support functions did not really affect the value of the firm. Even the wife's expert conceded that the husband was "largely responsible for the success of [the firm]."

While the husband won the date-of-valuation issue, the wife won the battle over the method of valuation. The wife argued that the value was $21.8 million. The husband's expert presented three valuation methods, one of which was the comparable-sales method, which resulted in a value of between $16.7 million and $25.5 million. (The other two were the "gross revenue multiplier" method and a value based on a buy-sell agreement.) The court adopted the comparable-sales method and valued the firm at $25.5 million.

The husband wanted to discount significantly the comparable-sales-method value because, if the business was sold, he would certainly receive a five-to-10-year employment contract, which represents his separate property. The court rejected this argument because the husband did not have such a contract, so the argument was speculative. More importantly, there was no pending sale, so the effect that a sale would have on the value of the business was too speculative for the court to properly consider. This point is helpful for attorneys arguing that, if a spouse is awarded real property, there should be no discount for cost of sale if the sale is speculative.

Apparently the husband did not have to pay the community interest for his "use" of the community business from the date of separation to the date of trial. The parties separated in September 1994, and the trial court's determination of the community value of the business did not occur until April 1997. An argument could have been made that the husband owed the community interest for his exclusive post-separation use of the community business at a reasonable rate of return from the date of separation.

Alternatively, based on a case called *In re Marriage of Imperato*, 45 Cal.App.3d 432 (1975), the community would be entitled to a reasonable rate of return on the community interest in the firm as of the date of separation. The court did not address this issue directly. It stated that Family Code Section 2552(b) remedied the inequity when the post-separation work of one spouse increases the value of a community business, which previously was only addressed by the rule stated in *Imperato*. It is questionable whether Section 2552(b) was intended to deprive the community of this claim to interest. Nevertheless, a party in the husband's position can still rely on this case in arguing against a claim for interest, although this case may be dicta on this point.

Finally, *In re Marriage of Duncan* reminds attorneys not to take a valuation date as of the date of separation for granted, even if the law compels a valuation date as of the date of separation. If an alternative valuation date is appropriate, and if the opposing party will not stipulate, then the attorney should file a motion for an alternative valuation date.

Mitchell A. Jacobs, a certified family law specialist in Los Angeles, limits his practice to marital dissolution and other family law matters. **David L. Marcus**, an attorney with the Law Offices of Mitchell A. Jacobs, also practices exclusively in the area of family law.