

State Bar Annual Meeting, October 7, 2004 (program sponsored by Family Law Section of California State Bar Association), “*Goodwill: Does It Exist, How to Recognize It, and What to Do with It Once You’ve Found It*”

RONALD S. GRANBERG, CFLS

DOES FAMILY CODE SECTION 771 INVALIDATE A GOODWILL VALUATION METHOD THAT CONSIDERS A BUSINESS’S *FUTURE PROFITABILITY*?

Preface

“*You can never plan the future by the past.*” Edmund Burke.

“*The present tense includes the past and future tenses, and the future, the present.*” Family Code section 9. [Author’s observation: the Family Code’s drafters, not being physicists, had little appreciation of Euclidean space-time limitations.]

Facts

In their divorce proceeding, Wife will purchase from Husband his interest in the community property Business that she operates. Wife wants a low value on the Business; Husband wants a high value.

In recent years the Business has grown phenomenally in both profitability and value. Evidence supports a substantial likelihood that these growths will continue. Husband urges the court to consider the likelihood of continued growth while valuing the Business. Wife opposes the consideration.

Dialogue

Husband’s Attorney: Your Honor, Husband requests the court’s valuation of the Business take into consideration the substantial likelihood that Business profitability will increase greatly in the future.

Wife’s Attorney: Such consideration would be improper. It would violate all relevant precedent.

Husband’s Attorney: Not so. Business and Professions Code section 14100 provides: “The goodwill of a business is the expectation of continued public patronage.” Future public patronage translates into future profitability. Future profitability translates into current value.

Wife’s Attorney: Business and Professions Code section 14100 doesn’t apply to marital dissolutions. In fact, Business and Professions Code section 14000 limits its applicability to Business and Professions Code Division 6.

Husband’s Attorney: Section 14100 applies to business valuations. If marital dissolutions are to be grounded in reality, they must consider all of the business valuation factors that appraisers consider.

Wife's Attorney: If the valuation were to consider the Business's future profitability, the court would be violating Family Code section 771(a): "The earnings and accumulations of a spouse . . . while living separate and apart from the other spouse, are the separate property of the spouse." Whatever my client does with the Business in the future must inure to her sole benefit.

Husband's Attorney: An appraiser cannot determine an appropriate capitalization rate without considering the Business's risk, and cannot determine the Business's risk without considering the Business's likely future. A business that is facing a calamitous future downturn is riskier and merits a higher cap rate.

Wife's Attorney: *In re Marriage of Lopez* (1974) 38 Cal.App.3d 93, 107-108; 113 Cal.Rptr. 58 stated: ". . . in marital cases the expectancy of future earnings is not synonymous with, nor should it be the basis for, determining the value of 'goodwill' of a professional practice, but is simply a factor to consider in deciding if such an asset exists. *A community property interest can only be acquired during the marriage, and it would be inconsistent with that philosophy to assign value to the postmarital efforts of either spouse.*"

Husband's Attorney: Whereas counsel has emphasized her quotation's second sentence, I emphasize its first: ". . . in marital cases the expectancy of future earnings is . . . a factor to consider in deciding if [goodwill] exists."

Wife's Attorney: *In re Marriage of Rives* (1982) 130 Cal.App.3d 138, 150, 181 Cal.Rptr. 572 stated: "The potential income approach used by wife's expert witness was based entirely upon the expectation of future efforts of husband and as such was an improper means of valuing goodwill."

Husband's Attorney: *Rives* doesn't apply here because, unlike the expert in *Rives*, our expert isn't basing her opinion of value "entirely upon the expectation of future efforts of" Wife. Our expert is basing her opinion *partially* upon the expectation of future efforts of Wife.

Wife's Attorney: I cite *In re Marriage of King* (1983) 150 Cal.App.3d 304, 309, 197 Cal.Rptr. 716: "The difficulty with wife's expert's methods of evaluating goodwill is that the future income . . . is the major and controlling factor in attaining the goodwill figure selected by such expert. [¶] The philosophy of the community property system is that a community interest can be acquired only during the time of the marriage. It would then be inconsistent with that philosophy to assign to any community interest the value of the postmarital efforts of either spouse. * * * Since a community interest can only be acquired during the time of the marriage, the value of the goodwill must exist at the time of the dissolution and that value must be established without dependence on the potential or continuing net income of the professional spouse. (*In re Marriage of Fortier* [(1973) 34 Cal.App.3d 384, 387-388 [109 Cal.Rptr. 915].]; *In re Marriage of Foster* (1974) 42 Cal.App.3d 577, at p. 582 [117 Cal.Rptr. 49].)

Husband's Attorney: *King* is also distinguishable. Unlike in *King*, future income isn't "the *major and controlling factor* in attaining the goodwill figure selected by" our expert. It is merely *one of the factors* our expert used.

Wife's Attorney: *In re Marriage of Duncan* (2001) 90 Cal.App.4th 617, 633-634; 108 Cal.Rptr.2d 833 stated: ". . . the court may not value business goodwill by "any method that takes into account the postmarital efforts of either spouse." [citing *King*] However, 'a proper means of arriving at the value of such goodwill contemplates any legitimate method of evaluation that measures its present value by taking into account some past result.' [citing *Foster*] In this regard, the value of goodwill existing at the time of marital dissolution is separate and apart from the expectation of the spouses' future earnings."

Husband's Attorney: If counsel had read the remainder of that paragraph, she would have noticed that *Duncan's* footnote 12 approves of the application of Business and Professions Code section 14100 to divorces: "Valuing goodwill necessarily takes into consideration future income because the definition of 'goodwill' is 'expectation of continued public patronage.' [citing Bus. & Prof. Code, §14100 and *King*]"

Wife's Attorney: I have an illustration that will demonstrate how misguided Husband's contention is. As the court is aware, Husband is being awarded 1,000 shares of community property IBM stock, which is currently trading at \$30 per share. How would Husband respond if Wife were to argue, "Your Honor, I request you value the IBM stock at \$100 per share, because IBM has announced that it will be releasing a new, highly-profitable product in the near future"? Husband would insist on the current \$30-per-share value and complain that a \$100-per-share value would: a) be speculative, and b) violate Family Code section 2552(a)'s requirement that assets be valued as to date of trial.

Husband's Attorney: To the contrary, this argument nicely illustrates why postmarital profitability *must* be considered. Stock analysts always consider the future. The marketplace's established \$30-per-share price includes consideration of the profitability of IBM's anticipated products. The current price of a stock contemplates a business's future profitability, the same way the current price of a business contemplates a business's future profitability. You can't examine either type of asset in a vacuum.

The Court: The matter stands submitted.

DOES AN IMPERMISSIBLE “DOUBLE DIP” OCCUR IF A COMMUNITY PROPERTY BUSINESS OPERATOR PURCHASES HER SPOUSE’S INTEREST IN THE BUSINESS, AND LATER POSTMARITAL BUSINESS PROFITS ARE CONSIDERED INCOME TO THE OPERATOR FOR PURPOSES OF COMPUTING HER SPOUSAL SUPPORT OBLIGATION TO HER FORMER SPOUSE?

Preface

“*Double your pleasure, double your fun.*” Wrigley’s chewing gum commercial.

“*You dirty, double-crossing rat.*” James Cagney.

Facts

During their divorce proceeding, Wife purchased Husband’s interest in the community property Business she operated. The Business had been realizing \$200,000 in annual profits after paying its expenses (including Wife’s \$100,000 annual salary). The court determined Wife’s salary to be fair compensation for her services, and valued the Business by capitalizing the \$200,000 in excess earnings. Although no spousal support was ordered (due to the parties’ similar incomes), the court reserved jurisdiction over spousal support payable to either party.

Now, two years after judgment, Husband has lost his job and has filed a spousal support motion. The Business is still realizing \$200,000 in annual profits after paying Wife’s \$100,000 salary and its other expenses. Wife contends that the \$200,000 in annual profits shouldn’t be considered income to her for purposes of computing spousal support.

Dialogue

Wife’s Attorney: Your Honor, the price Wife paid Husband for his interest in the Business was computed by capitalizing the Business’s \$200,000 annual profits. Therefore, my client already fully paid Husband for his interest in the Business. It would be unfair for the court to now consider the Business’s profits as income to my client for purposes of computing her spousal support obligation – the court would be allowing Husband to receive double payment from the same fund.

Husband’s Attorney: This issue was resolved in an analogous pension context by *In re Marriage of White* (1987) 192 Cal.App.3d 1022; 237 Cal.Rptr. 764. In that case, Bernice White received the community property residence and beauty shop, in exchange for which Dewitt White received his community property retirement. When Dewitt began receiving monthly pension payments and Bernice sought to have those payments considered income to him for purposes of computing his spousal support obligation to her, Dewitt made an argument analogous to the argument Husband makes here: Dewitt argued that he had already paid for his retirement once and that, therefore, it couldn’t be considered income for support purposes. The trial court accepted Dewitt’s argument, but the court of appeal reversed, stating: “Dewitt contends the parties’ property division agreement removed the pension from the trial court’s jurisdiction. Otherwise, he urges,

Bernice will twice receive the benefit of the pension, once upon dissolution and again for spousal support. This, according to Dewitt's reasoning, is 'double-dipping.' Although Dewitt's argument may have a superficial appeal, it is inherently unsound. * * * '[it] is possible, without committing the error of 'double counting,' . . . to take the earner spouse's receipt of pension benefits into account in determining whether there should be any alimony award' (*Id.*, at pp. 1027-1028)

Wife's Attorney: Although I concede that *Marriage of White* provides analogous authority, the more relevant authority would have been the California Supreme Court's ruling in *In re Marriage of Sullivan* (1984) 37 Cal.3d 762; 209 Cal.Rptr. 354. The issue there was whether upon divorce the non-physician wife should receive a community property interest in the income-enhancing effect of her husband's medical school education, which the community paid for.

Husband's Attorney: The California Supreme Court never reached the issue, merely remanding the case for decision in accordance with the recently-enacted Civil Code section 4800.3 (now Family Code section 2641) by which the legislature resolved the issue through a dollar-for-dollar reimbursement to the community of certain educational expenditures.

Wife's Attorney: The \$200,000 in annual profit that Husband in our case would like considered for spousal support computation is the very \$200,000 that was used to value the Business. That's a classic "double dip."

Husband's Attorney: Not so. Defined benefit retirement plans are similarly valued. Although the facts are not specifically stated, it is reasonable to assume that the *White* retirement was appraised by actuarially projecting future benefits, then discounting the benefits to present value.

Wife's Attorney: I'll bet the husband in *White* didn't argue that wife's income from her beauty shop shouldn't be considered income when spousal support was determined.

Husband's Attorney: No he didn't. California law favors payment of fair support. Not much flies under the radar screen, especially when support factors are defined as broadly as they are in our state.

The Court: The matter stands submitted.