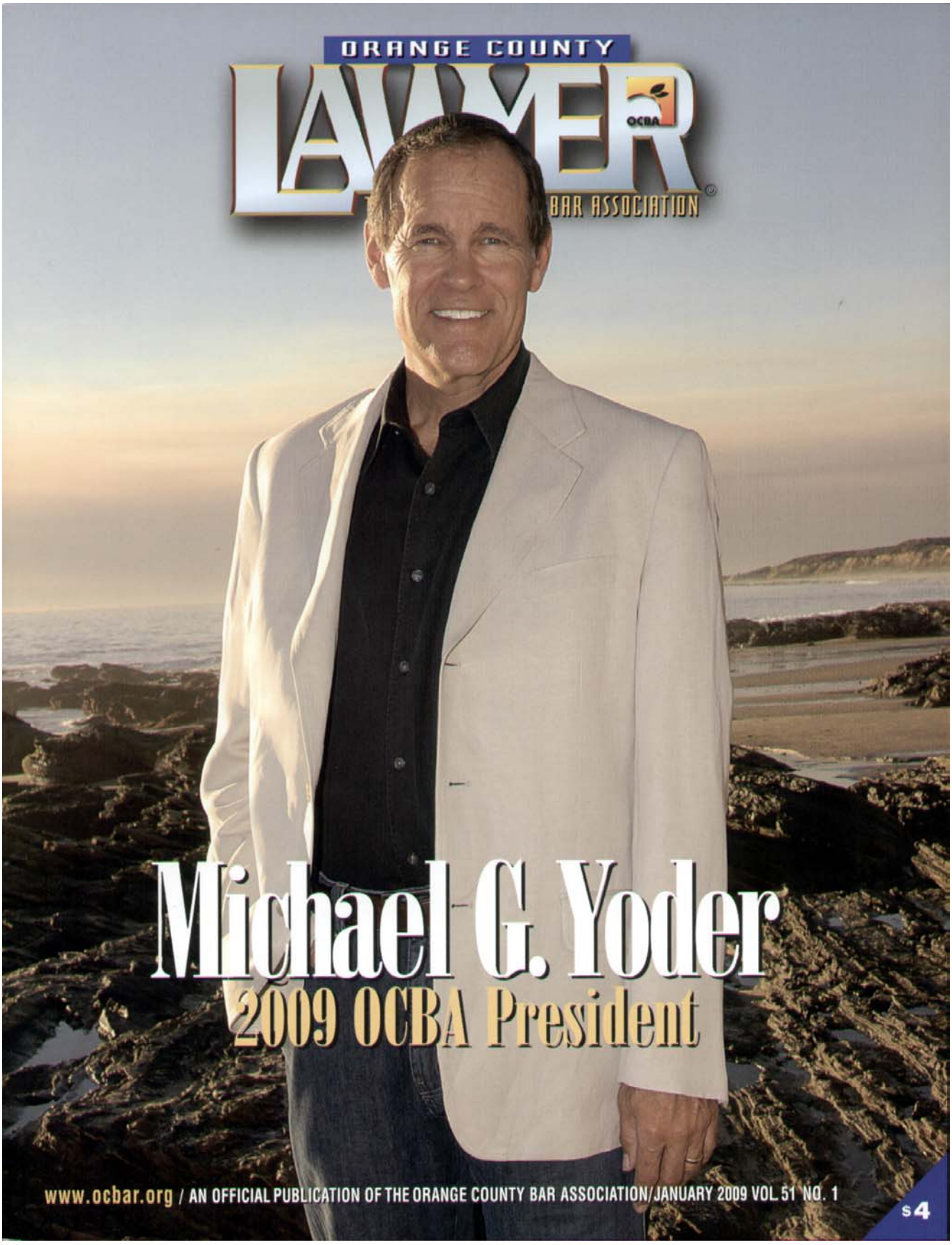
January 2009
Executive Divorce by Lisa Hughes
Hughes & Sullivan



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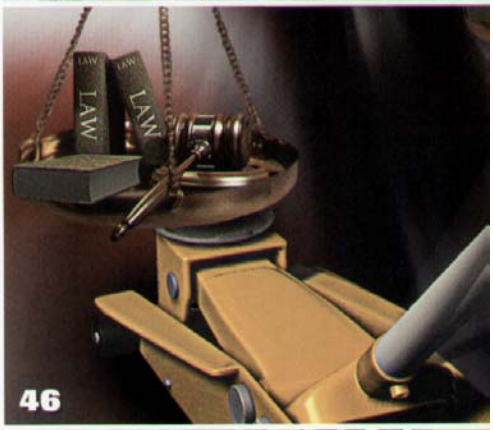

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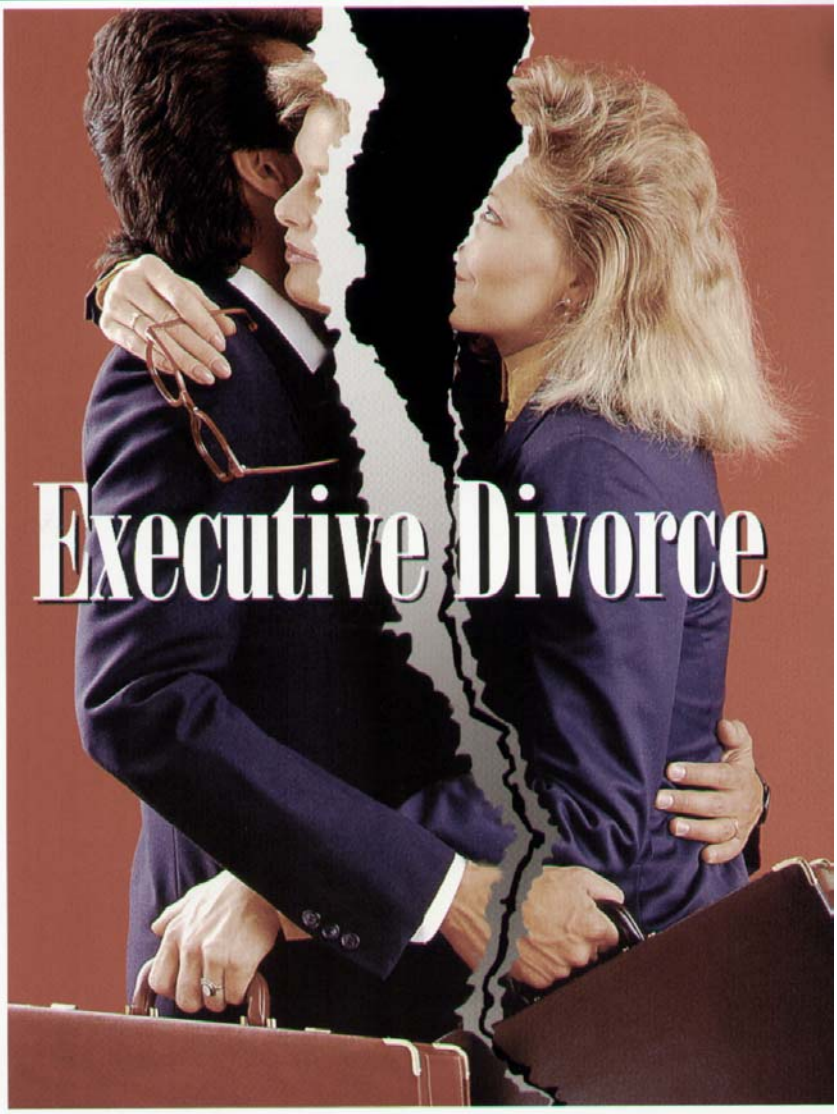
Executive Divorce



by Lisa Hughes

The rich really are different. How they live and how they divorce give fodder for television shows, novels and newspaper headlines. Comparing the dissolution of marriage between clients worth many millions, and clients with two kids, a dog and a tract house in the suburbs, is like comparing a Ferrari to a Toyota. Both will get you there, but the first is a much more complex piece of machinery and decidedly more expensive. Because Ferrari drivers are different, it follows that their representatives must have unique qualifications. This article explores some of those differences.

Unless it is simply inherited money, affluent individuals primarily responsible for acquiring wealth are generally driven, highly compensated, well educated (but not always), and focused on growing and maintaining their elaborate estates. It is no surprise that the executive who has spent hundreds of hours per month providing for his or her family is now faced with a bored and lonely spouse who wants to leave . . . with the money, of course.

Executives are often generous people who are sincerely concerned with their employees, partners, legacy and public image. In addition to their own multiple business interests, often there are charitable foundations in the picture whose purposes are near and dear to one of the divorcing spouses' hearts. Tense issues arise when the other spouse becomes suddenly less generous when faced with a substantial dilution of the marital estate. Because philanthropy is an honored tradition of the very wealthy, seeing that the purposes of accumulating vast wealth are continued in their best light after the dissolution is a factor to be considered.

These wealthy executives run our country's businesses, employing literally hundreds of thousands of people. When they go though the divorce process, they are hurting, too. Legally, they are treated equally. Yet financially, some circumstances are "more equal than others" and it is that complex financial structure that can make these engagements so exciting.

Building Your Team

The lawyer who facilitates the marriage dissolution process for the executive must be well qualified in numerous areas. The marital breakup requires meeting the client's emotional needs (which is necessary whether the divorcing spouse is rich or poor) and preparing for the division of the balance sheet and reallocation of proceeds from the relevant income stream. If terms such as *consolidated tax return, reviewed financials,* and *phantom income* are out of the attorney's comfort zone, or if Nikkei is thought to be a tennis shoe and the GAAP to be a clothing store, that attorney probably should not be handling this dissolution at all, or at least not without substantial help.

It is essential to have an understanding of accounting and finance in the complex dissolution practice. The serious practitioner should be aware of the implications of the Internal Revenue Code, rules and regulations of the State Board of Equalization, and promulgations of the American Institute of Certified Public Accountants (AICPA). For example, recognizing the importance of proper and consistent valuation in the marital arena, the AICPA has weighed in by issuing Statement on Standards for Valuation Services no. 1 entitled *Valuation of a Business, Business Ownership Interest, Security or Intangible Asset.* The standard specifically

addresses the "(v)aluation of a family-owned business included in a marital estate, for family law purposes," effective January 1, 2008. (John R. Gilbert, *50 Examples of When to Apply SSVS1*, J. of Accountancy (Sept. 2007)). This first attempt to create predictability and consistency in marital valuation issues in the accounting arena has obvious implications for the executive divorce.

High net worth individuals usually bring with them an army of financial consultants, along with their turf to protect. Although willing to help, their perspective is not necessarily concomitant with the divorce process. The CFO and accountant of the corporation may have a fiduciary duty to *both* spouses. It may be impossible or at least unadvisable to include them in all aspects of settlement or trial strategy. Thus, it is not unusual to find that a substantial team, in addition to the client's representatives, is needed to untangle the web of interests: a business appraiser, generally a forensic Certified Public Accountant, an equipment or inventory appraiser, a real estate appraiser (residential or commercial specialist or both), an economist or actuary, a trust attorney, the corporate, tax and business attorney, and in some cases, a private investigator. Even an international attorney may need to be asked to locate assets overseas. It is no time for generalists when millions are at stake.

The ability of the attorney to exercise discretion and maintain confidentiality is paramount. The professional representing these clients must be cognizant of the fact that adverse or misinformation about the client's business interests can move markets. I often remind myself that not only is the immediate family involved, but perhaps hundreds of innocent investors who have put their trust in the client's enterprise and we are required to consider their interests as well. A gracious rendering of "no comment" to the eager local press corps is a practiced skill. Maintaining the trust and confidence with that same group of individuals is also helpful when issues need to be published. Our firm does not hesitate to employ or utilize the client's or a credible public relations firm to provide expertise in these arenas.

In the vast majority of these cases there will be family businesses or multiple business interests. With publicly traded stocks, the division of the estate may be simple. However, the parties sometimes hold substantial interests in these companies and during the pending dissolution, they must cooperate in voting blocks of shares in public companies they either control or have enough stock ownership to influence. This may sound easy, but in some circumstances the parties already are bitter enemies and the lawyer's skill in seeking reconciliation for the greater good comes into play.

The Sticky Issue of Stock Options

No discussion of modern day business would be complete without including the issue of stock options, and this issue is also typical – and sticky — in the executive divorce. Stock options have many subtle sub-issues, which have not been adequately resolved by case law. For example, options granted *prior* to marriage are not necessarily the separate property of the grantee if the employed spouse was required to remain employed for the granting employer after the date of marriage. Further, options granted *after* the date of separation may not be separate property due to the time rule calculation as set forth in *In re Marriage of Hug*, (154 Cal. App. 3d 780 (1984)), *In re Marriage of Harrison* (179 Cal. App. 3d 1216 (1986)), and *In re Marriage of Nelson* (177 Cal. App. 3d 150 (1986)), although one case has identified these post separation grants as separate property. Options may not be transferable to the non-employee spouse and the employee spouse must pay income tax on income recognized from the exercise of the options.

The theories used for the division of stock options are not limited to the time rule or variations of it. The community interest in options may be determined by the use of the incremental or the cumulative theory of why the options were granted. The incremental theory states that each option grant stands alone and has no relation to the time with the employer. The cumulative theory states that all of the time with the employer is relevant to the grant of the options.

Dividing Assets for the Non-Working Spouse

In most cases, the closely held business interests will be valued and awarded to the spouse primarily responsible for acquiring them. The reason for this is that the non-working spouse is unable or unwilling to assume responsibility of continuing the business operations. In any business or industry, losing 50 percent of value instantly is devastating. If there are substantial offsetting assets, the executive will often continue

in as normal a manner as possible. But if the assets are not sufficient for an equal trade, the court has the power to sell the business, which is not the result that business owners generally want. A sale of a business ordered by the court usually does not maximize the selling price. To combat this, equalizing notes or payouts may be required. Faced with the prospect of having to borrow 50 percent of the business equity, many enterprises do not survive. Business lawyers retained to assist in these cases generally are astute in the area of mergers and acquisitions. Together, it is our responsibility to structure a settlement that will seek to protect all of the interested parties, which includes the employees and partners/shareholders of the enterprise.

At the same time, the executive spouse becomes accustomed to the lifestyle and the law not only recognizes this concept, it supports the right of the non-working spouse to maintain the standard of living obtained during the marriage for conceivably a lifetime if it is a marriage of over 10 years (typically half the time of the marriage if it is less than 10 years). Family law courts have long determined that a non-working spouse is considered a "silent partner" in the business interest, whether a sole proprietorship, partnership or corporation, and all the fiduciary duties afforded non-marital partners and corporate shareholders may be added to the protections and benefits granted under the Family Code.

Clearly, "[u]nder the principles of community property law, the wife, by virtue of her position of wife, made to that value the same contribution as does a wife to any of the husband's earnings and accumulations during marriage. *She is as much entitled to be recompensed for that contribution as if it were represented by the increased value of stock in a family business.*" (*Golden v. Golden*, 270 Cal. App. 2d 401, 405 (1969)); (*In re Marriage of Foster*, 42 Cal. App. 3d 577, 584 (1974)); (*In re Marriage of Fenton*, 134 Cal. App. 3d 451, 461 (1982)). Serious family law lawyers who practice executive divorce know these cases well.

With business interests, which a spouse operates, there are many difficult issues to resolve. The actual income of the business must be determined as if an independent manager were operating the business trying to maximize the profits. This means the perks, personal expenses, and unreported income, accounting issues relating to tax planning/saving, excess compensation, etc. all must be examined. If the operating spouse is withdrawing more than a reasonable salary, then that spouse is withdrawing community profit if the business is community property. Compensation experts are necessary to determine what is reasonable compensation and accountants are necessary to determine the actual income and what community profits are being withdrawn and owed to the non-operating spouse, generally on an after-tax basis.

Often the parties will have living trusts containing the assets acquired during marriage. The parties may have lines of credit secured by the assets in the trust. Whether to revoke the family trust may be a critical decision. For example, our firm was involved in a substantial multi-million dollar case and we received a notice of revocation of the family trust almost immediately upon entry into the case. It was obviously a hasty or unknowledgeable action, causing us to pick up the telephone and ask the opposing counsel why he would do such a thing when this instrument secured the personal credit lines of the parties, and the revocation would result in the immediate calling of over $100 million of outstanding credit. Within hours we received a revocation of the revocation of the trust and the case proceeded in a more thoughtful manner.

For similar reasons, the parties need to cooperate in ensuring that insurance is maintained and obligations are met, including IRS obligations. Maintaining an exemplary credit rating will be valuable when all is said and done and the equalization payment needs to be borrowed.

Often, one spouse has spent years avoiding involvement in the financial structure of the community. Those advisors who were formerly ready and willing to help are now helping the executive and may be conflicted in their loyalties. I recommend finding several financial advisors who will help the newly disenfranchised spouse invest and plan for his or her financial future. I recommend the family law attorney avoid managing the estate either during or after the pendency of the divorce. I have seen several cases where my counterpart has put him or herself in a position of compromise by doing so.

Supporting Children of Wealthy Parents

Turning to the issue of child support, it is well known that California Family Code

Sections 4050 through 4076 provide a statewide uniform guideline for making these support awards. One purpose of implementing these guidelines was to prevent discrimination in the courts in supporting children on the basis of geographical areas. Is a child in Yolo County afforded the same rights as a child in Orange County? The answer is yes, unless that child is rich.

The presumption that the amount of child support under the guideline formula is the right amount may be rebutted by evidence that the payer has an extraordinarily high income and the amount determined by application of the formula would exceed the child's needs. (Cal. Fam. Code § 4057(b)(3).) According to *2008 Practice Under the California Family Code*, a Continuing Education of the Bar publication, "[t]he percentage of income attributable to the guideline formula at its highest income level is 12 percent for one child, 19.2 percent for two children, 24 percent for three children, and so forth. Family Code Section 4055 (b)(3)." (*2008 Practice Under the California Family Code: Dissolution, Legal Separation, Nullity* 335 (M. Dee Samuals, Esq. & Hon. Frederick A. Mandabach eds., CEB 2008).) By way of example, running the Dissomaster Program at two children, 30 percent timeshare, and self-employment income of $10,000 per month (with no other program factors) child support is $2,251 per month. At $1,000,000 per month it is $99,034 per month. Of course, child support is tax-free to the payee and not deductible to the payer. Most of these individuals are in the approximately 50 percent combined state and federal tax bracket which means that the custodial parent would be devoting the equivalent of nearly $200,000 per year to the two children.

Many years ago I tried a high earner child support case in which both parents were quite wealthy. The father complained to the appellate court that a child support order in excess of $100,000 per year was excessive (since child support is tax-free to the recipient, this resulted in the father being obligated to approximately $200,000 per year pre-tax). The trial court found among other things that this teenager was allocated $2,000 a month "mad money" on an unlimited credit card account and another $1,500 or so per month for travel and entertainment, plus $2,000 per month for clothes. In an unpublished opinion, the appellate court upheld the findings. However, in a scathing dissent, one of the justices railed on the concept that a child should have so much money available. He referred to my client's progeny as being trained as a "power shopper" and that the other parent should not have to pay for the training.

Perhaps the complaining justice was more in line with the much later case of *In re Marriage of Cheriton*, (92 Cal. App. 4th 269 (2001)) which deals with the issue of needs of the children. In the opinion, the court relates "[b]ecause the definition of extraordinarily high income is tied to the children's needs in each instance, the evidentiary focus must be on the children's needs and not on the absolute amount of the parent's income." (*Id.* at 297 (comparing to *Estevez v. Superior Court*, 22 Cal. App. 4th 423, 429-430 (1994))). "As the trial court correctly observed in this case: 'The legislature did not define the term extraordinarily high income, leaving that to the discretion of the trial court.' In exercising that discretion, however, the trial court must at least approximate the point at which the guideline support obligation due from a high earner would exceed the children's needs.'" (*Id.* (citing *McGinley v. Herman*, 50 Cal. App. 4th 936, 945 (1996))). In other words, what are reasonable needs for a child of wealthy parents may be unrecognizable to some. Some of these children have only flown by private jet because of security reasons.

What happens with the non-working rich? The court will impute income on assets whether or not they produce income. As the trial court stated in *In re Marriage of Destein*, (91 Cal. App. 4th 1385 (2001)), the court did not abuse its discretion in imputing investment earnings, when determining child support, to assets of husband's that were historically non-income-producing assets. Though an asset's income-producing history was a factor to be considered in determining child support, it was not a barrier to the exercise of discretion; the primary obligation of husband was to support his children according to his station in life and ability to pay, and a significant disparity existed between children's life-style at the home of each parent. Similarly in *In re Marriage of de Guigne*, (97 Cal. App. 4th 1353 (2002)), the court imputed income on the residence of husband when there was evidence that the residence site could be subdivided and sold off.

The $10,000 Handbag

The interesting anomaly in the issue of spousal support is that in the executive divorce arena there may be *none*, despite what was determined for child support. California Family Code section 4321 allows that in a judgment of dissolution of marriage that if "the party has separate property, or is earning the party's own livelihood, or there is community property or quasi-community property sufficient to give the party proper support," the court may deny support altogether. The devil is in the details of course. What is an amount sufficient for proper support? Is the Gulf Steam IV really necessary? The shopping trips to New York and beyond? And my personal favorite - is it necessary to carry a $10,000 handbag?

California Family Code section 4320 provides the framework for permanent spousal support. The standard is not what the average person would deem necessary, but appropriate for the *station in life* the divorcing spouse maintained during the marriage. This "station in life" is also described as "the marital standard of living." So the shopping trips to New York, the $10,000 handbag as well as the "mad money," entertainment costs and clothes as discussed above, could very well be included in the spousal support calculation. An interesting question is whether or not the ability to save and invest is part of the algorithm of spousal support. These estates have grown due to the community doing exactly that. Is that part of the "marital standard of living?" It may be, according to the case of *In re Marriage of Wittgrove*, (120 Cal. App. 4th 1317 (2004)).

Feldman Changed the Rules

And last, but certainly not least, it is of critical importance to comply with the need for full disclosure. California has long found the need for adequate disclosure and has codified these requirements. The code was given teeth *In re Marriage of Feldman*, (153 Cal. App. 4th 1470 (2007)). In *Feldman*, the court awarded $250,000 in sanctions and $140,000 in attorneys' fees before trial, for failure to provide the wife with full information necessary for her to properly identify, characterize and value assets. Poor Mr. Feldman ultimately was found to be worth some $50,000,000. The exchange of information, informal or formal, is mandatory. However, the family law practitioner must appreciate that discovery under the Family Code statutes are in addition to the Civil Discovery Act (Cal. Code Civ. Proc. §§ 2016-2030). The spouse's post separation fiduciary duty is said to be extremely broad. These are dangerous waters to tread if the practitioner tries to shortcut the process. Thanks to modern technology, roomfuls of documents can be scanned and shared with all parties by the push of a button. Some of the older practitioners went into this new arena kicking and screaming, but we are glad we did. In a post-*Feldman* era, I believe it would be virtually impossible to comply without these tools.

In conclusion, the practice of executive divorce is not for the faint of heart. The clients are often self-made individuals who have no lesser expectation of their representatives than they have for themselves. They expect the same attention to detail, reservoir of talent, passion and dedication that brought them to where they are. For some of us, it is an honor and a privilege to meet those demands.

Lisa Hughes, Esq. and CPA, is founding partner of Hughes & Sullivan Family Law in Tustin, Calif. The firm specializes in family law issues including dissolution of marriage, child custody and executive divorce. Mrs. Hughes may be reached at 714.538.5200. For more information: www.hughesandsullivan.com.