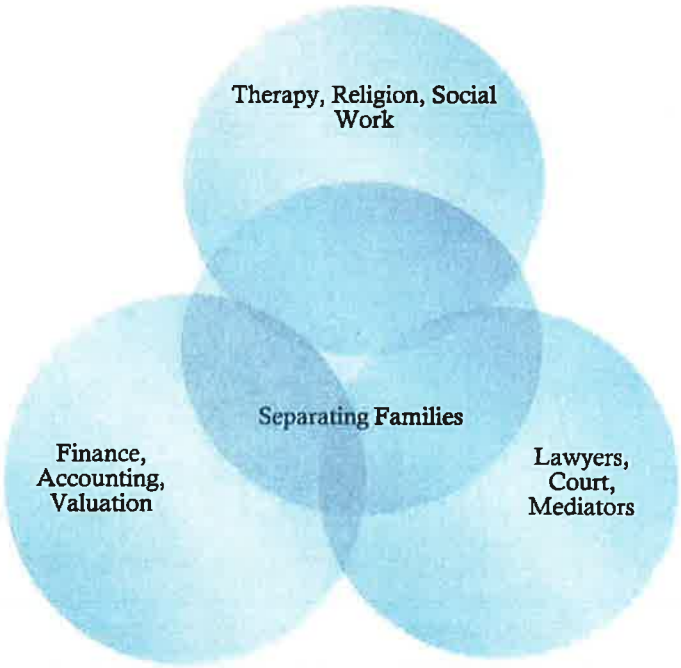
Greg Kincaid-Editor

Spring 2014

SENSIBLE SEPARATION



Sensible Separation is an interdisciplinary newsletter for professionals assisting families with divorce or separation. If you would like to contribute an article or have an announcement you would like to share, please submit to gkincaid@hrkklaw.com. For more information about divorce mediation, please visit www.sensibleseparation.com. Another opportunity to share helpful thoughts or insights about our work exists on the *Sensible Separation* FACEBOOK page, which is located at www.facebook.com/sensibleseparation. Please visit our site. We are just getting it started and would appreciate the traffic and any helpful information that you would like to share.

Evan Ash- Mediator and Episcopal Priest

I asked Evan Ash to share his thoughts on how the clergy can best serve divorcing families. For many families, this is an important first step.

Honorable Kelly Ryan

Judge Ryan spent four and one-half years on the Family Law Bench. I asked him to ruminate a bit about the experience and why he decided to make a change.

Rob Metcalf, CPA and business evaluator.

Family-owned businesses cause some perplexing issues in a divorce. One is the "double dipping" problem, e.g. using the same stream of income to simultaneously define both the future value of the business and pay the families' current expenses. Rob shares some insights into both sides of the argument.

THE THEORY OF THE CASE

By Greg Kincaid

Successful trial lawyers and fiction writers alike need to have a theory or theme around which they organize their work. Taking this concept one step further, I have identified one theme for the focus of my entire law practice as a divorce attorney and mediator. ***The task of the law is to skillfully balance legitimate, yet often competing, interests.***

The crux of our work--as professionals helping families through a divorce--often comes down to one word in that bold sentence: *legitimate*. Legitimacy exists on a spectrum. Put another way, certain issues or positions are inherently more legitimate than others and it's our job to help our clients or patients to see those differences. Logically, we must constantly ask ourselves how we can best accomplish that very difficult task.

There is a long line of therapists, religious leaders and philosophers that provide a possible answer to that difficult question. The therapists on the list (for example Abraham Maslow, Ken Wilber and James Fowler) would say that the end goal for all of us is to become more adult in our thinking. Read, less selfish and more concerned with others. Basically, the Golden Rule. These scholars have actually charted stages or levels of adult development. The law says that a child becomes an adult when he turns 18. These men believe that becoming an adult has very little to do with age and a lot to do with maturity. Becoming an adult is a process that never really ends. It should be our life goal to progress as far along that path as we possibly can and to help our clients do the same.

If we can agree that the heart of our work is helping our clients and patients to be more adult, how does that change or affect the way we do our work? Perhaps for the marriage therapist it means helping the client or patient to become more self-aware, to help them get beyond their own wounds and injuries, so they can see how their behaviors may be affecting their spouse or children. Certainly, a difficult task.

For legal professionals, we too need to get our clients to understand that it's not just about them and even though we are their advocates we do them no service when we destroy the whole family in the selfish pursuit of their individual needs.

Perhaps the clergy are well-positioned to help divorcing families to pursue legitimate adult interests. I asked Evan Ash to contribute to this edition of *Sensible Separation*. Evan is unique in his skills and background. He is both a priest and a mediator at Johnson County Court Services. Evan's article, I believe, also resonates with this same theme. Evan suggests that the clergy need to askew critical or harsh judgments and instead focus on helping family members to ask the right questions.

The Honorable Kelly Ryan also contributes to this issue. Judge Ryan just ended his tenure as a judge focusing on divorcing families with children. He now has a criminal docket. Among other subjects, he also

stresses how hard it is to balance interests when the parties are stuck in an injured and not terribly adult state of mind.

Finally, I asked Robert Metcalf to take on the tall task of fleshing out some of the complex analysis necessary when valuing a family owned business. You'll see that Robert purposely did not take either side of the "double dip" issue. As you might have guessed by now, the answer is in a proper balancing of both sides of the question!

I hope you enjoy this issue of *Sensible Separation*. Please note that at the end of this issue, I have added an *Announcement* Section. If you have news that is noteworthy or would like to contribute an article that might be helpful to divorcing professionals, please feel free to email me at gkincaid@hrkklaw.com.

I. DIVORCE GUIDANCE FOR CLERGY (AND OTHERS, TOO!)

By Evan Ash, Episcopal Priest and longtime mediator for Johnson County Court Services

When a member of your congregation comes to you seeking pastoral counsel and guidance about marital problems, they are facing a complicated personal crisis. The marriage relationship is unique in that it is primarily based on choice, and when that choice is troubled, it may say more about the chooser (of the divorce) than the chosen. When the level of crisis is presented in the form of questions of separation and divorce, the person seeking divorce may feel both bold and chaotic at the same time. This is a potentially reckless condition that needs gentle guidance and reflection.

As clergy, we have the pastoral opportunity to help that person consider some questions about their marriage journey that has brought them to this moment. Encourage questions:

a) What is missing in the marriage that has brought that person to this moment?
b) What extraneous factors may be contributing to this sense of loss and vulnerability?
c) Have they considered counseling related to the source of vulnerability – personal, faith, interpersonal, financial?
d) If there are children, how will a divorce impact the children?
e) What questions or issues need to be defined to better assess what resources to consider?
f) What would it mean for them to take a chance on their marriage?

Such counsel would be sabotaged if you:

a) Judged the person for their outlook on their situation;
b) Trapped them in their chaos, potentially leaving them to make hasty emotional decisions, or
c) Direct their actions, even if faith based.

Consider this a crisis of faith for the person or they might not have sought your counsel. They see you as a sanctuary where they can wrestle with their soul. You are not the adversary but the mediator. Help them

think and feel beyond the stress that brought them to you. Help them explore the challenge they face with hope, in whatever form it will take for them. Faith is indeed about things not known!

Evan will soon retire from his position as mediator at Johnson County Court Services. On behalf of the thousands of families he has assisted, a hearty thank you is in order.

II. REFLECTIONS FROM THE FAMILY COURT BENCH

By Thomas Kelly Ryan, District Court Judge, 10th Judicial District, Johnson County, Kansas

My judicial career started on November 6, 2008 with an appointment to one of three positions in the Family Court of Johnson County District Court. I had served as a *pro tem* judge for various judges over the course of the previous five years and felt a certain comfort in handling cases on a family docket since that was my primary focus in the private practice of law for 20+ years. Oh, what a surprise I was in for on that cold Friday in November!

There is no real preparation for an attorney who transitions to become a judge, even in working as the substitute or fill-in judge on a sporadic basis. I had experienced the "other side of the bench" in handling hearings and even trials in my numerous appointments to sit for a regular judge while they were on vacation or otherwise unavailable to hear a particular day's docket. Yet, I had no comprehension of the constant stream of litigants and attorneys who file into family courts with their complaints, arguments, anger, anxiety, complaints, fears (rational and otherwise), disputes, complaints, retribution, sniping, grousing and, of course, complaints.

About three weeks into my new position, a wise veteran attorney provided me the insight that nobody else had bothered to mention to me. He asked me if I could remember the certain feeling of freedom that I attained as an "experienced family law lawyer" in being able to choose my clients and withdraw from representation of those persons who I found to be unreasonable or constantly defiant to my voice of reason. "Well, keep that memory because now as a judge, you have to take everybody that comes into your courtroom, be they among the good, the bad or the ugly." I quickly found his wisdom to be true in working with our "frequent filers" and those persons with an amazing reservoir of persistence to seek justice in their case that the judge just never seemed to understand in their previous appearances before my predecessor, Judge Bill Isenhour.

Now, don't think that I am bemoaning the work of a family court judge because I truly enjoyed the work with attorneys and parents in attempting to fashion some reasonable future plan for their family or the resolution of their source of financial distress. Other civil judges (not in Family Court) often complain that they must hear "divorce cases" for a variety of reasons. Contrary to popular opinion, there are many talented and professional attorneys who practice family law here in Johnson County and, after adjusting to the fact of my different relation with these attorneys with whom I previously worked on the other side of cases, I came to a newfound appreciation for the patience and client control methods utilized by my former compatriots with some very challenging personalities and issues in their cases before me. I understood the

parties appearing in court were much more complex and often difficult to manage than how they appeared in the family court forum. The most difficult time to control and handle the client usually occurred in the courtroom.

I realized early on in my judicial work that I could not view attorneys and clients in my own narrow perspective of "how would I handle this client's behavior?" or "I sure wouldn't present my evidence to the judge with (or without) all of that documentation." An appreciation for the tremendous pressure and critical evaluation of a family lawyer's work led me to a more detached viewpoint of cases in my court. My judicial view always accounted for the grind that the attorneys faced in handling even "simple" cases.

However, I came to see a darker side of the practice of family law from a limited number of attorneys who clearly failed to prepare either the evidence or their clients for the likely outcomes resulting from a contentious proceeding in court with the other parent or extended family members. It was evident that I needed to remind attorneys that they hold a higher duty to work diligently for a client who is often operating at a substandard level of comprehension and minimally cooperative attitude when their life is being torn apart, no matter how long the marriage or relationship and without regard to the number or age of their children or the amount in their bank accounts or retirement savings. I hope that my efforts to listen and learn from the litigants in cases before me provided a reasoned and viable result in my decisions which would likely affect these people for the foreseeable and even distant future.

The opportunity to change judicial dockets came my way last summer and I moved to take over a criminal docket when Judge Steve Tatum retired. Many attorneys and plenty of lay people told me "You must be really burned out with that family court docket, since you are 'getting out' of there." I told everyone who made such comments that I was undeniably **not** burned out on family law but, after more than 4-½ years of hearing exclusively family cases, I did not want to **become** burned out on the important issues and decisions that make up every case in our family court. I always reiterated with my MacArthur promise: "I shall return (to family court)!" Naturally, the attorneys would scoff at me and suggest that I was being anything but truthful with that comment. I simply responded with the refrain: "I'll see you back here if you're still practicing family law!"

A wise adage comparing family court and criminal court clientele has been proven true to me in my first six months in this new position: Criminal court has some of the worst people on their best behavior. Family court has some of the best people on their worst behavior. I've come to realize that both areas of law in their essence deal with people and their emotions and actions or inaction. Certain similarities are evident but I know now that the work of attorneys, judges and assorted professionals in family law cases are handling some of the most important aspects of peoples' lives and that the future of our community rests with that important work. I am proud to have served as a Family Court judge and will continue to be involved in our bench/bar activities and handle mediations and settlement conferences of family cases with attorneys and litigants. And beware..... I shall return!!

III. BUSINESS VALUATIONS IN DIVORCE: THE DOUBLE DIP PROBLEM

By Rob Metcalf

In my 19 years as a business valuator in family law cases, an issue frequently arises related to the interplay between the business valuation methodologies applied and the business owner's salary resulting in associated support obligations (I will use the term "support" to include both maintenance and child support payments in this article). This issue has lovingly been termed "the double dip." The short definition of this issue is counting the same income stream twice, once for division of property and the other for determination of support. Any seasoned family law attorney will take one of two positions to advocate for his or her client. This article will discuss the two options or viewpoints related to the double dip issue. While I do not intend to resolve the issue, I do hope to provide a clarifying understanding of its underlying factors.

At the heart of the issue is the application of business valuation methodologies. Because I have been valuing closely held businesses for family law purposes since 1995, I have been on both sides of this debate. Consequently, I am conversant with the underlying topics involved.

The first point to bring to bear is the application of the business valuation methodologies themselves. Three approaches are used by valuators: asset, market and income. Each one of these approaches has multiple methods associated with it.

The first approach is the asset approach. It will look at the tangible assets of a business, adjust the assets to their fair market values and subtract the fair market value of the business's liabilities, either on a going concern basis or on a liquidation basis.

The second approach is the market approach. It employs market multiples from guideline public companies or guideline closely held company transactions and applies these multiples to a level of revenues and/or earnings of the subject business. Because these multiples are derived from non-normalized, operating results (normalization adjustments will be defined below), they would be applied to non-normalized revenues or earnings as appropriate.

The third approach, which I saved for last because it is the heart of the matter, is the income approach. This approach also includes a number of different methods under its banner; however, the methods are based on the same general principles. The subject business's operating results are normalized. Normalized earnings are defined as the "economic benefits adjusted for nonrecurring, noneconomic, or other unusual items to eliminate anomalies and/or facilitate comparisons."[1] A multiple of normalized earnings is derived based on an assessment of the risk of achieving the normalized earnings in future periods and an assessment of the sustainable growth rate of those earnings into perpetuity. One of the most

[1] International Glossary of Business Valuation Terms

prevalent normalization adjustments is the adjustment to owner's compensation.[2] In general, compensation paid to a business's owner consists of two components: compensation for services rendered (otherwise termed "reasonable compensation"[3]). Sometimes, the amount of compensation is determined in the course of tax planning to reduce the amount of tax that an owner will pay. The bottom line is that because owners have control over the compensation that they pay to themselves, this expense account is closely scrutinized by valuators to ascertain whether adjustments to owner's compensation amounts are required.

The question at the heart of the double dip issue is if an adjustment to compensation to a divorcing owner is made, does this "reasonable compensation" amount become the appropriate base from which to calculate support. To state it another way, the purpose of the normalization process is to determine the cash flow available for the hypothetical purchaser(s) under the fair market value standard. The amount of cash flow available assumes a deduction of compensation including only "reasonable compensation." The question then becomes whether the portion of compensation related to the return on investment is included in the value of an ownership interest in a business.

If the value of the business includes the investment return portion of compensation, it is then argued to be unfair to use the actual compensation level, including both portions of compensation previously discussed, in calculating support. The argument from the attorney of the owner spouse is that to do so would be to include the investment return portion in the value of the to-be-divided business interest and then use it again in the computation of support amounts. While not an attorney, it is my understanding that certain courts have adopted this view, e.g., New York in Grunfeld v. Grunfeld, 94 N.Y.2d 696 (2000).

The other side of the argument comes from attorneys representing the non-owner spouse who might state that the concept of business value is entirely separate and distinct from the support calculations. One is an issue related to property division and the other related to spousal support. Again, my understanding is that certain courts have adopted this view as well, e.g., New Jersey in Steneken v. Steneken, 873 A.2d 501 (N.J. 2005).

This view might be supported under the following hypothetical. Owner A owns 100% of a business earning $1,000,000 per year. A earns $400,000 per year and reasonable compensation is estimated at $250,000. Assuming no other normalization adjustments, normalized earnings would be $1,150,000 ($1,000,000 plus $150,000 [$400,000 less $250,000]). If an earnings multiplier of five (5) is used, the value for divorce purposes would be $5,750,000 ($1,150,000 x 5, ignoring any consideration of discounts or tax affecting).

The attorney for non-owner B might argue that support should be based on $400,000 of compensation. How could that argument be made? The attorney might say that A does not intend to sell the business and might own the business for ten (10) years more. If this scenario proved true and the support period was only six (6) years, A will continue to receive $400,000 annually through the entire support period. Would it be equitable for the trier of facts to base support on $250,000 when A will receive $400,000 per year?

And what will occur when A sells the business in ten (10) years? Assuming the business is operating as it was ten years prior, a valuator would make the same $150,000 normalization adjustment and the business would be valued at $5,750,000 and sell for that amount. Under this scenario, to use a support amount of $250,000 because of the double dip argument would shortchange B.

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[2] For purposes of this article to keep our discussion simpler, I will assume a single owner.

[3] Defined as the estimate of what the owner-manager would be paid as an employee, given his/her experience and relative work effort (return on labor), not including disguised dividends or distributions from business (return on investment) from BVR presentation slides "Double Dipping: Incomes, Assets, and Double Counting in Divorce" by Adam John Wolfe, Esq., Stacy P. Collins, CPA/ABV, CFF and Donald J. DeGrazia, CPA/ABV/CFF, September 13, 2013.

What is the alternative argument? Fair market value is normally used as the standard of value in divorce matters in Kansas and Missouri. It is defined as "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller ... "[4] It therefore assumes a change in hands, i.e. an exchange. It may be appropriate to assume that A has sold the 100% interest in the business and will no longer annually earn $400,000 as an owner but only $250,000 as a non-owner employee.

In addition, it must be noted that valuations are forward looking. What I mean by that is that the valuator may use historical operating results but only as an indication of what the operating results are expected to be in the future. Purchasers do not buy historical cash flows, but the estimated future cash flows of a business. Under the fair market value standard, purchasers are assumed to use the normalized cash flows of a business to pay the derived purchase price. One can see that the period over which normalized cash flows are used to "purchase" the non-owner spouse's business portion will overlap with the period over which support is being paid. The compensation component considered a return of investment will serve double duty during this period of overlap.[5]

The above analysis assumes the use of the income approach only; however, I was intentional when I previously referenced the other two approaches to estimating value, the asset and market approaches. These approaches do not require an adjustment to owner's compensation discussed above. It has been a long-standing requirement of proper valuation practice to use as many methods as appropriate to render a credible conclusion of value. The Uniform Standards of Professional Appraisal Practice (USPAP 2014-2015 Edition) states:

"In developing an appraisal of an interest in a business enterprise or intangible asset, an appraiser must:

(a) be aware of, understand, and correctly employ those recognized approaches, methods and procedures that are necessary to produce a credible appraisal;" [6]

The goal is to harmonize the values derived from the employed valuation methodologies as generally, it is assumed that values derived using appropriate methods ought to result in reasonably consistent values. If that is the case, what implication does that have on the double dip issue? If one method requires an adjustment to owner's compensation and the other one does not, and yet the values confirm one another, does it favor one view of the double dip argument over the other? In my opinion, it favors the view that the adjustment to owner's compensation only reflects the application of a valuation methodology to derive an appropriate value.[7]

Offsetting this view is the fact that when a business sells, the purchase price must be paid in real dollars that must come from a business's earnings. It is assumed that for the period of time over which the purchase price is paid, a working owner will only receive "reasonable compensation" and will not receive the investment return portion of compensation. The purchase price must be paid from the business's earnings even when methods under the asset or market approach are used to determine value.

In summary, the double dip issue comes down to how one looks at the owner's future tenure at the business. If one assumes that the owner will remain with the business and earn compensation as he or she has per the valuation analysis, the non-owner spouse might be shortchanged if the court decides to use only

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[4] The International Glossary of Business Valuation Terms

[5] See Rivers, Jr., Robert J., Esquire, The "Double-Dipping" Concept in Business Valuation for Divorce Purposes, originally published in Section Review, Vol. 8 - No.3 (Mass. Bar Institute 2006).

[6] Standards Rule 9-1(a)

[7] See Morgan, Laura W., "'Double Dipping': A Good Theory Gone Bad," Journal of the American Academy of Matrimonial Lawyers, Vol. 25, 2012, p. 133 - 151.

"reasonable compensation" for support purposes. It must be added that assuming the owner will remain with the business and retain the rewards of ownership may contemplate a value to the holder concept which valuators normally call "investment value" or value to a particular owner.

On the other hand, if one assumes a fair market value standard that posits the sale of the owner's interest as of the valuation date, it would favor the use of "reasonable compensation" for support purposes because that would be the amount assumed earned by the owner as a non-owner employee post-valuation date.

As I stated in my opening paragraph, I did not intend to solve the double dip issue. My hope is that this article has added to your knowledge of the issues involved from a valuator's perspective.

Rob Metcalf CPA/ABV/CFF, CVA, CBA, ASA, MAFF is a partner at Marks Nelson, an accounting and business consulting firm. He specializes in business valuations and litigation support services and administers the MarksNelson business valuation practice. Since 1995, he has been involved in hundreds of valuations of various companies in a wide variety of settings.

IV. ANNOUNCEMENTS.

Johnson County Court Services is looking for a volunteer to help with supervised visitation on Tuesday evenings. If you or someone you know would be interested in working with families in this situation, please contact Erin Poolman at Johnson County Court Services. She may be reached at (913) 715-7481.

Casa's **Promise of Hope** luncheon is scheduled for Thursday, April 3. Contact Lois Rice at lrice@casajwc.com to reserve your seat or for more information.

Sensible Separation is a Quarterly Newsletter, edited by Greg Kincaid. Submissions are welcome. If you would like to contribute, I may be reached at (913) 782 2350 or at gkincaid@hrkklaw.com. My web address is www.sensibleseparation.com. If you would like to initiate a dialogue, where others can participate, please do so at www.facebook.com/sensibleseparation.