A LONG AND WINDING ROAD
"Untangling the Knots in Business Valuation and Apportionment Issues"

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In 2013, I authored my original article *A Long and Winding Road "Untangling the Knots in Business Valuation and Apportionment Issues."* The major focus of my original article and this update is to explore separate property business valuation and apportionment issues, i.e., the community's potential claim to a portion of the compensation and increase in value of a sole and separate business. This article is specific to Arizona, however, professionals practicing in other community property states and/or states that recognize the potential apportionment of profits and/or increased value of a separate business during marriage may find this article helpful.

My original article stemmed from my involvement in a complex case during which I represented the owner-operator of the business at issue. In my original version of this article, I explained that I did my best to present an unbiased description of the applicable case law and issues involving community liens in business apportionment cases.

Subsequently, from 2019 until 2022, I represented the out-spouse (i.e., the spouse of the separate property business owner) in an equally complex business apportionment / community lien case. Pursuant to my involvement in this later case I realized that it is easy to become somewhat blinded when analyzing applicable case law until you have represented both owner-operators and out-spouses through trial in these types of complex community lien cases.

Although I have been involved in a number business of apportionment cases throughout the years, the two described cases were the most complex. In both cases, the amounts at issue were substantial, which meant there were few restrictions to the number of legal and financial issues explored. In both cases the parties proceeded to trial before a Family Law Master. In this updated article I have incorporated much of my original article, but have added sections regarding additional issues and analysis, and have addressed various inconsistencies in the case law and application of community property principles. For purposes of this article, I have referred to the first major case described herein as my "Original Case," and the later described case as my "Recent Case."

I. <u>Utilization Of Expert Witnesses</u>

There is little doubt that qualified experts are usually essential in business valuation and apportionment cases. If you are litigating a case involving the assessment and apportionment of a community interest in the increased value and profits of a sole and separate business, there is a good chance that you are going to spend a lot of time with your expert over many months or even years.

There are of course many moving parts to a community property business valuation case. However, when the community makes a lien or equity claim to a portion of the increased value of a sole and separate business, the issues increase exponentially. To begin with, you are now dealing with at least two valuations, and possibly more if there exists a dispute regarding the end valuation date.[1] Once the increase in value is determined, the experts generally address several apportionment approaches described in caselaw, hybrids of such approaches, and potential approaches that may not have been described in prior case opinions but may make logical sense in that particular case.

Something that attorneys must always keep in mind in apportionment cases is considering what issues experts, including business valuation experts, can render opinions considering Arizona Rules of Evidence Rule 702, which incorporates the *Daubert* evidentiary standards for expert testimony. See A.R.S. Section 12-2203. Note that under Rule 2, Arizona Rules of Family Law Procedure, Rule 702 of the Arizona Rules of Evidence still applies regardless of whether a party files a Rule 2 notice requiring compliance with the Arizona Rules of Evidence.

While there are published authorities regarding business valuation principles and application for an expert to rely upon, such are not available for purposes of apportionment analysis since apportionment principles are based upon community property laws and application as opposed to published business valuation standards. Accordingly, while experts may be able to present 'examples' and calculations, one must question whether they can provide "opinions". Such is addressed in more detail later in this article.

As family law attorneys, it is sometimes easy to defer to our experts to simply tell us the bottom line. However, the best experts equally rely upon the attorney to challenge their opinions, especially when opposing counsel and the expert retained by the other party will be doing just that. An attorney who takes on an apportionment case should obtain an intricate knowledge of the case law and the numerous valuation and apportionment methods due to the substantial interplay of legal, valuation and apportionment concepts. The attorney should also keep an open mind regarding possible apportionment concepts that have not been discussed in case decisions to date, but that may appear to be logical and equitable under the facts and circumstances of the case. At the end of the day, the resolution of each issue and sub-issue may have a substantial impact upon whether the community has a claim to a portion of the increase in value and undistributed earnings, and if so, the amount to which the community may be entitled.

II. <u>Use of A Family Law Master</u>

In *Rueschenberg v. Rueschenberg,*219 Ariz. 249 (App.2008) discussed in Section IV.C of this article, the parties stipulated to the appointment of a Family Law Master (referred to in the case opinion as the Special Master). Similarly, in both my Original Case and my Recent Case referred to in this article, the parties stipulated to the appointment of a Family Law Master pursuant to Rule 72, Arizona Rules of Family Law Procedure. Unless you have a judge assigned to your case that has substantial experience in business valuation and apportionment cases, and who is willing to provide you with ample trial time, I highly recommend the retention of a Family Law Master in an apportionment case. This is not to say that your assigned judge is not capable of assessing these types of cases. However, as we know, it is often difficult to obtain the

[1] In some cases, additional shares may be gifted to or acquired by the owner-operator with separate funds during the marriage, thus requiring staggered initial valuation dates and blended analysis.

trial time and flexibility necessary to present a very complex case. In both of my major apportionment cases described herein we ended up needing more trial days than originally anticipated.

Another advantage of using a Family Law Master is the ability to present your case in phases. In my Original Case, we did just that. Each phase allowed for updated reports by the experts, which in turn helped establish what the remaining disputes were. Considering the numerous issues that were litigated, I cannot imagine how a trial judge could sift through the various issues and come to a numerical conclusion unless the judge simply selected one of the expert's opinions on each issue. If a judge decided that one of the experts was more credible on one specific issue, and the other expert was more credible on another issue, it is likely that no corresponding calculation would have been submitted that fit such scenario. Unless the judge is a valuation expert, or the issues merely require adjusting mathematical calculations, follow-up expert analysis on certain issues may be necessary. In my Original Case, we agreed that the experts would be able to submit supplemental reports based upon the Special Master's initial determinations on specific issues. The ultimate goal was that once the Special Master eventually ruled upon such issues, the two experts' ultimate calculations "should" be identical.

Another consideration to keep in mind is your professional liability insurance premiums. By utilizing a Family Law Master in such a complex case, there is a better chance of filling in the gaps if new sub-issues arise in the middle of trial.

Fortunately, in both of my described cases, we had a Family Law Master who was accommodating and knowledgeable, and trial judges that were flexible with providing continuances on the inactive calendar as we made our way down the long and winding road.

III. Valuation Issues

If a company has no goodwill value beyond its tangible assets and liabilities, an asset-based approach is generally applied. If a company is the type that can be sold and there have been sales of comparable businesses in the marketplace, a market approach may be appropriate. However, for a company that appears to have goodwill value beyond its net assets but is the type of company that cannot be sold or involves limited or no comparable sales, an income approach is generally relied upon. The experts usually provide an analysis of all three approaches but recommend the result they deem most reliable. The experts in both of my described cases concluded that an income-based valuation was appropriate because of limited or no published sales transactions that were comparable to the companies at issue.

A. Valuation Dates for Purposes of Apportionment

The end valuation date for purposes of identifying the increase in value to a business can be a hotly litigated issue depending upon the circumstances. The initial valuation date is *usually* obvious, i.e., the date of marriage if the business was started before marriage, or the date that the sole and separate business interests were inherited or gifted to the business owner as in my Original Case. The date selected for the end valuation can be more challenging.

In *Sample v. Sample*, 152 Ariz. 239, 731 P.2d 604, 607 (App. 1986), the Court of Appeals explained that the valuation date is to be "dictated by largely pragmatic considerations," and that "the equitableness of the result must stand the test of fairness on review." *Sample* explained that, the trial court is not bound by a specific date for purposes of valuing a business but should determine a date that is equitable under the circumstances.

Although such holding makes common sense, such broad discretion often gives rise to expensive and complex litigation. Many equitable arguments can often be made by both sides. Accordingly, the litigants may find themselves presenting alternative "end date" valuations if the value of the company has materially increased or decreased during the proceedings. Such may involve separate valuations submitted as to each valuation date at issue. As such, the parties may consider litigating the "end date" issue as a separate phase of the trial prior to spending additional funds to obtain alternate end date valuations.

In my Original Case, the business realized a substantial post-service decrease in profits, which affected the overall value of the company. It was for the most part uncontested that the decrease in profits was a result of Arizona's economy at the time, industry conditions and other factors outside of the owner's control. Under such circumstances, it was arguably unfair to penalize the sole and separate owner for the decrease in value that took place after the termination of the community. Accordingly, it made sense that a later valuation date be applied.

The converse argument could apply depending upon the facts. A valuation after the termination of the community may be desirable to the non-owner spouse if the value of the company has increased post-service as a result of prior community contributions, because of the economy, and/or reasons other than the post-service efforts of the owner spouse.

In my Recent Case, the company at issue realized increased profits after service of the divorce action. The valuation date applied by the mutually retained expert was close to the date of service of process. [2] The company, which had historically outsourced the manufacturing of its products, made capital investments into machinery and began manufacturing some of its own products the year before the divorce action commenced. The company realized an increase in profits after service of process which at least a portion of arguably flowed from pre-service capital investments and community efforts. Under such scenario, it could be argued that a subsequent valuation date would be appropriate, and that the community should receive at least a portion of the increased value realized after service of process resulting from capital investments and community efforts prior to the termination of the community. Under such scenario the

[2] Where a mutual expert has been retained, the opposing party may not agree to utilize the mutual expert to provide a valuation as of an alternate valuation date, thus the party that desires such alternate valuation associated with a later valuation date may need to retain a separate expert to provide the same. Thus, when retaining a mutual expert, the attorneys should consider flexible language in the engagement agreement regarding alternate end dates if the expert concludes that such may be appropriate.

increased value after service of process may need to be apportioned between that attributed to the pre-service community capital investments and community labor versus the portion of the increase in value attributable to the post-service efforts and investments by the owner-operator.

Soon after the trial in my Recent Case was concluded, the Court of Appeals issued its well-reasoned opinion in *Meister v. Meister*, 252 Ariz. 391 (App. 2021). The *Meister* opinion provides further clarification regarding valuation date issues. In *Meister,* the trial court adopted Wife's expert's date of service valuation despite a substantial decrease in the value of the business after the date of service. Such decrease in value was primarily the product of the business being fired by its main client within weeks after service of process. Such termination by the company's main client resulted from alleged overcharges that took place during the marriage. Although the trial court adopted Wife's contentions that such was the fault of Husband, the Court of Appeals noted that both parties worked for the business, that such actions, if true, were taken for the benefit of the community, and noted that there was no judicial determination that Husband had breached the contract with the client or that he engaged in tortious conduct. *Id*. at ¶24 n. 3. In rejecting Wife's argument that the trial court's ruling should be affirmed, the *Meister* Court explained:

> Neither party has cited, nor have we found, any Arizona authority mandating or even suggesting a community asset must be valued at or near the date of service. The absence of a specific standard, or even a presumption, in Arizona is consistent with many other jurisdictions that grant broad discretion to determine the valuation date.

Id. at ¶15 (citations omitted). The *Meister* Court further explained that:

> The [trial] court certainly may use the date of service, or a date near the date of service, as a starting point in choosing the valuation date. But the court must select a different date when necessary to ensure an equitable result.

Id. ¶18 (citation omitted).

In *Meister*, although allegations were also made that Husband violated the preliminary injunction and temporary orders during the proceedings, the Court of Appeals found the evidence of record did not establish that such affected the equitable analysis as to the valuation date itself. *Id*. ¶24. The *Meister* Court further explained that standard expert valuation concepts, such as whether post-service changes that affect the value of the business are "known or knowable" or "foreseeable" at the time of service, may be relevant but are not determinative, and that what is equitable under the circumstances is the key inquiry. *Id*. at ¶22-23. The Court remanded the matter for the superior court to address the following in addition to any other relevant matters:

> (1) How the loss of the [contract] and Receivable affected the value of PBS; (2) selection of a valuation date that is supported by sufficient evidence and analysis to allow meaningful appellate review; (3) the value of PBS as of the valuation

> date; (4) the amount Wife was harmed by Husband's wasteful business practices after service of the petition in terms of causing a decrease in the value of PBS; (5) the amount Wife was harmed by Husband's wasteful spending of other community funds; (6) calculation of appropriate offsets if any; and (7) how the ultimate property distribution is equitable.

Id. ¶31 (emphasis added). The Court of Appeals in its remand instructions went on the state that "the court may permit the parties to present additional evidence appropriate to achieve an equitable division." *Id*.

The *Meister* decision provides further context to the ruling in *Sample* that the adoption of a valuation date must be equitable under the circumstances. The *Meister* decision makes it clear that there is no presumption that the valuation date should be the date of service. If a party engaged in wrongful conduct post-service, such may be relevant to damages, but not necessarily effect the valuation date issue. If a party engaged in wrongful conduct pre-service, such again may be relevant but not necessarily determinative depending upon whether such actions were in furtherance of the community, whether one of the spouses was indeed innocent, and other considerations that may be relevant to a waste analysis.

As set forth above, post-service changes in value due to economic conditions may support a different valuation date. A post-service increase in value which is a result of post-service efforts by the owner-operator would of course not support a later valuation date, however a post-service increase in value attributable at least in part to pre-service community efforts and/or capital contributions may support a later valuation date and at least a pro-rated apportionment of the post-service increase in value. The *Meister* Court makes it clear that regardless of whether findings of fact and conclusions of law are requested, the trial record must include sufficient evidence that the chosen valuation date is equitable under the circumstances. *Id.*

These issues do not just apply to the the valuation end date, but in some circumstances, may involve the beginning date for purposes of addressing the increase in value during the marriage for purposes of the apportionment analysis. A twist that I discussed with experts recently involves a case where a business was started prior to marriage, but the business filed bankruptcy during the marriage. After the bankruptcy concluded, the business was successful and increased in value during the marriage. The experts agreed that the business had zero value at the time of the bankruptcy. Thus, the issue of whether the value at the commencement of the marriage as the starting point made sense, or whether the starting value should be zero for purposes of the apportionment analysis. Such issue may also present itself where a business did not file bankruptcy, but did in fact decrease in value for a period of time during the marriage. Such unique case facts shows us that one must continue to focus on Arizona's community property principles as opposed to blindly adopting methods of calculation applied in specific published opinions. Although prior published opinions utilized the date of marriage as the starting date for the apportionment analysis, no cases state that this is the exclusive date to apply. In fact, the *Sample* and *Meister* decisions support the proposition that the principles in those cases should also apply to the beginning date analysis if such involves these types of unique facts. Similarly, as addressed later in this article, the calculation methods for purposes of apportioning the increase in value and profits affirmed in published and memorandum opinions may be appropriate in certain situations, however, the methods of calculation are not "the law", but rather examples of how equity *may* be accomplished pursuant to the underlying legal principles. As addressed later in this article, the Supreme Court of Arizona makes this abundantly clear pursuant to its language in *Cockrill v. Cockrill*, 124 Ariz. 50 (1979).

B. <u>Valuation Discounts</u>

Whether fair value (the investment value to the owner and/or community) or fair market value (the value to a hypothetical buyer) is adopted can be a significant issue, especially if the application of discounts is litigated. Most experts provide such valuations in the alternative, at least regarding companies that are capable of being sold. Arizona has no published case authorities that directly specify when one valuation premise should be adopted over the other. Like many issues, such is subject to what the court deems equitable under the circumstances. *Schickner v. Schickner*, 237 Ariz. 194, ¶ 16-17(App. 2015).

Some experts distinguish between fair value and fair market value when applying discounts (i.e., only applying discounts to their fair market analysis). *See generally Bibars v. Bibars,* 1 CA-CV 11-0473 ¶11 (Ariz.App. memo. dec. 7-26-2012) (wherein fair value was addressed without discounts and fair market value with discounts). *See also Top-Down Process: Understanding Business Valuation*, Lynton Kotzin, CPA, ABV, et al., Arizona Family Law Section Newsletter (March 2023). Other experts include potential discounts to either premise of value. Such generally includes marketability and/or minority discounts. These discounts can be very substantial, sometimes leading to a 20% to 70% reduction in the overall value depending upon the circumstances.

In *Schickner*, the Court of Appeals explained that the application of discounts in a divorce case should be determined by equitable division principles on a case-by-case basis. *Schickner*, 237 Ariz. at ¶¶ 12-20 (distinguishing such from *Pro Finish USA, Ltd. V. Johnson,* 204 Ariz. 257 (App. 2003)*,* which was a dissenters' rights case and inapposite to dissolution cases). In citing to cases from other jurisdictions, the *Schickner* Court declined to provide any bright line rule, but explained that a discount for a minority interest is appropriate "when the minority shareholder has no ability to control salaries, dividends, profit distribution, and day-to-day corporate operations." *Id*. at ¶ 17 (citations omitted). The Court noted that the application of a minority discount may be inappropriate "when underlying assumptions regarding lack of control and lack of marketability are not supported by the evidence." *Id*. (citation omitted). Because in *Schickner* the record showed that Husband held significant power regarding financial decisions, the Court of Appeals overruled the trial court's application of a minority discount regarding the business in which the parties held a 50% interest, while affirming such discount as it applied to the business that the parties owned a 20% interest and had no substantial control. *Id*. at ¶¶ 18-20.

Marketability discounts may "potentially" be appropriate where a company is illiquid and not readily marketable. No Arizona published cases have provided any detailed analysis as to when such a discount is appropriate in a marital dissolution matter, although *Schickner* addressed lack of marketability in the context of a minority discount analysis. *Id*. at ¶16.

Subsequent unpublished opinions adopting *Schickner's* main principles have provided further analysis as to when marketability discounts may be appropriate. In *Gardner v. Gardner,* No. 1 CA-CV 21-0135 FC (Ariz.App. memo. dec. 4/26/2022), the Court of Appeals affirmed the trial court's determination that a marketability discount was appropriate as such was supported by the evidence in general. No request for findings of fact and conclusions of law was filed in that case. Although it was unclear how the trial court specifically reached its conclusions, the Court of Appeals addressed the arguments made by the experts regarding the application of a marketability discount and explained that such was appropriate as the dental practice at issue was an illiquid asset, there was increased competition amongst dentists in the area, and there were various other obstacles to selling the practice if such were to be sold. *Id*. at ¶18-20. It should be noted that only a marketability discount was at issue in that case, not a separate or combined minority discount. *Id*.

The unpublished opinion *Bowe v. Vogel, Sr.*, No. 1 CA-CV 16-0578 FC (Ariz.App. 2/06/2018), provides a more in-depth analysis of both minority and marketability discounts. In that case, the parties owned a 58.32% interest in land-broker firm (LAO) and a smaller 16% in an affiliated firm. Despite the fact that the parties owned a majority interest in LAO, the Court of Appeals affirmed the trial court's application of a 15% minority discount and a 25% marketability discount to the value under the circumstances. The court rejected Wife's argument that applying discounts was improper because there was no evidence that Husband planned to sell his shares in the foreseeable future. The court explained that Arizona has refused to adopt a bright line rule, and that such involves a case-by-case analysis "based on factors including the degree of ownership control, the degree of marketability, and the likelihood of a sale of the minority interest in the foreseeable future." *Id*. at ¶27 (citing *Schickner,* 237 Ariz. at ¶17) (explaining that although a marketability discount was not applied in *Schickner*, the "no bright line" reasoning is the same). The *Bowe* Court further emphasized that although the likelihood of a potential sale is "an important factor," such is not determinative. *Id*. at ¶30 (citations omitted).

The *Bowe* Court went on to explain that "[a] discount for a minority interest is appropriate when the minority shareholder has no ability to control salaries, dividends, profit distribution, and day to day operations." *Id*. at ¶31 (citation omitted). Multiple factors should be considered including the degree of control over important business operations, and the likelihood of a sale. *Id.* (citing *Schickner,* 237 Ariz. at ¶17). The Court further explained the complexity of the analysis and noted that courts may reach different conclusions in similar cases without abusing their discretion. *Id*. at ¶31 (citations omitted).

In *Bowe*, Husband was able to demonstrate significant limitations to his control regarding profit distributions and transfers of shares as a result of the company's operating agreement despite the fact that he owned more than an equal share. Husband testified that he would be interested in selling his ownership interest, but such would be improbable under the circumstances. The Court agreed that because the of restrictions in the operating agreement, an imminent sale of Husband's interest was unlikely. *Id*. at ¶32-33. In affirming the marketability discount (on top of the minority discount), the Court explained:

> Similarly, the superior court did not abuse its discretion by applying the marketability discount. When determining whether to apply a marketability discount, the court focuses on the liquidity of the shares and the likelihood that the shares will be sold. *See e.g.,* Hess, *Use of Marketability Discount*, 16 A.L.R. 6th 693 Section 2; *In re Marriage of Tofte*, 895 P.2d 1387, 1392-93 (Or. Ct. App. 1995) (focusing on "the price that the hypothetical willing buyer would pay the hypothetical willing seller" for the shares that the buyer could not swiftly convert back into cash).

Id. at ¶*36.* The *Bowe* Court further described the restrictions on the marketability of Husband's shares set forth in the operating agreement included the right of first refusal by the members, the risk that a potential buyer would not be a voting member, that the shares had limited liquidity, and related factors. *Id*. at ¶37.

Bryson v. Bryson, No. 1 CA-CV 16-0531 FC (Ariz.App. memo. dec. 6/08/2017) is also a very detailed memorandum case opinion regarding the court's discretion in adopting fair value versus fair market value, and the potential application of minority and marketability discounts. In that case the parties owned a 50% interest in a specialized electrical contracting business. The *Bryson* Court affirmed the trial court's determination not to apply discounts to the value. The Court explained that in that case, although Husband did not have total voting control as a 50% owner, his veto power afforded him substantial influence over the management of the company. The Court further explained that Husband was the most critical member of the company because he held the contractors license, had major business contacts, and had a significant role in day-to-day management decisions. *Id*. at ¶17. The Court further explained:

> … the record bears no evidence that Husband's decision not to sell his interest in High Side in the foreseeable future was influenced by High Side's lack of marketability. Rather Husband's desire to remain involved with High Side appears to stem from personal fulfillment in operating the small business and its apparent success. Because Husband's intention not to sell was not demonstrably linked to High Side's lack of marketability, a marketability discount would serve no purpose but to provide Husband a financial windfall and would, therefore, constitute an inequitable division of the marital community's interest. We cannot say the family court abused its discretion in denying a marketability discount where marketability is not a material consideration.

Id. at ¶18.

As noted in the above opinions, when determining whether a marketability discount should be applied, the illiquidity and lack of marketability of a business is not dispositive. Rather, one should also look to whether the spouse is retaining the business for reasons other than the lack of liquidity, as well as various other factors identified in the opinions.

In my Original Case, Husband made the argument that a marketability discount should apply because the company was closely held, which would lead to marketability problems with finding a qualified hypothetical investor who would be willing to purchase his interest in the business. Because Husband was a minority owner, he also argued that his interest was non-controlling, and that a potential investor would desire a further minority discount. Conversely, the out-spouse (Wife) argued that fair value should be adopted (i.e., without valuation discounts) for various reasons, including the fact that the business was not being marketed for sale, and there was no imminent sale. Wife also contended that the application of combined discounts (i.e., both marketability and minority discounts in the aggregate) would lead to a result that was little more than the value of the hard assets thus nullifying any goodwill value. In the alternative, Wife argued that if a discount were provided, only a marketability discount should apply, and not a minority discount, for the reason that such discounts would be cumulative and based upon similar factors.

One can see some overlap between a marketability discount and a minority discount. It is possible that a marketability discount may be appropriate because the owner has a minority interest, and that because of the lack of control, it will be difficult to market such interest. These same facts give rise to an argument that a minority discount is appropriate because it is not a controlling interest, and an investor would want a discount considering such lack of control. In such case, the court may be inclined to apply only one of the discounts or a blended discount to avoid providing separate discounts based upon the same or similar circumstances. Of course, the court may determine that no discount should be applied if the result is not equitable to the community under the circumstances.

In my Recent Case where I represented the out-spouse, the owner shared an equal interest in the company with his father. This led to litigation regarding whether an equal interest is in effect a minority interest, and whether there was lack of control issues where a 50% owner does not have a majority controlling interest. This was further complicated by the fact that one of the co-owners directed or took the lead in certain aspects of the company, while the other co-owner directed or took the lead in other aspects. It was our argument that because the business was family owned and the owners were cohesive in their decision-making, lack of control was not a factor. It was Husband's contrary argument that such did not matter as applied to a hypothetical investor that was not a family member.[3]

There does appear to be a disconnect to the extent that fair value has been historically applied by some experts to professional practices (such as law firms), which are not capable of

[3] This case was similar to *Schickner* to the extent the owner had a 50% interest, but it was contested whether the owner had as much control regarding business decisions as the owner in *Schickner*.

being sold, and only apply discounts if a fair market value can be determined. An argument can certainly be made that it is unfair that a company that is capable of being sold may be eligible for such discounts, while a company that is unlikely to be marketable is not. The recent memo decision in *Gardner v. Gardner*, No. 1 CA-CV 21-0135 FC) (Ariz.App. memo. dec. 4-26-2022) provides a good discussion regarding the possibility of marketability discounts when a business (a dental practice in that case) is solely owned but illiquid.

C. Capitalization Rates

One of the most significant issues litigated pursuant to income-based valuation cases is the appropriate capitalization rate ("cap rate").

The cap rate is the number used to convert a benefit stream (e.g., income stream) into a company's value. The cap rate equals the discount rate (the yield necessary to attract investors to a particular investment given the risks associated with the investment) less the expected growth of the company (generally 2 - 3% as a rule of thumb). The determination of the appropriate cap rate is based upon the risk associated with a company's historical income stream recurring in the future. The greater the risk, the less an investor will be willing to pay. Valuation experts look to various publications to determine an appropriate cap rate. In simple terms, the greater the risk associated with the company, the higher the cap rate, and the lower the value.

The importance of cap rates can be exponential in a sole and separate business apportionment case because cap rates are being applied to both the beginning and end values. For example, if the cap rate applied to the initial valuation (generally the date of marriage) is too high, the starting value would be artificially low. If the cap rate applied to the end valuation is too low, the end value would be artificially high. Under this scenario, the increase in value during marriage would be inflated on both ends. The reverse scenario could of course apply, i.e., an artificially low cap rate applied to the beginning valuation and an artificially high cap rate applied to the ending valuation could dramatically reduce the amount subject to the community's claim.

Litigation involving the appropriate cap rate can be substantial considering the impact that cap rates have on the overall value (and the resulting increase in value during the marriage, if any). Even a few percentage points can have a substantial impact.

When litigating the issue of the appropriate cap rate, the attorney who is arguing a higher cap rate (i.e., a lower value) should be prepared to present evidence regarding the risks associated with the business, and the possibility that the historic stream of income may not occur in the future. The attorney who is arguing a lower cap rate (i.e., a higher value) should of course be prepared to present the opposite, i.e., that the company is very stable, and that there is a high probability that the company will continue to realize equal or greater profits in the future.

D. Operating Assets Versus Excess Cash and Other Non-Operating Assets

Another major issue in my Original Case involved a determination of how the funds in the company accounts, and the company's investments should be treated.

For purposes of income-based valuations, the cash on hand that is necessary to continue to operate the business is already included in the overall valuation of the company. Cash that is necessary to generate such income falls within the category of "operating assets" (i.e., necessary for the ongoing operations of the business). Operating assets also include equipment, inventory, etc. that is necessary to produce the income upon which the valuation is based. Accordingly, it is improper to add the value of operating assets to an income-based valuation.

Non-operating assets, on the other hand, are those assets that are not necessary to produce the income upon which the valuation is based. My Original Case involved substantial litigation over what portion of the cash in the company accounts was necessary to generate the income upon which the valuation was based, versus the amount of cash that could arguably be distributed to the shareholders without affecting the operations of the business. The cash that is not necessary to operate the business is called "excess cash." Because excess cash is not necessary to operate the business, such is generally added to the value of the business after capitalizing the income stream.

In my Original Case, the company had real property investments as well. Because the company did not invest in real estate as part of its operations, these were passive investments. Such constitute additional non-operating assets and are generally added to the value of the business accordingly.

Although these principles are standard in a valuation case, an apportionment case may alter such analysis in part. An interesting twist in my Original Case involved Wife's argument that the excess cash and other non-operating assets should not be added to the value of the company, but rather treated as undistributed assets which still needed to be divided. Such issue is addressed in more detail in Section V.J, *supra*. See also Section VI, *supra,* which addresses the community's potential claim to a share of the business' undistributed earnings and post-service profits proportionate to the community lien.

IV. <u>Apportionment Case Law and Issues</u>

Once the Court determines the increase in value of a sole and separate business during the marriage, the Court must determine what portion of such increase, if any, constitutes sole and separate property, and what portion of such increase, if any, constitutes community property. The general rule as addressed more specifically below is that the sole and separate owner should retain any portion of the increase in value that is inherent to the pre-marriage separate property nature of the business, and that the community should receive any portion of the increase in value that is not inherent to the separate property nature of the business and is thus presumed to be a product of community efforts or investment. As can be seen by the alternate apportionment methods and numerous sub-issues described in this article, this is easier said than done.

The apportionment litigation stage can be much more subjective than the business valuation stage. The business valuation expert has numerous publications, sources, etc. to rely upon to substantiate his / her valuation conclusions. ***That is not so once we enter the apportionment part of the case***. While there are various caselaw decisions in Arizona and other states, many of which are somewhat inconsistent in application, there are no authoritative publications for financial experts regarding how to apportion the increase in the value of a sole and separate business. Moreover, although certified valuation experts are trained to provide valuations consistent with authoritative guidelines, such is not necessarily the case with apportionment issues which are based upon legal principles. Although Arizona has a few published court cases, including the lengthy and detailed 2008 *Rueschenberg* decision described in Section IV.C of this article, such cases often give rise to more questions than answers.

A. Cockrill v. Cockrill

The seminal business apportionment case in Arizona is *Cockrill v. Cockrill*, 124 Ariz. 50 (1979). In *Cockrill*, the Supreme Court of Arizona addressed various business apportionment issues including the uncertainty at that time regarding where the burden of proof lies in cases involving a separate property business which increased in value and generated profits during the marriage. The Court concluded, citing *Barr v. Petzhold*, 77 Ariz. 399 (1954), that "… the burden is upon the spouse who contends that the increase is also separate property to prove that the increase is the result of the inherent value of the property itself and is not the product of the work effort of the community." *Id*. at 52 (overruling *Percy v. Percy*, 115 Ariz. 230 (App. 1977)). The Court also concluded that such burden of proof on the part of the separate property claimant is by clear and convincing evidence. *Id*. The Court in rejecting the "all or nothing" rule applied by some of Arizona's prior published decisions explained:

> Seldom will the profits or increase in value of separate property during marriage be exclusively the product of the community's effort or exclusively the product of the inherent nature of the separate property. Instead, as in the instant case, there will be evidence that both factors have contributed to the increased value or profits.

Id. at 53. The *Cockrill* Court further explained:

> If there is insufficient evidence for the trial court to determine what the primary cause of the increased value is, the entire increase in value will be found to be community property, because, as stated previously, the burden of proof is upon the spouse who seeks to establish that the increase is separate property.

Id.

The *Cockrill* Court went on to note that there is no precise criterion or fixed standard to apportion such interests, but addressed three non-exclusive examples (what it termed as "approaches" or "yardsticks") that may potentially be applied to apportion the increase in value and profits depending upon what "is the most appropriate and equitable in a particular situation." *Id*. at 54 (only two of the approaches apply to business apportionment cases as the first one addressed applies to real property). Citing California case examples, the *Cockrill* Court explained that one potential approach "is to determine the reasonable value of the community's services and allocate that amount to the community and treat the balance as separate property attributable to the inherent nature of the separate estate." *Id*. (citations omitted). The Court explained that an additional possible approach is to "simply allocate to the separate property a reasonable rate of return on the original capital investment. Any increase above this amount is community property." *Id*.

These possible approaches have subsequently been addressed by experts as the *Fair Compensation Method*, and the *Fair Return Method* respectively. Although various Arizona cases issued after *Cockrill* have altered the landscape somewhat, the *Fair Compensation Method* and the *Fair Return Method* are still addressed by experts as two of the possible methods for the court to adopt. However, as addressed further in this article, how such approaches should be applied is less clear and has led to substantial litigation over the years. The main conclusion that resonates from *Cockrill* is that the trial court has substantial discretion to adopt an apportionment method "that will achieve substantial justice between the parties." *Id*. Of significant note, *Cockrill* makes it clear that its listed potential "approaches" are not all inclusive and that different circumstances may require the application of different methods of apportionment. *Id* at 54. Accordingly, any attempt to argue that one method is predominant in all cases is unsupportable.

<u>Cockrill Critical Analysis</u>

The *Fair Compensation Method* mentioned in *Cockrill* addresses whether the community received fair compensation during the marriage. If the community did not receive fair compensation considering the community efforts and contributions, the community would have a claim to a portion of the increase in value (and undistributed profits if applicable) up to the amount that the community should have received. Some experts apply this method by comparing what they deem as "reasonable compensation", "market compensation", or "normalized compensation" versus the amount of compensation the community received. If based solely upon a "market" compensation analysis as argued by such experts, this method does not appear to be a true apportionment of the increase in value as it does not necessarily correlate to the inherent nature of the business and only measures whether the community received reasonable compensation for its efforts, and thus any remaining increase in value would automatically revert to the sole and separate business owner. It goes without saying that such application of the *Fair Compensation Method* is generally favorable to the sole and separate business owner. No Arizona published opinions issued after *Cockrill* have adopted such limited application as the determinative approach. Such limited application was rejected and criticized in *Rueschenberg*. See Section IV.C *infra*.

The *Fair Return Method* is essentially the flip side of the *Fair Compensation Method.* Pursuant to the *Fair Return Method,* the sole and separate business owner is apportioned the value of the business as of the date of marriage (or date of acquisition, if later) plus a "reasonable rate of return" on such sum. Some experts apply a rate of return synonymous with the return a hypothetical investor would require considering the associated risk (i.e., the higher the risk, the higher the rate of return). Such experts generally use the same discount rate that is part of their cap rate set forth in their valuations. Opposing experts may criticize such assessment and recommend a reasonable rate of return based upon factors such as what one would have expected to receive considering market returns during the years of marriage. Once a rate of return is apportioned to the sole and separate owner, a strict application of the fair return method would then apportion the remaining sum of the increase in value to the community. Whether this method is equitable, or more favorable to the community or separate property owner, depends upon the selected rate of return.

One of the most significant issues that is litigated pursuant to the *Fair Return Method* is the rate of return to apply. Even small adjustments to the rate of return will have a major impact on the overall apportionment applied over a long-term marriage. Like the *Fair Compensation Method*, no Arizona published opinions issued after *Cockrill* have adopted a pure *Fair Return Method* by itself as the determinative approach (as can be seen in the discussion in Section IV.C below, *Rueschenberg* applied what it considered a fair rate of return followed by an apportionment of the differential).

While *Cockrill* sets forth the prevailing and authoritative legal principles for apportionment cases, it does not provide as much explanation regarding real-life application of the two listed potential "yardsticks" as may be desired. For example, when discussing these two potential approaches, the *Cockrill* Court does not emphasize that the application of such approaches must still be consistent with its basic principles, i.e., that the separate property owner must establish the portion of the increase in value that is inherent to the separate property nature of the business, and that such must be established by clear and convincing evidence. Such lack of clarity has resulted in some experts' overreliance upon mathematical calculations and parties submitting arguments that are inconsistent with *Cockrill's* main principles.

As discussed further in this article, there is nowhere in the *Cockrill* opinion that states that a fair rate of return for apportionment purposes should be synonymous with the discount rate applied to the valuation of the company, or that fair compensation to the community should be measured by "market" or "normalized" compensation attributed to a hypothetical replacement employee. That is not to say that such analysis should be precluded in all circumstances. However, unless such analysis leads to a result that is consistent with the key principles set forth in *Cockrill*, such should be at least suspect.

Additionally, there are language variations in the *Cockrill* decision that can lead to potentially different applications. These language variations apply to both the separate and community property descriptions.

In describing the apportionment of the increase in value and profits, *Cockrill* first describes the apportionment "in accordance with whether they are the result of the individual toil and application of a spouse or the inherent qualities of the business itself. *Id*. at 52 (emphasis added) (citing *Rundle v. Winters,* 38 Ariz. 239 (1931) and *Nelson v. Nelson*, 114 Ariz. 369 (App. 1977)). This language suggests that the community share not only includes what flows from the individual toil of the owner / operator, but also the "application" of the owner / community efforts. This arguably includes managing employees and contractors and making decisions that place the business in the position of taking advantage of changing market conditions, etc. This cited language suggests that any of the profits or increase in value that does not directly result from the "inherent qualities of the business itself" as it existed at the time of marriage or later acquisition would demur to the community. This is bolstered by the language in *Barr v. Petzhold*, 77 Ariz. 399 (1954) which is cited by *Cockrill*:

> [W]here doubts exist as to whether the proceeds represent the product of skill, labor, or management, as opposed to the inherent return on investment, they are generally resolved in favor of finding the former, there being a strong presumption rebuttable only by clear and convincing evidence …

Id. at 52 (citing *Barr v. Petzhold*, 77 Ariz. at 409). Such language adopted from *Barr* goes beyond a narrow measurement of what is derived merely from the owner-operator's labor but includes the broader application of that which is the "product" of the owner-operator's "skill, labor or management."

The *Cockrill* Court, however, uses somewhat different language in other portions of its opinion. The *Cockrill* Court addresses the separate property portion as that derived from the "inherent value" of the business, but then uses related but varying terms such as the "inherent qualities" of the business and "inherent return on investment". *Id*. at 52. The Court in other places describes the separate property portion as that derived from the "inherent nature of the property". *Id*. at 52, 53, 54. Whether the term "inherent qualities" is different than "inherent nature," "inherent value," "inherent return" and other language variations described above in application is subject to debate.

The *Cockrill* Court also uses different language at times when describing the community portion of the increase in value and profits. As noted previously, *Cockrill* initially characterized the community portion as that which resulted "from the individual toil and application" of the spouse. *Id*. at 52. In citing to *Barr v. Petzhold* at 399 (1954), *Cockrill* adopts the language that the community share is that which "represent the product of skill, labor or management" of the owner. *Id*. at 52. But *Cockrill* also uses language describing the community portion as that derived from "the work effort of the community" and "product of the community's effort," which arguably has a narrower application than the language quoted above. *Id*. at 52. Such has been construed by some litigants as narrowing the community claim to only that portion that results from the owner-spouse's direct efforts. This is similar to the gap discussed below in Section IV.B of this article regarding the *Rowe* and *Roden* distinction between "community efforts" and "other factors," or what was described in *Rueschenberg* as "external factors," i.e., factors external to community efforts.

Arguably these inconsistencies in the language of *Cockrill* should be determined considering its key principles, i.e., that any portion of the increase in value and profits not established as inherent to the separate property business qualities by clear and convincing evidence should be awarded to the community. *Id*. at 52. However, as described further in this article, whether these principles were strictly applied in the subsequent *Rowe*, *Roden* and *Rueschenberg* opinions is ambiguous at best.

Finally, a clarification of the case law regarding the applicable burdens of proof in an apportionment case is important. In *Hefner v. Hefner*, 248 Ariz. 54, ¶17 (App. 2019), the Court explained that the spouse arguing that community efforts have led to at least a portion of the increased value of a separate property business has the initial burden to show the amount of the increase. *See also Standage v. Standage*, 147 Ariz. 473, 481 (App. 1985). It is at that point that *Cockrill* shifts the burden of proof to the separate property owner to establish whether and how much of such increase in value and profits at issue are attributable to the inherent qualities of the business. Though the separate property owner's burden of proof is clear and convincing, the initial burden of proof attributable to the non-owner spouse is not specifically addressed in these cases and appears to be by a preponderance of the evidence. *See Id.; Tester v. Tester*, 123 Ariz. 41 (App. 1979).

B. <u>Rowe v. Rowe / Roden v. Roden</u>

Subsequent to *Cockrill*, the next major published opinions to address the business apportionment issues were the appellate cases *Rowe v. Rowe,* 154 Ariz. 616, 744 P.2d 717 (App. 1987)*,* and then ten years later, *Roden v. Roden*, 190 Ariz. 407, 949 P.2d 67 (App. 1997). In my prior article, I addressed both cases together as the courts reached similar conclusions based upon similar principles. In this update however, I have provided additional details regarding the cases individually.

In *Rowe*, the owner-operator established his sales representative and distribution business ten years prior to marriage. While the trial court found that the predominant cause of the growth, profitability and increased value of the company during marriage resulted from "community toil, effort and credit," the trial court also found that:

> … such was also caused, in substantial part, from <u>*other factors*</u> including: the marketing efforts of the manufacturers that JRA represented; increased consumer acceptability of those manufacturers' products; western population growth; inflation; increased consumer buying power; increased demand for consumer electronic products; and account development and sales efforts by JRA representatives other than Jack Rowe.

Rowe, 154 Ariz. at 620 (emphasis added). The *Rowe* Court further explained that "Jack Rowe's 10 years of effort before marriage gave JRA a well-established reputation," and that Wife did not dispute that the community was adequately compensated for its efforts. *Id*.

In *Rowe*, the Court apportioned the increase in value and compensation already received by the community based upon community efforts versus "other factors" (later called "external factors" in the *Rueschenberg* case discussed in the following section). The Court then determined that the community was already compensated for its share of the increase in value because of its receipt of compensation during the marriage. In other words, the court found that a portion of the compensation received by the community was a result of factors other than community efforts, and that because the community had already received its fair share of the increase in value as a result of its receipt of the sole and separate owner's share of the earnings, the community was not be entitled to further compensation. As noted in *Rowe:*

> The court admitted that it could not precisely quantify the overlapping contributions. It did determine that at least two-thirds of the responsibility for the post-marital growth of JRA was due to the community contribution and that at least one-quarter of the growth was attributable to a return on the inherent value of the pre-marital company. The court concluded that a fair ratio to apply would be three-fourths/one fourth. Because the community had received, through distribution and pension and profit-plan contributions, more than 75% of the sum of net distributable earnings and (assumed) goodwill, the court held that the community had been fairly compensated for all of its contributions to the growth of JRA.

Id.

Like *Rowe*, the owner-operator in *Roden* established, operated, and managed the business at issue well before marriage (the owner-operator owned fifteen Subway franchises by the time the parties were married). The Court in *Roden* explained:

> Here, the trial court found that the increase in value of Desert Subway, Inc., which resulted from community efforts, was offset by the amount of compensation – community property – that each party received during the marriage.

Roden, 190 Ariz. at 411.

<u>Rowe and Roden Critical Analysis</u>

Some practitioners previously interpreted *Rowe* and *Roden* as adopting a limited application of *Cockrill's* fair compensation method, i.e., if the community received "reasonable compensation," it is not entitled to further compensation or a share of the increased value. However, *Rowe* and *Roden* were not based upon such principle. Rather, the respective courts concluded that the community received excess compensation (i.e., the portion that the sole and separate owner would be entitled to pursuant to the apportionment), and that this excess compensation adequately compensated the community for its share of the increase in value to the business during the marriage.

Neither the *Rowe* or *Roden* opinion provides a detailed analysis regarding how the respective courts quantified the increase in value and net distributable earnings that flowed from the inherent qualities of the business as it existed pre-marriage. Nor did either case opinion specifically explain whether and how the separate property owners met their burden of proof by clear and convincing evidence. The cases do, however, include fact findings that show the businesses at issue were established years prior to marriage and that substantial efforts and/or capital contributions had been made by the separate property owner prior to marriage.

Although it makes sense that a well-established business may have inherent qualities and momentum at the time of marriage which can be logically connected to a portion of the subsequent profits and increased value, both *Rowe* and *Roden* unfortunately lack in detail.

There is also a potential gap between *Cockrill's* requirement that the separate property owner must prove what portion of the increase in value is attributed to the "inherent qualities of the business", as opposed to the "other factors" analysis (factors other than community efforts) described in *Rowe* (and later in *Rueschenberg*). The portion of the increase in value and/or profits attributable to these "other factors" may or may not have been realized absent the continued management and oversight by the owner-operator during marriage. While *Cockrill* describes the separate property portion of the increased value as that which is inherent to the pre-marriage qualities of the business, the *Rowe* Court's application of "other factors" appears to suggest that the portion of the increased value of the business that is not directly attributable to community efforts constitutes separate property. The *Rowe* decision does not address whether such "other factors" would have been realized <u>absent the ongoing management, oversight and other efforts during marriage by the owner-operator</u>. Nor were any of the "external factors" quantified, which in other community property cases (such as tracing cases and real estate community lien cases) is required to meet the clear and convincing burden of proof. *See Drahos v. Rens*, 149 Ariz. 248 (App. 1985); *Cooper v. Cooper*, 130 Ariz. 257, 259-260 (1981); *Andrews v. Andrews*, 252 Ariz. 415 (App. 2021).

Additionally, the last listed "other factor" by *Rowe*, i.e., "sales efforts by JRA representatives other than Jack Rowe," stands out to the extent that employee and independent contractor contributions to business value and profits during marriage do not necessarily flow from the inherent qualities of the pre-marriage status of the business, but rather should arguably be credited to the community to the extent that such contributions would not exist absent the ongoing management and oversight of the business by the owner-operator (unless the owner is merely a passive investor and does not manage or operate the business).

Roden provides even less analysis regarding the apportionment issues other than to conclude that Wife received more than enough compensation to offset the community claim to any portion of the increased value. While the *Roden* opinion specifies the amount the community received during the marriage, and the amount Wife subsequently received as temporary support during the proceedings, the opinion includes no findings or analysis regarding the amount of the business' increase in value during marriage, the percentage of the increase in value that should be apportioned between the separate property owner and the community, or any other calculations in support of its ultimate conclusion. As such, criticisms of the *Roden* decision are exponential to the criticisms set forth above regarding the *Rowe* opinion.

Finally, while offsetting "excess funds" received by the community against the community's share of the increased value, neither *Rowe* nor *Roden* address the fact that the income received by the community was as a practical matter co-mingled (i.e., the separate portion of the compensation was co-mingled with the community portion of the compensation, as well as potentially being co-mingled with other community funds), the fact that the community compensation was possibly already spent by the community, and whether the compensation received by the community was treated by the owner-operator during the marriage as community funds.[4] The absence of such analysis is likely the result of the non-owner spouse not raising such arguments at either the trial level or on appeal. The described co-mingling, estoppel and waiver issues were not directly addressed in the *Cockrill*, *Rowe* or *Roden*, opinions, and are addressed only in a footnote in the *Rueschenberg* opinion. Such issues are addressed more specifically in subsections V.F and V.G of this article.

C. Rueschenberg v. Rueschenberg

And then along came *Rueschenberg v. Rueschenberg*, 219 Ariz. 249 (App. 2008). In *Rueschenberg,* the trial court adopted the Special Master's rulings, which were affirmed by the Court of Appeals. The *Rueschenberg* Court then went on to provide a history lesson regarding separate property business apportionment cases up to that point in time, and went to great lengths to dispel Husband's arguments that the community had already been adequately compensated for the community's efforts, and that the trial court did not have the discretion to also award Wife a portion of the increase in the value of the business.

In short, *Rueschenberg* summarized the potential methods of apportionment which had been addressed thus far in prior published opinions including: (1) the *Fair Compensation Method* addressed by *Cockrill*; (2) the *Fair Return Method* addressed by *Cockrill*; (3) and the apportionment and offset analysis applied in *Rowe* and *Roden.* What was ultimately applied by the Special Master and trial court in *Rueschenberg,* and affirmed by the Court of Appeals, was somewhat a hybrid of the prior case applications.

Affirmation of Trial Court's Rulings (Hybrid Method)

Rueschenberg involved a business that Husband started approximately 2 ½ years prior to marriage called Desert Mountain Medical ("DMM"), which sold medical hardware for the repair

[4] In *Rowe*, Wife did argue that the company assets in general were not segregated at the time of incorporation, but as the *Rowe* Court pointed out, such is different than the co-mingling of monies in an account. *Rowe*, 154 Ariz. at 619.

of human joints to surgeons and hospitals. *Id*. at ¶2. The parties were married approximately 5 ½ years. *Id*. at ¶3.

The Special Master's report adopted an income-based capitalization of earnings method of valuation to find that DMM had a fair value of $163,166 at the commencement of the marriage and $1,440,000 as of the end valuation date. *Id*. at ¶4.

The Special Master's apportionment rulings regarding the increase in value took the apportionment analysis to a somewhat different level by applying a combination of the *Fair Return Method* addressed in *Cockrill,* and an apportionment type analysis as addressed in *Rowe*. The Special Master first applied an annual rate of return to the value of the business from the initial valuation date. This amount was then apportioned to the business owner as his sole and separate property. The analysis did not end there, however. The Special Master then applied an apportionment analysis to the remaining increase in value (the Special Master determined that two-thirds of the remaining increase in value was a result of community efforts, and one-third of the remaining increase in value was a result of "external factors" to be credited to the separate property owner (similar to what was done in the *Rowe* case). *Id.*, at ¶¶4-6. Contrary to what was done in *Rowe*; however, the Special Master did not offset a portion of the compensation received by the community during marriage against the community's share of the increase in value. *Id* at ¶6. The ultimate result was that the community share of the increase in value of the business equaled $593,334 (i.e., Wife's share thus equaled $296,667) of the total value at dissolution of $1,440,000. *Id*. at ¶¶4-5.

The *Rueschenberg* Court, in its decision, spent little time addressing the trial court's adoption of the Special Master's rulings, and simply held that the rulings were within the broad discretion of the trial court. Because Wife did not cross-appeal, the *Rueschenberg* opinion is generally limited to Husband's arguments that the community had no claim to a portion of the increase in value of the business as a result of the compensation it had already received during the marriage, and that the trial court abused its discretion pursuant to its two third / one third apportionment analysis. In short, the *Rueschenberg* Court held that pursuant to the principles set forth in *Cockrill*, the community is entitled to a portion of <u>both</u> the profits and increase in value to the extent that the community contributed to both, and substantial justice supported such apportionment. *Id.*at ¶¶ 17, 20-21.

In rejecting Husband's argument that a finding the community received reasonable compensation preluded the community's receipt of a share of the increased value, the *Rueschenberg* Court explained that the Supreme Court of Arizona in *Cockrill* "rejected any requirement that the trial court follow one method of apportionment over another," and that "[t]he clear distinction from *Cockrill* is that the method of apportionment applied must 'achieve substantial justice between the parties.'" *Id*. at ¶¶ 25-26.

In response to Husband's argument that *Roden* supported his position that adequate compensation to the community precluded further apportionment of the increased value of a business, the *Rueschenberg* Court explained that although there was language in *Roden* consistent with such argument, the ultimate holding in *Roden* did not stand for such proposition. Rather, in the *Roden* case, as explained previously, "the trial court determined that the increase in value of [the separate business] which resulted from community efforts was offset by the amount of compensation - community property - that each party received during the marriage." *Id*. at ¶29. In other words, the key inquiry in *Roden* was not whether the community received resonable compensation for the community labor, but rather whether the community received excess compensation (i.e., a portion of the sole and separate owner's share of the compensation) in a sufficient amount to "offset the community's share of the increase in value." *Id.*

The court then addressed Husband's argument that the Special Master / trial court's two-thirds / one-third apportionment was not supported by the facts, and that Wife presented no evidence that the growth of the company was caused by anything other than "external factors". *Id*. at ¶33. The court in rejecting such argument, explained that Husband misapplied the burden of proof, and that it was incumbent upon Husband to establish that the increase in value was a result of the inherent value of the property (i.e., the business as it existed at the time of marriage) by clear and convincing evidence. *Id*. at ¶34. The court explained that "Husband did present evidence that DMM's growth was influenced by external factors, including an increase in manufacturer marketing and sales assistance, increased customer acceptance of the products, increased research and development by manufacturers, natural population growth in market area, and other DMM sales personal expanding the market." However, there was testimony that Wife's contributions and the "work effort of the community" also contributed to such increased growth and profits. *Id*. at ¶35. Accordingly, the court held that "because there was reasonable evidence supporting the trial court's finding … there was no error." *Id*. at ¶35.[5]

The *Rueschenberg* Court then addressed Husband's argument that the trial court erred by not applying an offset of the community's receipt of compensation against the increase in value. The *Rueschenberg* Court explained that such offset analysis was applied in *Rowe*. In *Rowe*, as discussed previously in this article, the trial court applied a three-fourths / one-fourth apportionment between the community efforts and sole and separate portion of the increase. *Id*.at ¶38. *Rueschenberg* explained that the *Rowe* Court found that the entire increase in value was sole and separate property because:

> [T]he community had received, through distribution and pension and profit-plan contributions, more than 75% of the sum of net distributable earnings and (assumed) goodwill." *Id.* Accordingly, there was no error in the trial court's conclusion that 'the community had been fairly compensated for all of its contributions to the growth of [a separate business].

Id. In applying the *Rowe* methodology to the facts at hand, the *Rueschenberg* Court went on to explain:

[5] If Wife had cross appealed, a question may arise whether "reasonable evidence" would be sufficient to affirm the ruling as Husband's burden of proof was by clear and convincing evidence.

> If, as a result of its receipt of the funds, the community already had received more than its proportionate share of the total profits <u>and</u> increase in DMM, and the trial court used the reasonable rate of return method to award the community additional monies, that may violate the fundamental rule from *Cockrill* to apportion the increase equitably.

Id. at ¶37. The *Rueschenberg* Court, however, rejected Husband's argument that the community had already been compensated for the increase in value based upon procedural deficiencies:

> [N]o request was made of the trial court to determine the amount of the net distributable earnings paid to the community. Neither was there a request to determine that the same two-thirds / one-third ratio as to value (goodwill) applied to net earnings.

Id. The *Rueschenberg* Court thus held that Husband was unable to make such offset argument on appeal, and further explained:

> To prevail on this argument, Husband would be required to show at a minimum that the community received more than its pro rata share of the combined total of net distributable earnings and increase in goodwill. Equally, and conversely, he would have to show that he received less than his pro rata share of the earnings as separate property. As pointed out above, the trial court was never asked to determine, and did not determine, the amount of net distributable earnings (income less salary and other expenses) generated during marriage. Because of this, we are unable to determine the combined total of net distributable earnings and increase in value. Thus, there is no factual basis on which to assert error as there is no total figure to which the two-thirds / one-third ratio can be applied to determine - as the court did in Rowe - whether the community has already received its proportionate share of the total and no further moneys were owed.

Id. at ¶40.

As described in the following section, the *Rueschenberg* opinion is somewhat limited as such addressed only Husband's arguments on appeal as Wife did not cross-appeal. The bottom line holding by the *Rueschenberg* Court is that the trial court "is not bound by any one method [of apportionment] but may select whichever will achieve substantial justice between the parties." *Id*. at ¶25 (citing *Cockrill*, 124 Ariz. at 54).

<u>**Rueschenberg Critical Analysis**</u>

A straightforward application of the *Fair Compensation Method* versus the *Fair Return Method* as described in *Cockrill* may result in a significant disparity in results between the two approaches, and depending upon the facts, neither result may satisfy the underlying principles set forth in *Cockrill*. The hybrid approach provided in *Rueschenberg* appears to seek a balance as applied to the facts in that case.

The *Rueschenberg* opinion itself provides very little description regarding how the Special Master determined his two-thirds / one-third apportionment between the community and separate property shares based upon the external factors analysis. The opinion only generally summarizes such external factors including "an increase in manufacturer marketing, sales assistance, increased customer acceptance of the products, increased research and development by manufacturers, natural population growth in the market area, and other DMM sales personnel expanding the market." *Rueschenberg,* 219 Ariz. at ¶5. Such leaves one to question how Husband satisfied his requisite burden of proof that even 1/3rd of the increase in value could be apportioned to him. However, upon reviewing the appeal briefs filed by the parties, there is much more specific evidence and description of such external factors, how such were external to the community labor and investment, and how such external factors applied to the increase in value during the marriage. For example, it was relatively undisputed that most of Husband's efforts during most of the marriage were focused upon two related businesses that the parties started during marriage which had already been accounted for. Husband's brief included citations to the record that DMM mainly purchased its goods from one supplier, which it purchased products from prior to the marriage and with which it had an exclusive agreement, and that most of the community efforts regarding DMM took place during the initial nine months of the marriage whereafter limited efforts by Husband and Wife were required. Husband's brief also included citations to the record evidencing that the growth in profits and value was partially due to the manufacturer expanding its product lines; the manufacturer's direct marketing to both doctors and patients; cited to explosive population growth in Husband's market areas; that the products had gained more acceptance; the doubling of the doctors in Husband's market area; and due to the company doubling its sales force.

In making its determination that Husband did not properly raise his arguments or present adequate evidence for a *Rowe* type of offset, the *Rueschenberg* Court arguably raised the bar above and beyond the evidence described in the *Rowe* and *Roden* opinions. It appears from the *Rueschenberg* opinion that the trial court was at least provided information regarding the gross compensation reported on the tax returns. *Id*. at ¶6. An apportionment analysis was presented, and rulings were issued. Whether Husband argued that the community was adequately compensated, versus arguing that the community was overcompensated and that such overcompensation should be offset against the increase in value, is arguably a distinction without a difference. On the other hand, it appears that while evidence of gross income reported during the marriage was presented (i.e., similar to *Rowe* and *Roden)*, the record does not establish what the "net distributable earnings" received by the community were (i.e., net of taxes).

That being said, it is hard to argue that the failure to provide such offset was inequitable considering the trial court's findings that the business was barely sustainable at the time of marriage, that Wife made major contributions to the business success, and that Husband was not only provided a high annual rate of return (25%), but then provided an apportioned share of the differential.

It would also seem inconsistent to apply an offset analysis after awarding the separate property claimant both a rate of return (i.e., accrued interest on the initial separate property value of the business) plus a share of the remaining increase in value pursuant to its two-thirds / one-third apportionment. If the increase in value is directly apportioned as it was in *Rueschenberg*, the only thing left to apportion is the income received by the community. *Rueschenberg* thus seems to implicitly address the income prong of the analysis by applying a rate of return. After applying a rate of return and apportioning the remaining increase in value, there would arguably be nothing left to apportion to Husband as his share of the income and increase in value have already been apportioned. Thus, if Husband was successful in arguing that excess income should be offset against value, it would be inconsistent that Husband would also be able to receive a rate of return. Of course, if the Court had applied a *Rowe / Roden* type of analysis and applied such offset, as opposed to adopting a rate of return and apportioning the differential, the community may not have received anything further. As noted by the *Rueschenberg* Court, such result would not have been equitable to the community pursuant to the facts in that case, i.e., where the community efforts from both parties (at least during the first nine months of marriage) were significant to the survival and ultimate growth and profits realized by the business.

The language in the *Rueschenberg* opinion is further convoluted by the inconsistent use of terms regarding compensation to be factored in the offset analysis including "net distributable earnings," "profits" and "total compensation" as well as Footnote 9 of the opinion, which explains that the issues of co-mingling, waiver or estoppel may preclude an offset of excess compensation paid to the community against the community's share in the increase in value. Such inconsistencies were not part of the appeal briefs or the Special Master Report. Thus, while *Rueschenberg* provides a certain amount of clarity regarding the various methodologies that may be applied in an apportionment case, the opinion also creates further confusion on several fronts.

Upon review of the various cases in detail, the *Rueschenberg* Court's rejection of Husband's arguments was not a rejection of the *Fair Compensation* approach described in *Cockrill*, but rather a rejection of Husband's narrow interpretation and application of such method. As noted by *Rueschenberg*, the *Cockrill* opinion does not suggest that fair compensation to the community be limited to a market or normalized compensation figure or that such method be applied to only earnings. Rather, *Cockrill* and its progeny make it clear that fair compensation to the community must include both its share of net distributable earnings (i.e., net compensation available for distribution) and the increase in value. In fact, upon further review, it appears that the *Rowe* and *Roden* decisions may be interpreted as a fair compensation analysis to the extent that its apportionment and offset analysis was the method the courts used to determine whether the community had been fairly compensated with regard to both the net distributable earnings and the increase in value.

Criticisms of the apportionment affirmed in *Rueschenberg* include (1) the application of the same rate of return as the cap or discount rate (see further analysis of what constitutes a fair rate of return in Section V.D. *infra*); (2) an apportionment based upon "external factors" which may or may not tie to the inherent qualities of the business as it existed at the time of marriage

(See criticisms of *Rowe* opinion Sections IV.B and V.E); and (3) the application of <u>both</u> a rate of return to the separate property owner followed by the apportionment of the difference is *arguably* a double dip (i.e., apportioning the increase in value to the separate property interests twice).

Like many appeals decisions, *Rueschenberg* does not fully address many of the stated facts and determinations made by the Special Master and adopted by the trial court. It is helpful to review the Special Master's Report to fill in some of the gaps, as well as to review the appeal briefs filed by the parties. Moreover, it is noteworthy that because Wife did not file a cross-appeal in that case, but rather contended that the trial court decision should be affirmed, potential issues from an out-spouse's perspective were not fully addressed in the *Rueschenberg* opinion.

V. <u>Litigating the Apportionment Case</u>

A. <u>Addressing the Burden of Proof</u>

Arizona cases hold that where a spouse argues that the community has increased the value of the other spouse's separate property through community labor and/or funds, "the burden is on the claimant to show the amount of the increase." *Hefner v. Hefner*, 248 Ariz. 54 (App. Div. 1 2019) (citing *Tester v. Tester*, 123 Ariz. 41, 44 (App. 1979). In *Hefner*, because the claimant spouse did not establish that the business at issue had increased in value during the marriage, her claim failed. *See also* memorandum decision *Larchick v. Pollock*, 1 CA-CV 19-0649 FC (App. Div. 1, September 2, 2021).

Once such initial burden of proof is established, as noted previously, the Supreme Court of Arizona in *Cockrill v. Cockrill* concluded the burden is then on the separate property claimant to establish by clear and convincing evidence how much of the increase in value and profits received during marriage constitutes his/her separate property. *Cockrill*, supra, at 52. [See Section IV.A. of this Article for additional detail regarding *Cockrill's* requirements.]

While litigating the apportionment case, the non-owner spouse should consistently question how the owner-operator is able to satisfy their clear and convincing burden of proof, as set forth in *Cockrill,* regarding each and every conclusion proposed. The non-owner spouse should not only reference such burden of proof, but challenge how each and every apportionment contention propounded by the owner-spouse meets such burden of proof. The non-owner spouse should also emphasize what such burden of proof means. Arizona case law provides that the clear and convincing burden of proof means that the proposed conclusion is "highly probable" or "reasonably certain." *Kent K. v. Bobby M.,* 210 Ariz. 279, 284-285 (2005). Thus, the non-owner spouse should challenge how the proposed methods and calculations presented by the owner spouse establish that the increase in value and net distributable earnings are "highly probable" or "reasonably certain" to be the product of the inherent nature of the business as it existed at the time of marriage (or later acquisition as separate property), and/or how the community has already been compensated for its portion.[6]

The owner-operator of the alleged separate property portion of the increase in value and profits during marriage should conversely attempt to establish that their proposed methodology and allocation is "highly probable" or reasonably certain" to be the product of the inherent nature of the business as it existed at the time of marriage (or later acquisition as separate property), and/or how the community has already been compensated for its portion. Although the post-*Cockrill* published business apportionment opinions, *Rowe, Roden and Rueschenberg,* do not specifically explain how the owner-operators in such cases objectively met their clear and convincing burden of proof, this does not mean that courts in the future will not require more specific evidence that the separate owner's apportionment positions are substantiated as such.

The memorandum decision in *Nackard v. Nackard*, No. 1 CA-CV 20-0621 FC (Ariz.App. memo dec. 10-14-2021) sets forth a good example where the separate property owner was able to meet his burden of proof that the increase in value of the business realized during marriage should be designated as his separate property. In that case, the owner was able to establish that the community was not entitled to further compensation as the community received virtually all the net distributable earnings from the company during the marriage. Additionally, because virtually 100% of the profits were received by the community and not reinvested in the company, the parties' experts agreed that the company experienced even less growth during the marriage than inflation or a reasonable investment-based rate of return. *Id*. at ¶ 21. Because the increase in value did not exceed even a conservative rate of return, an offset analysis was not necessary, albeit the Court did find that the community received fair compensation for the nominal increase in value in the form of the net distributable earnings it already received. *Id*. at ¶ 24.

As noted previously in this Article, one must keep in mind that any expert opinions applying various apportionment methods are subject to the *Daubert* standard pursuant to the Arizona Rules of Evidence (despite whether a party files a Rule 2 notice). Accordingly, experts may *arguably* provide examples, including calculations, examples and charts, which apply alternate apportionment methods (so long as such may objectively assist the trier of fact), but it is debatable whether they can provide "opinions" regarding which method the Court should adopt. As such, some experts may provide charts including various rates of return and apportionment examples for the court to choose from without providing an ultimate opinion as to which rate or return or apportionment percentage is most appropriate under the circumstances. Thus, the attorney must establish through fact testimony of the experts and his/her client how and why any particular example submitted by the expert is appropriate in light of the case law principles set forth by *Cockrill* and its prodigy.

[6] I added the language "as it existed at the time of marriage (or later acquisition as separate property)" based upon the language of *Cockrill*, *supra,* at 1338 which uses the term "original capital investment", and subsequent case law application. As noted in Section III.A of this Article, the beginning date of such assessment may arguably be different in unique situations.

B. **Litigating What Method to Apply.**

As made clear in the described cases, Arizona has not adopted a specific separate property business apportionment method that applies to all cases or even certain types of cases. As such it is likely that litigants will continue to address potential approaches or hybrids of approaches that favor their clients. In the same regard, litigants will need to present evidence and arguments why approaches proposed by the other side should not be adopted under the circumstances.

Although not directly addressed in the *Rueschenberg* published opinion, Wife in that case contended in her appellate response brief that *Cockrill's* citations to prior California cases suggests that the Court should adopt the *Fair Compensation Method* when the increase in value and profits during marriage mainly derived from the inherent qualities of the separate property business, and that the Court should adopt the *Fair Return Method* when the increase in value and profits during marriage mainly derived primarily from community efforts and contributions. The fair return approach was adopted in *Pereira v. Pereira*, 156 Cal. 1 (1909) where the increase in value and profits derived mainly from community efforts, and the fair compensation approach was adopted in *Van Camp v. Van Camp*, 53 Cal.App. 17 (1921) where the increase in value and profits derived mainly from the pre-marriage inherent qualities of the business. Such approaches and when they should be adopted were addressed more specifically in *Decker v. Decker*, 17 Cal.App. 842 (1993) and *Patrick v. Alacer Corporation*, 201 Cal.App. 4th 1326 (Cal.Ct.App.2011).

Although *Cockrill* cites to main principles from such cases, it does not go so far as to adopt the distinctions as to when such approaches should be used. However, litigants in an apportionment case can of course cite to such principles to the extent that the methodology adheres to *Cockrill's* basic principles that the apportionment be based upon what the separate property claimant can tie to the inherent qualities or nature of the business as it existed at the time of marriage (or later acquisition as separate property).

C. **Fair Compensation Litigation.**

When applying a *Fair Compensation* analysis, various issues remain unanswered by the Arizona cases addressed in this article, including how one determines fair compensation and whether and how such should be adjusted during the marriage.

"Does "fair compensation" equal "market compensation"? As noted previously, *Cockrill* does not provide any detail regarding what defines "fair compensation" when addressing a business apportionment case, but merely addresses such as one particular method which "may" be equitable depending upon the circumstances. Experts often rely upon business valuation publications to determine what is "reasonable compensation", "market compensation" and/or "normalized compensation." Although such provides an objective measure for purposes of a business valuation, the question remains whether such accurately applies *Cockrill's* fundamental principles, i.e., how does such relate to the inherent qualities of the separate property business?

In other words, is "fair compensation" to the community for apportionment purposes commensurate with "reasonable compensation", "market compensation" or "normalized compensation" applied in business valuations?

A related issue is whether such compensation analysis should change depending upon whether all or a portion of the increased income during marriage is tied to the enhanced abilities, experience, contacts etc. of the owner-operator acquired during the marriage. If the increase in income is a result of the owner-operator's increased experience and knowledge obtained during the marriage, is a normalized compensation analysis, which is based upon benchmarks and averages derived from publications, a true representation of what is inherent to the separate property qualities of the business at issue?

While market/normalized compensation is clearly relevant to a valuation analysis, does this same analysis apply to an apportionment analysis? Pursuant to an income-based valuation the expert looks to whether the owner-operator makes excess compensation (i.e., the amount of income above normalized compensation) to calculate a goodwill value that exceeds the book value of the company. However, an apportionment analysis is based upon different principles, i.e., what portion of such income is inherent to the separate property characteristics versus the remaining portion of the income assumed to derive from community efforts, management and oversight of the business. This can be a very important distinction if a *Fair Compensation* analysis is applied, and of course if the differential is then offset against the community's share of the increase in value as was done in *Rowe* and *Roden*.

In discussing these issues with business valuation experts involved in apportionment cases, such experts acknowledge that they generally cannot provide a formal opinion regarding "fair compensation" for purposes of an apportionment case due to the lack of data necessary to segregate income between community efforts, management and oversight -versus- the portion of income which flowed from inherent qualities of the separate business as it existed at the original valuation date. Such experts can provide an opinion of "reasonable compensation" based upon business valuation data, but acknowledge that such may not meet the *Cockrill* principles, and as such they rely upon counsel to establish how reasonable compensation equals fair compensation under such principles. Accordingly, some experts may also present charts with various examples of alternate reasonable and/or fair compensation computations for the court to choose from.

The separate property owner should thus establish to the court why a normalized compensation analysis should apply, or in the alternative, what separate property versus community property percentage should apply to the income apportionment. The community on the other hand will want to emphasize *Cockrill's* main principles and establish how such mathematical analysis does not fairly identify what is "fair compensation" to the specific owner-operator based upon the stated principles set forth in *Cockrill.*

D. <u>Rate of Return Litigation</u>

As noted previously, if the approach applied by the Special Master and affirmed in *Rueschenberg* is selected, the sole and separate owner would first receive the value of the business as of the date of marriage (or receipt of the business interests as separate property), plus a reasonable rate of return on such value prior to an apportionment of the remaining increase in value. As noted previously, the "reasonable rate of return" example was described in *Cockrill* as one possible approach to apportion the increase in value of a business between the separate and community property interests in an equitable manner. In *Cockrill,* the Supreme Court explained:

> Finally, the trial court may simply allocate to the separate property a reasonable rate of return on the original capital investment.

Cockrill, 124 Ariz. at 1338.

It goes without saying that the application of a high or low rate of return can have a significant impact upon whether the community is entitled to any of the increase in the value of a business and, if so, how much. Accordingly, it is always a good idea to obtain a second opinion – even if the clients agree to a mutual expert.

As noted earlier in this article, there may be a substantial difference in the proposed rates of return propounded by experts depending upon differing philosophies. *Cockrill* does not provide any details regarding what a reasonable rate of return should entail (other than it should be equitable). However, such should arguably correlate to the inherent qualities of the business to satisfy the basic principles of *Cockrill.*

In my Original Case addressed at the beginning of this article (where I represented the owner-operator husband), we made the argument that the rate of return should be synonymous with the discount rate applied pursuant to the valuation analysis. In other words, we argued that the sole and separate owner should receive a comparable rate of return that a third-party investor would desire to invest in the company based upon the applicable risk at the date of marriage or later acquisition. Wife on the other hand contended that a reasonable rate of return applied to an apportionment analysis is different than the expected return that a hypothetical investor would desire. Wife submitted data that Husband's requested rate of return far exceeded the average returns that investors realized pursuant to publicly traded investments, including small cap investments in the subject industry. Wife's proposed rate of return applied a buildup method similar to what was done by Husband's expert, but the differential applied to the risk factors for purposes of the rate of return was substantial.

Upon subsequently representing the out-spouse in my Recent Case, I became more critical to the idea of blindly applying the same rate of return as the valuation discount rate (or cap rate) to the subsequent apportionment analysis. Criticisms of applying the hypothetical investor rate of return to the apportionment analysis include but are not limited to the following: (1) a rate of return that is synonymous with a discount rate for valuation purposes is entirely different than that envisioned in *Cockrill; i.e.,* a reasonable return on investment that is inherent to the pre-marriage qualities of the business; (2) such application amounts to a guaranteed retroactive return to the separate property owner; (3) such ignores the risks that the community assumed via the continuation of the business during the marriage; (4) if the same hypothetical investor rate is applied throughout the marriage, such ignores that the risk factors may have changed throughout the marriage as the business became more successful; (5) a higher rate of return to the separate property owner based upon higher risk is inconsistent with *Cockrill's* basic principles; and (6) if the applied rate of return is too high and thus eliminates all or a large portion of the community share, such may in effect ignore the community's contributions to the increase in value.

Should the owner-operator in an apportionment case experience the same rate of return that a hypothetical third-party investor would desire to invest in the business? The reason the third-party investor would require a higher rate of return is because of the risk. Simply because the investor assumes more risk in the hope of a certain rate of return does not mean he or she will receive it. If a hypothetical investor rate of return is applied to an apportionment analysis, the owner would essentially be guaranteed that rate of return retroactively regardless of risk up to 100% of the increase in value. The retroactive application of a hypothetical investor rate of return over a long-term marriage may virtually eliminate the community's claim to any increase in the value of the business, especially if the return is compounded annually. The rate of return applied in *Rueschenberg* over the 5 ½ year marriage was based upon the same cap rate of 25% applied to the valuation.[7] Such still allowed for some of the remaining increase in value to be apportioned. However, if such rate of return is applied over a longer marriage, it may be relatively impossible for a company to experience an increase in value that exceeds such rate of return year after year.

Another way to look at the issue is that the hypothetical investor's desired rate of return increases with risk (i.e., the higher the risk the higher the potential reward). Thus, the application of a hypothetical investor rate of return to the apportionment analysis would result in a higher rate of return to the separate property owner of a risky business than it would to the owner of an already successful and stable business. Such is arguably inconsistent with *Cockrill* which directs that the separate property owner must establish that portion of the increase in value and profits that is inherent to the separate (pre-marriage) qualities of the business. As such, the rate of return realized by the separate property owner should arguably be higher if the business is already successful and the growth and profits can thus be more easily tied to the pre-marriage characteristics of the business, and conversely lower if the business at the time of marriage is struggling and high risk.

This analysis is subject to debate amongst business valuation experts that frequently testify in business apportionment cases. On one hand, some experts assess the language of

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[7] The rate of return in *Rueschenberg* proposed by Wife was 10% based upon the rate associated with treasury bonds, i.e., a market approach rather than a risk related one. This was similar to the California case *Decker*, 17 Ca. App.at 842. where the court also applied a 10% market-based rate of return. One can also argue the statutory interest rate as a reasonable rate of return. A.R.S. Section 44-1201 provides the legal interest rate for judgments as the lesser of 10% or 1% plus prime.

Cockrill, *supra* at 138 regarding a “reasonable rate of return on the original capital investment” as inviting a valuation cap rate analysis for purposes of the rate of return, while other experts find such language as non-determinative, and that a reasonable rate of return is a question for the trier of fact based upon equitable principles as opposed to being subject to valuation principles. According to an expert I recently discussed these issues with, the application of a cap rate as a rate of return would effectively apportion both the increase in value and the income components, thus any additional apportionment (such as what took place in Rueschenberg) would thus constitute a double dip in favor of the separate property owner.

The unpublished opinion *Rozenman v. Rozenman*, 1 CA-CV 09-0337 (Ariz.App. memo. dec. 3-11-2011) provides an example where the court found the hypothetical investor rate as unjustified. In that case the trial court applied the national annual growth rates for cigar sales to determine the rate of return attributable to the inherent qualities of the cigar business at issue. *Id*. at ¶8. Husband’s expert unsuccessfully proposed that the reasonable rate of return should be 27% based upon a hypothetical investor rate of return analysis, which the trial court did not find reasonable or commensurate to the inherent qualities of the business at the time of marriage. *Id*. at ¶9. The Court of Appeals acknowledged that the trial court’s reliance upon the annual growth of cigar sales was a “rough approximation,” “[b]ut in the absence of any better measure, it is a reasonable estimate of what the business assets would have earned without Husband’s labor.” *Id*. at ¶¶9-10[8].

A similar more conservative rate of return was applied in the unpublished decision, *Weinstein v. Locke, supra*. In that case, the court adopted what it termed as separate “passive appreciation”. *Id*. at para. 5. The *Weinstein* Court did not specify in the opinion what the rate of return was, other than that it adopted Wife’s expert’s conclusions. I was able to confirm with Wife’s expert that the Court adopted the same 12.5% rate of return as the valuation cap rate. In such case, it appeared that the Court found that the more conservative cap rate in that case was appropriate, but no cases to date have found that the valuation cap rate is determinative.

A fair rate of return application could of course be equitable where the result complies with the fundamental principles of *Cockrill*. When it comes to determining a reasonable or fair rate of return, it is easy to get caught up with expert schedules and mathematical calculations. Thus, attorneys and courts should not lose sight of the fundamental *Cockrill* principles and applicable burden of proof in deciding whether to adopt a rate of return analysis, and how a reasonable rate of return should be determined in order achieve an equitable apportionment in accordance with such principles.

As noted above, the *Fair Rate of Return* method involves the application of a percentage or an interest rate as the measure of return to the separate value of the business. Such gives rise

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[8] The *Roseman* unpublished opinion addresses two of the points highlighted in this article, i.e., that a “reasonable rate of return” should relate to the pre-marriage inherent qualities of the business, and that an “external factors” analysis if applied should arguably be limited to those factors that would have been realized absent material community efforts, management and oversight.

to the additional issue whether such should be simple interest or compound interest. Simple interest provides a return on the original value only (i.e., the same amount every year), while compound interest provides a return on both the principle and accrued interest. Over the length of marriage, the differential may be significant. One potential distinction that may be considered is applying compound interest to a market rate of return, which would be logical as an investor in the market would expect the same, but applying simple interest if the rate of return is based upon the cap rate. In *Rueschenberg*, the Special Master applied compound interest based upon the cap rate, however, the rate of return and interest accrual determinations were not appealed. No published Arizona cases to date have addressed such simple versus compound interest issues for purposes of an apportionment analysis directly.

E. <u>Apportionment Percentage Litigation</u>

Pursuant to both the Special Master's hybrid analysis in *Rueschenberg*, and the courts' analysis in *Rowe* and *Roden*, a percentage apportionment was conducted between the separate and community portions of the increased value and net distributable earnings. Such was based upon what portion of the increase in value was attributed to community efforts versus what portion was attributed to "other factors" or "external factors"[9] If the Special Master's methodology in *Rueschenberg* is adopted, the percentage apportionment is applied after the sole and separate owner is attributed a fair rate of return. If a *Rowe / Roden* analysis applies, no rate of return is applied prior to the percentage apportionment; however, an offsetting analysis takes place after the apportionment is concluded as previously discussed.

In *Rueschenberg*, the Court referenced that at least a portion of the increase in value was attributed to factors other than community efforts. As noted previously, Husband presented evidence "that the company's increased value was due [in part] to an increase in manufacturer marketing and sales assistance, increased customer acceptance of the products, increased research and development by manufacturers, natural population growth in the market area, and other DMM sales personnel expanding the market." *Rueschenberg,* 219 Ariz. at 854. Based upon such evidence, as noted previously, the Special Master determined that two-thirds of the increase in value was attributable to the community, and one-third was attributable to such external factors.

In the recent unpublished opinion, *Weinstein v. Locke*, No. 2 CA-CV 2023-0163-FC (App. Div. 2 Filed May 23, 2024), Husband owned an insurance brokerage business, which he started approximately five years prior to marriage. There was no dispute that the business increased in value during the marriage. The *Weinstein* opinion provides more detail than usual regarding why the apportionment applied by the trial court was affirmed. In that case, the two opposing experts submitted divergent opinions on the apportionment of the increase in value between the community and separate property owner. Husband's expert submitted that the apportionment should be 55/45 in favor of the community, while Wife's expert submitted that the apportionment should be between 67% and 90% in favor of the community. The court

[9] As addressed in Section IV.B. and V.E *infra,* this method of apportionment is *arguably* different than the "inherent" test set forth in *Cockrill v. Cockrill*.

adopted Wife's expert opinion analysis but chose a percentage closer to the lower part of the range, i.e. a 70/30 apportionment in favor of the community. In adopting Wife's expert's analysis, the Court found that a higher percentage for the community was appropriate considering that the business was very dependent upon one person (i.e., Husband) and did not have a lot of employees. Although not specifically referenced in the *Weinstein* opinion, the trial court's rulings in its Decree of Dissolution of Marriage provides further detail in support of its decision that the community contributions were higher than that proposed by Husband, including the fact that Husband was the sole owner (thus minimizing external factors associated with other owners), that Huband was the primary decision maker for the business, and that a substantial amount of the increased profits resulted from the increased book of business that Husband generated from his efforts during marriage. The trial court's decree, in explaining the portion it attributed the separate property owner, included population growth and client referrals as "external factors".

Every case can of course be critiqued and criticized. In the *Weinstein* case, it could of course be argued that the "external factors" analysis is different than what can be proven as a passive gain and/or which flow from the inherent qualities of separate property business as it existed at the time of marriage. Certainly, including client referrals as an external factor could be challenged on the basis that such are arguably still a product of community efforts.

As previously noted, the overall apportionment analysis falls within the wide discretion of the trier of fact. Despite the analysis applied in *Rowe*, *Roden* and *Reuschenberg*, the question remains whether such apportionment requires precise quantification. Although one can certainly attempt to present an expert's opinion regarding such apportionment, it is questionable whether a CPA or other expert has any greater ability to reach an apportionment conclusion than the trier of fact. As such, many experts provide apportionment examples and defer to the trier of fact to apply the final apportionment percentages.

In my Original Case discussed in this article, the company was started by Husband's father. The father gifted separate 33% interests to each of his three children (including Husband), while retaining 1% of the stock. Although the father had limited stock ownership, he previously secured and continued to maintain the relationship with the company's main client, served as the company's chief executive officer, and made or was intimately involved in the most important company decisions. Husband served as president of the company, while his siblings both served as vice presidents.

To minimize the community claim, it was of course Husband's goal to establish that the increase in the value of the business was due primarily to the inherent qualities of the separate property business and/or external factors (factors that contributed to growth other than Husband's community efforts). Husband submitted evidence that the increase in the company's value first and foremost was a result of Husband's father, his connections, his knowledge of the industry, and his continued relationship with the company's main client. Husband also contended that various other persons had a major role in the success of the company, including Husband's siblings and the company's chief financial officer. In the same regard, Husband contended that although he was the president of the company, he was essentially second in command, and that his father was still the driving force.

In addition, the company was very reliant upon the construction industry. Husband submitted evidence that the major factors behind the growth and increased value of the company included population growth in the Phoenix metropolitan area, and the dramatic growth in the construction industry in Arizona during the marriage. Husband's contention was further supported by the fact that as the construction industry in Arizona later declined, the revenues and profits realized by the company declined as well.

Wife raised opposing arguments, including the fact that Husband worked full time, was the president of the company, and made various decisions regarding the company's daily operations. Wife also submitted evidence that the company's operating agreement allowed Husband and his siblings to exercise a control position, thus any control exercised by Husband's father was voluntary on the part of Husband and his siblings.

Wife's expert also made additional computations and notations that the separate property share could be limited to the percentage of the revenues associated with the one major client in place prior to Husband's acquisition of his share of the business in comparison to the gross revenues as of the end valuation date. Such argument had merit to the extent that such provided a measurement of what could arguably be quantified as inherent to the separate property characteristics of the business.

An additional issue that may be addressed is whether the apportionment percentage should change through the years of marriage. For example, pre-marriage contributions may be more significant earlier in the marriage but have a lesser role later in the marriage.

In my Recent Case in which I represented the non-owner spouse we contended that the apportionment of the separate property owner's share should not be based upon an "external factors" analysis applied in the *Rowe,* and *Rueschenberg* cases, but that such apportionment should be limited to that percentage of the growth in value that could be attributed by clear and convincing evidence to the "inherent qualities" of the business as of the date of marriage. As such, we argued that there was a gap between the "external factors" discussed in these Court of Appeals cases versus the mandate provided by the Supreme Court of Arizona in *Cockrill*, and that at least some of Husband's "external factors" arguments included factors that were not inherent to the separate nature of the separate property business as of the time of marriage, and which would not have been realized absent Husband's continued efforts, management and oversight.

Because the business at issue in my Recent Case had been operating for less than two years and was losing money at the time of marriage, we (unsuccessfully) argued that the separate property owner was unable to establish that any of the growth in value during marriage could be attributed to the inherent qualities of the business at the time of marriage. In the alternative, we submitted a time-line apportionment to which the separate property owner would receive a percentage of the increase in value based upon the number of years the owner operated the business prior to marriage in comparison to the years the business was operated during the marriage (thus providing equal weight to the separate and community property contributions based upon the timeline).

As set forth previously, there appears to be a potentially significant gap between what portion of the growth is "inherent" to the nature or characteristics of the separate property business as it existed as of marriage, as opposed to what is left over for the community after eliminating all "external factors." There are numerous "external" factors that may have led to the increased growth in a business other than the direct community efforts of the owner, but that could not have been realized absent the ongoing management, direction and oversight of the owner.

Accordingly, in my Recent Case, we emphasized a more restrictive application of *Cockrill's* language regarding "inherent qualities" and its language "as a result of the inherent value of the property itself." As such, we argued that the most applicable definition of the word "inherent" is that which is "derived from the essential nature of, and inseparable from, the object itself." Merriam-Webster.com Dictionary (2020). We further argued that the term "inherent" as applied to the business at issue is synonymous with "passive income" or a "passive gain," i.e., that which requires little to no effort to earn and maintain, or in other words, that in which the owner-operator did not materially participate. Black's Law Dictionary, 11th Ed. (2019). This is similar to the California "*Perieira"* approach" analysis discussed in *Beam v. Bank of America*, 6 Cal.3d 12 (1971) which *Cockrill* cites to in support of its stated principles. *Cockrill*, 124 Ariz. at 54. Such analysis thus measures the separate property portion as what the company would have earned (or increased in value) "absent the spouse's personal management." *Beam*, 6 Cal.3d at19.

The separate property owner would on the other hand be inclined to argue broader definitions of the word "inherent," including the "essential character of something," citing Merriam-Webster.com Dictionary (2020), or an "essential attribute or quality of a thing," citing Black's Law Dictionary, 11th Ed. (2019). Under a broader definition of the word, an owner-operator would emphasize those characteristics of the business pre-dating the marriage that are the same or substantially similar to what continued to exist during the marriage (i.e., the company made widgets before marriage and still makes widgets.) Moreover, the separate property owner should emphasize that if *Cockrill* desired to limit the analysis to passive gains and profits only, it would have used such language rather than what is attributable to the inherent qualities of the business.[10]

After reviewing the various court cases in detail, there appears to be many more potential objective measures to delineate what can be inherently linked to the separate property

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[10] In Wife's appeal brief in *Rueschenberg* she noted that the external factors argued by Husband would not have been realized absent continued community efforts and thus would have been "nothing more than statistics." In other words, 'but-for' the community efforts no further profits or increased value would have been realized. Although a valid argument, neither *Cockrill n*or its progeny recognize such as the determinative issue.

characteristics of the business than what has been addressed in the described cases. As set forth above, this may include apportioning the increase in value proportionately pursuant to the years of operation prior to marriage versus the years during marriage as described above. This may include assessing what pre-marriage clients continue to do business with the company and the overall profits that such clients continue to provide. This may include an analysis of what products and services were provided pre-marriage and whether additional products and service were added during the marriage. This may include measuring what portion of the increase is attributable to pre-marriage novel concepts and products which the community later received the benefit of.

The unpublished decision *Menghini v. Menghini*, No. 1 CA-CV 190057 FC (Div. 1 March 3, 2020), provides a more obvious example where the value and profits arose from the "inherent nature" of separate property business. In that case, Wife inherited a one-third interest in certain real property along with her two siblings six years prior to marriage. During the marriage, Wife and her siblings established an LLC for purposes of entering into a solar lease with a solar energy development and generation company regarding the separate property real estate. The solar company was wholly responsible for maintaining the equipment, etc. pursuant to the lease. Although Wife spent some labor on establishing the LLC and negotiating the lease, once such was completed, Wife did relatively nothing except collect her share of the lease payments, which she deposited to the parties' joint account. *Id*. at ¶¶25-28. Nothing in the case suggested that the community made any capital contributions associated with the real property or the ownership entity.

Husband argued that the lease interest (and thus the future proceeds from the lease) was community property based upon the lease being entered into during marriage. The Court easily disposed of such argument on the basis that the lease regarded separate property, and that Husband was not on the deed to the property or listed as an owner of the LLC. In the alternative, Husband argued that the community had a community lien associated with Wife's community efforts. The *Menghini* Court held that the solar lease was "inherent" to the real property that Wife inherited. *Id*. at ¶36. Regarding Husband's argument that the community should be compensated for the hours Wife expended on setting up the LLC and leading up to the solar lease, the Court found that the community had received approximately $150,000 in lease proceeds, and that such clearly compensated the community for Wife's nominal time she spent during the marriage to establish the LLC and to negotiate and enter into the solar lease. *Id*. at ¶37.

For purposes of this section of the Article (i.e., "Apportionment Percentage Litigation"), the key point to emphasize from the *Menghini* case is that it applied the actual language and analysis from the Supreme Court of Arizona *Cockrill*, i.e. an "inherent nature" analysis, as opposed to the Court of Appeals' *Rowe* and *Rueschenberg* decisions that applied an "external factors" analysis.

How the word "inherent" is defined and applied is likely to continue to be a key point of contention. Likewise, how the application of "external factors" relates to the inherent qualities of the separate property business will continue to be disputed. Until there is further clarification by the higher courts, there is no doubt that arguments on both sides will continue to be made.

So long as the courts provide sufficient findings of fact and analysis in support of their apportionment analysis, it is apparent that their rulings will likely continue to be affirmed regardless of the somewhat inconsistent application of apportionment concepts. The bottom line is that the court is not bound to any one method, but rather should endeavor to achieve substantial justice considering the legal principles and burden of proof set forth by the Supreme Court of Arizona in *Cockrill*.

F. <u>Offset/Co-mingling Litigation</u>

As noted previously, *Rowe* provided an offset analysis after the apportionment stage was completed. Under the *Rowe* approach, a court would apply an apportionment percentage to both the increase in value as well as to the net distributable earnings received by the community.[11] The court would then offset any "excess compensation" received by the community (the portion of the earnings that would constitute the sole and separate property pursuant to the apportionment percentage) against the community's share of the increased value. In *Rowe*, the courts assessed the community's share of the <u>combined</u> sum of the increase in value and compensation received by the community, and then found that the community was already adequately compensated for its interest in the increased value pursuant to its receipt of the owners' separate share of compensation from the business during marriage.

One of the major issues argued during both of my cases described in this article was whether the alleged overcompensation of earnings received by the community (the sole and separate portion as described above) should be offset against the community's share of the increase in value. Although this is exactly what happened in *Rowe*, the *Rueschenberg* Court arguably threw a wrench in the analysis by providing inconsistent language. On one hand, the body of *Rueschenberg* states that such offset is part of a "contemporaneous" analysis of both the earnings received and increase in value. On the other hand, Footnote 9 of the opinion notes that such combined or contemporaneous analysis may arguably not take place if the funds received by the community were co-mingled, or if waiver other equitable considerations apply.[12]

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[11] This could be the same apportionment percentage or a different percentage. The experts in our cases concluded that no distinction should be made based upon our facts. No such distinction was made in *Rowe* and *Roden*, although Footnote 9 to the *Rueschenberg* opinion does address the possibility.

[12] Footnote 9 of the opinion provides in part:

> A hypothetical example may add clarity. Assume that a ratio of two-thirds/one-third was determined to apply to the share due the community and separate property, respectively, for its contribution to the growth of the business. Assume the amount of net earnings was $80 and increase in value was $20. The combined total of the increase is $100. The community would be entitled to $66.67, and the sole and separate property would be entitled to $33.33. If the community had already received $80 from net distributable earnings, it may not be entitled to any further amounts <u>unless issues such as waiver, commingling, or other equitable considerations required otherwise</u>… (Emphasis added).

In support of our position (in my Original Case) that the offset was warranted, we cited the following language from *Rueschenberg*, which explains:

> Rather, as we describe more fully below, we hold that the trial court <u>must</u> equitably apportion <u>the combined total</u> of the profits (net distributable earnings) and increase in value (whether goodwill or otherwise) of the separate business if the efforts of the community caused a portion of that increase and substantial justice requires it.

Rueschenberg, 219 Ariz. at 857 (emphasis added). *Rueschenberg* then goes on to explain:

> If, as a result of its receipt of the funds, the community already had received more than its proportionate share of the total profits <u>and</u> increase in DMM, and the trial court used [only] the reasonable rate of return method to award the community additional monies, that may violate the fundamental rule from *Cockrill* to apportion the increase equitably.

Id. at 861 (emphasis added).

Thus, it was our position that the apportionment analysis must apply to both the earnings received and increase in value (a combined analysis that provides for a contemporaneous offset).

If one were to rely solely upon the language above, a co-mingling defense pursuant to Footnote 9 of *Rueschenberg* makes little or no sense. For the community to have received excess compensation, there must be co-mingling of the portion of separate property percentage of the earnings with the community percentage of the earnings. The alternate scenario is that the sole and separate owner would foresee in the future what a court would determine is the sole and separate versus community portion of his or her earnings, and thus segregate the sole and separate portion of his / her earnings to avoid co-mingling. However, if this happened, the community would not have received overcompensation and thus the combined analysis discussed in the bodies of the *Rueschenberg, Rowe* and *Roden* opinions would never take place.

The location of Footnote 9 follows the language in the main body of the *Reuschenberg* opinion that it would be an abuse of discretion for either the community or the separate property to receive more than its proportionate share of the <u>combined</u> total. *Id.*at 861. The mathematical analysis set forth by the Footnote 9 hypothetical is consistent with the *Rowe* analysis until one reaches the word "unless." Starting with the word "unless," the Court addresses "equitable considerations" such as co-mingling, waiver and estoppel. Because this additional language is set forth only at the end of a hypothetical example, and because it would undercut the language that requires a combined analysis, it was our position that the additional language is *dicta.*

The other side of the argument is that the discussion in *Rueschenberg* of a contemporaneous offset is also *dicta* as the Court found that Husband had not preserved the issue on appeal.

The co-mingling / waiver / estoppel argument does not necessarily end with simply the co-mingling of the separate and community percentages of the profits upon receipt by the community, but also whether the owner-operator intended and treated such compensation as community property, whether such compensation was comingled further with other community funds, and/or whether such funds were spent on community liabilities (i.e., which would be presumed to constitute a gift to the community). None of the published cases described above directly address the issues of co-mingling, estoppel or waiver as applied to the facts in those cases as such issues were not raised on appeal, and as noted above, only tangentially addressed in a footnote in *Rueschenberg*.

Is the contemporaneous offset of overcompensation against the increase in value consistent with other Arizona cases regarding community property presumptions? Pursuant to Arizona case law, the co-mingling of funds is deemed to constitute a gift to the community unless such can be directly traced or established by clear and convincing evidence to not constitute a gift. *Cooper v. Cooper*, 130 Ariz. 259-260 (1981); *Martin v. Martin*, 156 Ariz. 440, 443 (App. 1986); *Andrews v. Andrews*, 252 Ariz. 415 (App.2021). In real estate community lien cases, co-mingled funds used for capital contributions (including the principal portion of the mortgage payments) are credited as community payments. *Drahos v. Rens*, 149 Ariz. 248, 249-250 (App. 1985) ("It should be noted that if the mortgage payments were made from commingled funds, there is a presumption that community funds were used.") (citation omitted); *Brucklier v. Brucklier*, No. 1 CA-CV 21-0106 FC at ¶ 23 (Ariz.App. mem dec. 8-25-2022) ("We, therefore, vacate the court's order and remand for the superior court to award the community an equitable lien equal to the amount spent increasing the homes equity from community and commingled accounts.").

In *Inboden v. Inboden,* 225 P.3d 599 (Ariz. App. 2010), the Court of Appeals explained that a trial court cannot merely ignore presumed gifts to the community and return separate property contributions. Rather, jointly held property must be divided substantially equally "unless there exists a sound reason to divide the property otherwise." *Id*. at ¶6, 9 (distinguishing its holding from the equitable rulings in *Toth v. Toth*, 190 Ariz. 218 (1997) and *Flower v. Flower*, 225 P.3d 588 (App. 2010)). By allowing for an offset analysis as part of the overall equitable division, it appears that *Rowe* (as well as *Rueschenberg* in its explanation) *arguably* deviated at least in part from these long-standing community property principles. Perhaps such is merely because co-mingling and other arguments were not raised on appeal, or perhaps because equitable analysis in apportionment cases have transcended beyond these basic principles.

The co-mingling issue was addressed in the memorandum decision *Vohland v. Vohland*, No. 2 CA-CV 2014-0076 (Ariz.App. memo. dec. 10-30-2014). In that case the court did a straight-forward apportionment of the increase in value to which neither a rate of return nor an offset was applied. The trial court determined that 60% of the increase in value was attributed to community efforts and 40% to the inherent nature of the separate property business. *Id*. at ¶6. In reaching its determination, the court apportioned to the community not only what resulted directly from the owner's labor, but that which stemmed from the owner-operator's "business acumen, insights, personality and drive." *Id*. at ¶20. In rejecting Husband's argument that the community was overcompensated, the *Vohland* Court affirmed the trial court's ruling and explained that the compensation received by the community had already been spent and not retained in the corporation. According to the trial court, as quoted by the *Vohland* Court:

> In testing for substantial justice between the parties, the court would also have to take into consideration that portion of the profits paid out which exceeded a reasonable compensation rate determined by the court. This payout was [in] part a return on the separate property investment in Veggies, Inc. That is to say, if there had not been monies previously paid out for the benefit of Michael which were in the nature of his separate property, those monies would remain in the corporation to be retained by him. Since those monies have been spent, they still need to be placed in his separate property column. Michael's decision to give his separate property monies to the community, to the children of Sandra, or to purchase items for himself, cannot now be altered or calculated.

Id. at ¶27. The *Vohland* Court further explained:

> Michael has not suggested how the court's analysis is inconsistent with Arizona law. *Cf. Cooper v. Cooper*, 130 Ariz. 257, 259, 635 P.2d 850, 852 (1981) (commingled funds presumed to be community property); *Baum v. Baum*, 120 Ariz. 140, 146, 584 P.2d 604, 610 (App. 1978) (refusing to reimburse spouse for separate property funds spent on community expenses).

Id.

The comingling issue was also addressed in the unpublished case, *Weinstein v. Locke*, *supra.* In that case, the trial court did not provide for a *Rowe*-type offset, and held that the funds the separate property owner paid to the community were used to pay community expenses, and were thus considered a gift to the community. *Id*. at ¶14 (citing *Bobrow v. Bobrow*, 241 Ariz. 592 (App. 2017) ("a spouse's voluntary use of separate property to pay community expenses is presumptively a gift to the community."). The *Weinstein* Court cited to *Rueschenberg*, footnote 9, that "equitable considerations such as waiver or commingling could alter a court's apportionment of income and value." *Id*. at ¶14 (citing *Rueschenberg*, supra, 2019 Ariz. 249, n.9).

What is not noted in the *Weinstein* opinion is that the underlying decree issued by the trial court in that case shows that the business owner was first provided a rate of return before the apportionment analysis. As such, any further offset in favor of the separate property owner would essentially constitute a three-layer separate property award, i.e. a rate of return, followed by an apportionment, followed by an offset. (See Section V.H of this article regarding such three-layered arguments).

A somewhat different result was reached in the memorandum decision *Nackard v. Nackard*, *supra*, at 24. As discussed previously, in the *Nackard* case, the community received all distributions and little to no funds were reinvested in the business. As a result, the growth of the company during marriage was even less than the rate of inflation. Wife in that case argued that as a result of co-mingling, the business somehow became community property. Such argument was easily dispelled. However, also implicit from the ruling was that it would be unfair to the separate property owner if the Court ignored the contributions received by the community pursuant to the co-mingling argument, and essentially forced the separate property owner to pay twice. The *Nackard* Court, without specifically stating so, appeared to apply the "contemporaneous" analysis described in *Rueschenberg*. A simplified alternate explanation is that the community was essentially paid its share in 'installments' during the marriage, with a potential equalization only if the community did not already receive its share of the increase in value and net distributable earnings.

In trying to reconcile the cases in a manner that an offset is appropriate despite a co-mingling defense, one could argue that the offset does not actually take place after the fact, but rather that the community received its share in installment payments during the marriage. If the community received its share of both profits and the increase in value as the payments were distributed to the community, one could argue that co-mingling concepts do not apply. Rather, it is simply a process of calculating the credits and debits that took place during the marriage.

Under such analysis, however, the separate property owner would not receive reimbursement for overpayment beyond the break-even point as such "excess" payments were in fact co-mingled and possibly already expended by the community. Such conclusion is consistent with Arizona's published and memorandum decisions discussed in this Article to the extent that none of the opinions supported reimbursement to the separate property owner above and beyond providing credit against what the community would otherwise be entitled to. The language of footnote 9 of the *Rueschenberg* opinion regarding co-mingling, waiver and estoppel, could potentially be rationalized as only applying to the amount of separate property received by the community above and beyond the amount it was entitled.

Without taking a side one way or the other, further clarification from the higher courts will be helpful. Either co-mingling should presumptively preclude a combined (contemporaneous) analysis, or a combined analysis should either be allowed regardless of co-mingling, or a determination that such payments are credited at the time they are made and thus do not involve co-mingling at all. The amount of money at issue may be very significant. Until further clarification is provided, we as practitioners have no choice but to take opposite positions on the issues depending upon whether we represent the owner or non-owner spouse.

G. <u>Kim v. Pak – The Trial Court Must Make Apportionment Findings Despite Co-Mingling.</u>

A few months after my prior June 2024 update to this article, the Court of Appeals (Division 1) issued its published opinion *Kim v. Pak*, No. 1 CA-CV 23-0409 FC (Filed 11-26-2024). The *Kim v. Pak* case provides further analysis and clarification of the apportionment versus co-mingling issues addressed in the preceding section.

Kim v. Pak does not alter the issues and analysis addressed in Section V.F above, but settles any procedural ambiguity in its holding that the trial court must first make an apportionment finding regarding separate and community profits prior to determining whether a separate property owner is able to trace their separate property contributions. *Id.* at ¶1.

In *Kim v. Pak*, there was no increase in value of the business at issue, thus the apportionment analysis was focused on profits derived from the separate property business and the commercial properties purchased from such profits. *Id.* at ¶10. The issue on appeal was narrow – i.e. can the trial court conclude that no apportionment is necessary based upon its determination that the profits were co-mingled and untraceable? Without deciding whether the funds at issue were in fact traceable, the Court of Appeals agreed with Husband that an apportionment finding must be made so that the separate property owner can then at least attempt to trace their separate property contributions to the commercial properties which were later purchased. Id. at ¶¶6, 11. The *Kim v. Pak* Court remanded the decision to the trial court to provide for such apportionment prior to determining whether the funds were co-mingled, were traceable, and/or applying other such considerations. Id. at ¶24.

Several nuances arise from the *Kim v. Pak* decision. One nuance is that there can technically be various levels of co-mingling. The first level of *arguable* co-mingling is the receipt of hybrid profits by the separate property business, i.e. the combination of separate versus community funds that flow into the business accounts. No Arizona cases have required a tracing analysis at this level as it would be unrealistic for a separate property owner to ask customers to apportion their payments, and to thus have two separate business accounts for pre-apportioned profits. It would be equally ridiculous for a business owner to foresee what such apportionment percentage would apply and then apportion such profits at this first level in anticipation of possible future divorce proceedings. It follows that the co-mingling issues thus apply to what happens after the profits are transferred out of the business account(s). As established in *Kim v. Pak*, the court cannot place the cart before the horse. An apportionment finding must be issued and then the co-mingling / tracing analysis and/or other evaluations can take place.

The *Vohland* and *Weinstein* memorandum decisions discussed in Section V.F. above are consistent with *Kim v. Pak* in application. In such cases, the trial court provided for such apportionment first, but then determined that the separate property owner had expended their separate property portions of the profits for community obligations, and that such constituted a gift to the community. See Section V.F. *supra*. It should be noted, however, in those cases the funds at issue had been expended for community obligations (and were thus gone) versus *Kim v. Pak* where the co-mingled funds at issue were used to purchase existing assets.

This brings us back to Section V.F above whether a business owner's failure to trace co-mingled funds defeats his claim of an offset or other credit for their separate property contributions to the community. This dichotomy was discussed above per the *Rueschenberg* language regarding a, "contemporaneous" / "combined" analysis versus its footnote 10 which described co-mingling as an "equitable consideration". *See* Section V.F. *supra*.

The bottom line still appears to be that the Court "may" but is not required to provide credit to the separate property owner when there has been co-mingling, and the owner is unable to directly trace such funds. However, pursuant to *Kim v. Pak*, the trial court must make an apportionment finding before applying further equitable analysis. This brings us back to the language in *Cockrill* and *Rueschenberg* that the court is not bound to any one method of apportionment but may apply whatever analysis that will achieve substantial justice between the parties. *Rueschenberg*, 219 Ariz. at 858 (citing *Cockrill*, 124 Ariz. At 54).

H. Potential Hybrid Litigation - Application of Special Master Methodology PLUS the *Rowe / Roden* Offset

Similar to what the Special Master did in *Rueschenberg* (a hybrid between the *Fair Return Method* and a *Rowe / Roden* apportionment method), there are any number of additional hybrid possibilities. In my Original Case described in this article, we argued that although the Special Master did not provide an offset in *Rueschenberg*, nothing prevented the finder of fact from doing so in our case – even if a rate of return was first provided to the sole and separate owner. As noted above, *Rueschenberg* held that Husband did not present the argument that the excess income realized by the community should be offset against the increase in value and was thus precluded from doing so on appeal. This of course suggests that such argument could be made, even if the sole and separate owner has already received a fair rate of return before the apportionment analysis is applied.

On the other hand, whether such offset should be provided after a rate of return is applied may also depend upon whether a fair rate of return includes only capital appreciation or both capital appreciation and income. If a fair rate of return is based upon what a hypothetical investor would require (i.e., commensurate with the cap rate), such would arguably include both anticipated capital appreciation and dividends and/or income. Thus, the receipt of both a high rate of return and an offset could arguably constitute double dipping, i.e., the sole and separate owner would receive a rate of return which includes expected income, as well as an offset based upon the income received by the community.

This is exacerbated by the possibility that a rate of return followed by a percentage apportionment analysis already constitutes a double dip if the combined apportionment to the owner is not directly attributable to the inherent qualities of the business as of the time of marriage or acquisition. Such would be even further convoluted by providing for an offset after applying two levels of apportionment already.

I. Litigation Regarding What Constitutes "Net Distributable Earnings"

Another issue that came up in my Original Case regarded what earnings are subject to an apportionment and offset analysis. The issue came up because of ambiguous, and at times conflicting, language in *Rueschenberg* and other decisions regarding the terms "net distributable earnings," "earnings," "compensation," "profits," and other references.

In my Original Case, it was uncontested that the community received substantially more compensation in the form of salary, bonuses, and shareholder distributions during the marriage than what constituted "normalized" compensation. While it was Husband's position that all earnings received by the community in excess of normalized compensation were subject to an apportionment and offset analysis, it was Wife's position that *Rueschenberg* defined the term "*net distributable earnings"* in a more restrictive manner, and thus only some of the earnings received by the community were subject to an apportionment and offset analysis. Specifically, Wife contended that pursuant to the definition of "net distributable earnings" described in *Rueschenberg*, Husband could only receive credit for the sole and separate portion of net income received by the community in the form of shareholder distributions and should therefore receive no credit for compensation received in the form of salary and bonuses. The language relied upon by Wife in the *Rueschenberg* opinion was the following:

> There was no request, however, by Husband to determine the amount of net distributable earnings *(generally, income less salary and other expenses)* generated by DMM during the marriage.

Rueschenberg, 219 Ariz. at 854 (emphasis added).

Husband's expert, on the other hand, testified that such distinction between salary, bonuses, and shareholders distributions would make no sense as applied to closely held corporations because the owners have utmost discretion in how much to pay themselves in salary, and how much is distributed pursuant to bonuses and other distributions. See Jay E. Fishman and Shannon Pratt, *PC's Guide to Business Valuations*, p. 4-25, Thomson Reuters (2003) ("Since most closely held businesses are managed by their owners, . . . owners may pay themselves excessive salaries instead of dividends to reduce their total tax liability.").

As noted previously, *Rueschenberg* is inconsistent regarding the language it uses to reference the earnings that would be subject to offset or credit against the community's share of the increase in value. In addition to the term "net distributable earnings," *Rueschenberg* refers to the term "profits" or "total profits." *Id.*, 193 P.3d at 855-57, 860-61. *Rueschenberg* also addresses the term "net earnings" as synonymous with the term "net distributable earnings" and with the term "profits." *Id.*, 193 P.3d at 857, 860, 861. *Rueschenberg* then only uses the term "earnings," i.e. [e]qually, and conversely, he would have to show that he received less than his pro rata share of the earnings as separate property.*"* *Id.*, 193 P.3d at 862. In *Rueschenberg* Footnote 9, the court refers to both the terms "net earnings" and "net distributable earnings." *Id.* at n.9. *Rueschenberg* in Footnote 11 only refers to "net earnings." *Id.* at n.11.

Such is placed in further context by *Rueschenberg*'s discussion of reasonable compensation. *Rueschenberg* held that the receipt of reasonable compensation by itself does not necessarily mean the community has been fully compensated, and that the community should be entitled to its percentage of both profits and increased value based upon the apportionment of community labor. *Id.*at 858-859. In discussing *Roden*, *Rueschenberg* then goes on to note that *Roden* attributed its offset based upon the amount of "compensation" received by the community (as opposed to net distributable earnings):

> This took place as the trial court applied, and this court affirmed, an "offset of the community's share in the increase in value of the separate property in light of the amount of compensation previously paid the community." *Roden*, 190 Ariz. at 411, 949 P.2d at 71.

Id. at 859. Thus, while using the term "net distributable earnings" in some parts of its decision, *Rueschenberg* refers to the total amount of compensation received by the community in the body of its opinion, as well as in its citation to *Roden*.

A query of cases in the United States that use the term "net distributable earnings" results in only four reported cases. Two of them are *Rueschenberg* and *Rowe*. The other two are a bankruptcy and a probate case that have nothing to do with the apportionment of increase value to the business and set forth no definitions of the term.

The *Rowe* decision refers on only one occasion to the term "net distributable earnings." *Rowe* at 721. However, *Rowe* does not directly provide a description of what the term means for purposes of its analysis. In fact, *Rowe* included pension and profit-plan contributions in its analysis of what the community received by way of net distributable earnings. *Id.* at 722. Rather than making a distinction between salary and other distributions, *Rowe* found that the overall compensation received by the community satisfied its interests in the increased value of the company. *Id.* Moreover, *Rowe* specifically states "that a community may be fairly compensated by salaries <u>and</u> draws received prior to dissolution." *Id.* (emphasis added). Thus, although *Rowe* uses the term "net distributable earnings," its analysis included both salaries <u>and</u> draws, as well as pension and profit-sharing contributions, i.e., all forms of compensation to the community.

In *Roden*, the Court also looked to the total compensation received by the community, and did not distinguish between salary and other types of distributions:

> Here, the trial court found that the increase in value of Desert Subway, Inc., which resulted from community efforts, was offset by the amount of <u>compensation</u> – community property – that each party received during marriage.

Roden, 190 Ariz. at 71 (emphasis added).

It is clear from *Rowe* and the language in *Rueschenberg* that if such offset is applied it must be based upon the actual amounts "received" by the community. Thus, applying gross income calculations set forth on tax returns etc. would arguably be improper as such would include pre-tax income that was not received by the community, and which would thus not be proper to offset against the community share of the increase in value.

A reconciliation of the cases appears to support the conclusion that courts should factor all net compensation actually received by the community if it applies an offset analysis. Such also supports the conclusion that the apportionment of income for purposes of such offset should be based upon the *Cockrill* test of what portion of the income received by the community was inherent to the separate property nature of the business. However, until further clarification is provided by the higher courts, it appears that the debate over what constitutes compensation subject to an apportionment and offset analysis will continue.

J. <u>Litigation Regarding Whether Excess Cash and Assets Are Included on The Value Side or As Undistributed Distributable Earnings</u>

In *Rueschenberg*, the Court found that "the marital community received virtually 100% of net distributable earnings during the marriage." *Rueschenberg,* 193 P.3rd at 861. In my Original Case, not all the earnings had been distributed.

In Section III, regarding business valuation issues, I discussed that operating assets and cash are part of the overall value of the business pursuant to an income approach, while excess cash and non-operating assets are not included in the base valuation, and thus need to either be added to value, or in an apportionment case, either added to value or treated as undistributed assets.

In a case where the court allows for an offset of the sole and separate portion of the income received by the community against the community's share of increase in value, it may not matter if excess cash and non-operating assets are added to the valuation side of the equation or are treated as undistributed assets. If the community has already been over compensated, the sole and separate owner may arguably be entitled to retain the undistributed earnings and assets.

If the Court follows the methodology adopted by the Special Master in *Rueschenberg* or other apportionment approach that does not provide for an offset analysis, this issue may still be significant. For example, if the fair rate of return to the sole and separate owner is high enough, such approach may eliminate any claim by the community – even after adding excess cash and non-operating assets to the value. However, if the excess cash and non-operating assets are not added to the value, but instead treated as undistributed assets or earnings, the community may still receive a portion of the undistributed assets so long as no offset analysis is applied.

K. <u>Litigation Regarding Changes in Products and/or Services / Subsidiary Companies</u>

Where a separate property business materially changes or adds completely different products and services during the marriage, and/or forms subsidiaries of the initial separate property company, such potentially raises additional valuation and/or apportionment issues.

First, it is reasonable to argue that the part of the business involving materially different products and services is *de facto* a distinct business formed during the marriage and should be valued separately as community property. If, on the other hand, such is included in the valuation of the separate property business, should different apportionment methods or percentages be applied to that portion of the business that was created primarily or exclusively during the marriage?

Although not part of the *Rueschenberg* published opinion, the *Rueschenberg* appeal briefs show that the parties started new businesses during the marriage which were distinct from but within the same general industry as DMM. During the proceedings the parties agreed that such businesses formed during the marriage were community property and thus such were more easily addressed. However, what if Husband in *Rueschenberg* provided such new products and services through DMM or did so through subsidiary companies to DMM? In such event, it is apparent that the same apportionment that was applied to DMM would no longer be equitable as such would arguably discount the community contribution regarding the new business services initiated during marriage. In such event one may reasonably contend that the apportionment analysis only be applied to the value of the business associated with the pre-marriage products and services, or at the very least, such should be accounted for through a different apportionment percentage than what would be applied otherwise.

VI. <u>Is the Community Entitled to a Proportionate Share of the Undistributed Earnings and Post-Service Profits Associated with its Lien / Equity Interests?</u>

As discussed in Section IV.C, *supra, Rueschenberg* clarified that the community is entitled to both its share of increased value and compensation associated with its contributions. A logical question that flows from such holding is how should undistributed profits and post-service profits in a separate property business / community lien case be addressed?

A claim that we made on behalf of Wife (non-owner) in my Recent Case was that the community was not only entitled to a proportionate share of the increase in value of the separate property business, but also a share of the post-service profits associated with its equity lien. Such issue has not been directly addressed in an Arizona published opinion (or memo decision to my knowledge) but is *arguably* a logical extension of Arizona community property case law.

Although *Schickner v. Schickner*, 237 Ariz. 194 (App. 2015) is not directly on point as it involves a community property business, the principles set forth lay the foundation for the community making a similar claim in a community lien case. In *Schickner*, the Arizona Court of Appeals addressed the community business operator's post-service income in the context of a community property business, including salary and profit distributions received by the spouse operating the business after service of process. The Court of Appeals explained that while the income resulting from the owner-operators' post-service labor constitutes separate property, the post-service profits that exceed reasonable compensation for such labor is community. *Id*. at 199-200 (citing *Rueschenberg,* 219 Ariz. at 249, 257). ("…profits of the business are either community or separate in accordance with whether they are the result of the individual toil and application of the spouse, or the inherent qualities of the business itself.") (quoting *Rundle v. Winters*, 38 Ariz. 239 (1931)). Thus, while the spouse operating the community business should receive post-service income associated with his or her post-service labor as separate property pursuant to A.R.S. §§ 25-211 and 25-213, the *Schickner* Court held that the excess income above such spouse's reasonable compensation received post-service constitutes community property. *Id.*

Although *Schickner* addresses a community property business, there is no case law that holds such analysis would not also apply to a community lien. It is logical that such *arguably* applies to a community lien if the community has not been compensated for its community lien interests during the pendency of the proceedings.

An initial reaction to this analysis is "why should the community receive any portion of post-service profits associated with a separate property business?" If a community claim was solely a reimbursement analysis, such reaction is valid. However, pursuant to Arizona case law, a community lien associated with a separate property business, if successfully established, is a community property equity interest. Such is a pro-rata community interest in the equity of the asset itself. Thus, while the law states that the nature of property is determined at the time of acquisition, the portion of the increase in equity attributable to community efforts or capital contributions was acquired during marriage.

Pursuant to *Cockrill*, "[t]he profits of separate property <u>are either community or separate</u>" depending upon the circumstances. *Cockrill*, 124 Ariz. at 52 (emphasis added). *Cockrill* goes on to explain that while the separate property remains separate, a portion of the profits and increase in value "may become community property as a result of the work effort of the community." *Id*. at 52. Similarly, *Rueschenberg* explains:

> In essence, <u>our community property laws transform the community into an equity partner</u> with the sole and separate property-owning spouse to the extent the community's efforts have generated net earnings, increased the value, or otherwise increased the net worth and/or market value of the company.

Rueschenberg, 219 Ariz. at 257 (emphasis added).

A simplified explanation is that the corpus of the property remains separate property, but a portion of the after-acquired equity is community property to the extent that a community lien is established. One can view the asset by way of a pie chart showing the corpus as separate property with the remaining portion of the pie divided between separate and community property based upon the apportionment principles described in *Cockrill*. In essence, the community is a shareholder to the extent of its equity interest and is thus *arguably* entitled to its proportionate share of the post-service profits.

Regarding a community lien claim to post-service profits there are additional factors to consider. If a portion of the post-service profits are attributable to the separate property's pre-marriage inherent characteristics (i.e., not a result of community contributions), it follows that the separate property claimant should receive a percentage of the post-service profits in addition to reasonable compensation before calculating the community interest. Thus, the separate property interest would receive the percentage of the post-service profits attributable to the inherent qualities of the business as of the date of marriage (or date of acquisition if later) as well as post-service profits attributed to the party's post-service labor.[13] The following simplified example is illustrative:

Separate Property Apportionment (*Cockrill et al.*):	30%
Community Apportionment:	70%
Owner total post-service compensation:	$500,000
Owner post-service normalized compensation:	-$200,000
Owner pre-marriage inherent qualities ($500K x .3)	-$150,000
Community portion of post-service income:	$150,000

Additionally, as pointed out to me by an expert recently, one should be careful when attempting to apply an apportionment lien to the time period prior to the valuation date where a valuation date subsequent to service of process is adopted. Such may lead to a potential double dip, i.e., including the increase in profits on both the valuation side as well as to profits received post-service.

<u>Burden of Proof / Additional Considerations</u>

An additional issue is the burden of proof regarding the community versus separate property portion of such post-service income. According to *Schickner*:

> Because property acquired during marriage is presumed to be community property, the spouse seeking to overcome the presumption has the burden of establishing the separate character of the property by clear and convincing evidence.

Id. at ¶22 (citing *Brebaugh v. Deane*, 211 Ariz. 95, 98, ¶6 (App. 2005)). *Schickner* goes on to state:

[13] *Cockrill* and *Schickner* focus on two distinct issues. A *Cockrill* apportionment analysis of a separate property business focuses upon the inherent qualities of the business as of the date of marriage to determine the separate property share of the increased value and income during the marriage. On the other hand, a *Schickner* analysis focuses on the separate property owner's post-service share of income pursuant to his or her post-service labor.

> As to the rest of Husband's compensation because it is derived from a community asset, Husband bears the burden of establishing the separate nature of <u>all the distributions he received</u>.

Id. at ¶27 (emphasis added). *Schickner* further explained:

> Nor does the record show that the trial court placed the burden on Husband of providing by clear and convincing evidence that the distributions he received from both businesses over the three-year period should be deemed his sole and separate property.

Id. at ¶29.

Because the trial court findings in *Schickner* failed to establish what portion of the post-service income was attributable to Husband's post-service labor, the Court remanded such issue for the trial court to determine the amount of compensation based upon Husband's post-service toil and labor with the remainder deemed community property. *Id*. at ¶30.

As addressed previously, Arizona cases have held that the community has the initial burden of proof to establish that the community has a lien (or equity claim) regarding a separate property asset. *Hefner v. Hefner*, No. 1 CA-CV 18-0404 FC (Ariz.App. Div. 1 (12-10-2019). Once it is established that a community lien exists (i.e., whether by capital contributions and/or community labor), it is the separate property claimant's burden to establish what portion of the equity and/or profits remain separate property. *Cockrill*, 124 Ariz. at 52. A fair assessment after reading *Schickner* and the other cited cases in harmony is that this separate property burden of proof also applies to post-service income where a community lien (i.e., community equity) has been established.

The counterarguments to such community claim includes the fact that no published Arizona cases to date have awarded a portion of the post-service profits from a separate property business to the community. At the same time, no published opinions have declined such request either because such issue has apparently never been specifically addressed on appeal. While A.R.S. §25-213 states that a separate property owner is entitled to the profits of their separate property, the portion of the profits that flow from prior community investment and efforts (i.e., that are not inherent to the separate property business or the product of post-service separate owner efforts) would not constitute separate property.

If courts do find that the community may in principle have a claim for a portion of post-service profits associated with its community property lien, the facts of the case may still not support such claim. The subsequent memo decision after *Schickner* was remanded is interesting to the extent that further analysis was applied regarding Husband's reasonable compensation. In *Schickner v. Schickner*, No. 1 CA-CV 16-0490 FC (Ariz.App. memo dec. 10-03-2017) the Court of Appeals affirmed the trial court's determination that Husband's reasonable post-service compensation (based upon his experience and the number of patients and procedures he performed during such period) exceeded the income he had received post-service. In making its determination, the court rejected Wife's contention that Husband's reasonable compensation should equal his salary and explained that a salary amount does not necessarily equate to reasonable compensation associated with a party's post-service efforts. Accordingly, the court determined that Husband's post-service income constituted his separate property as Husband (during round two) was able to establish that there were no excess post-service profits above his reasonable compensation to apportion to the community. *Id.* Thus, one needs to keep in mind that a reasonable compensation analysis pursuant to either valuation or apportionment issues should not be necessarily based solely upon a person's stated salary or published averages, but should consider additional factors such as hours worked and other factors support a more accurate assessment of normalized or reasonable compensation for the particular owner-operator.

It should also be noted that despite the language in *Cockrill* and *Rueschenberg,* which addressed the community's lien in businesses cases as an "equity interest", the Supreme Court of Arizona in *Saba v. Khoury* deviated from such concept in community lien real estate cases by describing the community lien as a "fair reimbursement of community funds, not an equitable division of property". *Saba v. Khoury*, No. CV-21-0023-PR at ¶19 (Ariz. 2022). The *Saba* Court described the method of measuring a community real estate lien as the community's capital contributions plus "a fair return on the amount paid". *Id*. *Saba* further explains:

> The Drahos/Barnett formula accounts for this return: it reimburses the community for the contributions made and apportions a share of the property's increase in value based on those contributions. *See Id*; *Barnett*, 219 Ariz. at 555 ¶21. The Drahos/Barnett formula therefore properly recognizes the nature of the separate property as separate while apportioning a fair and equitable reimbursement to the community. *See Bell-Kilbourn v. Bell-Kilbourn*, 216 Ariz. 521, 524 ¶12 (App. 2007) (remanding to trial court to calculate a reimbursement award that is "fair and equitable under the circumstances").

Id. at ¶15. Such real estate lien "reimbursement" analysis with a "fair return" is clearly different than a business lien "equity" claim. If the community claim is based upon an equity interest, it makes sense that the community should receive its share of post-service profits. However, if the community claim is merely a reimbursement amount plus a fair return on such amount, such arguably cuts against the principle behind the community's claim to a share of a separate property business' post-service profits.

A possible distinction between the "reimbursement" and "equity" treatment of community real estate liens versus community business liens is that real estate liens are primarily based upon community capital contributions to a relatively static asset, thus supporting a reimbursement analysis. In a real estate case, the increase in value is generally based upon passive factors (i.e., market increases) with the exception of capital improvements which are valued separately. In contrast, community business liens generally result from community efforts that led to the increased value of the asset (i.e., thus creating a larger asset).

As such applies to a post-service profits claim, perhaps I am overthinking the distinction between the community having an "equity interest" associated with its contributions, as opposed to the community having a claim for "reimbursement plus a fair rate of return". However, until the higher courts address the post-service profits issue as it applies to community liens, it is likely that such issues will continue to be litigated for the foreseeable future.

Husband in my Recent Case also argued that awarding Wife a share of the post-service profits would in part amount to a "double dip" on the basis that the income-based valuation was based in part upon the same assumed future earnings that Wife sought to apportion in part as undistributed profits. It was Wife's position that the income for valuation purposes was used as a proxy to measure the value as opposed to being actually divided pursuant to the valuation, and additionally such double dip analysis was not adopted by the Court of Appeals in its definition of the community's share in *Schickner*. Husband's argument regarding a "double dip" is similar to the argument sometimes seen in spousal maintenance cases where a spouse seeks both spousal maintenance and his or her share of the income-based value of the business. The many potential arguments involved with the double dip issue have not been directly addressed in any published Arizona case opinions and are beyond the scope of this article. One can view such issues in more detail in various articles and out-of-state case opinions. *See generally*, *"Double Dipping": A Good Theory Gone Bad*, Laura W. Morgan, Journal of American Academy of Matrimonial Lawyers, Vol. 25 (2012); *An Interview with Business Valuation Expert Shannon Pratt*, Family Lawyer Magazine (May 23, 2014); *In Divorce, Is the Double-Dip Concept a Misconception,* Robert W. Lewis, Family Lawyer Magazine (December 18, 2019); *The Persistent Problem of Double Dipping*, Shannon Pratt, The Family Lawyer Magazine (updated December 10, 2019).

An additional argument raised by Husband in my Recent Case was that the community's claim to a portion of the post-service profits should not be indefinite. Again, this is an issue that has not been directly addressed in an Arizona published opinion. Our counterargument was that until the community's equity interests had been satisfied the community should continue to receive its share of the post-service profits proportionate to its equity interest. In *Schickner,* the Court addressed the apportionment of profits "pending the final decree." *Schickner,* 237 Ariz. at ¶28. This makes sense to the extent that the community property ownership interests are analyzed as an equity interest upon which the return upon such equity interest has not yet been satisfied. On the other hand, *Schickner* also states that "the amount must be reasonable given the totality of the circumstances." *Id.* Thus, in a case where the divorce proceedings are lengthy (for example, if there is unanticipated post-decree litigation that extends the time for entry of the decree), the trier-of-fact may want to consider the cause of any delays, and if such were caused by the out-spouse the Court may consider an earlier date to terminate the division of post-service profits. Whether such claim to a portion of the profits should end at the time of trial, the entry of the decree, or continue until the community's interest has been satisfied, is yet another issue that may depend upon the equities of the specific case and thus will likely be litigated until the higher courts address such issue in more detail.

Because the division of post-service profits is based upon equitable principals, the separate property owner may also consider arguing that the out-spouse should only receive legal interest as a return on his or her share of the increased value of the business as opposed to a share of the post-service profits. Such was not addressed as an option in *Schickner*, however, *Schickner* involved a community property business, whereas a court may view the equities involving a separate property business differently. To reduce their exposure to paying a portion of post-service profits or interest, the owner-operator may consider paying the other spouse his or her undisputed share of the increased value of the business without prejudice earlier in the case assuming the owner-operator has sufficient funds to do so.

Undistributed Earnings

In prior versions of this article, this section was called “Retained Earnings”. However, an expert recently clarified to me that this is a different concept than “Undistributed Earnings”. The expert explained that retained earnings is not a pot of cash sitting in an account, but is an accounting construct which includes initial equity, subsequent investments and other factors as opposed to funds that could be distributed from business accounts. Thus, I have substituted the term “Retained Earnings” as “Undistributed Earnings” in order to avoid confusion. I have also addressed this issue pursuant to valuation issues in Section V.J of this Article.

The issue of undistributed earnings (i.e., funds remaining in the company accounts) was an issue in my Recent Case where Wife claimed that the community was entitled to its proportionate share of undistributed earnings acquired during marriage (i.e., funds on hand that had not been distributed as profits). This is similar to the concept of “net distributable earnings,” which includes earnings that are “distributable,” but have not yet been distributed. Husband argued that such undistributed earnings should not be apportioned as such were necessary for the future operations of the business, i.e., future marketing, future purchase of inventory, research and development, etc. Wife responded that the apportionment analysis should apply to earnings available for distribution regardless of the company’s future plans which would solely benefit Husband.

Such undistributed earnings accumulated prior to marriage (or as of acquisition as separate property) of course remain separate. One must be careful not to “double dip” the undistributed earnings acquired during marriage and post-service profits. For example, the owner may have $25,000 of undistributed earnings at the date of termination of the community, and subsequently receive all or a portion of these same earnings as post-service profits.

Conclusion:

As practitioners our analysis does not stop at establishing a community lien / equity interest regarding a separate property business. We should also assess whether the community has a claim to a portion of the profits, retained earnings, or other income held in the company or received after service of process that flow from the community’s lien.

As noted above, in a business apportionment case the first key determination in assessing whether the community will realize any share of the business’ post-service profits is determining the amount of reasonable compensation associated with the owner-operators post-service efforts. This can of course lead to competing experts and substantial litigation. The community share, if any, is further diminished by the fact that the community would only be entitled to a percentage associated with its community lien, as opposed to a 50% interest in the amount over reasonable compensation where the business at issue is community property. As can be seen from the *Schickner* memo decision described previously, there is no guarantee that the out-spouse will receive a share of the post-service profits. Thus, a litigant will want to feel fairly confident that there are excess profits above and beyond the owner-operator's inherent share plus reasonable compensation to justify the cost of litigation.

VII. <u>Procedural Tips</u>

Before concluding the article, I felt that it would be helpful to highlight some of the Arizona Rules of Family Law Procedure that one may want to pay particular attention to in a business community lien apportionment case.

Rule 2. Although Rule 2 (invoking the strict rules of evidence) is limited in application, you may find that the trial court is more careful with its evidentiary rulings when such notice is filed.

Rule 49(a)(1). Many practitioners overlook the Rule 49(a)(1) *purpose* section. Many of the disclosure statements I receive include little more than exhibits produced, the identity of potential witnesses, and a very general but brief description of their anticipated testimony. In accordance with the stated purpose of Rule 49, one should make sure to timely disclose all the legal theories, claims and defenses and important facts in the disclosure statements (and not wait until the Pretrial Statement to articulate).

Rule 49(i). You may have your client or other fact witnesses testify regarding certain matters that are relevant in the apportionment case (for example "external factors" as addressed in *Rowe, Roden* and *Rueschenberg*). Make sure to provide disclosure "fairly describing the substance of the expected testimony" at least sixty days prior to trial.

Rule 49(j). Although expert reports generally address at least some of the Rule 49 requirements, make sure that the reports include a summary of the "grounds" for their opinions. I often see reports that submit conclusions or opinions, some of which are speculative and do not include the actual grounds (basis) for their opinion. An example is an expert report that identifies various "external factors" without providing any quantification of the same and how such apply to the inherent qualities of the separate property business. Expert disclosure is required no more than sixty days prior to trial.

Rule 50. It is a good idea in complex property cases (especially business apportionment cases) to file a Rule 50 notice. Such must be filed within sixty days after the initial response (or later for good cause). Because of the possibility of multiple experts as well as the many issues that can arise in an apportionment case, I recommend that such notice be filed in any such complex case. This notice will require the Court to conduct a scheduling conference during which more reasonable and specific deadlines can be addressed regarding expert identification, expert reports, rebuttal reports, disclosure, discovery, etc. The rule also requires that the case be provided no less than twelve hours for trial.

Rule 76.1. Even if you miss the Rule 50 deadline, you can still file a Rule 76.1 request for a scheduling conference. Again, scheduling conferences are highly recommended in complex property cases, especially community lien cases. If requested, the Court must schedule such conference. Scheduling Statements require substantial details; thus, you can manage the identification of all issues in a complex case earlier on.

Example deadlines to be addressed:

- Deadline to identify experts and subject matter of retention
- Deadline for expert reports
- Settlement Conference / Mediation deadline
- Deadline for follow up written discovery requests
- Deadline for expert rebuttal reports
- Deadline to submit subpoenas to experts
- Deadline for expert depositions
- Deadline for party depositions
- Deadline for motions for summary judgment or other dispositive motions
- Deadline to exchange final lists of witnesses and exhibits
- Deadline to exchange final exhibits prior to trial
- Deadline to file the Joint Pretrial Statement (or separate statements)
- Trial date and time allotted
- Deadline to file proposed findings of fact and conclusions of law (I suggest that the parties stipulate to submit the same after trial).
- Deadline for attorney fee motions, responses, and replies
- Oral argument on attorney fees (I generally recommend bifurcating the trial or agreeing to post-trial oral argument regarding attorney fee requests)

Rule 51 et al. It goes without saying that requests for production, uniform interrogatories, non-uniform interrogatories and subpoenas are almost always utilized in complex property cases. In my Recent Case described in this article there was a fair amount of confusion regarding what the experts needed, whether such had already been provided, what format such files were requested, etc. Opposing counsel and I eventually agreed that my client's expert could meet with the business bookkeeper directly to view the company documents on-site and make requests for the specific information and computer files he felt he needed. This avoided additional back and forth between the attorneys.

Depositions are of course extremely important in complex business apportionment cases. The deposition of the owner-operator should address many of the key apportionment issues addressed in this article. Attorneys should have an intricate knowledge of the various principles involved to phrase their deposition questions in the most advantageous way possible.

Rule 51 work product experts. If your client is retaining their own expert, consider whether you want to first engage such person as a work product expert. You can later designate the person as a trial expert if desired (so long as you comply with Rule 49 and/or the Court scheduling orders).

Even if the parties stipulate to a joint expert, it is a good idea in complex business apportionment cases to have your own expert. This will allow you the flexibility to submit additional opinions if the other party objects to expanding the joint expert's retention (such as a value applied to a different valuation date), to critique the joint expert's opinion on one or more issues, to help you identify what additional discovery is needed, and an expert that you can discuss case matters with outside of opposing counsel's presence.

Rule 59. Remember to file your notice of intended deposition transcript testimony before trial or other evidentiary hearing. This includes page and line references. This can be done by separate notice or in the Pretrial Statement.

Rule 64. Requests for Admissions are often underutilized in family law cases. This may be a great avenue for certain discovery in complex property issues. Think through your clients and the other party's burdens of proof, applicable legal principles, and draft your request for admissions accordingly. For example, you may want to request an admission that the business is separate property (subject to a potential community property lien), or conversely that the business is community property. This is not always a straight-forward issue, for example where a business changed products and services during marriage, was incorporated prior to marriage but not yet operational, etc.

Rule 72. As set forth previously in this article, it may be a good idea to stipulate to the appointment of a Rule 72 Family Law Master regarding the valuation and apportionment issues. You can stipulate that the Family Law Master address all the issues in the case, or a portion of the issues thus leaving certain issues such as legal decision making etc. to the assigned judge.

Rule 76. The Resolution Management Conference Statement and hearing can be a very important stage to identify the many complex issues that can arise in a business apportionment case. This is an early opportunity to think through the many issues that may come up and attempt to formulate an early strategy. In complex cases you may desire to request a Rule 76.1 scheduling conference in your Resolution Management Conference Statement as it may be premature to schedule a trial date until the various pre-trial deadlines are thoroughly contemplated.

Rule 76.1 Pretrial Statement. It goes without saying that it is extremely important to address all your client's positions and requests in the Pretrial Statement to avoid waiving such issues at trial. In the same regard, make sure to raise all anticipated objections to the other party's claims, exhibits, witnesses etc. to avoid waiving such objections.

Rule 79. Another procedure often overlooked in complex property cases regards motions for summary judgment (or partial summary judgment). This may include issues whether a business is separate or community property as discussed above, the amount of capital contributions, undisputed values of certain assets, etc. Keep in mind that if the other party files such a motion, Rule 79 provides that you can request to extend the response deadline to take depositions, obtain your own expert report, conduct additional discovery etc.

Rule 83. I recommend in any case that is proceeding to trial that you file a request for findings of fact and conclusions of law. This is especially important in complex separate property apportionment cases. As noted previously, I recommend that the parties stipulate that the proposed findings of fact and conclusions of law be filed after the trial so that each party can cite to the actual testimony and exhibits presented (as opposed to what is anticipated prior to trial).

VIII. Conclusion

In some ways, *Rueschenberg* and the other cited cases provide clarification regarding the various methodologies and principles involved in apportionment cases. On other fronts, the case opinions invite additional questions and issues.

The main theme of this article is that, as attorneys, judges, and experts, we need to avoid oversimplified analyses and blind application of formulas in business apportionment cases absent establishing how such formulas or approaches meet the fundamental principles set forth in *Cockrill*. While a formula approach logically applies in separate property real estate apportionment cases (where separate and community capital contributions are easily calculated), business apportionment cases are more subjective and thus more difficult in practice and application.

For those looking for a "bottom line" answer how to solve an apportionment case, the bottom line remains: the trial court "is not bound by any one method [of apportionment] but may select whichever will achieve substantial justice between the parties." *Rueschenberg,* 219 Ariz. at 858 (citing *Cockrill*, 124 Ariz. at 54).

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