Business Entities in Equitable Distribution

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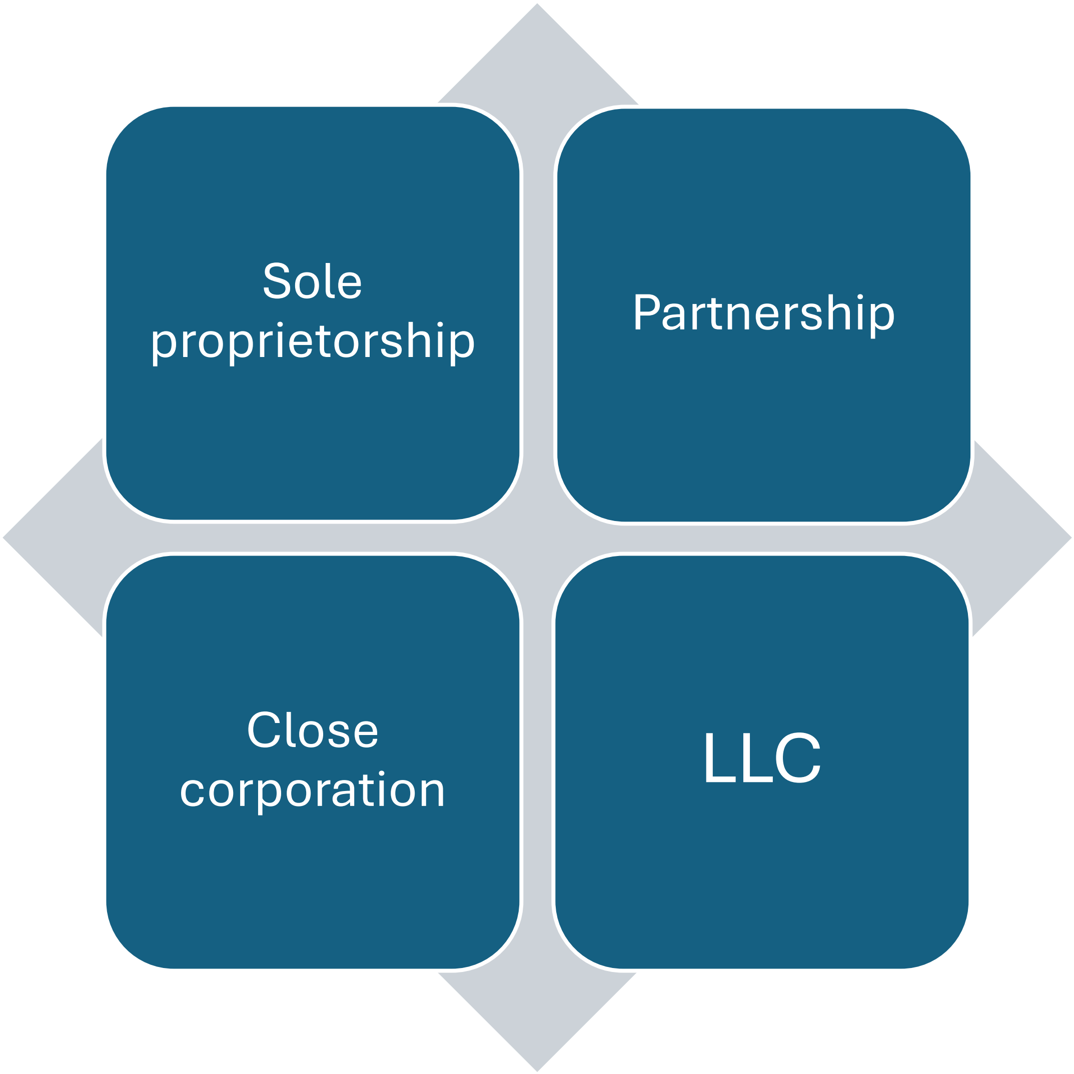
Resources

- Family Law Bench Book
  - ED Chapter, Pages 6-146 through 148
  - ED Chapter, Pages 6-182 through 193

- Valuation Methodologies in NC Distribution Actions
  - By Retired Judge Clarence E, Horton, Jr.
  - https://www.sog.unc.edu/sites/www.sog.unc.edu/files/course_materials/Tab%203%20Valuation%20Methodologies.pdf

Types of Businesses



- Corporations (including LLCs), professional associations, and partnerships are legal entities.

- Like people, legal entities cannot be ordered to do anything by the court and property of the entity cannot be affected unless the entity is a party to the action.
  - *Campbell v. Campbell*, 241 NC App 227 (2015)
  - *Geoghagan v. Geoghagan*, 254 NC App 247 (2017)

Who owns the property/assets?

- Sole proprietorship
  - Individual owns the property used in the business
  - *See Clark v. Dyer*, 236 NC App 9 (2014)(okay for court to disregard the business entity where owner of business had not maintained a business structure)

- Partnerships, corporations, and LLCs
  - The entity owns its property

Classification

- When one or both parties own a business, or own an interest in a business, on the date of separation, **the business or the ownership interest** in the business is marital property to the extent it was acquired during the marriage if it is not otherwise separate property.

- **Property owned by a business entity** cannot be marital property and cannot be distributed.

- When the business or the party's ownership interest in the business is classified as marital and distributed, the business entity is not a necessary party to the ED action.
  - *Poore v. Poore*, 75 NC App 414 (1985)(professional association)
  - *Smith v. Smith*, 111 NC App 460 (1993)(The Charlotte Motor Speedway)
  - *Montague v Montague*, 238 NC App 61 (2014)(LLC)

But property owned by a business may become marital property though court action

How???

Imposition of an equitable trust

- Constructive trust
- Resulting trust
- See discussion in bench book, pages 6-135 through138

Set aside a fraudulent transfer of property

- GS 39-23.4

Necessary Parties

- When a third party holds legal title to property claimed to be marital property, the third party is a necessary party to the ED action with their participation limited to the issue of ownership of that property.
  - *Upchurch v. Upchurch*, 122 NC App 172 (1996)
  - *Nicks v. Nicks*, 241NC App 487 (2015)
  - *Wenninger v. Wenninger*, NC App (May 7, 2024)

Procedure

Plaintiff can name the entity as a defendant in a complaint

Defendant can act as third-party plaintiff to file complaint against the entity pursuant to Rule 14.

Court must add a necessary party *sua sponte* to protect the jurisdiction of the court

A corporation must be represented by counsel

GS 84-5

Procedure: protecting marital assets

Rule 65 TRO and preliminary injunction.

GS 50-21(a); (e)

- But cannot affect business entity unless the entity is a party to the action
  - *Campbell v. Campbell*, 241 NC App 227 (2015)
  - *Cf. Liberatore v. Liberatore*, unpublished opinion, 230 NC App 410 (2013)(okay to appoint an “agent” to control finances of Professional Association)

Distribution factor

- Consideration of dissipation of marital assets
- Assign dissipated assets to ‘guilty’ spouse

What’s it worth?

From the
Valuation is FUN series
For Judges

VALUATION BASICS

everybody has to start somewhere

* For Marital Property:

  Date of Valuation = Date of Separation

* For Divisible Property:

  Date of Valuation = Date of Distribution

** See *Logue v. Logue*, 285 NC App 461 (2022)

Valuation is a FINDING OF FACT

Determine the **FAIR MARKET VALUE** of the item of property.

- The amount at which the property would change hands between a willing buyer and a willing seller, where neither is under a compulsion to act and both have reasonable knowledge of relevant facts.

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IT IS NOT:

Purchase price, replacement value, book value or comparable sale

(But these can be factors you consider in determining VALUE)

Methods of Valuation

No particular method is mandated:

MUST BE A SOUND METHOD, SUPPORTED BY EVIDENCE

And the court must state clearly the basis for determination

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PROFESSIONAL ASSOCIATION: Must consider **GOODWILL** as part of valuation

Poore v Poore 75 NC App 414 *disc. rev. denied* 314 NC 543 (1985) and *Dorton v Dorton* 77 NC App 667 (1985)

***Sneed v. Johnson*, NC App (May 7, 2024)((PLLC, law practice)

Methods of Valuation

BUSINESS INTERESTS:

PROFESSIONAL PRACTICE INTERESTS

PARTNERSHIPS

CLOSELY HELD CORPORATIONS

Methods of Valuation

BUSINESS INTERESTS:

PROFESSIONAL PRACTICE INTERESTS

1. Fixed assets
2. Receivables and work in progress
3. Goodwill
4. Liabilities

Can have comparable sales data sufficient to establish value.

Can also use Income/Earnings method to determine value based on future earnings.

Methods of Valuation

BUSINESS INTERESTS:

PARTNERSHIPS

Partnership agreements may set out a method to value a partner’s interest

= Not conclusive, but is EVIDENCE of a presumptive value

If the trial court adopts an approach that *reasonably approximates* the net value of the partnership interest, the decision will be affirmed on appeal.

Goodwill hunting

In Professional Associations and Partnerships:

GOODWILL

“...the court should clearly state whether it finds the practice to have any goodwill, and if so, it’s value, and how it arrived at that value.” *McLean v McLean* 88 NC App 285 (1987); *Sneed v. Johnson*, NC App (May 7, 2024)((PLLC, law firm)

Closely-held Corporations

The market price of stocks of corporations engaged in the same or similar line of business. (either exchange or OTC transactions)

Business Valuations

Methods of valuation of business interests (going concern)

1. Capitalization of Earnings

2. Comparison Approach

3. Asset Value or Book Value **

   (method generally ignores goodwill, so that has to be addressed in valuation)

Business Valuations

Asset Value or Book Value **

(method generally ignores goodwill, so that has to be addressed in valuation)

Value of the business is the value of the underlying assets of the business.

Example: Book value is better than nothing

Link: https://drive.google.com/open?id=1UrfkjLD_49EpgJ7pfQMITANRwyj90MuW

KMW Builders, Inc.	$129,342.50	$1,333,700.00

Profits Interests

A profits interest is a partnership interest other than a capital interest. See Rev. Proc. 93- 27. Essentially, it is an interest in the future profits and appreciation of the partnership, but not an interest in any liquidating proceeds that would be distributed at the time the interest is granted. https://drive.google.com/open?id=1U0xlPh0qbvhINuIodzWevNim-F1G1ZKd

Business Valuations

Comparison Approach

Comparing value of similar businesses, either through sale records or traded stock values, adjusting for differences.

- Dental practices
- Real Estate Investment Management

Business Valuations

Capitalization of Earnings

Capitalization of earnings is a method of determining the value of an organization by calculating the net present value (NPV) of expected future profits or cash flows. The capitalization of earnings estimate is done by taking the entity's future earnings and dividing them by the capitalization rate(cap rate). This will take into account the risk that earnings will stop or be lower than the estimate.

$$\text{Value} = \frac{\text{Earnings In Future Years}}{d - g}$$

d=discount rate

From Investopedia

Wait, forget that - think of it this way……..

Value (today) = how much money it can earn for you (future)

-considering risk and growth-

Break it down:

Super Machine = Earns $100 / yr

How would you decide what it’s worth?

You would consider:

- Has it always made that amount of money?

- How long will it make money?

- Will the amount it makes grow or decline?
  - As a result of the industry or economy in general
  - As a result of the company

- Can I sell it later?

- How much of the box do I own?

You would consider (in other words):

- Future revenue projections
- Length of projected revenue (obsolescence)
- Risks to revenue
  - Industry / Economy
  - Company
- Marketability
- Minority Interest

So in my little example…….

Income projected at $100 / yr and a growth rate of 2%

= Future value of earnings after 5 years of $520.40 (FV=amt * $(1+.02)^5$)

= Present Value of those future earnings of $471.34 (PV=FV/$(1+.02)^5$)

= Discounts for risk ? / marketability ? / minority ownership ?

= 10% chance it will collapse / 20% reduction hard to sell / own 100%

= $329.94 fair value for a 100% interest in the Super Machine

Using a business valuation report:

Generally contains:

- Introduction (including limitations)
- Industry analysis
- Company / Financial analysis
- Selection of methodology
- Valuation analysis
- Discounts
- Conclusion

You can establish your own value… BUT

You CANNOT split the difference

You must use a SOUND METHOD and support it with FINDINGS OF FACT

A word about taxes - other than *#!!&*

There can be a difference in the valuations depending on how the expert has treated the tax consequences of both the valuing the income stream and the ownership interest.

BEST TIP

If you have two good valuation experts, ask if they have had a chance to talk before trial - they may be able to get to a number or range that both are comfortable with, thereby settling that issue and saving you from hours and hours of their fascinating testimony.