# New Jersey Family Lawyer

Volume 24 • Number 2
October 2003

CHAIR'S COLUMN

## Some Thoughts on the Future

*by John DeBartolo*

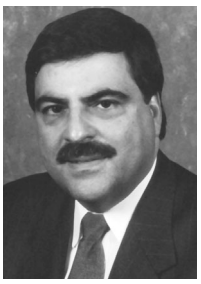
A new term has begun, and I am honored to serve as chair of the Family Law Section of the New Jersey State Bar Association for the coming year. For my first column I decided to share my thoughts about the role of this section, and what I hope we will accomplish this year. The section will continue its mission of representing and advancing the interests of the attorneys of this state who practice in our family part. We will continue to analyze and take positions on pending legislation, discuss and take positions on internal matters of policy in the NJSBA, and provide the practitioners' perspective to the Supreme Court Family Practice Committee.

We will continue to foster and strengthen the dialogue and exchange of ideas with the bench that has long been the hallmark of this practice. We need look no further than the success of the annual Bench Bar Conference commenced three years ago, and the outstanding attendance and participation at the first Annual Meeting Bench Bar Conference in May.

This section will continue its working relationship with the financial and mental health professionals who assist daily in litigating and settling our clients' disputes and educating us by their participation and support in continuing legal education programs. In so doing, we will continue to protect the interests of the children, who, too often, go unrepresented. Let us endeavor to guide litigants to fair, expeditious and economical resolution of their disputes with a minimum of rancor, so they may preserve their resources to provide for their children.

We will continue our proud and selfless tradition of educating, formally and informally, each other and of mentoring our younger and less experienced members.

Please note that I use the term *continue* because all of these goals have been advanced over the past 39 years by the able and tireless efforts of the men and women who have been officers, executive board members and members of this section and the NJSBA. My



immediate predecessor, Mike Stanton, has set a high bar for me, and for the chairs to follow. We owe him a debt of gratitude for his direct and diplomatic advocacy of our interests to the Supreme Court Practice Committee, the Conference of Presiding Judges, and the New Jersey State Bar Association Officers and Trustees. He chaired informative, lively, and thought-provoking meetings of the executive committee, at which we explored many legislative, policy, procedural, and substantive issues that have life-altering effects upon the families of this state and our daily practices. I trust that with his continuing support as immediate past chair, I, Chair-Elect Madeline Marzano Lesnivich, First Vice Chair Bonnie Frost, Second Vice Chair Patricia Roe, and our newest officer, Secretary Ivette Alvarez, will provide service that at least approaches the success of Mike's term.

The year 2003–2004 is a historic year for the NJSBA; on May 15, 2003, Karol Corbin Walker became the first African American president of the association. She will undoubtedly lead the NJSBA with the style and grace for which she has become known. Although you may not find Karol litigating in the family part, please know that she is a friend of our section. She even attended our Bench Bar Conference in Atlantic City the morning following her installation. Indeed, the conference at the Annual Meeting in Atlantic City was engineered by Karol's leadership, and we all hope it will become an annual tradition.

President Walker announced the theme of her presidency as "NJSBA — Inclusive of You, Your Practice and Your Community." That concept, to be inclusive, will be central to the work of the Family Law Section this year as well. Just as President Walker seeks to include more attorneys as members of the NJSBA, so will we include attorneys whose practices serve the diverse and chang-

*New Jersey Family Lawyer*

# Table of Contents

**Chair's Column: Some Thoughts on the Future .....1**
*by John DeBartolo*

**From the Editor in Chief: They Do Care About Life in the Trenches.....4**
*by Mark H. Sobel*

**From the Editor Emeritus: MESP Revisited .....6**
*by Lee M. Hymerling*

**The Internet: Uses and Limitations for the Family Law Practitioner .....8**
*by Marilyn J. Canda*

**Cursed Infirmities and Their Impact on Value .....12**
*by Kalman A. Barson*

**From Life on Food Stamps to Life on Easy Street: Does Roccamonte Provide a Workable Palimony Model? .....14**
*by Donald E. Taylor*

**Adjusting Executive Compensation When Valuing a Closely Held Firm.....19**
*by Les Barenbaum and Lisa Cruikshank*

**S Corporations: Taxable Income, Cash Flow and Distributions .....26**
*by Leonard M. Friedman*

ing families of this state. Some may have viewed this section, and its executive committee, as elitist, concerned only with high-income, big-asset divorces. That view, while never accurate, will no longer have *any* basis. The officers have invited new members to the executive committee, attorneys who represent low- and modest-income individuals, individuals for whom English is a second language, individuals who are first- and second-generation immigrants with cultural traditions about marriage, and attorneys who appear regularly in the non-dissolution courtrooms of the family part. It is my hope that inclusion of the many varied aspects of family law will increase membership, enhance the stature of this section, and advance the practice for the common good of the attorneys, the bench and the public.

All of us who practice law have an obligation to each other and our communities to educate. Each time we deal with a new or inexperienced attorney, we are to be professional and collegiate. We must be prepared to educate and to be educated each time we meet a new client; each time we sit at a four-way conference; each time we appear in court, before an arbitrator or in a mediation session.

The journal you are reading is the showcase for legal writing on family law and a primary educational tool. Each issue contains law review-quality articles on current issues that confront us in our daily practice. I urge all of you, not just the few on the executive committee, to submit articles for publication. A recent brief on domestic violence written for the Appellate Division is an excellent basis for an article that will educate the thousands of attorneys and hundreds of judges who read this publication. I hope, before my term is over, to read articles about termination of parental rights, Division of Youth and Family Service cases, domestic violence, custody, wage earner arguments about marital lifestyle, and trial tips, alongside the esoteric discussions of *Brown v. Brown* and fair value.

We are a diverse section that has always been, and always will be, inclusive. Participate, educate, and make your voices heard. Family law is the most inclusive of all practices. Every citizen of this state, whether married or divorced, living alone or with a domestic partner, young or old, has the potential to be a litigant in the family part.

The recent holding in the Appellate Division of *Weishaus v. Weishaus*[1] should be known to all readers of this publication. This case echoes and expands the responsibilities imposed upon the bar and bench by the Supreme Court in *Crews v. Crews.*[2] Every alimony case must now have a stipulation or a finding by the trial court about marital lifestyle, income of the parties, and the ability of the supported spouse to maintain the marital lifestyle after divorce.

On one level the *Weishaus* holding illustrates the duty to educate discussed above. All attorneys and judges should know about this decision and its practical implementation. On another level the implementation of the procedural requirements outlined by the Appellate Division will undoubtedly extend the time necessary to place an uncontested divorce on the record. Additionally, there are cases that will not settle because of the procedural requirements to stipulate income and marital lifestyle.

One need look no further that the facts in *Weishaus* that brought it to the Appellate Division. The parties in that case settled the substantive aspects of their divorce case, but because of an inability, or unwillingness, to stipulate marital lifestyle and the income sources that supported it they sought to defer determination of marital lifestyle until either party made an application for modification of support. The trial court rejected the settlement, and the Appellate Division affirmed and remanded the

case for determination of marital lifestyle consistent with the principles articulated in the opinion.

The responsibility of the organized bar at this point is to monitor the day-to-day effects of *Weishaus* upon the practice. Are settled cases becoming unsettled? How much time do judges devote to conducting hearings in otherwise settled cases to find marital lifestyle? And how much bench time are judges devoting to taking the stipulations as to marital lifestyle. This information from the active bar will be important to collect and present to the Supreme Court Family Practice Committee for consideration in promulgating future rules and procedures.

It is going to be a good year. Please be active, attend the programs sponsored by the NJSBA, attend our social events, continue your own legal education and participate in the legal education of the rest of the bar. There are some dates I ask that you diary now:

December 8, 2003 — Family Law Section Holiday Reception

March 24–28, 2004 — Family Law Section Retreat in Las Vegas, NV

May 4, 2004 — Family Law Section Annual Dinner and Tischler Award

May 19–21, 2004 — NJSBA Annual Meeting.

If there are issues you would like to have presented to the full executive committee drop me a note or email. I look forward to meeting as many members of the section as I can during the year. Indeed, if your county bar family law committee would like me or one of the other officers to attend a meeting, just let us know. I also look forward to my remaining columns in upcoming issues, and I invite anyone with a topic to contact me. ■

**ENDNOTES**

1. 360 N.J. Super. 281(App. Div. 2003).
2. 164 N.J. 11 (2000).

FROM THE EDITOR-IN-CHIEF

# They Do Care About Life in the Trenches

*by Mark H. Sobel*

**The demands on matrimonial lawyers are intellectually far ranging, enormously difficult on an emotional level, and carry a unique responsibility to represent people who often have had limited exposure to our legal process.**

Diary of the typical matrimonial attorney:

6 a.m. — make mental list of all reply certifications, as well as surreplies (who cares about the Court Rules), that were to be filed last week; unable to sleep so begin *happy, happy day*.

8:30 a.m. to 10 a.m. — appear at case management conference (yes, many family court trial judges begin work well in advance of 9 a.m. and force us to); attempt to schedule all discovery that has not taken place within the parameters of the fixed trial date that will not be adjourned as it is between nine and 12 months from the date of the filing of the complaint (see, *Best Practices*).

10 a.m. to 12:30 p.m. — appear at two different orders to show cause in two different counties to deal with everything from camp visitation expenses to the incremental increase in value of a minority interest in a closely held corporation that is being liquidated by the adversarial spouse's parents.

12:30 p.m. to 1:30 p.m. — (no lunch, as in *Wall Street* "lunch is for wimps") return some of the unanswered phone calls from the previous day, week and month, covering issues ranging from where to put the costs of dog grooming in the case information statement to the tax ramifications of a Section 1031 like-kind exchange of several real estate investment trusts.

1:30 p.m. to 3:30 p.m. — attend four-way conference to negotiate settlement with issues ranging from custody, removal of the children from the jurisdiction, alimony, support, equitable distribution, legal and expert fees, tax ramifications of all of the above and the inability of the wife to change the surname of the children.

3:30 to 5:30 p.m. — prepare appellate brief for the third appeal regarding enforcement of litigant's rights.

5:30 until 11 p.m. — prepare for direct and cross-examination of psychiatrist for custody dispute being tried tomorrow. Issues include, but are not limited to, a review of 300 pages of the diagnostic and statistical manual of mental disorders.

11 p.m. — make note to appear at 8:30 tomorrow morning to put the settlement through. (Remember you actually settled a case.)

Next Day — Arrive at court and learn that the settlement may take several hours to put through, despite the existence of a property settlement agreement, due to a dispute over what the marital lifestyle was and the need for both parties and their accountants to testify regarding marital lifestyle. Seek adjournment of custody case to provide time to put through uncontested matter; request denied. Plead with associate to put through uncontested matter and learn from associate (who actually reads all of the current case law) that in New Jersey there no longer is such a thing as an uncontested matrimonial matter (resolve to read some current case law during next vacation, if you ever take one).

In the spirit of full and fair disclosure, if matrimonial lawyers ever imparted the above to potential new associates, there probably would be fewer of us, at least under the age of 40. The demands on matrimonial lawyers are intellectually far ranging, enormously difficult on an emotional level, and carry a unique responsibility to represent people who often have had limited exposure to our legal process. In dealing with all of these often competing components, matrimonial lawyers can operate under a malaise that those specially selected individuals in the black robes sitting in review of the trial court are somewhat removed from the inordinately difficult day-to-day life of both the lawyers and judges in the trenches at the first level of the divorce litigation process.

However, just when there appears to be no hope, a helping hand indicating that we are not alone has appeared. Recently that helping hand

evidenced itself in the nature of the Supreme Court's granting of certification in the matter of *Weishaus v. Weishaus*.[1] For those who are less familiar with this case, it does not deal with a particularly acrimonious litigation (in fact, the parties entered into a property settlement agreement), nor does it deal with a series of extremely intricate legal issues (the core issue was the marital lifestyle of the parties). In fact, it is unlikely that a paramount legal principal of law will be established in this case in the same way that matrimonial lawyers utilize the shorthand of *Lepis*[2] applications or *Brown*[3] evaluations or *Miller*ising[4] an asset.

In large part, the most important aspect of the granting of certification is that it reflects an understanding that what happens in the trenches is important. It confirms that the practical aspects of how the system operates at the trial level may have a greater impact upon more people within the system than the intricate evaluation of an esoteric principal of equitable distribution. It also says simply to us that the Court does understand the need to deal with practical issues matrimonial attorneys must confront on a day-to-day basis merits review at the highest level. It gives us hope.

I do not intend, in this editorial, to comment on the issues or my predilections about them in this pending matter. That is for attorneys to file briefs about and for the Court to hear argument on before rendering its determination. The import and importance of the Supreme Court granting certification to those of us in the trenches is not just the decision, but the fact that the Supreme Court is going to make a decision. It is the perfect illustration that our system is a symbiotic relationship between the Court and the lawyers. It reemphasizes the Court's commitment to the proposition that our system effectively function for the benefit of our mutual consumers (*i.e.,* the public), and that the practical way we deal with cases on an everyday basis merits examination.

Just this week I attended one of the many early settlement conferences that take place throughout our state. As is normal, the trial judge provided the litigants with information on the purposes of the program, the fact that the lawyers on the panels are volunteering their time, and that, most importantly, over 96 percent of all divorce complaints end in some form of consensual resolution by the parties prior to any final determination by a trial court. That statistic confirms the need to be able to effectively resolve cases. A review of that aspect of our practice can only be helpful in promoting what will have the greatest impact on the most people who enter the system.

I do not know what the outcome of the Supreme Court's decision will be on *Weishaus*. I do know, however, that every matrimonial lawyer in this state sees the Supreme Court's action in this area as a clear and distinct message that it cares about what we do, that it cares about the efficiency of the system, and that it is willing to devote its time and energies to making certain that it achieves the most good for the most people. It is a refreshing reminder that we are not in this alone, and that the need to work within the system but periodically examine and re-examine how that system works is an integral part of our jurisprudence in this state.

Life in the matrimonial trenches is difficult. It is of almost unimaginable support to those of us down there that our Supreme Court will devote its time and energy to reviewing what we predominately do each day, evaluating it and making sure the system affords its assistance. It is a reassuring reaffirmation of the fact that what we do every day is important, meaningful and merits review at the highest level. ■

**ENDNOTES**

1. *Weishaus v. Weishaus*, 360 N.J. Super. 381 (App. Div. 2003).
2. *Lepis v. Lepis*, 83 N.J. 139 (1980).
3. *Brown v. Brown*, 348 N.J. Super. 466 (App. Div. 2002).
4. *Miller v. Miller*, 160 N.J. 408 (1999).

FROM THE EDITOR EMERITUS

# MESP Revisited

*by Lee M. Hymerling*

Among the greatest contributions family lawyers have made to the administration of matrimonial justice is our now almost 25-year-old effort to assist litigants in settling their matters through active and dedicated participation in our county matrimonial early settlement programs (MESP). The MESP concept began in the late 1970s, and rapidly grew into the most significant tool our court system now uses to assist matrimonial litigants in resolving their dispute, short of judicial resolution.

Some years ago, I was asked by a program within the American Bar Association to visit another state, which wanted to learn about New Jersey's MESP experience. The questions posed to me were surprising within the context of the selflessness with which our colleagues routinely serve. Will experienced matrimonial attorneys volunteer their time? Why will they do so? Does the program work? Will it sustain itself? These and many other questions focused upon whether a bar would be willing to make the commitment to assure continuity in the program so the program would become an accepted part of the judicial process.

The answers were simple and direct. New Jersey matrimonial lawyers have been willing to serve and, to this day, continue to do so. They do so because they recognize that their contribution is needed as an important component of how matrimonial cases can be resolved in the clients' best interest. By the time I took that field trip years ago, the program had already sustained itself for many years. In the years since, the MESP program has continued to thrive, benefiting thousands of litigants, assisting an overburdened judiciary, and reflecting great credit on program participants and the county and state bars that have made the program a reality. It continues to be a program that permits the family bar to show itself in the very best light.

This is not to suggest, however, that New Jersey's unique MESP program cannot be improved. Nor is it to suggest that our program should be regarded as static. The program must respond to each decade's unique challenges.

Six specific thoughts deserve special attention.

First, the MESP program must never lose sight of the word *early* in its title. To the greatest extent possible, we, as lawyers, and those who serve on the bench or who administer our judiciary, should guard against the program's becoming a matrimonial *late* settlement program. While MESP hearings should not take place too early in the process because sufficient discovery must have taken place for the MESP effort to prove meaningful, MESP programs should not, in this era of *best practices*, happen too late. Whether the most appropriate time is four, five, or six months after issue has been joined, matrimonial early settlement panels should be seen as a vehicle for encouraging litigants to resolve their matters sooner, rather than later.

Second, the MESP program should recognize that it can and will co-exist with economic mediation and other forms of alternate dispute resolution (ADR) in an era in which ADR will undoubtedly play a greater role in matrimonial litigation. The balance our Supreme Court has struck as to the timing of mandatory economic mediation in the pilot counties makes a great deal of sense. Mandatory economic mediation, as presently constituted, takes place after, rather than before, an MESP hearing. Even were economic mediation to be more widely judicially required after an unsuccessful MESP hearing, MESP panelists, and the bar which supplies them, must not feel their contribution or the contribution of the overall MESP program has been challenged. Each of the two programs has its place. Each is founded upon the basic premise that it is better for matrimonial litigants to resolve their matters than for those matters to be litigated.

Third, matrimonial early settlement panels and the MESP system deserve receipt of submissions at least five days before a panel hearing, and further deserve more than simply a fact sheet and an accompanying case information statement for the panel process to be given its best opportunity to work. Panel

memoranda should be required, and panelists should be accorded sufficient time to review those memoranda before, rather than during, an MESP hearing. Although this is the case in most vicinages, it may not be the uniform practice. And yes, if counsel fail to provide timely submissions, *modest* sanctions are not inappropriate.

Fourth, in every county, on every day a matrimonial early settlement panel sits, the presiding family part judge, or his or her designee, should explain the program to litigants and encourage them to empower themselves by participating fully in the process. From the perspective of the litigants, the 10 or 15 minutes necessary at the beginning of each panel day for the judge to address the parties is essential to their availing themselves of the benefits of the process.

Fifth, an effort should be made to better quantify and accurately keep records concerning the success of the MESP effort. Reporting forms should be developed or improved so fully accurate statistics can be provided regarding the number of cases paneled, the number settled on the day of the panel session, and the number settled within weeks of the panel hearing. Those statistics would prove useful as the bar and the judicial system seek to study and improve the process.

Sixth, the system, at both the state and county levels, should appropriately recognize the MESP process and those who serve. One specific form of recognition would be for the judiciary to bi-annually invite representatives of all 21 county MESP programs to Trenton to share experiences and practices, and to receive the judiciary's thanks. This event would afford those who lead the county programs the statewide recognition the MESP program long ago earned.

The New Jersey MESP Program is unique. Its uniqueness deserves praise. It is an example of the profession and the judiciary working together in the public interest. ■

# The Internet: Uses and Limitations for the Family Law Practitioner

*by Marilyn J. Canda*

For most young lawyers, aside from the mandatory legal research class offered in the first year of law school, books are a thing of the past. Nevertheless, although we have grown up in the era of computers and the Internet, we recognize that computers are not invulnerable and sometimes crash. Therefore, we have to be willing and able to research the old fashioned way. However, many of our more senior counterparts are unable (or unwilling) to incorporate the computer and the Internet into their practices. This article is intended to serve as an introduction to less computer-literate peers about some of the ways the Internet can simplify the life of a family law practitioner.

There are endless websites that can save hours of time, which translates into substantial savings to our clients. We can also prepare our cases more efficiently and access necessary information within moments before a court appearance or settlement conference. Websites are also extremely helpful in lower income cases when the parties do not have the financial ability to hire employability experts and/or appraisers.

Legal research is the most widely used, obvious advantage of Internet technology. A costly site such as Westlaw provides access in seconds to current laws and cases, so long as the fact pattern is appropriately referenced in a typed question. A computer user also can *keycite* a source to determine whether it is still good law.

Accessing secondary sources, such as New Jersey Practice, provides background information on your specific topic and leads you to additional sources, such as statutes and case law. These secondary sources also provide access to hundreds of forms, sample motions and pleadings that the practitioner can cut and paste to fit a particular set of facts. Excerpts can be cut and pasted from sources into legal briefs and memoranda. Online researching is usually more reliable, timely, and faster than locating the information in a book.

More specific websites allow you to access important information in moments.

### SUPPORT OBLIGATIONS

If you represent a payee-spouse, you will want to access www.njchildsupport.org for up-to-date information regarding the status of child support payments. Many of us know how difficult it is to contact the various probation departments for this information and to retrieve written confirmation, especially if we are walking out the door to argue an enforcement motion. Accessing this website will allow you to instantly view and print up-to-date information in support of your position. Information provided includes the amount of the weekly obligation, last payment date, arrears due and owing, if any, and whether or not the case is in warrant status. This website also provides access to probation forms, community resources and information on local offices.

The website supportguidelines.com will give the family law practitioner information on child support guidelines nationwide, for all 50 states and the District of Columbia, including statutes, court rules and child support calculators. It also includes links to other websites for researching family law topics.

### THE U.S. DEPARTMENT OF STATE, OFFICE OF CHILDREN'S ISSUES

The website www.travel.state.gov/children's_issues.html explains the Child Passport Issuance Alert Program. Guide clients who have expressed concerns that the other parent may remove the child from the country without consent to this site. This program is not a passport tracking system. The purpose is to insure that once your client is in possession of the existing passport, a duplicate will not be issued without notification to your client. The website explains with specificity how to enroll your child in this program to protect against abduction.

### U.S. DEPARTMENT OF STATE, CHILD SUPPORT ENFORCEMENT ABROAD

The site http://travel.state.gov/child_support.html provides information regarding enforcement of a child support obligation when the payee-spouse is not residing in the United States, including a listing of countries that have agreements with the United States regarding child support enforcement. The website also includes specific contact information for central authorities of reciprocating countries. Other information includes how to

locate an absent parent owing child support who may be overseas, and how to request information from the U.S. Embassy to locate a U.S. citizen abroad who is obligated to pay child support. There is also a listing of child support enforcement offices for all 50 states.

**CHILD SUPPORT AND RELATED SITES**

Njcourtsonline.com (www.judiciary.state.nj.us/probchild/prob02.html) is useful for a client after you have concluded your representation. The site contains information pertaining to commonly asked questions about child support enforcement hearings when actions are brought by the probation department post-judgment.

U.S. Department of Health and Human Services, Administration for Children and Families, www.acf.dhhs.gov/contracts.html, has several pages of important contact information, *i.e.* National Domestic Violence Hotline, National Center for Missing and Exploited Children, National Runaway Switchboard, National Adoption Directory, how to report suspected child abuse, and state liaison officers for child abuse and neglect.

**VALUATION ISSUES AND OCCUPATIONAL DATA**

Kelly Blue Book values are available at www.kbb.com (for car values). This website offers, among other things, retail and trade-in value of automobiles. In order to determine the value of a boat, see www.internetboats.com. See www.nada.com for airplanes, motorcycles, personal watercraft, classic cars, recreational vehicles mobile homes and more. Art values can be found at www.artbrokerage.com, although the site provides only information about retail value. Collectible information can be found at www.csmonline.com. (firearms, knives, stamps, coins, records, toys and antiques). None of these websites (other than www.csmonline. com) require fees and/or membership. All of these sites are user friendly. The author cautions, however, that most of these sites should be used only as an aid to guide you on whether additional evidence should be sought if the website reveals there is a legitimate valuation issue.

If you are attempting to estimate certain expenses for the purpose of preparing a case information statement, you can visit the following sites:

If a client is seeking an automobile loan, and you are trying to determine the monthly cost, www.carcalculator.com will help the practitioner estimate the cost. Be aware, however, that this website requires payment of a fee. An excellent site for determining the cost of life insurance is www.budgetlife.com. This site is free and does not require one to become a member. For auto, life and homeowners' insurance, visit www.e-insure.com; however, be aware that to gain access to the information, the inquirer must complete a personal information sheet that enables the site to send unsolicited information.

In matrimonial litigation we often face the issue of an unemployed and/or underemployed spouse. In a case when an employability expert is too costly for the litigants, the attorney can rely on the New Jersey Occupational Wages Survey www.state.nj.us/labor/. This site supplies immediate, up-to-date information on prevailing wages for the purpose of imputing income to a spouse in computing a support obligation. The Child Support Guidelines permit the court to take judicial notice of this information when determining a child support award. In addition, http://stats.bls. gov, U.S. Department of Labor, Bureau of Statistics, supplies labor statistics for the entire United States.

Martindale.com and Findlaw.com will help the practitioner find information about an adversary, including education, years of practice, accomplishments, affiliations and level of experience in family law.

NJICLE.com, New Jersey Institute of Legal Education online, provides up-to-date seminar information by topic. You can purchase seminar materials and software, download articles written by the top family lawyers in the state of New Jersey by topic area (for a fee), and link directly to *New Jersey Lawyer*.

**LOCATING PEOPLE, PHONE NUMBERS, ETC.**

The following websites will help the family law practitioner locate people and phone numbers:

1. To locate people: www. 411 locate.com, www.switchboard.com, www. ussearch. com, www. anywho.com. Although one can search these websites free of charge and locate addresses in seconds, for more advanced searches one has to pay a fee.
2. To locate email addresses: www.iaf.net/. There is a note on the website stating that it is a work in progress and that when it is finished, it will be the most complete email directory on the web. This website is also free of charge, and one is not required to become a member.
3. Convicted sex offenders can be located by a state registry located at http://www.crimetime.com.
4. The website http://timeanddate.com/date/dateadd.html quickly calculates the precise date of service/filing. Among many services, this site provides times around the world, helps you create a meeting planner, creates calendars and calculates time between two dates.

**HEALTH ISSUES**

There are many websites, all of which are free of charge and easy to use, that can assist the attorney in determining generally why certain medications are prescribed. If one spouse located a prescription bottle of another spouse, this site will help you determine whether or not the other spouse may suffer from a mental or physiological condition.

The site http://mentalhealth.com has a list of medications, pharmacology, indications, side effects, warnings, etc., and http://www/druginfonet.com deals with medications, diseases, frequently asked questions, medical conditions and related sites. Again, this site is comprehensive and extremely helpful in providing information about the underlying diseases or sicknesses for which various medications are prescribed.

**RELOCATION MATTERS**

If a client is considering relocation, there are many free sites that enable the family law practitioner to retrieve invaluable information regarding cost of living comparisons, salaries, information on school systems and crime rates. The sites http://salary.com, http:// homefair.com and http://ddir.yahoo.com/education are the most user friendly. In using these websites, the author was able to locate information on a former high school, including programs offered and actual email addresses of former teachers. In addition, homefair.com enables you to conduct a cost of living comparison by entering the salary earned in New Jersey and comparing that salary with any city in the United States. The site will tell you, for example, that if you earn $90,000 in New Jersey, you must earn $85,000 in Palm Beach Florida to maintain your standard of living.

To determine the cost of mortgage payments for the purpose of estimating a client's future expenses, see www.mortgagecalc.com, www.ewmortgage.com, and http://nolo.com. These websites are easy to use and provide additional services such as a mortgage calculator, credit card calculator, IRA calculator, college savings calculator and more.

In short, although it is important for all of us to be able to research using hard copy publications, and although the computer will never substitute for a human being, none of us should ignore the value of the Internet, and the ability to access endless sites of information. The more familiar we become with the changing technology, the more we will discover how to use the Internet to our advantage to prepare cases more effectively and, in turn, save our clients the time and money associated with more costly alternatives.

**LIMITATIONS ON USE OF THE INTERNET**

Although the Internet is an invaluable tool in our every day lives, "The more hours people use the Internet, the less time they spend with human beings," said Stanford professor Norman Nie in his recent study of the social consequences of the Internet, titled, "Is the Internet Causing Social Demise?" Learning through the computer has changed the entire educational experience. Communication through the computer does not allow emotional interaction with other human beings.

Direct communication allows people to interact in ways that are precluded by the computer. A sentence can be stated in a number of ways to invoke several different emotions in the listener. Emphasis can be placed on any one word in a sentence, and can be expressed in a number of volumes and tones. Computer screen communication cannot always accurately convey the feeling or mood of the writer. For example, if a child were to send an instant message to his parent stating, "I got a B on my math test," it would be impossible for the parent to know immediately how the child felt about this experience without probing further. In addition, viewing an image of a loved one on a screen can never compare to the actual touch of someone's hand, a hug, or the sound of a voice.

However, on January 5, 2001, the appellate court determined that a trial court should have considered the use of the Internet to enhance visitation with a child. In *McCoy v. McCoy,*[1] the appellate court found that in denying relocation of the custodial parent, the trial court failed to consider the plaintiff's suggested use of the Internet to enhance visitation. They called this proposal "creative and innovative."

The suggested Internet communication in these cases would be accomplished by setting up a website with video cameras at the home of the child and the parent. The parties connect to one another and they can either type or talk to each other. Through this setup, the technology has the ability to digitize anything through a scanner into an image, for example, report cards, drawings, and photographs. There is also the option of a web camera that can be accessed by anyone over the Internet; this allows the non-custodial parent to view sporting events, school plays and any activity in which the child is engaged. This alternative, however, is costly and not yet mainstream. The other method of contact is through email and instant messaging, which is available in virtually every home with a computer.[2]

As evidenced by the recent decision in *McCoy v. McCoy,* the Internet will undoubtedly play a role in relocation cases, but it should not play a significant one. In deciding whether or not the current visitation can be duplicated, the Internet, in most cases, probably should not be substituted for actual parenting time with the child. For example, if the non-custodial parent has frequent weekly contact, *i.e.* dinners during the week and participation in after school activities, the Internet is no substitute. This is especially true for younger children who cannot respond the same way to a parent over the Internet, and to older children as well, who may not be disciplined enough, or interested enough in the process, to log on to a computer to initiate contact with the non-custodial parent.

As the *New Jersey Law Journal* reports, on January 15, 2001, in "Appeals Judge Orders Serious Look at Using Internet for Child Visitation," leading family law practitioners

**Continued on page 13**

NEW JERSEY STATE BAR ASSOCIATION

# Legal Career Center

*Go to www.njsba.com and click on Legal Career Center — the place for searching job opportunities and recruiting top staff.*

**JOB SEEKERS**

- Over 3,000 legal positions available, locally and nationally, for review.
- Options tailored specifically for the legal market.
- Search by position, years of experience, area of law, location, and more.
- Receive new postings by email.
- Post resumes confidentially.
- Access resume writing tips, interviewing techniques, cover letter advice.
- Create online career agent.
- Job seeker features are **FREE**.

**EMPLOYERS**

- Search an online resume database of over 12,000 legal professionals across the country.
- Post a free company profile.
- Post jobs online for a nominal fee
- Job postings are distributed nationwide to a network of more than 60 legal career and portal sites.

*The Legal Career Network currently includes 56 bar associations, four national support staff associations, over 15 legal portals including Legalstaff.com, LawGuru, Attorney.com, LawStar.com, and more.*

# Cursed Infirmities and Their Impact on Value

*by Kalman A. Barson*

Among the many aspects, approaches and variations of valuation theory is the fact that we are valuing a block of stock. Sometimes that block of stock represents all outstanding shares, or a portion of those shares. Who owns the stock should be irrelevant. We are valuing an interest in the company, not the person who owns that interest.

While this is nearly always the case for a small minority interest in a company with multiple owners and significant depth, it is probably too simplistic when it comes to valuing an interest held by a major player in the company, and certainly when he or she is the sole (or nearly sole) owner/shareholder. There are certain elements of the human aspect of ownership that must be taken into account at times. This article will address two such aspects — age and health — and how these factors impact value.

The age of a business owner, or his or her health, can be relevant to the valuation process. For purposes of this article, our concern with age is where the business owner is of senior status, and the concern with health is where the business owner is in poor health. Either advanced age or poor health may indeed have an impact on an otherwise determined value. With that point as a backdrop, let's discuss how these two factors may negatively impact valuation.

Even for those of us in good health, age is a factor with which we can identify. The concept of getting the *right* value for a business, whether that value is defined as fair market value, fair value or investment value, is that one has the ability, without undue pressure, to sell that interest in a fashion to maximize one's benefit. In the context of the definition of fair market value it is the idea that neither the buyer nor the seller is under any compulsion to buy or to sell. It must be a level playing field — the seller has the ability to wait for the right price, and the buyer has the ability to take the time to negotiate the best price. When we are valuing the interest of someone who is older, we must recognize that he or she may very well be subject to pressure to sell now, while he or she is able to run the business. The older the seller, the fewer the years remaining to properly control the business (and it is a given that a potential buyer knows this), and therefore, a potential buyer, in the process of negotiating price, knows that as time passes, the leverage continues to tilt in favor of the buyer. Ill health impacts the process in the same way.

The preceding briefly touched on how age or health would work against a seller in favor of a buyer. This, indeed, may be so if you're actually trying to sell the interest (just as taxes at that point would be a real concern). But, in the context of a hypothetical sale between a buyer and a seller (which of course is not the situation when dealing with valuation in the context of divorce), why and how do age and health factors make a difference? If analyzed from a fair market value standard, the theory requires the valuation be done within the framework of what a buyer would be willing to pay a seller in an arm's length transaction. Recognizing that defines value, whether you are looking at a hypothetical sale in the course of a divorce litigation or whether you are trying to assist a client in negotiating a real sale, this concern is more than just a theoretical one.

An older or ill business owner is faced with potentially some, or all, of the following factors, which tend to be unique to age and/or health problems, and tend to negatively impact value.

- There is less time to market/sell the interest.
- There is, therefore, less leverage to the seller in the eyes of the buyer.
- The clients are, or customer base is, often older because it tends to mirror the primary driver of the business (especially if this is a first generation business and/or if it is a service business).
- There is also less time to bring in a partner/associate to train and transfer control for adequate and fair compensation.

These factors tend to work against the seller being able to maximize the value for that interest — the result of a transaction between two equally empowered people.

When age or health play a role, the buyer and the seller are no longer on equal footing — the seller has a disadvantage, and it can be expected to be reflected in the price. Indeed, the value might be greater if the seller were 20 years younger, but that's not the set of facts involved, and therefore the fair and correct conclusion regarding value might very well be different when the interest is held by an older or ill individual.

These factors would be considered, in the valuation calculus, in either the risk factors (expressed as a greater capitalization rate), or in a marketability discount (because the age or health of the seller makes that interest somewhat less marketable, or certainly more at risk to the market), or, perhaps, in a lower multiple of revenues or net (if the approach is not directly developed through a capitalization of earnings approach), or some combination. Interestingly, while the best and fairest approach to this issue might be via a marketability discount, this fact of economic/financial life may run up against a wall called *Brown*, which applies *fair value* and frowns on the use of discounts. This might result in a situation where competent valuation experts will apply the appropriate discounts/risk factors for this type of situation, but in order to meet the artificial strictures imposed by *Brown*, may be forced (in order to come to the correct conclusion) to disguise what might be best expressed as a discount, as greater risk factors instead, resulting in a greater capitalization rate. The reader should not confuse this step with an attempted subterfuge of building a minority interest or lack of marketability discount into the capitalization rate to sidestep the impact of *Brown*.

While the nature of the impact on value of the factors of age and ill health is essentially the same, ill health may be the more pressing concern, and therefore have the greater impact. Age is, of course, predictable, and as long as health doesn't interfere, matters can be planned in an orderly fashion, even if the timeframe is shorter than desired. On the other hand, serious health issues can more precipitately interfere with the ability of a seller to properly control, operate and ultimately sell the business. The issue of poor health, which often poses greater time pressures and uncertainties, resulting in greater risks for the business, may call for greater reductions in value than the simple issue of advanced age.

In summary, the value of the interest (assuming here a significant interest, or at the very least, the interest of someone who is a significant player within the business) held by a septuagenarian, or someone who, regardless of age, has serious (and for our purposes, job performance interrupting) health problems, may be negatively impacted by those factors of advanced age and/or ill health, resulting in a lower value than the business interest would ordinarily have. ■

***Kalman A. Barson,*** *CPA/ABV, CVA, CFE, is the founder and shareholder of the Barson Group, PA, a CPA firm devoted primarily to litigation support services and business valuation.*

## The Internet: Uses and Limitations for the Family Law Practitioner

**Continued from Page 10**

in New Jersey have mixed feelings on the subject. "With the growing mobility of society, it is only natural that litigants and courts will increasingly be looking to technology to try to maintain ties between children and non-custodial parents," says Sally Goldfarb, who teaches at Rutgers Law School–Camden. Gary Skoloff says that Internet contact is not only less expensive "but parent and child can see each other, in contrast to the telephone, on which they cannot."[3]

Others disagree: "The Internet makes no difference and certainly doesn't substitute for personal contact," says Elliot Gourvitz. But Robert Levy, University of Minnesota Law Professor who co-authored a book with Skoloff on child custody law, says cybervisitation is "not the same as holding your child in your lap, but faced with the reality that someone is going to be without the child on a daily or weekly basis, this is going a great distance by the custodial mother to try to maximize the opportunities."[4]

The bottom line in this ongoing debate is that although the Internet has become a valuable tool in our society, we need to step back and be careful not to rely on this technology to replace human contact, especially in the context of child custody and relocation cases. Although this technology can enhance parenting time that would not otherwise occur, it probably, in most cases, should not be considered as a substitute for parenting time that already exists, especially if the relationship between child and non-custodial parent is close, frequent and consistent. ■

**ENDNOTES**

1. 336 NJ. Super. 172 (App. Div. 2001).
2. *See* author Reni Gertner, *Lawyer Weekly* USA No. 9919902.
3. *See* 163 N.J.L.J. 153.
4. *See* 163 N.J.L.J. 153.

***Marilyn M. Canda*** *is an associate in the law firm of Finnerty & Sherwood, P.C. in Fair Lawn.*

## From Life on Food Stamps to Life on Easy Street

# Does *Roccamonte* Provide a Workable Palimony Model?

*by Donald E. Taylor*

In the case of *In re Estate of Roccamonte*,[1] the New Jersey Supreme Court held that economic promises between cohabitants who choose to live outside the bond of matrimony are enforceable, and that a party's mere participation in that relationship, whatever his or her contribution may be, is consideration in full measure for the promises.[2] The Court further held that the measure of damages in such a case is a "one-time lump sum in an amount predicated upon the present value of the reasonable future support defendant promised to provide, to be computed by reference to the promisee's life expectancy."[3]

The desirability of empowering an unmarried cohabitant to the extent set forth in *Roccamonte* is a subject ripe for fair debate. In fact, a valid argument could be made that *Roccamonte* places a palimony plaintiff in a far stronger position than a divorcing spouse. While, as stated previously, those points are ripe for fair debate, the factual circumstances of the *Roccamonte* case provided the Supreme Court with a sympathetic plaintiff for which to broaden and entrench New Jersey palimony law. In *Roccamonte*, the Supreme Court was presented with a plaintiff that had made a substantial investment of time in the unmarried cohabitation relationship (25 years), of advancing age (77 years old at the time of trial), and subsisting solely on food stamps and other public assistance. The Court recognized that, under the circumstances, the plaintiff had no reasonable prospect of becoming self-sufficient.[4] In *Roccamonte*, as in its predecessor cases, *Kozlowski*[5] and *Crowe*,[6] the Supreme Court was faced with plaintiffs with substantial investments in the unmarried cohabitation relationship (15 years and 20 years, respectively, in *Kozlowski* and *Crow*), of advancing age (each over 60 years old), and with no reasonable prospect of becoming self-sufficient.

The question, then, is how does the trilogy of *Roccamonte*, *Kozlowski* and *Crowe* translate to a cohabitation relationship of relatively short duration, and a young plaintiff with a long, promising professional life ahead? How will (and should) a court apply *Roccamonte* to *do equity* under such circumstances? In addition, does the *Roccamonte* model even apply where an engaged couple chooses to live together before marriage, not in the stead of a marriage, and makes plans for the future in anticipation of that marital bond? If *Roccamonte* applies under those circumstances, how does it square with the firmly entrenched prohibition against enforcing promises made in contemplation of marriage?

This article addresses the guidance provided by the New Jersey reported and unreported case law and, where instructive, out-of-state authorities, on these issues.

### LENGTH OF RELATIONSHIP

In assessing the relevance of the length of the underlying cohabitation relationship, courts have discussed the importance of a relationship of "long duration."[7] Courts have said that to provide the requisite "cohabitation" from which consideration for the promises might flow the relationship "must be shown to be serious and lasting."[8] In fact, in the seminal New Jersey case of *Kozlowski v. Kozlowski*, the court framed the issue before it as follows:

> The dilemma may be simply stated: Is there any remedy available under our law for a woman who has devoted 15 or more years living with a man, for whom she provided the necessary household services and emotional support to permit him to successfully pursue his business career ...[9]

In fact, in drawing a distinction between the length of the relationships involved in *Kozlowski* (15 years) and *Crowe* (20 years) and the length of the relationship in the case before it, the Chancery Division in Bergen County in *Zaragoza v. Capriola* held:

> Clearly, the duration of the parties' relationship was a major factor the Court considered in reaching its determination in both cases [*Kozlowski* and *Crowe*]. This Court finds that the parties to this action cohabitated for some 11 months, then separated.

> Said separation lasted approximately one full year, followed by a reconciliation that endured for two or three months. In light of the parties' statements, and their acts and conduct in light of the subject matter and the surrounding circumstances, this Court finds that no agreement existed between the parties, either express or implied.[10]

**In each of the landmark Supreme Court cases decided under New Jersey law, the court was faced with a plaintiff who, at the end of the relationship, was left financially destitute and with little prospect of rejoining the workforce to earn a reasonable living.**

In addition, in *LaRocca v. Gardella*, the court addressed whether a relationship wherein the parties lived together on weekends for several months was a relationship of sufficient duration and seriousness to be venued in the family part as a "family-type" matter.[11] The family part judge held that such a relationship "falls woefully short of the substance of the domestic situations considered by the decisions submitted as purported authority, and fails to establish a cohabitative relationship."[12]

In fact, a survey of New Jersey palimony law reveals that in no case has a New Jersey court ever afforded palimony protection to a plaintiff following a cohabitation relationship of less than 15 years.[13] Out-of-state authorities are also instructive on this point in that each palimony case required a cohabitation period of considerable duration.[14] Thus, with regard to the significance of the length of the relationship, the case law leaves a substantial gray area between the 15-year relationship found to be sufficiently "serious and lasting" in *Kozlowski*, and the approximately 14 months, with an interim separation, that was found to be insufficient in *Zaragoza*.

To predict how a court might look upon the duration of a relationship in the gap between 14 months and 15 years, a consideration of matrimonial law is helpful. In a somewhat analogous context, courts have addressed the significance of the length of a marital relationship in the context of assessing the propriety of permanent versus rehabilitative alimony. In that regard, the Appellate Division has held that a 10-year marriage was an "intermediate length" marriage, and thus remanded for a determination of permanent alimony at some "reduced rate."[15] Thus, in the case of a relationship where the parties chose to avail themselves of the statutory protections incident to a marriage, the Appellate Division recognized that a 10-year marriage is "on-the-fence" as being of sufficiently long duration to warrant permanent financial support.[16] Likewise, family courts have found that marriages of 18 months[17] and 3½ years[18] were not sufficiently "long term" to warrant an award of permanent alimony.

Thus, while it remains open to debate how long a cohabitation relationship must endure before it warrants protection under a palimony theory, unless an unmarried cohabitation relationship is deemed more worthy of protection than a marriage, it would seem reasonable to assume that a cohabitation relationship of less than 3½ years does not warrant an award of lifetime support.

#### PLAINTIFF'S NEED AND EARNING CAPACITY

While the New Jersey Supreme Court has made clear that "complete economic dependence" is not required to sustain a cause of action for palimony, it made equally clear that a plaintiff's ability to be self-sufficient following the termination of the relationship is a relevant consideration. Thus, in *Roccamonte*, the Court held:

> [t]he issue is [not complete economic dependency, but rather], one of economic inequality, and the relevant question is whether the promisee is self-sufficient enough to provide for herself with a reasonable degree of economic comfort appropriate in the circumstances.[19]

The Court further held:

> [t]he difference is only in the amount of the promised support that must be fixed in order to reach a reasonable lump-sum payment.[20]

Thus, the Supreme Court made clear that the plaintiff's capacity to become "self-sufficient enough to provide for herself with a reasonable degree of economic comfort" following the termination of the relationship is a relevant consideration in assessing the plaintiff's palimony claim.

In each of the landmark Supreme Court cases decided under New Jersey law, the court was faced with a plaintiff who, at the end of the relationship, was left financially destitute and with little prospect of rejoining the workforce to earn a reasonable living. For example, in *Roccamonte*, when the relationship was ended by Arthur Roccamonte's death, Mary Sopko was 70 years old. By the time of trial, she was 77 years old, had exhausted all of her assets, and was living in poverty, existing solely on food stamps and other public assistance.[21]

Likewise, in *Kozlowski*, the plaintiff had performed domestic services for 15 years,

> giving up for that time all other potential avenues of pursuit of career

**[T]here is language in the case law to suggest that a palimony plaintiff with a promising career and significant earning capacity at the end of the relationship should not necessarily expect a damage award under the same formula as espoused in *Roccamonte*.**

> or employment as well as other possible means of providing for her future support and retirement. She has foregone any chance to develop skills or to seek out opportunities which, in the revealing light of hindsight, may well have served her better.[22]

The court stated that it

> could not countenance the unconscionable result which would obtain should all relief be denied this plaintiff who was cast adrift at 63 years of age without means of support assets, and with little hope of developing support opportunities.[23]

Similarly, in *Crowe*, the Court noted the significance of the fact that "[a]t the time of trial Crowe was 63 years old and claimed to be unskilled, unemployable and in poor health."[24] Thus, in each of the landmark New Jersey palimony cases, the Court found it significant that the plaintiff was left at an advanced age with little or no means or likelihood of becoming self-sufficient.

Moreover, the California cases make clear that while a plaintiff's financial need is plainly a relevant consideration, it is not enough, in and of itself, to justify a rehabilitative award. In fact, in what many consider to be the case from which palimony was born (although the concept of support from an unmarried cohabitant actually was addressed by much earlier case law), *Marvin v. Marvin*, the appellate court made a point of noting that a plaintiff's need, and a defendant's ability to pay, do not, by themselves, support an award of rehabilitative damages.[25] Likewise, in *Taylor v. Polackwich*, the court held that the plaintiff's need alone does not justify a rehabilitative award in the absence of some underlying legal or equitable obligation on the part of the defendant.[26]

Untested so far in the case law is the situation where a plaintiff seeks palimony from a wealthy individual despite the fact that the plaintiff is at the beginning of a promising career, has significant earning potential, and the cohabitation relationship merely caused a minor delay in launching that fledgling career. Because New Jersey courts have made clear that palimony is simply a contract action between unmarried cohabitants, there is no reason to believe that the principle of mitigation of damages will not be fully applicable as in any other breach of contract action.[27]

Moreover, by suggesting that the family part is especially equipped to determine support-type issues, the New Jersey Supreme Court in *Roccamonte* recognized that issues such as a plaintiff's earning ability, with issues relating to imputation of income, will be relevant inquiries in an appropriate case. Thus, there is language in the case law to suggest that a palimony plaintiff with a promising career and significant earning capacity at the end of the relationship should not necessarily expect a damage award under the same formula as espoused in *Roccamonte*. At a minimum, expert testimony should be taken to determine the plaintiff's imputed income for his or her life expectancy, and any award to the plaintiff should be reduced by that imputed income.

### PROMISE IN PLACE OF A MARRIAGE VERSUS PROMISE IN CONTEMPLATION OF A MARRIAGE

Palimony under New Jersey law addresses the situation of unmarried adults choosing to cohabit without invoking the statutory rights and obligations that would be incident to being married. Thus, in each of the palimony cases decided under New Jersey law, the parties chose to live together and make provision for their financial futures, absent the expectation of becoming married. The palimony cases do not address the situation where unmarried adults choose to have a brief period of cohabitation in contemplation of marriage. In *Roccamonte*, the Court recognized the right of unmarried adult partners to "choose to cohabit together in a marital-like relationship" and make enforceable agreements regarding financial support.[28] In *Kozlowski*, the Court stated that

> [t]he primary issue on appeal is whether a man and a woman who are not married to each other, and who live together without a promise of marriage, may enter into a contract which, if otherwise valid, is enforceable by our courts.[29]

In *Kozlowski*, the defendant made it clear that he did not intend to marry the plaintiff.[30] The plaintiff cohabited with the defendant in reliance upon specific promises of support, not in anticipation of marriage.[31] The Court found it important that when the defendant promised to support the plaintiff for the rest of her life, he did so after expressing to the plaintiff that he did not intend to marry her.[32] The Court specifically noted that if the plaintiff had cohabited with the defendant in anticipation of marriage, rather than in reliance on specific promises of support, relief would be barred by the Heart Balm

Act, N.J.S.A. 2A:23-1 *et seq.*[33] The Court went on to say

> [w]e do no more than recognize that society's mores have changed, and that an agreement between adult parties living together is enforceable to the extent it is not based on a relationship proscribed by law, or on a promise to marry.[34]

This is a theme that was reiterated by the Appellate Division on remand.[35]

In *Zaragoza*, the Court found that the plaintiff had relied upon the defendant's promises to marry her, not on independent promises to support her for the rest of her life. Thus, the Court held that the plaintiff's claims were barred by the Heart Balm Act.[36] Similarly, in *LaRocca*, the Court noted *in dicta* that claims regarding funds provided during a "relationship in contemplation of marriage" are of "questionable validity" because they would be barred by the Heart Balm Act.[37]

Also instructive is the Maryland case of *Miller v. Ratner*.[38] In *Miller*, the plaintiff alleged that the parties were "making a permanent commitment that would be followed by marriage," and "in anticipation of their marriage, the defendant told her that he had plenty of money and that he would take care of her." Following a break up, the Maryland Court of Appeals provided a thorough and well-reasoned analysis of the history and policy behind the Maryland Heart Balm Act, and held that the allegations were barred by the statutory prohibition against enforcing promises to marry.[39]

Thus, there is substantial authority from which a distinction can be drawn between a promise made in the absence of an expectation of marriage (which is enforceable under *Kozlowski*), and a promise made in expectation of a future marriage (which is barred by the Heart Balm Act).

**[T]here is substantial authority from which a distinction can be drawn between a promise made in the absence of an expectation of marriage (which is enforceable under *Kozlowski*), and a promise made in expectation of a future marriage (which is barred by the Heart Balm Act).**

**DAMAGE FORMULA**

The New Jersey Supreme Court has issued what might seem like a bright line damage formula:

> A one-time lump sum in an amount predicated upon the present value of the reasonable future support defendant promised to provide, to be computed by reference to the promisee's life expectancy.[40]

In doing so, the Court merely reiterated what it had already determined to be the appropriate formula in *Kozlowski*.[41] However, what at first blush might seem like a mechanical task to calculate damages, is anything but a bright line formula.

In remanding the matter to the trial court, the Supreme Court in *Roccamonte* specifically referenced the discretion vested in the trial judge to fashion an appropriate damage award after considering all of the relevant factors:

> Family Part judges have developed a special expertise in dealing with family and family-type matters ... and, surely, fixing levels of support is an adjudicatory task well within that special expertise.... We leave to the trial judge the determination of an appropriate level of support in the circumstances and the resolution of such questions as whether the Estate is entitled to a credit on the lump-sum payment for the amount of the certificate of deposit in plaintiff's name, the life insurance proceeds, and her receipt of Social Security benefits.[42]

By referencing the expertise of the family part judges regarding such matters as "fixing levels of support ... in the circumstances," and leaving to the trial judge "such questions as" credits against the lump sum award, the Supreme Court recognized that assessing the appropriate level of support under the circumstances is not merely a mechanical task. Moreover, the Appellate Division articulated that the damage formula was discretionary, a finding undisturbed by the Supreme Court: "The trial court on remand should consider the appropriateness of such relief [a lump sum payment] here."[43]

The need for application of discretion by the trial court in fashioning an appropriate award is highlighted by contrasting the plaintiff in *Roccamonte*, *Kozlowski* and *Crowe* with a hypothetical plaintiff that has had a much shorter relationship. For the sake of argument, compare *Roccamonte*, *Kozlowski* and *Crowe* with a plaintiff having a relationship of the same duration as the marriage in *D'Arc*, cited above, where a 3½ year marriage was found to be of insufficient duration to warrant permanent alimony. In *Roccamonte*, *Kozlowski* and *Crowe*, the plaintiffs each had a substantial

investment in the relationship (25 years, 15 years and 20 years, respectively), and a comparatively short damage period (*i.e.*, life expectancy) to compensate them for the breach of the palimony contract. In the case of a 3 1/2 year relationship, ended at a point when the plaintiff is still very young and with a promising professional career ahead, a court would be faced with the flip side of *Roccamonte*, *Kozlowski* and *Crowe*, that is a plaintiff with a very short investment in the relationship and a disproportionately long damage period.

Thus, there is no reason to believe that a palimony plaintiff with significant earning potential over a comparatively long life expectancy will not be required to mitigate his or her damages. Nor is there any reason to believe that the palimony plaintiff's imputed income over his or her life expectancy will not be taken into account in assessing damages. In such a case, it appears that the testimony of an economist may be appropriate in calculating plaintiff's damages.

## CONCLUSION

In *Roccamonte*, the New Jersey Supreme Court broadened and entrenched the palimony cause of action based upon a set of facts begging for sympathy. It remains to be seen how a court will apply *Roccamonte* to a plaintiff left in a less dire situation. As set forth above, in the circumstances of plaintiffs less sympathetic than Mary Sopko, there are a host of legal and factual issues that stand in the way of an award of lifetime financial support, and regarding what level of support is necessary to do equity under the circumstances. ■

## ENDNOTES

1. *In re Estate of Roccamonte,* 174 N.J. 381 (2002).
2. *Id.* at 389, 392-93.
3. *Id.* At 390.
4. *Id.* at 389, 394.
5. *Kozlowski v. Kozlowski,* 80 N.J. 378 (1979).
6. *Crowe v. DeGioia*, 90 N.J. 126 (1982), *on remand*, 203 N.J. Super. 22 (App. Div. 1985).
7. *In re Estate of Roccamonte*, 346 N.J. Super. 107, 119 (App. Div. 2001).
8. *Konzelman v. Konzelman*, 158 N.J. 185, 203 (1999).
9. *Kozlowski*, 164 N.J. Super. 162, 170 (Ch. Div. 1978).
10. *Zaragoza v. Capriola*, 201 N.J. Super. 55, 64-65 (Ch. Div. 1985).
11. *LaRocca v. Gardella*, 352 N.J. Super. 234, 241 (Ch. Div. 2002).
12. *Id.*
13. *See Roccamonte*, *supra.* (25-year relationship); *Kozlowski*, *supra.* (15-year cohabitation relationship); *Crowe*, *supra.* (20-year cohabitation relationship); *Caraluzzo v. Montford*, Docket No. A-4967-00T2 (June 7, 2002) (27-year cohabitation relationship); *Recigno v. Recigno*, Docket No. A-2023-01T5 (Jan. 7, 2003) (26-year cohabitation relationship).
14. *See Marvin v. Marvin*, 18 Cal. App. 3d 660, 665 (1976) (seven-year cohabitation relationship); *Taylor v. Fields*, 178 Cal. App. 3d 653, 658 (Ct. of App. 1986) (palimony claim not viable in context of a 42-year relationship with express promise of lifetime support, but without cohabitation because it is not a "stable and significant relationship evolving out of cohabitation"); *Kohler v.Flynn*, 493 N.W. 2d 647, 649 (N.D. 1992) (distinguishing the seven-year relationship in *Marvin*, the North Dakota Supreme Court commented that the six-month cohabitation period was "anything but a substantial period").
15. *Id.*
16. *Id.*
17. *Skribner v. Skribner*, 153 N.J. Super. 374 (Ch. Div. 1977).
18. *D'Arc v. D'Arc*, 164 N.J. Super. 226 (Ch. Div. 1978), *certif. denied*, 85 N.J. 487 (1980), *cert. denied*, 451 U.S. 971 (1981).
19. *Roccamonte*, 174 N.J. at 393.
20. *Id.*
21. *Roccamonte*, 174 N.J. at 389.
22. *Kozlowski*, 164 N.J. Super. at 177-78.
23. *Kozlowski*, 164 N.J. Super. at 178.
24. *Crowe*, 203 N.J. Super. at 28.
25. *Marvin*, 122 Cal. App. 3d at 876.
26. *Taylor v. Polackwich*, 145 Cal. App. 3d 1014, 1021 (Ct. of App. 1983).
27. *See Banco di Roma v. Fidelity Union Trust Co.*, 464 F. Supp. 817 (D. N.J. 1979) (party injured by a breach of contract is under a duty to mitigate damages); *Sandler v. Lawn-A-Mat Chemical & Equipment Corp.*, 141 N.J. Super. 437 (App. Div.), *certif. denied*, 71 N.J. 503 (1976) (in employment context, holding that discharge of full-time employee frees him to earn money from other sources for his personal services).
28. *Roccamonte*, 174 N.J. at 389.
29. *Kozlowski*, 80 N.J. at 380.
30. *Id.* at 382.
31. *Id.*
32. *Id.* at 383.
33. *Id.*
34. *Id.* at 387.
35. *See Kozlowski*, 164 N.J. Super. at 176, holding that the Heart Balm Act did not apply because the promise to future support was made during a reconciliation in the relationship when the defendant made it clear that he did not intend to marry the plaintiff.
36. *Zaragoza*, 201 N.J. Super. at 62-63.
37. *LaRocca*, 352 N.J. Super. at 236 and fn. 1; *see also Rubenstein v. Lopsevich*, 4 N.J. 282, 286 (1950) (holding that where a woman provides domestic services in reliance upon a promise to marry, she cannot circumvent the Heart Balm Act by suing in quasi-contract for the reasonable value of those domestic services).
38. *Miller v. Ratner*, 114 Md. App. 18 (Ct. of App. 1997).
39. *Id.* at 23, 40-43.
40. *Roccamonte*, 174 N.J. at 390.
41. *Kozlowski*, 80 N.J. at 388.
42. *Roccamonte*, 174 N.J. at 399.
43. *Roccamonte,* 346 N.J. Super. at 122.

***Donald E. Taylor** is a shareholder with the Woodbridge-based law firm of Wilentz, Goldman & Spitzer.*

# Adjusting Executive Compensation When Valuing a Closely Held Firm

*by Les Barenbaum and Lisa Cruikshank*

The focus of this article is to explore the process of adjusting executive compensation as part of the valuation of a closely held business. Expected long-term distributable cash flow ultimately drives shareholder value. One of the factors that affects the amount of distributable cash flow is executive compensation. This article will discuss a framework for estimating reasonable executive compensation as part of the determination of expected long-term distributable cash flow. In addition, it will discuss how the level of reasonable executive compensation impacts the selection of capitalization rate. The framework will present valuation theory and methodology, examine several court opinions, and demonstrate the process through a mini-case study based upon several actual valuations engagements.

Valuation professionals estimate the value of closely held enterprises through the application of valuation theory. The value of financial assets, whether traded or not, is generally based upon the following:

- the level of expected distributable future cash flows
- the timing of those expected distributable cash flows
- the uncertainty in receiving expected future cash flows

The value of a closely held business is driven by the future distributable cash flows the business is expected to generate. Distributable cash flow represents monies that can be distributed to a business owner after the needs of the business are met. Included in the needs of the business is compensation to its executives for their labor.

As is often stated, cash is king. An estimate of future accounting earnings is often useful, but only as a reasonable proxy for expected future distributable cash flow. The relationship between accounting earnings and distributable cash flow must be carefully analyzed. When expected accounting earnings are not an adequate proxy for cash flow, specific adjustments to the earnings must be made to more closely project future levels of distributable cash flow. For example, sales growth may require an investment in working capital (*e.g.,* inventory, accounts receivable, etc.) whose impact will not be captured in an earnings forecast, but would be captured in a forecast of distributable cash flow.

When analyzing a set of financial statements, adjustments are typically required in order to produce a clearer picture of likely future income and distributable cash flow. This normalization process usually considers three types of adjustments to a firm's income statement. First, the impact of non-recurring events should be removed from a firm's financial statements in order to produce a clearer picture of likely future income and cash flow. Second, when determining distributable cash flow, the link between non-cash expenses (*e.g.,* depreciation expense) and expected cash expenditures (*e.g.,* fixed asset acquisitions) must be analyzed. Finally, a buyer of a business may plan to spend more or less than the current business owner for executive compensation, travel and entertainment expenses, and other discretionary expenditures and perquisites of current management. Adjustments to the historical and current level of these expenditures should be made to determine future distributable cash flow.

One of the more significant and often difficult adjustments is separating reported executive compensation into two components — return to labor and return to equity. Return to labor is a normal business expense, and return to equity is that component of reported executive compensation that would be more appropriately characterized as profit.

It is important to recognize that a compensation adjustment does *not* necessarily imply that compensation is unreasonable, rather that a willing buyer may not choose to pay the levels of compensation that are currently being made.

## FACTORS FOR ANALYSIS OF REASONABLE OFFICERS' COMPENSATION

The first major component of our framework for analyzing officer compensation was cited in the U.S. Tax Court case *Elliotts, Inc. v. Commissioner.*[1] In this case, the court outlined five factors that should be considered in the analysis of reasonable compensation. The factors cited were as follows:

1. The employee's role in the company;
2. A comparison of the employee's salary with those paid by similar companies for similar services;
3. The character and condition of the company;
4. Any factors which may indicate a conflict of interest between the company and the employee, and;
5. The internal consistency in the company's treatment of payment to employees.

The U.S. Court of Appeals stated that no one of the five factors cited in *Elliotts* is dispositive.[2] This framework has also been employed in recent tax court cases.[3]

**INDEPENDENT INVESTOR TEST**

The second component in our framework for analysis is the independent investor test. This was developed from the court of appeals decision in *Rapco Inc. v. Commissioner,*[4] which indicated that in evaluating the reasonableness of compensation "it is helpful to consider the matter from the perspective of a hypothetical investor."[5] Furthermore, the court articulated the importance of the hypothetical or independent investor's test when it stated the following:

> The court should assess the entire tableau from the perspective of an independent investor — that is, given the dividends and return on equity enjoyed by a disinterested stockholder, would that stockholder approve the compensation paid to the employee?

The independent investor test is consistent with financial theory, which distinguishes between a return to labor and a return on equity. Officer compensation is a return to labor. The return on equity is driven by the required rate of return expected by an independent investor and the returns the shareholder/investor realizes.

More recently, the U.S. Court of Appeals in the Second Circuit articulated a set of factors that the Internal Revenue Service and taxpayer should consider in the application of the independent investor test. These factors were set forth in *Dexsil Corp. v. Commissioner*,[6] whereby the appeals court vacated a U.S. Tax Court decision because the tax court failed to consider, among other things: 1) whether compensation was reasonable from an independent investor's perspective, and 2) whether the compensation paid was comparable to compensation paid by similar companies for comparable services.[7] As stated by the U.S. Court of Appeals in *Dexsil*, *supra*, no single factor is dispositive, and trial courts should assess reasonableness of compensation in terms of:

> [w]hether an inactive, independent investor would be willing to compensate the employee as he was compensated. The nature and quality of the services should be considered as well as the effect of those services on the return the investor is seeing on his investment...

The case stated further that relevant factors to be considered as part of the independent investor test are as follows:

1. The taxpayer corporation's return on equity;
2. Whether (and to what extent) the taxpayer corporation has paid dividends;
3. Increases in the taxpayer corporation's net worth; and
4. The increased fair market value of the taxpayer corporation's stock.

**THE EMPLOYEE'S ROLE AND SALARY COMPARISON**

The goal of examining a firm's return on equity is to assess the firm's profitability, comparing it to the profitability of other relevant firms. This addresses the first two factors cited by the court in *Elliotts*: 1) the employee's role in the company; and 2) a comparison of the employee's salary with those paid by similar companies for similar services. Some of the factors surrounding the executive's role at the company, and which affect the compensation of executives, include:

- Input in terms of hours;
- Level of responsibility within the business;
- Depth of management within the business;
- Complexity of the business.

As suggested by the court above, return on equity would seem to be an effective way to examine a firm's financial performance from an investor's perspective. However, this financial metric has many shortcomings, especially when comparing public firms to private firms. Relative to private firms, public firms, by their nature, retain more earnings to finance growth. In addition, public firms that distribute earnings as dividends cause shareholders to be subject to double taxation. This mechanism of distribution to shareholders through dividends is much less frequently observed in closely held businesses. Thus, public companies tend to have a higher proportion of equity in their financial structure than private firms.

An alternative analytical measure for examining the relative profitability of firms is return on assets.[8] The use of return on assets as a measure of financial performance eliminates any bias produced by differing capital structures. Return on assets is calculated based upon operating profits (EBIT), that is, before the impact of interest expense, thus eliminating the affect of differing financial structures. Therefore, because capital structure often differs markedly between public and private companies, and because return on assets allows comparison of profitability before consideration of the effects of capital structure, return on assets is a useful measure to compare profitability of

private companies to that of public companies.

If a large proportion of the corporation's earnings is being paid out in the form of compensation so the corporate profits do not represent a reasonable return on the shareholder's investment, an independent investor would probably disapprove of the compensation arrangement.

The appeals court emphasized that the independent investor test is not a separate, stand-alone factor to consider, but rather a framework through which the entire compensation analysis should be viewed. Therefore, if the taxpayer corporation's earnings are at a level that would satisfy an independent investor, there is a strong indication the shareholder/employee compensation is reasonable.

There are several tax court cases that provide guidance in the determination of what can be considered as reasonable officers' compensation. In *Elliotts, Inc. v. Commissioner*,[9] the tax court held that a 20 percent return on equity would satisfy an independent investor. In *Kennedy v. Commissioner*,[10] the tax court indicated that a six-fold increase in net worth over a 10-year period indicated that compensation was reasonable.

### THE CHARACTER AND CONDITION OF THE COMPANY

Another major factor cited in *Elliotts* was an analysis of the character and condition of the company. The condition of a company is often examined through an analysis of a firm's performance, including but not limited to, the following factors:

- Financial performance of the company
- Sales growth;
- Profitability;
- Financial performance of the firm relative to its industry and the general economy
- Salary policy of the company's executive relative to other employees.

### EXTERNAL COMPARISON

As discussed above, the second factor articulated in the *Elliotts* case was a comparison of the shareholder/employee's compensation to that paid by similar companies for similar services. An examination of proxy statements issued by public companies is another technique that can often assist in this analytical comparison.[11] Proxy statements disclose compensation data for a public company's five highest paid employees. Of course, the selected public companies must be *comparable* to the private company. However, appraisal literature is not clear whether the same guideline company criteria used to select valuation multiples should be utilized for officer compensation comparison and analysis. When comparing the compensation levels of comparable public companies' executives to those of closely held companies, adjustments must often be made to reflect differences between the firms in such areas as size, complexity, diversity, etc. When making such comparisons it is also important to take into account the value of non-cash compensation such as stock options and restricted stock grants.

### FACTORS WHICH MAY INDICATE A CONFLICT OF INTEREST

The fourth factor cited for consideration in *Elliotts* is whether or not a potential conflict of interest exists between the taxpaying company and its employee(s). Such a conflict might enable the company to distribute non-deductible dividends disguised as salary, which is a deductible expense. *Elliotts* states further that such a situation would warrant an evaluation of the compensation payments from the viewpoint of a hypothetical independent investor.

### INTERNAL CONSISTENCY OF PAY THROUGHOUT THE COMPANY

The fifth factor in *Elliotts* requires an examination of compensation of officers relative to other employees in the firm. This must be done with a careful examination of job responsibilities. Again, the use of industry data and compilations of comparable firm data can often help in such an analysis.

### CATCH-UP PROVISION: COMPENSATION PAID FOR PRIOR SERVICES

The final component of our framework for analyzing officer compensation expense is an analysis of the firm's compensation history. Based on the court's findings from the *Lucas v. Ox Fibre Brush Co.*[12] case in 1930, and the more recent *R.J. Nicoll*[13] and *Alpha Medical, Inc.*[14] cases, the court held that compensation paid in a given tax year for services performed in prior tax years may be reasonable, even though that amount, when added to compensation for the employee's current services, exceeds a reasonable allowance for current services. This situation can occur when executives take less than reasonable compensation in prior years in order to foster the company's development. It is well established that compensation paid in a given tax year may be deducted from taxable income because it represents payment for services rendered in prior years. This has been allowed, even though that amount, when added to the employee's compensation for current services, exceeds a reasonable allowance.

### MINI CASE

The following mini case example has been drawn from several actual valuation engagements. The level of profitability of OES, a chemical products distributor, is examined after reported executive compensation. The resultant return on assets is compared with returns reported by an industry data source. OES executive compensation levels are analyzed and adjusted to determine appropriate reasonable levels.

EXHIBIT ONE

**FINANCIAL PERFORMANCE AS REPORTED BY OES**
(thousands)

| | Five-year average | 2002 | 2001 | 2000 | 1999 | 1998 |
|---|---|---|---|---|---|---|
| OES Revenue | | $16,247 | $11,114 | $10,716 | $10,543 | $9,679 |
| Reported Operating Earnings | | 110 | 25 | (62) | 45 | 48 |
| Reported Operating Profit Margin[15] | 0.25% | 0.68% | 0.22% | -0.58% | 0.43% | 0.50% |
| Total Assets | | $6,110 | $4,588 | $3,351 | $2,700 | $2,300 |
| Return on Assets[16] | 0.85% | 1.80% | 0.54% | -1.85% | 1.67% | 2.09% |
| Reported Officer Compensation | | $600 | $295 | $410 | $375 | $350 |
| Officer Compensation as a Percent of Revenue | 3.47% | 3.69% | 2.65% | 3.83% | 3.56% | 3.62% |

Exhibit one provides summarized financial statements for OES, Inc., for five years ending with 2002. OES, Inc., is a distributor of chemical products that operates in the Mid-Atlantic area. Ms. Olney is the CEO of OES, Inc., and the value of her firm is being determined as part of divorce proceedings.

Ms. Olney is fully engaged in the management of the firm. The firm has 35 employees. There are six sales personnel, and the sales manager reports directly to Ms. Olney, as does the controller and plant manager. She is responsible for setting the strategic direction of the firm's activities. She is the only officer of the business.

OES revenue has grown from $9.7 million to $16.2 million between 1998 and 2002, as indicated on exhibit one. Profits have been volatile during this period, declining for the first three years, with a reported loss in 2000, and then growing between 2000 and 2002. The firm has an average reported profit margin on sales of .25 percent for the past five years. Officer

EXHIBIT TWO

**INDUSTRY FINANCIAL PERFORMANCE AS REPORTED BY INDUSTRY DATA**

| | | 2002 | 2001 | 2000 | 1999 | 1998 | Five-year Average |
|---|---|---|---|---|---|---|---|
| Officer Compensation as a Percent of Revenue | 25th percentile | 2.10% | 2.60% | 2.10% | 2.20% | 2.30% | 2.26% |
| | **median** | **2.85%** | **3.10%** | **2.53%** | **2.70%** | **3.50%** | **2.94%** |
| | 75th percentile | 4.80% | 5.10% | 4.50% | 4.20% | 4.90% | 4.70% |
| Return on Assets: Operating Profits as a Percent of Assets | 25th percentile | 2.10% | 2.90% | 2.10% | 2.50% | 2.30% | 2.38% |
| | **median** | **4.30%** | **5.20%** | **4.60%** | **4.20%** | **4.75%** | **4.61%** |
| | 75th percentile | | | | | 10.50% | 9.08% |

compensation has grown from $350,000 in 1998 to $600,000 in 2002. However, as shown on exhibit one, officer compensation fell in 2001. According to Ms. Olney, the reduction in officer compensation in 2001 was necessitated by the need for funds to expand plant capacity to meet expected sales growth.

To determine whether OES officer compensation needs to be adjusted, a comparison to industry financial data was undertaken using industry performance data. As shown on exhibit two, OES' financial performance has been below industry norms based upon reported profitability as measured by return on assets.

As discussed above, the use of industry profit comparisons for determining officer compensation is best made using return on assets and/or return on sales. However, some data sources[17] provide financial performance data with a distribution across sample firms. Other data sources present only one measure, such as a mean or median. For example, in the 2002 data presented above, one-half of the firms in the industry sample (that is from the 25th percentile to the 75th percentile) had a return on assets between 2.1 and 8.0 percent. Where possible, using data that presents the distribution of results across the sample of firm performance is preferable. This allows the analyst to adjust executive compensation for different levels of firm performance.

OES reported return on assets has averaged 0.85 percent over the past five years, as shown on exhibit one. This is well below the 25th percentile of firms within the industry as indicated on exhibit two. Thus it is reasonably clear that OES' reported financial performance is materially below general industry norms. However, at the same time officer compensation as a percent of revenue for the past five years has averaged 3.47 percent, while the average of industry medians for the past five years is only 2.94 percent. This dichotomy may be an indication of excess compensation.

EXHIBIT THREE

**ADJUSTING OFFICER COMPENSATION TO MEDIAN INDUSTRY NORMS**

| | 2002 | 2001 | 2000 | 1999 | 1998 | Five Year Average |
|---|---|---|---|---|---|---|
| Reported Officer Compensation | $600 | $295 | $410 | $375 | $350 | |
| Officer Compensation at *Median* levels | 463 | 345 | 271 | 285 | 339 | |
| Adjustment to Reported Earnings | 137 | (50) | 139 | 90 | 11 | |
| Adjusted Return on Assets | 4.04% | -0.54% | 2.30% | 5.00% | 2.57% | 2.67% |

Exhibit three presents OES financial performance after adjusting officer compensation to industry medians. As shown on exhibit three, the decrease in officers' compensation increases income, and thus return on assets has increased from an average of 0.85 percent (from exhibit one) to 2.67 percent. However, an adjusted average return on assets of 2.67 percent is still significantly below the median industry profitability of 4.61 percent.

Adjusting officer compensation to the 25th percentile instead of the median level is shown on exhibit four. Return on assets now averages 4.99 percent over the past five years, which is consistent with industry median return on assets of 4.61 percent. With this smaller adjustment to officer compensation we find that firm profitability is now consistent with the industry data.

As illustrated in the mini-case above, it is important to analyze each situation in the appropriate context. Reported profitability after reported levels of executive compensation should be compared to industry measures. Adjustments to normalize executive compensation should be analyzed in the context of the financial and operational performance of the subject firm after consideration of relevant factors. Some of the factors discussed in various court cases can provide suggestions and guidance for the analysis. As illustrated above, it is an error in finan-

EXHIBIT FOUR

**ADJUSTING OFFICER COMPENSATION TO 25TH PERCENTILE INDUSTRY NORMS**

| | 2002 | 2001 | 2000 | 1999 | 1998 | Five Year Average |
|---|---|---|---|---|---|---|
| Reported Officer Compensation | $600 | $295 | $410 | $375 | $350 | |
| Officer Compensation at 25th Percentile Levels | 341 | 289 | 225 | 232 | 223 | |
| Adjustment to Reported Earnings | 259 | 6 | 185 | 143 | 127 | |
| Adjusted Return on Assets | 6.04% | 0.68% | 3.67% | 6.97% | 7.61% | 4.99% |

cial judgment to arbitrarily set officer compensation at industry medians.

**DISCOUNT RATE CONSIDERATIONS**

Discount rates in valuations are selected based on the perceived level of risk borne by shareholders. If reported executive compensation is significantly above industry levels, one may be tempted to assume higher risk and select a higher discount rate. For example, when employing a discounted earnings approach, if the selected discount rate is 20 percent, one is implying that investors require a 20 percent return on the normalized future earnings of the company. This 20 percent return is the same for other equity investments with a similar risk profile. However, once compensation is adjusted to reasonable levels, the selection of the discounted rate returns to the analysis of other relevant factors.

Normalized earnings reflect a level of officers' compensation consistent with market conditions and firm performance. To the extent that officer compensation is expected to change with firm performance it represents a variable cost. All else equal, variable costs provide less risk to shareholders than do fixed costs. This in turn would result in a shareholder's required rate of return being lower the greater the percentage of variable costs in the overall cost structure of a firm. However, it is the fundamental nature of the business and its performance expectations that drives shareholder required rate of return estimates. To a large extent, once adjustments have been made to officer compensation, the level of officer compensation is unlikely to have a material impact on the determination of the capitalization rate used in the valuation of a closely held business.

**CONCLUSION**

This article has presented a discussion of factors affecting the analysis of reasonable or normalized executive compensation in the context of a business valuation. The authors have reviewed various factors presented by the courts in several cases, and have presented a mini-case which illustrates an adjustment to compensation in the context of the overall profitability of the firm relative to its industry group.

As illustrated in the above case, adjusted officer compensation can be either greater than or less than industry norms based upon the resulting financial performance of the firm. The independent investor's test is satisfied, as adjusted firm performance is consistent with industry profitability. There is no formula or mechanical process to determine what constitutes normal officer compensation. The level of officer compensation, in part, should be based upon the financial performance of the firm, the firm's performance relative to the industry in which it operates, and levels of compensation one would expect to find in comparable firms. ■

**ENDNOTES**

1. *Elliotts, Inc. v. Commissioner*, 52 AFTR 2d 83-5976.
2. Owensby & Kritikos, 819 F.2d at 1323.
3. *See Labelgraphics, Inc. v. Commissioner*, TC. Memo 1998-343 (Sept. 28, 1998).
4. *Rapco Inc. v. Commissioner*, 77 AFTR 2d 96-2405 (85 F. 3d 950).
5. *Elliotts*, *supra*, at page 5979.
6. *Dexsil Corp. v. Commissioner*, 81 AFTR 2d 98-2312.
7. On remand, the tax court considered these factors in *Dexcil Corp. v. Commissioner*, TC Memo 1999-155.
8. Return on Assets is the ratio of Earnings Before Interest and Taxes to Total Assets or Total Invested Capital (EBIT/Total Assets or EBIT/TIC)
9. 716 F.2d at 1247.
10. 671 F. 2d 167,176 [49 AFTR 2d 82-628].
11. Industry survey data can also provide useful information in assessing officer compensation.
12. *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115 (1930).
13. *R.J. Nicoll Co. v. Commissioner*, 59 T.C. 37 (1972).
14. *Alpha Medical, Inc. v. Commissioner*, U.S. App. (6th Cir Apr. 19, 1999).
15. Ratio of Earnings Before Interest and Tax to Revenue (EBIT/Revenue).
16. Ratio of Earnings Before Interest and Tax to Total Assets (EBIT/Assets).
17. For example, RMA – Risk Management Associates.

***Les Barenbaum*** *is a professor of finance at La Salle University and principal in the Philadelphia office of Kroll, Inc.* ***Lisa Cruikshank*** *is a senior associate at Kroll, Inc.*

# www.njsba.com

# Online Communities

Log in with your NJSBA Member ID and password to:

- See what's new and noteworthy on your section's home page.
- Communicate news quickly and easily to all section members using the email distributor.
- Post questions to the forums and exchange information with your colleagues.
- Review the latest section newsletters online.
- Check the section meeting minutes online.
- View the calendar for upcoming meeting information.

*"The opportunities are endless in terms of members communicating within the email distributor and forum in their substantive areas,"* says NJSBA president Karol Corbin Walker. *"We are pleased that we are able to offer this unique benefit for the exclusive use of our sections and Young Lawyers Division."*

***Update your records with the NJSBA. Send your current email address and Member ID to sfrost@njsba.com to make sure we have the most up-to-date information. Thank you.***

New Jersey State Bar Association
One Constitution Square
New Brunswick, NJ 08901-1520
732-249-5000 FAX 732-249-2815

## S Corporations

# Taxable Income, Cash Flow and Distributions

*by Leonard M. Friedman*

A unique issue arises when one spouse's income is derived through ownership in an S corporation. How much of that income the shareholder-spouse is required to report is actually income to be considered for purpose of support? Interestingly, this issue is often overlooked, but there is authority, in both law and accounting, which has addressed the topic.

I recently reviewed a Kansas Appellate Court decision concerning a husband's minority (25 percent) ownership in a family-owned S corporation.[1] The husband also owned minority interests in other S corps with non-family owners. The case did not contain a valuation issue, but involved S corp income and distributions, and whether they should be included in income for purposes of support.

First, everyone reading this should be comfortable with the income tax mechanics of an S corp. An S corp is an incorporated entity whose income is not taxed at the entity level by virtue of an election made by its shareholders. The income from the S corp is taxed to each shareholder based on his or her ownership percentage during the year. This allocation is inflexible, and must be made in accordance with ownership, unlike a partnership structure, which has much more flexibility in allocating income. Since the income from the S corp is taxed to the individual shareholders, any future distributions of the allocated income are not taxed again at the individual level. This is unlike a regular corporation or C corp, which taxes the income at the corporate level and taxes the distributions of this income (dividends) again at the individual level. Therefore, the advantage of an S corp is that it avoids double taxation.

In the Kansas divorce case, the non-owner wife filed a petition to modify child support because her former husband's main business converted to an S corp from a C corp, and was distributing income to the shareholders. As a minority owner, the husband had no control over the total amount of distributions made by the company. Ultimately, the corporation was only distributing enough cash for the owners to pay their share of income taxes resulting from the income passed through to the shareholders. This is not an unusual practice. On his personal tax return for one year, Mr. Brand reported S corp income from various entities of $200,000, but only $70,000 of this was actually distributed to him.

The trial judge was sensitive to these accounting issues, citing to some of the following facts and circumstances:

1) The income was not the husband's income, but corporate income taxed to the shareholder based on an election.
2) Some of the income was from the non-recurring sale of corporate assets.
3) The funds would not have been available to the parties for support when the family was together prior to divorce. (This was a paper transaction, not an actual distribution.)

Kansas defines domestic gross income as income that is regularly and periodically received from any and all sources. The court cited other states' cases that distinguish income for tax purposes and income for child support purposes. Although these cases are not binding on a New Jersey court, the author knows of no New Jersey divorce cases directly on point. Therefore, a court may be persuaded by citation to out-of-state cases when this issue arises in a New Jersey divorce matter.

### TAXABLE INCOME V. CASH FLOW AVAILABLE

The salient point of the case is that the taxable income allocated to an S corp shareholder is not always indicative of the actual cash funds available or distributable to the shareholder. The practitioner has to consider the following:

1) Is the actual cash distribution commensurate with the taxable income?
2) How has the entity historically distributed profits?
3) Does the owner-spouse have

the ability to direct distribution of the entity's income?

4) Are the non-spouse shareholders conspiring to keep available cash flow to a minimum to assist the spouse in divorce planning?

Note that regarding item number 4, the retention of cash in the business may add to the value of the business for equitable distribution purposes. Excess cash is generally added back as a separate item of value. However, the Kansas case was a motion for adjustment in child support, so the increase in business value had no relevance.

**NJ GUIDELINES FOR CHILD SUPPORT**

Further support for the foregoing argument can be derived from the New Jersey Child Support Guidelines. Child Support Guidelines Appendix IX-B gives line-by-line instructions for completing the sole parenting worksheet for the determination of income for child support purposes. In the section titled "income from self-employment or operations of a business," item b discusses the availability of using discretion in the amounts used. Income and expenses from operations "should be reviewed carefully to determine gross income that is available to a parent to pay a child support obligation. In most cases, the amount will differ from the determination of business income for tax purposes." The section goes on to include examples of specific adjustments to taxable income; the examples include add backs as well as subtractions. The section also speaks to the averaging of sporadic income.

Again, the salient point here is that all items of income are not cash flow available for living and/or (in a divorce case) support. Other examples of income that may be excluded are as follows:

1) capital gains and losses
2) phantom income from certain partnerships where no cash is distributed
3) lump sum payments of retirement plans
4) stock options exercises included in the employee's W-2 (although the trend in the nation is directly opposite on this point)
5) lump sum payment of deferred compensation

**CONTROL V. MINORITY**

Even though *Brand* is not a valuation case, the court referred to and relied on a minority shareholder's ability to control corporate policy (*i.e.*, dividends), and makes a strong case for minority discounts. The court made it clear that the results may have been different if the husband owned a controlling interest in the entity's production of income, thereby allowing a shareholder greater discretion over distribution of available profits.

**CONCLUSION**

One must be vigilant when addressing the income of a spouse who has an interest in an S corp. We must look beyond the tax return to determine, from a fairness perspective, the extent of income that is truly available for support.

**ENDNOTE**

1. *Brand v. Brand,* 44 p. 3d:321 (2002).

***Leonard M. Friedman**, CPA/ABV, CBA, is a partner and director of matrimonial and valuation services at Rosenberg Rich Baker Berman & Company, PA, with offices in Bridgewater and Maplewood.*

# Facts

- Alcohol is the most widely used and destructive drug in America.
- Cocaine use causes marked personality changes; users become impatient, suspicious and have difficulty concentrating.
- Marijuana affects memory, concentration and ambition.
- Early intervention with alcohol and drug problems most often leads to complete recovery.
- Attorneys can and do suffer from alcohol and other drug abuse problems.

**NJLAP wants to help. You only need to call.**

**1.800.246.5527**

Free, confidential help is available for you or a lawyer you know who has problems with alcohol or drugs. Assessment sessions are available to help define the problem and to recommend a helping hand. Our conversations are understanding of your need for confidentiality.

NEW JERSEY LAWYERS ASSISTANCE PROGRAM

New Jersey Law Center
One Constitution Square
New Brunswick, NJ 08901
1.800.24NJLAP 1.800.246.5527

**NEW JERSEY STATE BAR ASSOCIATION**
New Jersey Law Center
One Constitution Square
New Brunswick, New Jersey 08901-1500
(732) 249-5000



*Another Service For:*

**NEW JERSEY FAMILY LAW SECTION**

**Your Section Enrollment: 1,258**