NFLR

NEVADA FAMILY LAW REPORT

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DOMESTIC PARTNERSHIPS:

AN INTRODUCTION TO THE NEW LAW, CHAPTER 393, TAKING EFFECT OCTOBER 1, 2009.

by Kimberly Surratt, Esq.

Long overdue, the law of domestic partnerships has arrived in Nevada. Time permits only an introduction, and more detail will come in later articles.

The Mechanics of How It Happened

SB 283 was introduced in the Nevada State Senate on March 16, 2009 by Senators Parks and Coffin to establish domestic partnerships in the state of Nevada. On April 8, the Senate Committee on Commerce and Labor heard the bill with a proposed amendment. The amendment primarily removed all fiscal notes from the bill, by not requiring an agency of the state of Nevada or a local governmental agency of the state of Nevada to provide health care benefits to or for the domestic partner of an officer or employee of that agency.

On May 12, the bill was introduced to the Assembly Judiciary Committee. Another amendment was proposed upon submission to the committee. The primary change in the amendment was to include that private employers in the state of Nevada would also not be required to provide health care benefits to or for the domestic partner of an officer or employee.

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DOMESTIC PARTNERSHIPS

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The Senate gave a final passage for the bill on April 21, by 12-9, and the Assembly gave a final passage to the bill on May 15, by 26-14. The bill was vetoed by Governor Gibbons on May 25. On May 30, the bill was returned to the Senate and the veto was not sustained, by 14-7. On May 31, the bill was returned to the Assembly and the veto was not sustained, by 29-15.

What Happened

Senate Bill 283 establishes a domestic partnership as a type of civil contract recognized in the state of Nevada. The intent of the bill was to provide the same rights, responsibilities, obligations, protections, benefits and duties, with the exception of mandated employer health care benefits, as do parties to any other civil contract created pursuant to title 11 of NRS, whether derived from statutes, administrative regulations, court rules, government policies, common law or any other provisions or sources of law. The bill, as enrolled, specifically provides that a "domestic partnership is not a marriage for the purposes of Section 21 of Article 1 of the Nevada Constitution."

On June 1, 2009, Senate Bill 283 was enrolled and delivered to the Secretary of State as Chapter 393. The bill will take effect on October 1, 2009. The Office of the Secretary of State will be responsible for collecting a fee and issuing a Certificate of Registered Domestic Partnership to persons who qualify under the chapter. The fee for filing with the Office of the Secretary of State is unknown at this time as it will be set by the Office of the Secretary of State pursuant to the guidelines set by the chapter.

What it Does

The basic requirements to be eligible to register as domestic partners in the state of Nevada are:

1. Two persons.

2. Furnish proof satisfactory to the Office of the Secretary of State that: both persons have a common residence; neither person is married or a member of another domestic partnership; the two persons are not related by blood in a way that would prevent them from being married to each other in Nevada; both persons are at least 18 years of age; and, both persons are competent to consent to the domestic partnership.

3. A solemnization ceremony is specifically not required, but not prohibited.

4. The chapter provides definitions of the following terms as used within the bill: domestic partners; domestic partnership; common residence; and residence.

5. The bill provides procedures for a simplified termination proceeding. However, if the domestic partners do not qualify under this chapter for a "simplified termination proceeding," then they must follow the procedures set forth in chapter 125 of NRS to terminate their domestic partnership.

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LOANS AND TAXES IN QDROs

by Marvin Snyder

This article discusses loans as well as the separate subject of tax implications that arise when a Qualified Domestic Relations Order (QDRO) is used in a divorce settlement with reference to an individual account defined contribution plan**.**

PLAN LOANS

For loans, as an example, consider the husband in a 401(k) plan with a total account balance of $100,000 at the date of divorce that is 100 percent marital property. His account in the plan consists of $80,000 in various investments and $20,000 in a loan. That is, he has borrowed from his plan account from time to time, and the current outstanding loan balance is $20,000. The marital settlement agreement in the divorce awards 50 percent of the community portion of the Husband's "retirement plan" to the Wife.

The question, then, is whether the intent for the QDRO is to award to the wife one half of $80,000 ($40,000), or one half of $100,000 ($50,000)? In either case, the wife's dollar award comes from the husband's non-loan plan account investments. By federal pension law, as well as by the terms of every plan, the plan loan is always the responsibility of the employee and the loan and obligation for repayment to the plan cannot be transferred to anyone.

If the agreement in divorce is silent on the loan issue, the drafter of the QDRO must inquire of the parties and their lawyers as to how it is to be treated. If no agreement can be reached, then the matter must be adjudicated.

PLAN TAXES

When there is a lump sum cash distribution available from a plan by QDRO, there are three possibilities, as follows:

1. The alternate payee spouse elects to receive all cash.
   a. There is personal ordinary income tax on the amount of the distribution, taxable as income to the alternate payee spouse in the year received. Because of this, the plan is required to withhold exactly 20 percent, with no choice of changing withholding amount or percentage. The 20 percent amount is sent by the plan to the Internal Revenue Service in the name and Social Security number of the alternate payee spouse, as a credit – a prepayment of tax. However, it is not the tax in and of itself.
   b. There is no penalty. This is not as well known as it should be. The confusion is that if an employee receives a cash distribution under age 59 1/2, it is a premature withdrawal subject to a 10-percent penalty. If the individual has terminated employment, the age becomes 55. Nevertheless, when there is a QDRO, the penalty does not apply, regardless of age or employment.
2. The alternate payee spouse elects a rollover to an Individual Retirement Account (IRA).
   a. There is no tax, no withholding, and no penalty. The entire distribution goes to the IRA of the alternate payee spouse, who doesn't even see the check.
   b. The downside of this is that the funds then become subject to IRA rules; they are no longer QDRO money. So, if the individual withdraws any portion of the IRA in cash under age 59 1/2, the 10-percent penalty would then apply in addition to the tax.
3. The alternate payee spouse may take the distribution in a combination.
   a. Some amount in cash, subject to the 20-percent withholding; and
   b. The balance rolled over to an IRA.

FINAL WORD

Before the QDRO is begun, the issues of plan loans and taxes should be discussed. Plan loans should be addressed in the divorce settlement. No reference to taxes should appear in the settlement, because the local court has no say over the IRS.

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NOTE FROM THE EDITOR

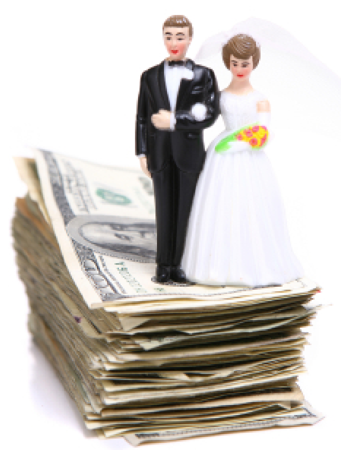
Thank you for your patience during the last year, when publication of the Nevada Family Law Report (NFLR) was paused. Following reorganization by the Family Law Section Executive Council with different approaches and editors, we have resumed the collection of articles for the NFLR (coined the "Niffler" by Liz from Silverman Decaria and Kattelman, a hidden talent helping with past printings). The new electronic format replaces costly printings, saving funds of your Family Law Section.

Articles are invited, and we are no longer limited in size. Send us your treatise or haiku on family law issues.

Bob Cerceo

ALIMONY: WHEN NONMODIFIABLE TERMS FAIL

by Dixie Grossman, Esq.



Assume a marital settlement agreement includes an alimony provision making alimony nonmodifiable. At first blush, it appears inclusion of the clause is intended to prevent relitigation of alimony agreed upon as part of the larger settlement. Of course, this is a two-edged situation – one party is banking that no unexpected event will affect the ability to comply with it, while the other party gambles that there will be no unforeseen contingency increasing their need or otherwise warranting an increase in support.

It is presumed that a court would be loathe to grant modification of a purportedly unmodifiable support obligation if it looked as if one party or the other was simply trying to renege on their deal. However, irrespective of intentions to settle fully, fairly and for all time the obligations of the parties toward one another, it is not difficult to anticipate situations in which the court might be tempted to modify the "nonmodifiable" alimony. What if the obligor, through no fault of their own, is no longer able to afford the alimony obligation as previously agreed? What if an obligee, granted alimony for a set term about to expire, shows need for additional support? It is these cases and the manner in which courts have dealt with them that should give family law practitioners pause in drafting "nonmodifiable" alimony provisions.

In these situations, our sister states have found such clauses unenforceable, stating that parties are unable to nullify a court's inherent power under state law to amend an order for alimony in certain circumstances. *See Vorfeld v. Vorfeld*, 804 P.2d 891 (Hawaii Ct. App. 1991). Other courts have held such clauses to be contrary to public policy and therefore refused to

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ALIMONY

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recognize or enforce them. *See Smith v. Smith*, 618 A.2d 381 (NJ Super. Ct., Chanc. Div. 1993). These cases show a predisposition, at least in some jurisdictions, to modify supposedly "unmodifiable" alimony terms in certain circumstances.

Nevada's focus follows whether or not an agreement was merged into the decree. If so, the agreement can be modified, but if not, the clause prevents modification. In other words, in the reported cases where the agreement is not merged into the decree, the agreement survives as an independent contract and is not modifiable. *See Ballin v. Ballin*, 78 Nev. 224, 371 P.2d 32 (1962), *Rush v. Rush*, 82 Nev. 59, 410 P.2d 757 (1966), *Jones v. Jones*, 86 Nev. 879, 478 P.2d 148 (1970), *Gilbert v. Warren*, 95 Nev. 296, 594 P.2d 696 (1979). Conversely, where the agreement is merged into the decree, the agreement loses its status as an independent contract and modifications to the agreement may be made. *See Lewis v. Lewis*, 53 Nev. 398, 2 P.2d 131 (1921), *Day v. Day*, 80 Nev. 386, 395 P.2d 321 (1964), *Folks v. Folks*, 77 Nev. 45, 359 P.2d 92 (1961), *Murphy v. Murphy*, 64 Nev. 440, 183 P.2d 632 (1947).

In drafting marital settlement agreements where the parties intend alimony to be non-modifiable, it is important that the drafter contemplate the effect of merging the agreement into the decree – including the possibility that merger may nullify the parties' intent. Similarly, for practitioners wishing to modify "non-modifiable" alimony, merger of the agreement may provide the opportunity for making such a claim so long as a change in circumstances warrants such relief.

In those situations where merger allows a litigant to seek modification of "non-modifiable" alimony, the litigant need only show a change in circumstances warranting such relief under NRS 125.150(7), which states:

> If a decree of divorce, or an agreement between the parties which was ratified, adopted or approved in a decree of divorce, provides for specified periodic payments of alimony, the decree or agreement is not subject to modification by the court as to accrued payments. **Payments pursuant to a decree entered on or after July 1, 1975, which have not accrued at the time a motion for modification is filed may be modified upon a showing of changed circumstances, whether or not the court has expressly retained jurisdiction for the modification**. In addition to any other factors the court considers relevant in determining whether to modify the order, the court shall consider whether the income of the spouse who is ordered to pay alimony, as indicated on the spouse's federal income tax return for the preceding calendar year, has been reduced to such a level that the spouse is financially unable to pay the amount of alimony he has been ordered to pay (emphasis added).

See also Schryver v. Schryver, 108 Nev. 190, 826 P.2d 569 (1992); *Martin v. Martin*, 108 Nev. 384, 832 P.2d 390 (1992); *Siragusa v. Siragusa*, 108 Nev. 987, 843 P.2d 807 (1992); Nevada Family Law Practice Manual, 2008 Edition § 1.224, dealing with modification of alimony.

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VALUATION OF GOODWILL IN PROFESSIONAL PRACTICES AND "DOUBLE DIPPING" WITH SPOUSAL SUPPORT

by Brian M. Boone, CFA, CVA, CPA-ABV, MBA

INTRODUCTION

What is the reasonable basis for the value of any "financial asset?" For the purposes of this paper, a "financial asset" is any asset that serves as an investment for investors seeking a "return;" "return" is the cash flow to an investor from income generation or realized capital gains. The reasonable basis for the value of any financial asset is the expected future return (cash flow) as adjusted for the perceived risks.

In a marital dissolution, the expected future income stream (cash flow) of a financial asset is valued for the purpose of the community property division and the expected future income is also considered as income available for support. In effect, a spouse can often pay the community in a property division for the present value of an expected income stream from a financial asset and can then be ordered to pay support from the same income stream after the property division.

When we identify excess earnings in valuing the financial asset of goodwill for marital dissolution purpose we are identifying a part of the earnings stream that is attributable to elements of the practice developed during the marriage (a trained workforce that produces gross margin, continued patronage from a loyal customer or referral base, a reputation calling for a higher billing rate, etc.), and not the post separation efforts, even though the professional still needs to work to yield the excess earnings. Is payment of support from excess earnings after award of valuable goodwill a payment twice for the same income stream?

A HYPOTHETICAL

Assume a marital estate has two assets: an oil and gas royalty interest that pays $50,000 per year consistently and that was valued at $500,000 (a price indicating a 10-percent rate of return expectation) and a family residence valued at $1 million subject to a $500,000 mortgage encumbrance. Assume that wife (W) has been awarded the residence at a net value of $500,000 and the husband (H) has been awarded the royalty interest valued also at $500,000 for an equal property division.

Assume that W was unemployed during the 25-year marriage and has no earnings capacity. Assume the parties have no children. Wife has been awarded an asset with a $3,200 per month debt service obligation. Husband is employed earning wages of $325,000 per year and has an additional $50,000 of taxable ordinary income from the royalty interest. Should the royalty income be included as or considered to be income available to H from which he can pay support? H has already paid wife for her half of the present value of the royalty income in the property division.

W in our example has received a residence that produces no income but that allows her to enjoy the use of a $1 million home while only having to service $500,000 in debt. If H is to replicate the standard of living, he will need a $1 million home but, in our example, he does not have $500,000 in cash to put down on a home. H will have to borrow more and will have greater debt service in order to acquire a similar residence. Many can query: how is it fair and equitable that H gives up his half of the equity in the family residence in exchange for the royalty interest and then is also required to help W pay the mortgage payment with support funded with the same royalty income?

THE PROFESSIONAL PRACTICE AND PROFESSIONAL GOODWILL DISTINCTION

The circumstance of a payment for the present value of expected income in a property division and the payment of support from that same source of income is often referred to as "double dipping." The double dipping debate is often centered around the identification and valuation of professional practice goodwill based upon the capitalization of excess earnings and the award of support to be based upon and paid from those same earnings. As set forth in the example of the oil and gas royalty interest, double dipping occurs whenever a financial asset is valued and divided as part of a community property division and the related income is considered to be income available from which support can be paid.

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Is there a distinction to be made between income attributed to valuable goodwill of a professional practice (based upon capitalization of excess earnings) and the income from a gas royalty interest or net rental income from an investment in a commercial building or from any other financial asset? Certainly, there are key differences, but should those differences be considered relevant to the double dipping debate? The difference most often cited is that many of the financial assets can be classified as "passive" in nature (distinct in this paper from the tax code definition of passive income) while the excess earnings, arguably, require the post separation efforts of the "professional" who is awarded the goodwill and consequently the related excess earnings are considered by many to be "active" in nature.

Much of the typical argument against the inclusion of excess earnings as income available for support is the same argument made against valuing professional goodwill in the first place. A common argument is that the "excess earnings" being considered in the goodwill valuation requires post separation efforts and additionally that the professional goodwill is often not transferable and saleable while other income-producing assets can be separated from the individual efforts such that the related value can be liquidated through a sale. The requirement for support to be paid from those excess earnings layered on top of the requirement to pay the community for the present value of those excess earnings in the property division is considered by many professionals to "add insult to injury."

BACK TO BASICS: UNDERSTANDING THE CONCEPT OF GOODWILL AND PARTICULARLY PROFESSIONAL GOODWILL VALUED FOR MARITAL DISSOLUTION PURPOSES

Black's Law Dictionary offers many different definitions for goodwill. One popular definition is: the expectation of continued patronage associated with the reputation of a business or its products. It is possible that continued patronage associated with a reputation can be identified and determined to exist but to have no value. You can identify an asset but that does not mean it is valuable. For example: John has a 1974 AMC Gremlin stored in the alley behind his house. John Doe has a car and few would argue that a car is not an asset. However, John has offered the car for sale and his best offer was for $75 from a junkyard, but only if John delivers the car to the yard. The lowest quoted cost to have the car towed to the yard was $100 and the lowest quote for the cost to get the car operational and drivable to the yard was $250. We can identify an asset (a car) but, in this example, it has no real net identifiable value. We can often identify a professional practice with a good reputation and evidence of continued patronage (goodwill according to Black's definition), but there will be no identifiable value to attribute to that asset unless we can also identify excess earnings or a market for the sale of the business evidencing a likely sales price in excess of the value of the tangible assets in the practice.

It is important to remember that valuable goodwill is an income-producing asset. It is also important to remember that goodwill is an intangible asset as distinguished from a tangible asset. Intangible assets are riskier assets, with certain exceptions, than tangible assets. If earnings fail to materialize to provide a return on a tangible asset, the asset can still be sold to provide, at least, some return of capital. In the absence of earnings or when long-run average earnings decline, much (if not all) of the intangible value is completely lost. The exception might be a trademark or brand name that could generate income for a new owner despite the absence of earnings for an existing owner. In effect, businesses with tangible assets representing the biggest portion of total value require a lower return on investment than businesses with intangible assets representing the biggest portion of the total business value.

The relationship between tangible assets, goodwill and earnings is easier to illustrate and understand for a capital (tangible asset) intensive business:

> Company A and Company B are both widget manufacturers. Both companies have identical balance sheets with identical assets. Both companies have $1 million in tangible operating assets with an equal proportion of equipment, real property (factory), and working capital (inventory, cash and receivables). Both companies (A & B) have balance sheets and asset composition that compare with the typical company in the widget manufacturing industry. Both companies distribute their products in the same marketplace. The average return on tangible assets in the widget manufacturing industry is 10 percent. In other words, the typical widget company stockholders require a 10-percent return on the investment in tangible assets. Company A has a current earnings expectation of $100,000 or a 10-percent return on assets, which is consistent with the industry norm. Company B has a current earnings expectation of $150,000 or a 15-percent return on assets, which is well above the industry norm. Both companies have equal earnings growth expectations of 5 percent annually. It is presumed that a buyer of Company B would be willing to pay a price in excess of the value of the tangible assets. In paying for goodwill (the price in excess of the value of tangible assets) the buyer is paying for the superior or excess earnings that Company B has demonstrated that it can earn while taking no more risk than either Company A or the typical widget manufacturer in the industry. If the superior or excess earnings fail to materialize in the future for Company B and earnings drop to the level of 10 percent of tangible assets, the goodwill is lost and Company B would be worth no more than Company A. But in this example there is a higher value placed on Company B currently based upon an expectation of higher earnings at the same level of operating risk.

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The income return to tangible operating assets can be thought of as a return having a priority over the income return to intangible assets. The business owner will associate earnings to tangible assets until they receive a level of earnings that represents fair return for operating those assets at a specific business risk level. Any expected earnings that exceed a required return to tangible assets will provide the basis for a price for a business that exceeds the sum of the fair market value of tangible assets (less the fair market value of included liabilities). The expectation of superior earnings given a comparable level of risk provides the basis for intangible value.

In the case of a professional practice there are typically insignificant tangible assets relative to the level of earnings. If earnings fail to materialize for a professional practice because the value of the tangible assets is usually insignificant, there is very little value. If any significant value is to be found (other than accounts receivable) in a non-transferable professional practice, it will be an intangible value placed upon the reputation and continued patronage evidenced by earnings power of the individual professional. After a return on tangible assets is subtracted, the excess earnings are measured by comparing the total remaining discretionary cash flow to the professional (salary, perks, benefits and owner draws) to the "fair or reasonable" compensation for a comparable professional. If the total "normalized earnings" to the professional, after a return to tangible assets, exceeds "fair" compensation, then it can be found that excess earnings exist that provide the basis for intangible value.

Alternatively, valuable goodwill may be identifiable in a professional practice if comparable market transactions indicate that the subject practice is transferable and would sell at a price that exceeds the fair price for the tangible assets of the practice. Theoretically, another professional would pay more than the value of tangible assets to buy and receive the tangible assets along with the reputation, continued patronage and earnings power of the selling professional. However, in reality, the "goodwill" of many professional practices is not transferable to a buyer and may be of value only in the hands of the current "owner." In a divorce, the reputation, continued patronage and earnings power of the individual need not be saleable or transferable. The individual professional is "buying out" his spouse's share of the community interest in the (demonstrated) superior earnings power that was developed during the marriage with community efforts. Post separation efforts will need to be expended to generate any earnings but the ability to generate the excess portion of earnings (charge a higher billing rate or generate profit from other billing for other professional staff services) is an asset that may have been "acquired" during the marriage.

In *In re Marriage of Lopez*, 38 Cal.App.3d 93, 113 Cal.Rptr. 58 (1974), the court stated the following:

> Certain matters merit consideration which may be said to reasonably contribute to, diminish, or effect, the intangible value of professional goodwill at the time of dissolution and the continuity and retention of benefits thereof which the professional practitioner will continue to enjoy after the marital dissolution. In that context some such factors are the practitioner's age, health, **past demonstrated earnings power,** professional reputation in the community as to his judgment, skill, knowledge, his comparative professional success, and the nature and duration of his business as a sole practitioner or as a member of a professional corporation to which his professional efforts have made a proprietary contribution.

The court also said:

> The fact that "professional goodwill" may be illusive, intangible, difficult to evaluate and will ordinarily require special disposition, is not reason to ignore its existence in a proper case.

The court issued a caution by saying:

> Mindful of the nebulous area into which we venture, we believe that for purposes of a marital dissolution, the parties are primarily concerned with the existence, value and consequences of the "goodwill" of a professional business in an **economic sense,** as distinguished from legal or accounting concepts.

The key language in *Lopez* that is often pointed to by attorneys and experts representing the "in spouse" is:

> **We think it follows that in marital cases the expectancy of future earnings is not synonymous with, nor should it be the basis for, determining the value of "goodwill" of a professional practice, but is simply a factor to consider in deciding if such an asset exists.** A community property interest can only be acquired during the marriage and it would be inconsistent with that philosophy to assign value to the post marital efforts of either spouse.

The court in *Lopez*, however, cites an authoritative source and clearly acknowledges that the economic concept of goodwill is related to future receipts and that the economic value of any asset is based on the future receipts which the asset will produce. The court in *Lopez* is trying to protect the post separation earnings of a practitioner that is related to post separation efforts. However, a level of "premium" or excess earnings that can be reasonably determined and expected as of the date of separation is related to the practitioner's efforts prior to separation. In fact, one could conclude that the court is saying that capability of the practitioner that exists at the date of separation to generate excess earnings is more important

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than the expectancy that those earnings will materialize. Hence a practitioner cannot manipulate the determination of the value of professional goodwill through a temporary lapse of efforts or the threat to "quit."

If the *Lopez* decision is read in its entirety, it reveals that the court agrees with and acknowledges authoritative literature regarding the fact that the current value of any asset is based upon the expectation of future earnings to be derived from ownership and operation of the asset. The court in *Lopez* provides a word of caution regarding the prospect of future earnings because of the need to protect both parties in a marital dissolution. The difficulty for practitioners in calculating professional or personal goodwill in a marital dissolution case is determining the extent of expected future earnings that is a result of efforts expended during the marriage versus the expected future earnings that are exclusively attributable to post separation efforts.

EXPANDED HYPOTHETICAL TO INCLUDE A PROFESSIONAL PRACTICE

The proper determination of fair or reasonable compensation, the methods to calculate the normalized income of a practice and the methods to keep from valuing post separation efforts when valuing professional goodwill are topics of discussion for other papers. We can, however, close this paper by illustrating the economic impact of valuing expected excess earnings and then also including that earnings in the determination of support by altering and expanding the hypothetical example set forth earlier in this paper that included the oil and gas royalty.

Assume that in addition to the family residence and the oil and gas royalty interest that there are additional community assets subject to the property division. H has a physician practice. Assume that the $325,000 in wages for H represent, essentially, the pay-out of all owner's discretionary earnings from H's professional practice. The professional practice was valued at $500,000 with $300,000 of that value being professional goodwill. H's fair compensation was determined to be $215,000 based upon Medical Group Management Association (MGMA) survey data for the 75th-percentile comparable physician. The 75th percentile was used for compensation because H worked a comparable amount of clinical hours and saw a similar number of patients as the 75th-percentile physician in the MGMA study. The result, after consideration of a fair return to tangible assets, identified excess earnings of $100,000, which was multiplied by a factor of three for goodwill purposes. Assume also that H has $1.2 million in a retirement plan portfolio through his practice.

Assume that H is awarded the practice at $500,000 and W is awarded the oil and gas royalty interest at $500,000. Assume that the residence will be sold with the proceeds from sale to be divided equally and that each party is expected to receive $210,000 in net proceeds. The parties have stipulated that they will each use the $210,000 proceeds to fund down-payments on their respective replacement residences and agree that no income will be imputed to those funds for support purposes by agreement. Assume that the retirement plan value will be divided equally through a QDRO.

H and W are both 49 years old. H is expected to continue working in his professional practice as a full-time physician for at least 15 years. H has consistently generated excess earnings at the level indicated for the last five years. We will assume for illustrative purposes that he will generate excess earnings of $100,000 for at least 10 years, at which time the excess portion will decline at 20 percent per year until retirement at age 64. The multiple of three that was used to value excess earnings as goodwill was a discounted value of expected future excess earnings based upon the high required rate of return given the high risk of such an intangible asset. In effect, through the property division, H paid W $150,000 for her half (one half of $300,000 goodwill) of the right to share future excess earnings in order for H to have the chance to collect her half share ($50,000 for 10 years and then a declining amount for five years: in excess of $600,000.) The reason that H pays only $150,000 for the chance to receive in excess of $600,000 over 15 years is that there are risks that the excess earnings will decline or terminate even though there is a reasonably higher probability that they will continue as expected. In our example we have assumed that they do continue for 15 years.

Remember our expectation that given the common objections and arguments, H will surely argue that he has to work those 15 years so that the excess is really attributable to post separation efforts and that it is not fair to value. A manufacturing plant producing widgets that has earnings attributable to goodwill must also continue operating to produce that excess earning. When we identify excess earnings in valuing goodwill for marital dissolution purpose, we are identifying a part of the earnings stream that is attributable to elements of the practice developed during the marriage (a trained workforce that produces gross margin, continued patronage from a loyal customer or referral base, a reputation calling for a higher billing rate, etc.), and not the post separation efforts, even though the professional still needs to work to yield the excess earnings. Remember, in our example, we took care not to compare our physician to the physician in the study working the median clinical hours and with the median patient visits. We used the 75th percentile to avoid valuing those extra efforts that are required post separation to continue H's pattern of earnings. We did not value the portion of the income stream that is fair compensation so that this "expense" is allocated to provide for continued service and maintenance of the "goodwill."

What can we say about the oil and gas royalty now awarded to wife in our expanded hypothetical? Let's assume that wife will receive a $50,000 royalty for the next 15 years, with de-

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clining receipts (declining annually by 20 percent of the $50,000 per year) for another five years. W paid H in the property division $250,000 in exchange for H's community property right to receive his half of the royalty ($25,000 for 15 years and then a declining amount for five years thereafter until the oil and gas wells are fully depleted: in excess of $425,000). The present value of the royalty stream included discounting for some risk of future decline or termination of the royalty. In our example we assume that the royalty continues for 20 years after the property division.

If the royalty income and the excess earnings are both considered income available for support, we have some possible "double dipping" in both cases. All income that is included as income available for support for post judgment support in any dissolution is from separate property or separate property efforts (as it relates to the divorcing spouses). Professional goodwill is an income-producing financial asset and the oil and gas royalty interest is an income-producing financial asset, and these are H and W's respective separate property post judgment. Should W not be asked to use that income to support herself and should the court not consider the excess earnings as income available from which H can support W (subject to all the factors for consideration set forth in the code) just because the income comes from financial assets valued and divided in the property division?

Figure 1 (page 11) is a marital settlement balance sheet setting forth the property division in our expanded hypothetical along with a summary of the expected relative incomes. An equal division of property has been achieved with each party having an equal net worth and each party having income-producing assets. Figure 1 also illustrates the amount of support (using Alameda County guideline support as a proxy for post judgment support for illustrative purposes and assuming 2007 tax consequences for each year) and net spendable income for each party for the first five years after judgment given our assumptions. Figure 2 on the same page is identical to Figure 1 in representing our hypothetical, with the exception that the income used to value assets is excluded from income available for support. Note the difference in Alameda Guideline support and net spendable income.

CONCLUSION

Clearly, the hypothetical and other conceivable hypothetical examples raise additional points relating to the valuation of professional goodwill and the association with support that leads to the "double dipping" question. At reasonable retirement age, even if H continues to work in his practice, W will have access to the retirement account awarded to her in the property division, which could trigger a change in circumstance and a reduction is support. Wife could also remarry, thus terminating the support altogether.

As the expanded hypothetical indicates, the professional buying out goodwill from the community (based upon valuing excess earnings) is truly not paying twice for 100 percent of wife's share of the excess earnings, as is often contended (see Figures 1 and 2). In our hypothetical example, H's support payments were approximately $25,000 higher annually and annual net spendable income after payment of support was approximately only $13,000 per year lower as a result of the inclusion of the excess earnings and the royalty income to the wife. The excess earnings, assuming H continues to operate his practice for 15 years, will generate in excess of $1.5 million, while H paid the community $300,000 for the related goodwill.

Like any financial asset, some fractional portion of an income stream that was the basis for asset valuation and paid for in a property division can end up funding a support payment. The argument against allowing "double dipping" is often related to the arguments against valuing goodwill in a "non-transferable asset" setting and is less about the payment of support from available income. Pursuant to *Lopez* we must reasonably determine and assign a community value to an identifiable financial or economic asset that is supported by excess earnings power of a professional when related earnings can be attributed to marital efforts. The "double dipping" argument, to be valid in the context of professional goodwill, would then also extend to other financial assets that have expected future income streams that are valued and divided in the property division and for which that same income stream is included for the purposes of determining income available for support.

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SEE FIGURES ON PAGE 11

Brian M. Boone, a main session presenter at the 2008 Ely Family Law Conference, is a principal partner in Schultze, Boone & Assoc., focusing its practice entirely on business valuations and litigation support. Because of the unique concentration in the area of forensic accounting, Schultze, Boone & Assoc. has the resources and expertise to handle the most complex and challenging cases, and offers expert testimony services and has been retained as a joint expert on many cases. Boone can be reached at 350 University Ave., Ste. 110, Sacramento, CA 95825, (916) 576-2330, bmb@sba-valuations.com.

Figure 1

Hypothetical Property Division and Income Scenario
Illustrative Example Related to "Double Dipping Claim"
Includes Excess Earnings and Royalty Income
Figure 1

	Property Division		Income For Support	
	Community Values		Annual Income Produced	
	Awarded to Wife	Awarded to Husband	Wife	Husband
Professional Practice Value Goodwill (valued at 3 x excess earnings)		300,000		100,000
Professional Practice Tangible Asset Value Including Receivables		200,000		20,000
Residence (Net Sales Proceeds)	210,000	210,000		
Husband's Retirement Account	600,000	600,000		
Oil & Gas Royalty (valued at $50k annual income capitalized at 10%)	500,000		50,000	
Equity From Property Division	1,310,000	1,310,000		
Total Income from Assets Awarded			50,000	120,000
Fair Wages from Professional Practice				215,000
Total Pre-Tax Income Available Before Support			50,000	335,000
Support Based Upon Alameda Guideline ($7,633 monthly)			91,596	(91,596)
Taxes			(26,796)	(74,220)
Net Spendable Income			114,800	169,184

Figure 2

Hypothetical Property Division and Income Scenario
Illustrative Example Related to "Double Dipping Claim"
Excludes Excess Earnings and Royalty Income

Figure 2	Property Division		Income for Support	
	Community Values		Annual Income Produced	
	Awarded to Wife	Awarded to Husband	Wife	Husband
Fair Wages from Professional Practice				215,000
Professional Practice Value Goodwill (valued at 3 x excess earnings)		300,000		-
Professional Practice Tangible Asset Value Including Receivables		200,000		20,000
Residence (Net Sales Proceeds)	210,000	210,000		
Husband's Retirement Account	600,000	600,000		
Oil & Gas Royalty (valued at $50k annual income capitalized at 10%)	500,000		-	
Total Income For Support Purposes			-	235,000
Income from Assets Not Included for Support Purposes			50,000	100,000
Equity From Property Division	1,310,000	1,310,000		
				-
Total Pre-Tax Income Available Before Support			50,000	335,000
Support Based Upon Alameda Guideline ($5,574 monthly)			66,888	(66,888)
Taxes			(18,480)	(85,296)
Net Spendable Income			98,408	182,816

FAMILY LAW AND CONTINGENCY FEES: TIME TO RECONSIDER?

By Marshal Willick, Esq.

The *Tomkins* Matter (Marquis & Aurbach v. Dist. Court) Opinion, 122 Nev. 1147, 146 P.3d 1130 (2006).

Andrew and Judy Tomkins divorced in 1973 after an 11-year marriage. Their stipulated decree divided property and contained a convoluted provision paying principal and interest on a note payable to Judy, with the interest denominated "alimony," apparently for tax reasons. Under the agreement, Judy could delay taking principal indefinitely, thus prolonging the payments of interest/alimony.

Twenty-five years later, she had still not taken the principal, was still getting interest/alimony payments, and in 1998 Andrew, fed up, filed a motion to set aside the agreement. Judy hired Marquis & Aurbach to defend it and insisted on a contingency fee agreement, after being offered the opportunity to hire the firm on an hourly basis. The firm negotiated a large lump-sum payment to Judy (in excess of her specified minimum terms) in exchange for termination of the payment stream, and was paid its contingency fee.

Some months later, Judy's son was appointed as Judy's conservator, learned all of the above, and initiated a fee dispute to retrieve the fee. After proceedings not relevant here, the matter reached District Court, which ultimately upheld the fee award. The son filed a writ to the Nevada Supreme Court, which struck down the fee award and remanded for rendition of a "reasonable fee" based essentially on the hours worked and results obtained.

The court found that the contingency fee agreement violated prior SCR 155 (now RPC 1.5), which prohibits such fees in "a domestic relations matter, the payment or amount of which is contingent upon the securing of the divorce or upon alimony, child support, or property settlement in lieu thereof." The opinion incorrectly states that new RPC is identical to the prior rule; it is not, but it has the same substantive prohibition.

Noting that the agreement was entered into 25 years post-divorce, the court found that settlement of Andrew's attempt to terminate the payment stream violated the "plain language" of the rule since it was "partially contingent upon a modified amount of alimony." The court found that "domestic relations matters" can be the subject of litigation post-divorce, and that alimony and the division of community property are "domestic relations concepts."

The court agreed that contingency fees are permissible in domestic relations actions to collect past-due payments (so long as the fee is reasonable, any fees court-awarded were credited against the contingent fee, and the client was advised of the options of hiring counsel hourly or seeking services from the district attorney's office). Further, the court apparently approved contingency fees in actions to modify property settlements "independent of support issues," taking the time to disagree with Ethics and Professional Responsibility Committee Formal Op. 16 (1993), which had indicated that ***any*** property settlement modification "necessarily" affected alimony, making contingent fees impermissible.

Here, however, Judy wanted to and did negotiate for a lump sum which necessarily terminated the payment stream she had been receiving labeled "alimony." The court found that a contingency fee agreement to pay counsel was therefore simply prohibited, under various cases and ethics opinions. Without questioning– or even reciting– the public policies implicated, the court casually noted that the rule "does raise some concerns with respect to certain individuals' ability to retain an attorney in domestic relations cases." The court also noted, without comment, that the Restatement (Third) of the Law Governing Lawyers § 35 (2000) provides that contingency fees are prohibited only when they are contingent on a specific result in a divorce proceeding or concerning custody of a child.

Dissenting, Justice Gibbons noted that the fee agreement was entered into at the insistence of the client, who was offered and rejected an hourly billing option. Since this litigation was post-divorce, he asserted, a contingency fee option should be available, and he urged the court to modify the rule to permit such agreements.

Public Policy & Modern Reality

The 'anti contingency fee in domestic relations cases' ethics rule is derived from the majority common law position established many years ago. The usually-cited public policy consideration is the state's strong interest in promoting and preserving marriage,

(cont'd. on page 13)

CONTINGENCY FEES

cont'd. from page 12

which is supposed to be served by prohibiting attorneys from taking divorce cases on contingencies, thus preventing counsel from "promoting divorce" and "hindering reconciliation" because of the attorney's (contingent) financial interest in the divorce proceeding. *See, e.g., Myers v. Handlon*, 479 N.E.2d 106 (Ind. App. 1985).

Even where this view has not been reexamined on its merits, courts have allowed the concept of fees based upon "results obtained" or "reasonable value of result achieved" in domestic litigation cases and concluded that such fees do not constitute impermissible contingent fees. *See, e.g., Eckell v. Wilson*, 597 A.2d 696 (Pa. Super. 1991); *In re Marriage of Malec*, 562 N.E.2d 1010 (Ill. App. 1990); *contra*, *State ex rel. Oklahoma Bar Association v. Fagin*, 848 P.2d 11 (Okla. 1992).

In fact, *Tomkins* itself is such a case – the first fee dispute panel found that the straight hourly value of the time put in by Marquis & Aurbach was $23,000, but that a "reasonable fee" would be $75,000. The only reasonable construction of the $50,000 additur was that it was added under the "novelty, difficulty, and skill," and "amount involved and results achieved" subsections of RPC 1.5.

The problem with such a resolution is that it leaves all parties uncertain as to their rights and obligations throughout the case, determining the value of the work by the retrospective opinion of strangers to the original agreement. If such factors are to be legitimately considered, as apparently they can, then a person should be able to contract relating to them with specificity as to the amount that would be owed based on a particular result achieved, ***before*** the fact.

In view of the result ultimately reached, it apparently would have been perfectly appropriate for the law firm to have contracted for their hourly rate, plus an additional $50,000 if they reached Judy's original target settlement, so long as they phrased the fee as a results-achieved bonus rather than a contingency percentage.

It seems incongruous for ethical propriety to hinge on a matter of semantics. A lawyer eligible to receive a "results achieved" bonus would have precisely the same incentive to "promote divorce" or "hinder reconciliation" as one with a contingency agreement, and as Justice Gibbons points out in *Tomkins*, the entire question is nonsensical in the context of post-divorce actions. In that case, a quarter century post divorce, it could safely be said that the form of Judy's retainer agreement with her attorneys could have no possible impact on the public policy of promoting marriage.

The Supreme Court in *Tomkins* properly criticized Formal Op. 16 for limiting the power of parties to contract for legal services beyond the plain language of the ethics rule, but stopped short of examining the policies supposedly served by the rule itself to see if they merited continuation.

The fine-line drawing calls into the question the ends that are supposed to be served by the prohibitions embedded in our ethical rules, and whether the public policies that are implicated are served by allowing or prohibiting either results-achieved bonuses, ***or*** regular contingency agreements, given the place of divorce in modern American life. Put another way, is there still a legitimate purpose to be served by preventing counsel from being retained other than on a strictly hourly basis in cases involving alimony, or any other domestic relations matters?

It is true that in that in the recent updating of the ethics rules in the Ethics 2000 initiative, the substance of the old prohibition on contingency fees in domestic matters was not addressed. But this was because the Standing Committee on Ethics and Professional Responsibility already had under submission a request to revisit Formal Op. 16 and the world of results-achieved bonuses and contingency fee agreements in domestic relations cases. The committee, in turn, could not act because it was aware of pending litigation (*Tomkins*) on the same subject matter.

Now that the opinion has been issued, the time has come for an honest review of public policy and modern realities, both socially as to the fact of divorce in modern culture, and economically as to the ability of persons to hire their counsel of choice – which our court has recently proclaimed is itself a right deserving of substantial deference and protection as a matter of public policy. *See Millen v. Dist. Ct.*, 122 Nev. 1245, 148 P.3d 694 (2006).

Bounds of Advocacy/American Academy of Matrimonial Lawyers Position

The American Academy of Matrimonial Lawyers ("AAML") was founded in 1962, by highly regarded domestic relations attorneys, "To encourage the study, improve the practice, elevate the standards and advance the cause of matrimonial law, to the end that the welfare of the family and society be protected." There are some 1,600 AAML fellows in 50 states.

It is a difficult organization to join, requiring an examination on wide-ranging issues pertaining to family law, admission to the bar for 10 years, a 75-percent specialization in matrimonial law (subject to certain exceptions), certification as a family law specialist if available, and a minimum of 15 hours of continuing legal education in each of previous five years, plus interviews by a state board of examiners and review by other matrimonial law practitioners in the state, as well as other requirements.

The qualifications for admission are sufficiently exacting that when the Board of Governors of the State Bar of Nevada approved Standards for Certification of Family Law Specialists in February, 2005, it recognized the existing Nevada fellows of the AAML as

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CONTINGENCY FEES

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certified specialists. This created a group able to draft standards and create a specialist certification test for other family law practitioners in Nevada.

The national AAML has for many years had working groups dedicated to review of the ethical codes governing family law practice, and conceived the idea for what would become known as the "Bounds of Advocacy" in November 1987. The committee, which canvassed the entire AAML for its collective wisdom and experience, included Gary Silverman of Reno; the proposed text was vetted and reviewed by academics and judicial authorities for years before its publication in 1991.

In 1995, at the urging of the State Bar of Nevada Family Law Section, the Nevada Supreme Court made compliance with the standards of conduct embodied in the 1991 Bounds an aspirational goal of every lawyer and *pro se* litigant involved in family law cases in Clark County, by adoption of EDCR 5.04.

The first version of the Bounds had only five guidelines addressing fees:

- 2.1 Fee agreements should be reduced to writing.
- 2.2 An attorney should provide periodic statements of accrued fees and costs.
- 2.3 All transactions in which an attorney obtains security for fees should be properly documented.
- 2.4 An attorney may withdraw from a case when the client fails to honor the fee agreement.
- 2.5 If the client fails to honor the fee agreement, an attorney may properly take all steps necessary to effect collection, including mediation, arbitration or suit.

The AAML continued studying the issue, and a decade after the first edition, published a substantially updated and expanded version of the Bounds in 2000.

Family Law Specialization Examination

The 2009 Family Law Specialization Examination is scheduled for Friday, **October 30** at the State Bar of Nevada offices in Las Vegas and Reno. Applications are being accepted through **July 16**.

You can download the application and standards from the Family Law Section's website:

http://www.nvbar.org/sections/sections_family_law.htm

The newer version includes an extensive discussion of the propriety of various fee arrangements, and setting out in summary form the research and commentary supporting the Bounds. The Family Law Practice Manual includes the newer version of the Bounds for reference.

The new Bounds express the opinion that the enhancement of an attorney's hourly fees by a "results achieved" bonus is ***not*** a contingent fee and is not prohibited by any model rule, past or present. Bound Standard 4.4 (2000 ed.).

They also suggest a dramatic change in such rules, expressly stating that contingent fees should be permitted in most domestic relations matters. Bound Standard 4.5 (2000 ed.):

> An attorney should not charge a fee the payment or amount of which is contingent upon: (i) obtaining a divorce; (ii) custody or visitation provisions; or (iii) the amount of alimony or child support awarded. An attorney may charge a contingent fee for all other matters, provided that:
>
> (a) the client is informed of the right to have the fee based on an hourly rate; and
>
> (b) the client is afforded an opportunity to seek independent legal advice concerning the desirability of the contingent fee arrangement.

The comments to Bound 4.5 contain extensive discussion of the traditional policy bases for prohibiting contingency fees, and citations to authorities indicating why the traditional blanket prohibition on such arrangements are inappropriate. The comments debunk the notion sometimes expressed that contingent fees are "unnecessary" to enable poorer parties to obtain qualified counsel because of the power of the courts to compel a spouse with greater assets to pay fees, and instead state that the expressed public policy bases are not served by a contingent fee ban.

The commentary states that such a ban undermines the freedom of attorneys and informed clients to enter into fee arrangements that best suit the nature of particular cases and interests of both attorney and client, and notes that in the real world, the inability of poorer clients to pay the hourly fees accrued if they do not win their cases produces exactly the same economic result as a contingency fee in any event.

The proposed rule would limit contingency fees to those aspects of divorce cases supported by the historic policy bases, and in all other cases give informed clients the same ability to choose a contingent fee arrangement as client in other civil matters. Finally, the Bounds advocate that: "Jurisdictions that completely ban all contingent fees should be urged to adopt a rule similar to this Goal."

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CONTINGENCY FEES

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Conclusions

Clearly, the question of what is considered proper in terms of retainer and fee arrangements in domestic relations matters is a topic on which authorities vary, and in which a long-ago expressed blanket rule may have outlived its legitimate bases for existence. The reality is that many legitimate cases for poorer people simply cannot be pursued if they are difficult, or novel, on a flat fee or hourly basis.

Footnote 30 of the *Tomkins* opinion obliquely notes this economic fact, and footnote 28 correctly notes the excesses set out in Formal Opn. 16. Gibbons' dissent in that case makes precisely the same "client should be allowed a choice" point made by the Bounds, and the court in the meantime (in *Millen*) has restated the importance of permitting clients to be able to secure counsel of their choosing.

Given the force of the policy conclusions in the Restatement and the Bounds, clients should be able to secure qualified counsel of choice whenever that goal can be achieved without sacrificing any legitimate public policy goal of equal magnitude. RPC 1.5 should be amended in such a way to squarely address both results-achieved bonus provisions and contingency-based fees in domestic relations matters in the modern world, to avoid the limitations and uncertainty suffered by client and counsel in the *Tomkins* case.

The AAML position, as stated in Bounds of Advocacy Nos. 4.4 and 4.5, seem appropriate rules, for the reasons set out in the commentary. The Standing Committee on Ethics and Professional Responsibility should propose such a revision, and the Nevada Supreme Court should act on it.

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Articles Are Invited!

The next NFLR is expected in October 2009. Please submit your proposed articles by September 1, 2009 to Bob Cerceo at rc@slwlaw.com. With our electronic format, we are not limited by space or length considerations.