

Bernier v. Bernier

The lessons to be learned from the Supreme Judicial Court's recent case, **Bernier v. Bernier**, SJC-09836 (Sept. 14, 2007) are lengthier than the decision itself. Whatever family law attorneys thought they understood about the "inexact science" involved in the valuation of S corporations is due for an intense refresher course. Whatever family law attorneys assumed about the finality of the Judgment of Decree Nisi foreclosing remedial action concerning temporary orders should be reviewed in light of this case. The Bernier case reminds the bar that M.G.L. Ch. 208, Section 34 is an equitable distribution statute, founded on equitable principles, which require divorcing spouses to stand in a fiduciary capacity towards each other in the achievement of an equitable outcome. Lastly, alimony awards are crafted to meet the support and maintenance needs of the divorcing spouse in light of the payor's ability to pay; alimony payments are not an entitlement program to ensure that an avocation – or vocation – of a recipient spouse is perpetuated if the activity produces only financial 'losses'.

FACTS:

The facts of Bernier may be briefly summarized as follows:

In June of 2000, after a long term marriage, Judith and Stephen Bernier (hereinafter 'Wife' and 'Husband') each filed complaints for divorce in Dukes County Probate and Family Court. During the parties' lengthy marriage they migrated to Martha's Vineyard and acquired sizeable real estate holdings, a

horse farm and established two supermarkets on the island. The two supermarkets, the most valuable of the parties' marital assets, were placed in two S corporations, of which the Husband and the Wife each owned one-half. The uncontested testimony presented by the Husband was that he was the engine behind the success of the supermarkets and that his expertise and management skills were critical to its continued success. He also testified that he would maintain total ownership and control of the supermarkets, after purchasing the Wife's interest. Furthermore, the uncontroverted evidence was "that the supermarkets would continue to operate as S corporations after the parties' divorce."

In the first year after the filing of the divorce, several stipulations were entered as Temporary Orders. The Husband and Wife agreed that they would share equally the marital assets, that the income derived from their equal interests in the supermarkets would be shared equally, that the Husband would have the sole control of the supermarkets and the Wife would have the sole control of the horse farm. No accounting or equal sharing of S corporation income occurred from Jan.1, 2001 through Feb.2, 2004 despite a temporary order to do so.

The divorce trial commenced in February and the last day of eight days of trial was held in May, 2002. The trial was necessitated by the inability of the parties' respective experts to agree upon the value of the two S corporations, the implementation of the temporary orders and the appropriate

alimony award. The Husband's expert valued the two S corporations at \$7.85 million and the Wife's expert set their value at \$16.4 million.

FIRST NOVEL ISSUE:

The first novel question presented is, "Whether it is proper to discount the value of an S corporation by 'tax affecting' income at the rate applicable for C corporations, where one spouse will receive ownership of all shares of the S corporation after the divorce and the other will be required to relinquish all ownership in the business."

The Supreme Judicial Court approached this first issue in a novel manner. The usual norms and adjustments governing the valuation of business interests were recast. Only what the two experts had agreed upon – that the applicable method was "the 'income' approach, taking the supermarkets' average adjusted income after expenses for a set number of years, divided by the appropriate capitalization rate" was left in tact.

The preliminary matter addressed by the Court went to the duty of the divorcing spouses to behave as fiduciaries towards each other in realizing an equitable distribution of the marital assets, not as hypothetical buyers and sellers engaged in an arm's length transaction. The import of this "preliminary matter" should not be underestimated as it justifies the Court's disregard of both the "key man discount" and the "marketability discount" utilized by the Husband's expert. A fiduciary cannot claim discounts for events that the fiduciary knows will not occur. Thus the Husband, who testified that he would maintain the two supermarkets in their current form of ownership (as S corporations) could not

legitimately reduce the value of his business interests because of its dependence upon his continued stewardship or upon the difficulties of a non-existent sale.

NOTE:

The Court rejected the usual standard of “fair market value” in the context of divorce in favor of “fair value”, a value based upon the actual facts, not a hypothetical buyer and seller.

NOTE:

The Court’s decision references a similar obligation of partners in partnership but does not specifically address whether divorcing spouses, who hold C corporation interests or interests in family businesses held in legal entities other than S corporations, owe fiduciary duties towards each other if one spouse, after the divorce, will have acquired the other spouse’s interest.

Family law attorneys should utilize the concept that divorcing spouses owe fiduciary duties towards each other in all valuations of business interests and real estate transactions. The actual facts and circumstances of the parties will control whether or not marketability, key man discounts, for example, are appropriate. The same thinking should be applied to real estate valuations: where no sale is going to occur as a result of the divorce, any broker’s fee or embedded capital gains tax is irrelevant in determining the fair value of the marital asset.

The discussion of how to appropriately “tax affect” an S corporation is the central thrust of the first issue. The reader is reminded of the fact that all

S corporation income is passed along to its shareholders and income is only taxed once. In contrast, C corporation income is taxed twice: once at the corporate level and a second time when distributions are made in the form of dividends or interest income to the shareholders (at the shareholder's tax rate).

The two experts applied different principles to determine the actual cash income generated by the two supermarkets. The Husband's expert applied a hypothetical tax to the S corporation income, which he labeled "average corporate tax rate" and reduced the S corporation income by 35%. The percentage reduction reflects the average amount of federal tax individual recipients pay upon receipt of corporate dividends and interest income, opined the Husband's expert. The Wife's expert declined to tax affect S corporation income for the reason that neither spouse experienced such reduction in income. The wife's expert also refused to utilize any other discount, specifically, "key man" and "marketability", because the evidence clearly pointed to the fact that the Husband was neither leaving nor selling the supermarkets.

The trial judge, Judge Randy Kaplan, adopted all aspects of the Husband's expert's approach to valuation of an S corporation. She adopted all reductions proposed by the Husband's expert and declined to increase the valuation based on inflation or evidence that the revenues of the corporations had increased annually, as suggested by the Wife's expert.

The Supreme Judicial Court found that the trial judge's decision was clearly erroneous. Valuation of a business is a question of fact. The trial Judge erred by assuming facts not in evidence and disregarding uncontroverted facts in

evidence. To wit, the trial judge ignored the clear evidence that the Husband planned to continue to run “the whole show” and had no plans to sell the business. The Husband’s expert’s creation of an “average corporate rate” was a fiction of the expert’s own imagination – not a fact! The actual figures demonstrated that the revenues of the S corporation had increased annually; growth had occurred and could not be ignored in finding fair value.

The Court directed the trial judge to apply the method outlined in Delaware Chancery Court’s 2006 decision in Delaware Open MRI Radiology Assocs. v. Kessler. The Delaware case had not been decided until after the trial of the instant case.

SECOND NOVEL ISSUE:

The second issue, “Whether the judge improperly dismissed the wife’s equity complaint against the husband for misuse of marital assets?” was decided in an unexpected manner. The parties had entered into stipulations, entered as Temporary Orders, which required the parties to share equally the net income generated by the two supermarkets. The husband failed to do so after the first year and the wife filed both a Complaint for Contempt and a Complaint in Equity to address his violation of the order. Despite evidence at the divorce trial of the husband’s violation of the temporary order, the trial judge’s final judgment did not address this matter. The wife’s attempt to reopen this matter via her pending Complaint in Equity was dismissed because of ‘res judicata’ and ‘issue preclusion’. The SJC reversed Judge Kaplan, finding that the violations had been ignored in the her judgment, that the wife had not waived

her claim and that her share of the marital assets was far less than equal if the matter was not rectified. The issue was remanded to the trial court.

THIRD ISSUE, NOT NOVEL, BUT NOTEWORTHY

The third issue addressed by the SJC was, “Whether the amount of alimony awarded to the wife was proper”. After reciting the usual criteria for determining the obligation to support and maintain – need, ability to pay, station – the SJC noted that the obligation did not extend to the continuation of a horse farm business which provided the owners with whopping losses only. ‘Support and maintenance’ does not mean that a vocation, or avocation of the recipient spouse, which generates expenses in excess of income, must be underwritten by the payor – even if it is woven into the fabric of the marriage. Noteworthy is the clarity of the decision on this point, which no earlier case has delineated as sharply.

Lessons to be learned from Bernier v. Bernier:

1. The divorce statute is an equitable statute. Arguments of ‘good faith and fair dealing’ are always appropriate.
2. Divorcing spouses are to be held to the standard of duty of fiduciaries in their financial representations to their spouse.
3. “Fair market value” of a willing buyer and seller dealing in an arm’s length transaction is not the

appropriate standard to utilize in the divorce context when, and if, one of the spouses stands to acquire the marital asset in question. By definition, spouses are not at arm's length; they also are engaged in an action which by statute has at its foundation concepts of equity.

4. Traditional discounts, such as “marketability discount”, “key man discount”, “inflation discount or increase” are matters of fact, not to be applied arbitrarily.
5. “Fair value” is the appropriate valuation measure to be applied in divorce actions, not “fair market value”.
6. Valuation is a question of fact, not a matter of discretion of the trial judge.
7. The trial judge is free to adopt a valuation not presented by either expert if the facts do not support either valuation.
8. The trial judge is free to adopt a valuation not presented by either expert if the judge's method is supported by the actual facts of the case.
9. Valuations in divorce actions are very fact and circumstance specific.

10. Valuations of real estate, like businesses, are fact specific.
11. Elicit at trial evidence of the acquiring spouse's business plans.
12. If an acquiring spouse intends to retain the business in its current form, the retention will affect its value (no marketability discount applies).
13. If the acquiring spouse is essential to the business and he has no plans to leave the business or change his role, the value of the business will be affected (no key man discount applies).
14. Elicit evidence about the history of the revenues of the business from the expert as that will affect the appropriateness/rate of the inflation index.
15. Elicit evidence of the acquiring spouse's intention to hold/sell/rent/partition the former marital real estate. No capital gains, broker's fee or costs of sale apply where the acquiring spouse intends to hold real estate in the same manner as previously held by the parties.
16. Temporary orders entered during the pendency of a divorce action may be enforced through not only a Complaint for Contempt but also by a Complaint in Equity.

17. Temporary orders which are violated should be addressed at trial.
18. Failure to address violations of Temporary Orders in the Judgment of Decree Nisi may be addressed by several actions: (a) A Motion to Amend and Alter the Judgment; (b) A Complaint in Equity filed prior to the Judgment by the party adversely affected.
19. Alimony awards are based on the recipient's need for support and the need to maintain the lifestyle of the marriage as well as the ability of the payor to pay the order. An award of alimony cannot be justified because the recipient needs the award to perpetuate a business that is losing money, even if that unsuccessful business had been woven into the fabric of the marriage.
20. Query: After the Bernier case, will the awards of alimony be differently measured in the context of a divorcing artist, musician or writer, who generates more expenses than income?

