

*Title: In a Divorce Case a California Court of Appeals Rejects Discount for Taxes Not Immediate and Specific But Allows a DLOM*

**Case Description:** In this Divorce Case on appeal parties the California Appellate Court (AC) rejects a discount for taxes not immediate and specific and allows a DLOM regarding the value of Wife's one-half interest in the jointly owned business. The Court also determined that "the [trial] court impliedly made the factual findings necessary to support its ruling regarding Cynthia's breach of fiduciary duty claim." Finally, the AC determined that the Trial Court (TC) had the authority to set its own terms for payment of the equalization amount to Wife.

**Categories:** Marital Dissolution/Divorce

**NAICS:** Manufacture and Supply of Industrial Chemicals

**Case Name:** *Harvey v. Harvey (In re Michael S.)*

**Citation:** 2021 Cal. App. Unpub. LEXIS 7867 \*; 2021 WL 5934472

**Country:** US

**State or Federal:** State

**State/Jurisdiction:** California

**Court:** California Court of Appeal, Fifth Appellate District

**Experts:** Michael Smith

John Iacopi

Price Waterhouse Coopers, LLP

**Judges:** DETJEN, Acting P. J.; FRANSON, J., SMITH,  
J. concurred.

**Summary:** In this Divorce Case on appeal parties the California Appellate Court (AC) rejects a discount for taxes not immediate and specific and allows a DLOM regarding the value of Wife's one-half interest in the jointly owned business. The Court also determined that "the [trial] court impliedly made the factual findings necessary to support its ruling regarding Cynthia's breach of fiduciary duty claim." Finally, the AC determined that the Trial Court (TC) had the authority to set its own terms for payment of the equalization amount to Wife.

### **Case Digest:**

This is an appeal and a cross appeal in a California divorce case. Michael and Cynthia Harvey were married in 1988. Three years later Michael formed Enviro Tech Chemical Services, Inc. (Enviro Tech). By 2010 the Harveys jointly owned 825 shares of Enviro Tech, representing nearly 70% of the outstanding stock. In 2011 they entered into a Shareholder Buy-Sell Agreement (Agreement), including provisions regarding marital dissolution. After separation in 2011 Michael purchased additional shares from other shareholders.

In final judgement in 2018 the Trial Court (TC) concluded that the FMV of the one-half interest in the jointly owned shares was \$21,332,000; awarded all of the shares to Michael and ordered Michael to pay Cynthia \$21,332,000 either in cash or a seven-year promissory note. The TC also determined that there was no impairment to her community estate from any breach of fiduciary duty by Michael.

On appeal Michael contends the TC erred by disregarding the Agreement terms of payment in a buyout by imposing much more burdensome terms of payment. On cross appeal Cynthia contends the TC erred in applying two discounts to the valuation of her interest in the shares; one for possible future taxes that were not immediate and specific; and one for a discount for lack of marketability (DLOM) of her jointly held shares. "Cynthia further contends that the court 'erred by denying relief to [her] regarding Michael's secret purchases of additional [Enviro Tech] shares.'" The AC concludes that the tax liability was erroneously accounted for, but the DLOM was supported by substantial evidence. Also the TC "impliedly made the factual findings necessary to support its ruling regarding Cynthia's breach of fiduciary duty claim."

### **The Agreement:**

The Agreement relates to two family revocable trusts and to the trustees, Cynthia and Michael and the Archibalds, and Enviro Tech Chemical Services, Inc. (Enviro Tech) (collectively the Shareholders). Other shareholders are not included. The Agreement as to the Shares owned by the Shareholders is "for the purpose of protecting the Corporation and the Shareholders, as well as providing continuity for the Corporation's business in the event of the occurrence of certain events discussed in this Agreement."

### **Restriction on Transfer:**

Shares held by the Shareholders may be transferred only as allowed under the Agreement.

### **Option to Purchase:**

A Shareholder desiring to sell their stock under the Agreement shall give notice to the other Shareholders and to “the Corporation” in accordance with the Agreement. The Option Period for Enviro runs for 180 days following receipt of the offer or 90 days following the final determination of value under the Agreement. The option is for the price determined under Section 10 of the Agreement and at the terms in Section 11 of the Agreement. If the Corporation fails to exercise its option for all of the shares, then for 90 days the other Shareholders have an option to purchase the shares not purchased by the Corporation under the same terms.

## **Section 8. Sale on Marital Dissolution or Separation of Shareholder:**

### **Provisions for Divorce:**

Michael Harvey shall be deemed to be the owner of the shares of the Harvey Trust. Any decree of dissolution, etc. between a Shareholder and his respective spouse shall include 2 provisions:

1. Shareholder shall purchase and spouse shall sell every interest the spouse has in the Shareholders’ shares in the Corporation
2. A provision granting to the divorced Shareholder the spouse’s entire interest in the shares of the Corporation.

### **Option to Buy Spouse’s Interest:**

If neither provision is included in a decree, et. then the divorced Shareholder shall be required to purchase from the spouse or ex-spouse and the spouse shall be required to sell the shares at the price in Section 10 and terms in Section 11.

### **Valuation Process:**

The purchase price to be paid for the Shares subject to purchase shall be the FMV of the interest in the Corporation represented by the Shares being sold. The FMV shall be determined by agreement of the parties within 30 days. If they do not agree the FMV shall be determined by Appraisal. The parties shall each appoint an appraiser within 15 days of the end of the negotiation period. “The two appraisers as timely designated shall confer within five (5) days thereafter to designate and appoint a third appraiser who shall be the 'Final Arbitrator Of Value' if the same is required hereunder.” There are further provisions explaining how the three appraisers arrive at a final value.

### **Payment:**

The purchase price is paid at the option of the purchaser by a promissory note(s) executed by the purchaser for a fifteen-year period amortized and payable monthly with interest, with prepayment allowed without penalty.

### **Valuation:**

**Michael Smith (Smith):**

Smith is a forensic accountant hired by Michael to appraise the Harveys joint interest in Enviro. He concluded that Cynthia's one-half interest in the 825 shares was \$21,331,895. Included was an adjustment for Enviro's deferred tax liability (presumably as recorded on its books). Smith explained that it would be paid as the time differences in deductions (primarily depreciation) reversed themselves in the future.

Smith then applied a DLOM. He explained his reasoning as essentially related to the lack of liquidity in a non-publicly held stock. He used restricted stock studies to arrive at a DLOM of 22.72%.

### **John Iacopi (Iacopi):**

Iacopi is a forensic accountant hired by Cynthia to determine the FMV of shares of stock owned by her. He determined the FMV of her shares to be \$39,954,388 exceeding Smith's appraisal by \$18,622 Million. Iacopi did not discount. Iacopi did not allow the deferred tax liability to stand and did not use a DLOM believing that the Agreement created a market for the stock and therefore no DLOM was appropriate. He also felt, as did Harvey, that the stock was "very marketable".

### **Pricewaterhouse Coopers, LLC (PWC):**

PWC was hired by the parties to be the final arbiter of the FMV. PWC concluded that Smith's opinion "most closely approximated the actual value of the shares which are subject to purchase (owned by Ms. Cynthia Harvey)." The TC also found Smith's appraisal to be more reasonable and adopted it.

### **Post-separation acquisition of additional Enviro Tech shares:**

Michael acquired 115 additional shares post separation, which he purchased with a combination of post separation earnings and a loan obtained on Plant 6. The Plant 6 building was owned by a partnership partly owned by Michael, which he received as part of the divorce property settlement. Cynthia testified that she did not receive any advance notice of these additional share purchases. "Iacopi testified that he and Smith 'normalized' Michael's "alleged bad acts" as part of their valuations and these acts 'did not impair [his] opinion of value of Enviro Tech...'"

### **Michael's Appeal:**

The opinion goes into extensive discussion of prior proceedings (*Harvey I*) as it relates to the manner in which the value was determined and upholds the methodology from the Agreement. Michael's appeal goes to the issue of the TC determining its own method of payment for the determined value of Cynthia's shares. Michael essentially contends that *Harvey I* "required the lower court to impose the terms and conditions set forth in Section 11 ('Payment and Transfer of Shares')." *Harvey I* did not address whether the payment provisions of Section 11 of the

Agreement applied in this case. The AC goes into a lengthy discussion of the application of the contract in this case as to this issue and concludes that the TC was free to set its own terms and conditions for the equalization payment.

### **Cynthia's Cross Appeal:**

#### **Valuation:**

Cynthia makes two arguments regarding the valuation of her one-half interest in the jointly owned Enviro Tech shares. "First, 'the [TC] erred in applying a discount for possible future taxes that were not immediate and specific. Second, 'the trial court improperly utilized a marketability discount in valuing [Enviro Tech].'" The TC has discretion to award property to one party and then provide for an equalization. However the TC may not divide the community property estate in any manner other than equally. There is no one applicable way to determine the value of closely held stock. The value of the property may be shown by qualified expert witnesses.

#### **Deferred Tax Liability:**

"[I]t is improper to take into consideration the tax consequences of an order dividing a community asset unless the tax liability is immediate and specific and will arise in connection with the division of the community property." Future tax consequences are inherently speculative. Smith accounted for Enviro Tech's \$2.5 million deferred tax liability. The tax primarily related to depreciation that would reverse itself in future years. Iacopi testified that both he and Smith agreed that the deferred tax liability was neither immediate nor specific. Michael counters that the TC did not err in adjusting for the deferred tax liability but cites no authority for this. "We conclude that the valuation erroneously accounted for a tax liability that was not immediate and specific."

#### **Discount for Lack of Marketability (DL0M):**

Smith opined that a DL0M was appropriate for this closely held business. A closely held business would lack liquidity. Iacopi believed such a discount was a misnomer because Michael was a specific buyer [under the agreement] which were not "exposed to an open and free market" and Enviro Tech was "highly marketable". The TC adopted Michael's valuation finding it "more persuasive," "compelling," "accurate," "reasonable," and "equitable." Any quarrel goes to the weight of Smith's testimony. The determination of the credibility and weight goes to the trier of fact and not to the AC. "We conclude substantial evidence supported a discount for lack of marketability".

#### **Relief for Breach of Fiduciary Duty:**

Cynthia identified as a contested trial issue, "Breaches of Fiduciary Duty by Mi[chael]," including his post separation acquisition of additional shares of Enviro Tech stock, which she believes should be Community Property. The TC decided that Cynthia failed to prove any impairment of

her one-half interest in the 825 Enviro Tech shares as a result of Michael's acquisition of additional shares. If anything the TC noted that the acquisition of those shares by Michael was similar to a corporate buy-back and helped to consolidate ownership with control. Demonstrably Enviro Tech increased significantly in value post separation so there was no diminution in value of the Community estate. ""Likewise, Husband's increases in income contrary to court orders and his, frankly, candid admission of what Husband refers to as 'bad acts' and what Wife refers to as 'money laundering' or 'round tripping,' as troubling as the Court finds them, are nevertheless not demonstrated by the evidence to have resulted in impairment of Wife's community interest in [Enviro Tech]." The TC seems to say that Michael did breach some of his fiduciary duties, but it also finds that none of these breaches impaired the value of Enviro Tech nor the Community Estate.

In her objections to the statement of decision Cynthia did not sufficiently identify any lack of findings with respect to Michael's use of community property to purchase additional Enviro Tech shares. ""Under the doctrine of 'implied findings,' . . . appellate courts reviewing the appealed judgment must presume the trial court made all factual findings necessary to support the judgment for which there is substantial evidence."" The AC concluded that community property was not used to purchase the additional shares in both purchases.

The judgment of the TC is reversed in part and remanded to reevaluate Cynthia's one-half interest in the jointly owned shares to eliminate the consideration of the deferred tax liability and to readjust the division of community property accordingly.