Retained Corporate Earnings in a Dissolution of Marriage Proceeding

By Eric Schulman

Your new client, after 25 years of marriage, retains you to represent her in the dissolution of her marriage. During the course of discovery you learn that her husband's business, which he formed and incorporated before the marriage, has built up millions of dollars in corporate retained earnings during the marriage. The company is a "subchapter S" business entity, from which he has received a modest salary throughout the marriage, coupled with corporate distributions.

As president and sole shareholder, the husband has operated the company and devoted substantial efforts to its success, and his hard work has helped to develop the company into the profitable and valuable business it remains today. The other marital assets in the estate are modest, and your client believes she is entitled to "something" from this business after 25 years of marriage, irrespective of the fact that it is "non-marital" under state law (in this case, Illinois). How do you advise her under these circumstances? Can she assert any claim over the company's retained earnings or over its increase in value attributable to her husband's efforts? Is she entitled to any of the corporate retained earnings? How do you proceed?

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Section 503(d) of the Illinois Marriage and Dissolution of Marriage Act (IMDMA) commands the court to assign to each spouse her or his respective non-marital property and to divide the couple's marital property between them in just proportions upon dissolution of marriage. 750 ILCS 5/503(d). Marital property is presumed to encompass "all property acquired by either spouse ... " during the marriage, regardless of how title is held. Non-marital property includes all property acquired by either spouse prior to the marriage (with limited exceptions), as well as any property acquired during the marriage that falls within certain statutory exceptions, including, for example, property acquired by gift, legacy, or descent.

When a spouse's non-marital property includes some ownership interest in a closely held corporation, a question of potentially significant financial consequence may include whether the retained earnings accumulated by a corporation during the marriage represent marital or non-marital property upon dissolution of marriage. Several Illinois appellate courts have described a framework for analyzing this question under the IMDMA. This article uses Illinois law as an example of how to effectively advise, and advocate for, your client with respect to these issues.

The Retained Earnings Problem

Retained earnings consist of the accumulation, over time, of a profitable business's net income that has been retained by that business, rather than distributed to its shareholders. Christopher P. Casey & James M. Godbout, Clarifying the Confusion Over Retained Earnings, *Stout Risius Ross J.*, Spring 2010, available at http://bit.ly/15bQLxt. Generally, a corporation's retained earnings represent an asset of the corporation and "remain the corporation's property until severed from the other corporate assets and distributed as dividends." *In re Marriage of Joynt*, 375 Ill. App. 3d 817, 821 (3d Dist. 2007). However, a spouse who works at, and owns a non-marital interest in, such a corporation can influence the decision of the corporation to either retain or distribute its net income (in whole or in part).

As such, that spouse may have the opportunity (and incentive) to deprive the marital estate of earnings that would ordinarily constitute marital income by deliberately retaining those earnings in the corporation's coffers without a business purpose. Should the corporation retain the earnings, which are not, then, directly received by the corporate owner spouse, that spouse will preserve her or his claim to the earnings as a shareholder while defeating the other spouse's claim to a just proportion of the earnings upon dissolution.

In the third appellate district case of *In re Marriage of Joynt*, an Illinois appellate court, for the first time, addressed the question of whether retained earnings of a closely held non-marital corporation may constitute marital property. The parties stipulated that the husband owned as non-marital property 33% of the closely held, subchapter S corporation (MVS), whose retained earnings had increased significantly during the marriage. The husband also served as the company's president and as a member of its board of directors (which had the authority to distribute retained earnings to shareholders).

After noting that courts in other jurisdictions have deemed retained earnings marital property "when a shareholder spouse has a majority of stock or otherwise has substantial influence over the decision to retain the net earnings or to disburse them in the form of cash dividends," the *Joynt* court found MVS's retained earnings to be non-marital because the husband possessed only a minority percentage of the company's shares and did not have the ability to distribute the retained earnings unilaterally to himself.

While appearing, at first, to arrive at its holding based solely upon the degree of control the husband could

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have exercised over the company's decision to retain or distribute its earnings, *Joynt* reaffirmed its holding by evaluating a second factor, namely, whether the company's retained earnings were considered in the value of the company (*i.e.*, a corporate asset or income). The court listed a number of additional considerations in determining that the company's retained earnings were a corporate asset: 1) the retained earnings were held by the corporation to pay expenses; 2) the corporation paid the income tax that flowed through to the husband as shareholder through year-end designated tax payments; and 3) the husband received a salary and biannual bonuses as compensation for managing the company's daily operations, which was reasonable and fair for the services he provided. The court also noted that the trial court had found insufficient evidence that the company's retained earnings were used to shelter marital income and defraud the marital estate.

Joynt left unanswered the question of how retained earnings should be classified if each of the grounds upon which the court based its holding, in its final analysis, support opposite outcomes. A spouse may, for example, exercise unfettered control (unlike the husband in *Joynt*) over the retention or distribution of a corporation's earnings, which appear to constitute a corporate asset, as opposed to income, for all of the same considerations described in the opinion. The next major decision in this area of developing law seemed to answer that question.

In re Marriage of Lundahl

In the first district appellate court case of *In re Marriage of Lundahl*, 396 Ill. App. 3d 495 (2009), the husband worked as officer and director of his solely owned non-marital subchapter S company. He could have unilaterally distributed to himself the corporation's retained earnings, having, in fact, done so in the amount of nearly $800,000 between 2004 and 2006 without requiring anyone's approval. Further, unlike in *Joynt*, the retained earnings were not held by the corporation to pay expenses, and the husband paid the income tax on those earnings himself. Thus, the court characterized the company's retained earnings as marital property.

Lundhal is an important decision because it was the first time an Illinois court found undistributed retained earnings to be marital property. Moreover, it is significant because it focused its analysis on the application of § 503(a)(8) of the IMDMA, which states that income from property acquired prior to the marriage is non-marital property if it is not attributable to the personal efforts of a spouse. The *Lundhal* court determined that the retained earnings were income (not an asset of the company), and because the income was attributable to the husband's efforts, and as the trial court noted, his "expertise and marketing abilities," the retained earnings were considered marital property. The court did not address, in its decision, which party had the burden to prove whether the income was attributable to the corporate owner's personal efforts; although, another court clarified that issue in a subsequent decision. *See In Re Marriage of Dann*, 2012 Ill. App. (2d) 10034, ¶ 86.

In re Marriage of Schmitt

Another 2009 case dealt with the related but distinct question of how to characterize distributions (and assets acquired from those distributions) out of a non-marital business. *In re Marriage of Schmitt* found that where a spouse works for a non-marital subchapter S corporation and receives distributions to make down payments and mortgage payments for various properties, absent proof that the distributions were not attributable to personal efforts (and thus non-marital), the properties must be deemed marital property. 391 Ill. App. 3d 1010 (2d Dist 2009).

The husband in *Schmitt* worked for his own company, and the payments made to purchase the various properties were reflected in the corporate books at the end of the year as distributions. The distributions represented income to the husband, and since there was nothing in the record to indicate that the distributions were attributable to something other than the husband's personal efforts, they were marital property.

In Re Marriage of Dann

The 2012 Second district opinion of *In Re Marriage of Dann* clarified who had the burden of proving whether earnings of a non-marital business relate to personal spousal efforts. In *Dann*, the husband unsuccessfully tried to place the burden on the non-owning spouse, but the court rejected that argument. The court first found that distributions disbursed during the marriage may be considered non-marital property if proven not to be compensation to the spouse or not to be due to the personal efforts of the spouse. *Dann*, 2012 Ill. App. (2d) at ¶ 86. Second, the court held that the burden of establishing that such income or distributions do not relate to personal efforts falls on the owner spouse trying to establish the funds as non-marital.

The court reasoned that, under the statutory scheme of 503(a)(8) of the IMDMA, that burden rested with the owner spouse. Further, the court supported its analysis by highlighting that remuneration to a spouse — in whatever form, during the marriage — is considered marital property. The court's analysis suggested that an important determination of whether the distributions would be considered non-marital related in large part to the adequacy of the salary taken by the husband/owner. In this case, which was an appeal from a summary judgment proceeding, the appellate court found that the husband had not met his burden since he offered no real evidence of whether his compensation (salary) was adequate for his efforts and whether the distributions made from corporate assets should

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be considered part of that compensation, in whole or in part.

Advising Your Client

The foregoing case law raises the question of how to proceed with discovery and with establishing your case if you are confronted with such an issue of retained earnings involving a non-marital business. First, it is important to obtain as many years of corporate tax returns and financial statements as you can to determine how the retained earnings accrued over time. This may establish trends that could lead to important questions about why the business was able to accumulate the earnings it did. Second, you must explore the ability of the owner spouse to take and control distributions from the company. Investigation must be made as to whether any restrictions exist on the ability to access or disburse the earnings. For example, are there internal corporate policies governing distributions? Are there bank covenants or other financing arrangements that would restrict the ability of the owner to draw distributions from the company?

Further, a financial expert may need to be retained to expose whether the retained earnings are needed to operate the business and determine if there is distributable cash flow that would not affect the viability of the company from an operational standpoint. In other words, are the retained earnings needed to sustain working capital requirements, debt servicing needs, or long term capital expenditures? All of these questions must be explored in assessing these issues.

In addition, counsel must obtain information on how personal income taxes arising from corporate earnings were paid by the owner spouse. Specifically, did the owner spouse pay them with personal assets, or was the owner spouse effectively reimbursed for any such tax liability? This is another factor Illinois courts have focused on when making an assessment of the character of the earnings.

Last, a compensation expert may need to be retained to evaluate separately whether the compensation taken by the owner spouse through salary was reasonable and fair for the services provided. This piece is a critical component if you represent the non-owner spouse, because the owner spouse will presumably maintain that his salary is reasonable for the services and efforts provided to the company.

Conclusion

In time, the classification of retained earnings will continue to attract the attention of appellate courts when the stakes in any particular case warrant. In resolving these future disputes, the court must maintain its focus on the statutory language of the IMDMA, the effect of evidentiary presumptions, the distinction between corporate earnings that have been retained versus those that have been distributed, and the equitable principles the court seeks to promote.

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Same-sex Marriage

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and state officials declined to take an appeal. The petitioners before the Supreme Court, the original proponents of Proposition 8, had been permitted by the trial court to intervene in the case and defend the initiative. On appeal, the Ninth Circuit upheld the district court ruling. But the Supreme Court found that petitioners had no standing and that neither the Court nor the Ninth Circuit had authority to decide the case on the merits. The Court thus vacated the judgment of the Ninth Circuit and remanded the case to that court with instructions to dismiss the appeal. *Id.* at *14.

Chief Justice Roberts, writing for the Court, noted that to have standing, a litigant must seek relief for an injury that affects the litigant in a "personal and individual way" and must possess a direct stake in the outcome of the case. But he found that the petitioners had only an insufficient "generalized grievance" to vindicate the constitutionality of the ballot initiative. He concluded that the Court had "never before upheld the standing of a private party to defend the constitutionality of a state statute when state officials have chosen not to" and declined to do so for the first time here. *Id.* at *14.

Justice Kennedy, dissenting, urged that California had the right to empower the petitioners to defend one of its state laws in federal court, noting that the California Supreme Court had held that state law afforded the petitioners "'the authority … to assert the state's interest in the validity of the initiative' when State officials decline to do so." *Id.* at *16 (Kennedy, J., dissenting). He concluded that the "State Supreme Court's definition of proponents' powers is binding on this Court" and "sufficient to establish the [requisite] standing and adversity under Article III" of the federal Constitution. *Id.* at *14.

By ordering the Ninth Circuit to dismiss the appeal in the case, the Court let stand the district court's original ruling in the case, striking down Proposition 8 as unconstitutional. Thus, though the majority in the minds of many had sidestepped a ruling on the merits in the case, the ruling will result in the resumption of legal same-sex marriages in California.

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