"Smoke and Mirrors: Cash Flow Games People Play"

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Overview of Materials And Presentation

Purpose of Presentation

- To illuminate situations where a Payor of support <u>can easily manipulate</u> the reasonably predictive income of a business for the purpose of avoiding support obligations.
- This is commonly accomplished through creative accounting techniques whereby the Payor <u>intentionally reduces the "cash flow"</u> of a business for divorce planning purposes.
- The Divorce Planning Payor accomplishes this by conducting unusual "expenditure transactions" or other "cash transactions" <u>that are not legitimately and/or customarily required</u> by the business.

Confusion Regarding

Expenses vs. Expenditures

Expenses vs. Expenditures

Expenses

- Transactions of a business that immediately reduce its accounting-based profits
- May or may not require the outflow of cash.

Expenditures

- Transactions of a business that reduce its cash balances but may ***not*** be "expenses" and therefore will ***not*** reduce its net income
- Example: Loan Payoff

The Issue

- If a Payor believes that the Court will order support based on "cash flow", he or she can easily accelerate "expenditures" in an effort **to reduce "**cash flow**"** available to pay support obligations.
- Support should be based on a reasonable predictor of recurring income – not an artificially suppressed level of "cash flow" created through divorce planning tactics.

Admonition

- This presentation, and the accompanying paper, focus on extreme examples of intentional divorce planning transactions conducted to suppress disposable income for the purpose of avoiding support obligations.
- This presentation, and the accompanying paper, do not assert that all expenditure or cash flow transactions must be rejected for purposes of determining reasonably predictive, recurring business income.

Simplified Example:

Cash Flow vs.
Recurring Income

Business Income During Typical Years Before Divorce Planning

Accounting Net Income:	$5 Million
Cash Distributions:	$5 Million

“Divorce Planning” Transactions

Accelerated Debt Payoff:	$2.0 Million
Accelerated Equipment Purchases:	$1.0 Million
Accelerated Vendor Payments:	$.50 Million
Accelerated Inventory Purchases:	$.50 Million
Deferred Collection of Receivables:	$.25 Million
Prepayments to Vendors:	$.25 Million
Total Divorce Planning Transactions	$4.5 Million

Note: None of the above “cash transactions” materially impact the accrual basis net income of the business.

The Result

Normal Years		Year Before Hearing	
Net Income:	$5 Million	Net Income:	$5.0 Million
Divorce Planning:	-	Divorce Planning:	($4.5 Million)
Cash Flow:	$5 Million	Cash Flow:	$.5 Million
Distributions	$ 5 Million	Distributions:	$.5 Million

Note: The Payor testifies to numerous “valid business reasons” in support of the Divorce Planning Items and asserts that support should be based on “cash flow” not “recurring Income”.

Questions to Consider

- Are the cash transactions recurring?
- Were the transactions done for legitimate business purposes or were they for divorce planning?
- Will these transactions have the same recurring impact on income for the forthcoming year?
- How will the transactions impact tax obligations on a recurring basis?

Common Areas of Manipulation

"Cash Transactions" Used by Payor Spouses Planning for Divorce

- Accelerate debt payments
- Accelerate the purchase of capital assets
- Accelerate payments to vendors
- Purchase excess inventory
- Pay expenses in advance
- Defer collection of receivables
- Loan money to third parties
- Misstate the value of ending inventory
- Accumulate large cash reserves
- Accelerate accrued expenses (e.g., bonuses)

The Irony of the Payor's strategy is…

- **Result**: The next year's "*cash flow*" should exceed the next year's "*net income*" as a result of these tactics (absent the continuation of such strategies to absurd levels).
  - ***Reason***: Once cash transactions have been accelerated in one year, the business has established a reserve and should have less cash requirements in the following year.
  - ***Example***: If all bank loans are paid off there is no debt service required in the next year.
- **Conclusion**: Stated income should be adjusted based on past income and known facts to reflect recurring, predictive income.

Defeating the Arguments of the Divorce Planning Payor

First Rebuttal:
Non-Recurrence of Transactions

- Most “cash flow” divorce planning transactions are nonrecurring by nature.
- These transactions impact the previous year but should not recur in the forthcoming year.
- The focus must be on reasonably predictable and recurring business income.
- Income for the previous 12 months (or other predictive period) should be adjusted for anomalous transactions.

Second Rebuttal:
Present the Reverse of Each Transaction

- If cash flow actually exceeded net income due to one-time, nonrecurring, cash **inflow** transactions…
- Would it be reasonable to order support based on artificially overstated and nonrecurring cash flow?
- Consider the following example based on the previous facts…

Example – Reverse Transactions:
"Non-Divorce Planning" Transactions

Increased Line of Credit:	$1.0 Million
Collected a Third Party Loan:	$1.0 Million
Had One Time Sale of Equipment:	$0.5 Million
Additional "Cash Flow" (Nonrecurring)	$2.5 Million

The Result

Normal Years		Year Before Hearing	
Net Income:	$5 Million	Net Income:	$5.0 Million
Irregular Items:	-	Irregular Items:	$2.5 Million
Cash Flow:	$5 Million	Cash Flow:	$7.5 Million
Distributions	$ 5 Million	Distributions:	$5.0 Million

Would anyone suggest that support should be based on $7.5 million of "cash flow" derived from these one-time, non-recurring transactions???

Third Rebuttal:
Analyze Historical Norms

- Present charts and tables to the Court demonstrating typical activities and transactions of the business prior to litigation.
- Compare these pre-litigation charts to post-litigation activities and transactions of the business.
- Consider the retention of an industry expert to rebut Payor's assertions that "Everything has Changed".

Fourth Rebuttal:
Understand the Business and its Industry

- The divorce planning Payor oftentimes cites "once in a generation" changes affecting the industry.
- However, management constantly faces industry challenges on a regular and recurring basis.
- In many cases, one could pick any year of the preceding 10 years and present compelling arguments on why the "next year" could be devastating.
- Consider the retention of an industry expert for rebuttal.

Discovery

Discovery Considerations

- A discovery plan must be developed in close collaboration with the party, attorney, and expert.
  - *Note: The Payor will frequently use the Recipient's discovery efforts to advance his or her arguments claiming that such efforts created concern in the minds of customers, lenders, employees, etc.*
- In the absence of discovery, the Recipient incurs the risk that the Court may not understand the nonrecurring nature of the strategies and tactics employed by the Payor.
- Question: Who should bear the burden of proving that cash transactions are recurring and will continue to suppress the distributable cash flow of the business?

Discovery Issues

- The Recipient must carefully analyze costs and benefits.
- Mid-year information is frequently not accurate and a creative Payor often will not enter transactions until year end.
- The Payor typically produces thousands of pages of largely irrelevant information preceding divorce planning activities.
- After the Payor has booked divorce planning entries, he or she will cite the volume of previously-produced documents as rationale for not producing additional, relevant documents.

Quandary…

- If the Recipient does not conduct early discovery, he or she may be unable to unearth the divorce planning tactics of the Payor (which arguably should be the burden of the Payor).
- However, at times a divorce planning Payor will not enter into misleading transactions until the eve of the support hearing.
- Thus, the Recipient must carefully devise a discovery strategy that is balanced and cost efficient yet still places him or her in a situation to be prepared.

Dissomaster™

2 Primary Purposes of Dissomaster™

- 1) To calculate tax obligations so that the gross income of the parties can be converted to net, after-tax, disposable income.
- 2) To calculate guideline support based on net disposable income.
  - The attorneys, experts and court must be well prepared to handle divorce planning transactions that can cause Dissomaster™ to generate fallacious results.

Dissomaster™ Tax Calculations

- Dissomaster™ **will** generally calculate accurate tax obligations **if** income data is correctly input.
- Dissomaster™ will **not** generate correct results if income data is simply input into the program based on an accountant's summary of either *cash flow* or *accrual basis income* that is in some other form than what will be reflected on the parties' income tax returns.

Common Errors Using Dissomaster™

- Failure to Distinguish Prior Year Income with Reasonably Predictable, Recurring Income
- Failure to Identify Tax Elections of Payor and Recipient (e.g., Cash, Accrual, or Modified)
- Inappropriate Distinction of Expenses, Expenditures and Other types of unusual transactions
- Failure to Consider Tax Attributes of Recipient
- Failure to Consider Tax Attributes of Payor

Other Issues

Business Valuation

- The Divorce Planning Payor often seeks 2 objectives in conducting abnormal transactions:

  1. Reducing Support Obligations, and
  2. Reducing Business Value

- As it pertains to Business Valuation, Consider the following impact on the business after multiple years of Divorce Planning activities…

Condition of Business After Years of Divorce Planning Transactions

- It becomes debt-free
- It has extraordinary levels of inventory, accounts receivable, cash and other assets
- It has low levels of trade liabilities
- Its net working capital becomes exorbitant
- It has extraordinary levels of property and equipment
- It has assets that are not essential to operations

The Result…

- Presuming that the valuation date is the date of trial, the company is in a far stronger financial condition at that date than its customary norms.
- The Divorce Planner will attempt to simply capitalize earnings to derive a value and ignore the significant improvement in the company's financial condition.
- The Recipient's expert must properly account for such improvements in financial condition in his or her appraisal and be able to articulate such results to the Court.

Interplay with Marital Standard of Living (MSOL)

- Assume the family consistently lived on $5 million of pre-tax income from the business (per the previous example).
- Using previous example, at support hearing, the Payor argues:
  - That support should be based on only $500,000 of cash flow – 10% of what the family lived on during marriage.
  - That the family was living beyond its means during marriage.
  - That if support is ordered at the MSOL instead of investing funds back into the business, the business will risk failure.

Result

- If the court orders support on $500,000 of cash flow, the Recipient and children will face a marked change in their standard of living and will likely default on fixed obligations.
- Exacerbating the situation:
  - If the Recipient must pay taxes on her half of the $5 million of community business income (i.e., "Phantom Income"), she will actually have negative cash flow - even after receiving a modest amount of support.

Agreements for No Support
Instead: Equal Distributions from Business

- Works if the Payor is Not Divorce Planning. Unfortunately, a Divorce Planning Payor often engages in some or all of the above tactics.
- Hence, the business has no cash to distribute after the Order. The Recipient receives nothing, defaults on obligations and is unable to support herself and the family.
- Meanwhile, the Payor "lands on his feet", increasing personal expenses through the business including divorce legal fees, increased bonuses, and "loans" to himself.

Closing Thoughts

- The strategies and tactics discussed are not rare in cases involving closely held businesses.
- These "business cash flow" transactions are extremely simple to conduct.
- These situations are becoming so common that every attorney and judge must be aware of these simple financial engineering tactics.
- Preparation, well-conceived discovery, and the involvement of competent experts are critical components in obtaining reasonable orders.

Case Study

Admonitions

- In the following case study, attorneys for the Payor and Recipient will argue the facts in favor of their clients' respective positions.
- The facts presented in the case study are designed to illuminate egregious situations of divorce planning tactics.
- The arguments of each attorney are intended for demonstration purposes only and do not necessarily reflect the opinions of the presenters.

Case Overview

- Temporary Spousal and Child Support Hearing
  - Mr. Payor (Petitioner)
  - Ms. Recipient (Respondent) and the 2 Children
- Date of separation: 12/31/13
- Date of Hearing: 1/31/15
- Most Recent Financials: Year ending 12/31/14

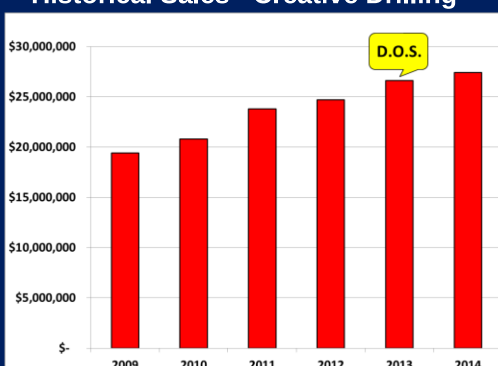
Case Overview (Continued)

- Primary Source of Income: Business owned by Mr. Payor known as Creative Drilling, Inc.
- Creative Drilling, Inc. Facts:
  - Provides drilling services for oil and gas companies
  - Has had steady and consistent growth before and after separation
  - "Net Income" is high in the year after separation
  - "Cash Flow" is low in the year after separation

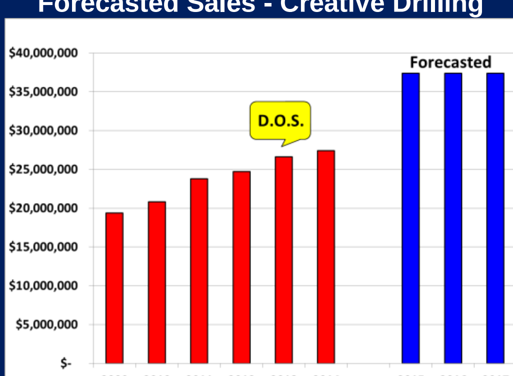
Creative Drilling Contract Facts

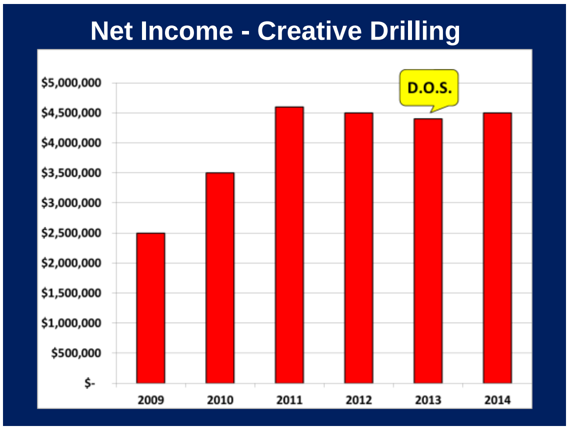
- Has an annual contract with Shell that expires each year
- Has a potential new contract with Chevron for $10 mil per year
- Internal forecasts show success with each contract
- Husband claims that both are speculative and are not Income Available for Support (IAFS)
- Wife claims that both are in forecasts and should be IAFS

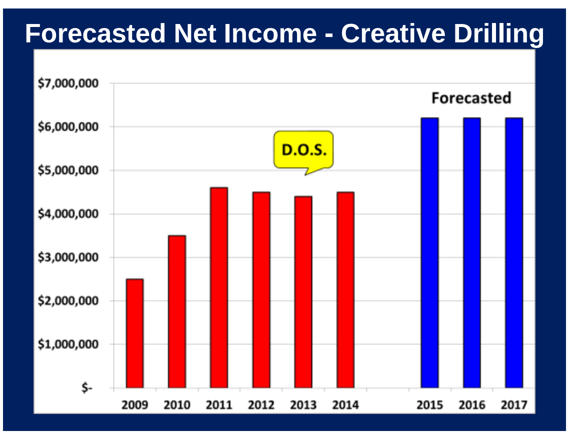
Historical Sales - Creative Drilling

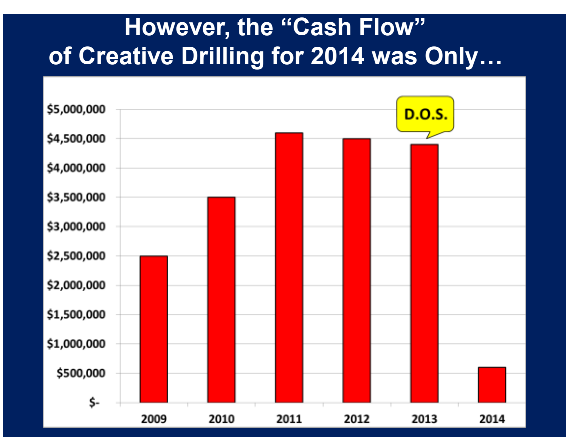


Forecasted Sales - Creative Drilling

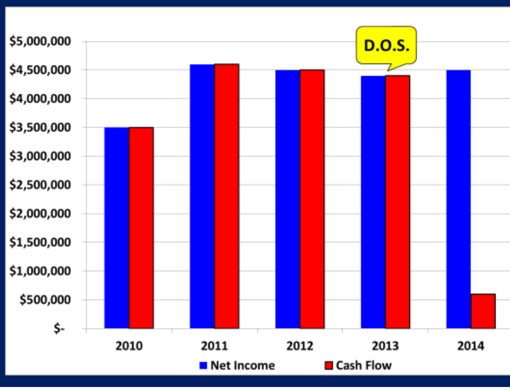



Net Income - Creative Drilling
D.O.S.
$5,000,000
$4,500,000
$4,000,000
$3,500,000
$3,000,000
$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$-
2009
2010
2011
2012
2013
2014


Forecasted Net Income - Creative Drilling
Forecasted
D.O.S.
$7,000,000
$6,000,000
$5,000,000
$4,000,000
$3,000,000
$2,000,000
$1,000,000
$-
2009
2010
2011
2012
2013
2014
2015
2016
2017


However, the "Cash Flow"
of Creative Drilling for 2014 was Only…
D.O.S.
$5,000,000
$4,500,000
$4,000,000
$3,500,000
$3,000,000
$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$-
2009
2010
2011
2012
2013
2014

Net Income / Cash Flow - Creative Drilling



Why Was Cash Flow Lower Than Net Income in 2014?

- Receivables were not collected as rapidly as normal
- Inventory purchases were significantly higher than normal
- Vendors were paid more rapidly
- Some Vendors were paid in advance
- Bonus payments were accelerated
- Equipment Purchases were greater than normal
- Line of Credit was paid down
- Long-Term Debt was paid down

Let's See How the Attorneys Argue the Case

Argument:
Mr. Payor's Attorney
Ron Granberg

Core Payor Arguments

- Ms. Recipient does not understand Creative's industry issues and wishes for the Court to ignore key facts impacting the business and include speculative contracts.
- The Cash Flow of the business is lower in 2014 and will remain so in the foreseeable future.
- Ms. Recipient does not understand that "Net Income" cannot buy groceries – only "Cash Flow" can.
- There is no "Divorce Planning" going on here – Mr. Payor is simply trying to position the Company to survive.

Lower Receivable Collections

- Yes. Accounts receivable collections were lower in 2014
- Ms. Recipient Ignores the poor financial condition of one of Creative's key customers, Legacy Oil, Inc. In fact, Creative may have to loan money to Legacy in 2015 to keep them afloat.
- Legacy Oil is critical to the success of Creative Drilling and comprises 20% of its revenue base – Creative cannot lose this customer and must accommodate it.
- See Exhibit 5 - Letter to Creative Drilling from Legacy Oil

Excerpts from Legacy Oil Letter (Exhibit 5)

- *"Legacy has been struggling to meet its cash flow requirements."*
- *"We appreciate your willingness to accommodate our needs for survival by allowing us to pay on our accounts to Creative in 120 days instead of our contractual requirement to pay in 30 days."*
- *"Additionally, we appreciate the offer of Creative to loan us $1 million next year and will be in contact with you regarding that proposal in the near future."*

Accelerated Inventory Purchases

- Creative Drilling has obsolete pipe and valve supplies and is also purchasing new supplies to be in compliance with the requirements of Chevron, a potential new customer.
- Ms. Recipient ignores the fact that Creative's contract with Shell ended in 2014 and that Creative may no longer be able to sell its older pipe and valve supplies.
- Shell comprised 40% of Creative's revenues in 2014.
- See Exhibit 6 - Letter to Creative Drilling from Shell

Excerpts from Shell Letter (Exhibit 6)

- *"Your annual contract expires on December 31, 2014."*
- *"We will again be going to competitive bid."*
- *"We anticipate receiving your bid and will notify you if Shell selects Creative as our service provider for 2015."*

Why Creative Prepaid Expenses

- Creative's pipe and valve supplies are difficult to obtain from overseas manufacturers.
- Creative prepaid vendors in order to expedite order fulfillment and to maintain an advantage over competitors.
- If Creative cannot stock these goods promptly, it may lose the new Chevron opportunity, which is already speculative at best.
- See Exhibit 7 – Deposition Excerpts from Creative's CFO

Depo Excerpts from Creative's CFO (Exhibit 7)

- *Q Why did Creative pay vendors in advance for supplies during the past 3 months?*
- *A The industry has become much more competitive in terms of procuring pipe and valve supplies.*
- *Q What has changed within the past 3 months?*
- *A We have been concerned about our ability to service the new Chevron opportunity and have wanted adequate supplies to fulfill our obligations.*

Accelerated Payment of Trade Payables

- Yes. Creative did pay its vendors more rapidly in 2014 than in prior years.
- However, this was a result of core business needs.
- Creative's vendors sell to its customers that are most solvent and pay their bills most rapidly.
- If Creative does not acquire these supplies, it may lose the opportunity to replace the Shell revenues with the new (yet highly speculative) Chevron opportunity.

Accrued Bonuses

- Yes. Creative did pay its employees their 2014 bonuses in late 2014 instead of early 2015.
- Creative's key employees were nervous with the pending expiration of the Shell contract.
- Without its key employees, Creative is nothing.
- Creative had to show stability and confidence to these employees in order to retain them.

Accelerated Equipment Purchases

- Creative must re-tool its equipment to handle Chevron requirements considering the potential loss of Shell.
- Chevron requirements are significantly different than Shell.
- Creative must have proper equipment to handle Chevron rigs.
- Creative may obtain neither the Shell nor the Chevron contracts, but it must plan for both. If it obtains neither, it is dead.
- See Exhibit 7 – Deposition Excerpts from Creative's CFO

Depo Excerpts from Creative's CFO (Exhibit 7)

- *Q Why did Creative acquire $800,000 in equipment in 2014 when its average annual capital expenditures were $300,000 per year for the years 2009 through 2013?*
- *A We had to position ourselves for the potential Chevron contract. Chevron's rigs are unique from Shell and our other customers and have different requirements.*

Pay-Down on Line of Credit

- Ms. Recipient, in her Slash and Burn discovery tactics, subpoenaed Creative's bank and deposed its loan officer.
- Creative's bank is now extremely nervous due to this contentious divorce and has threatened not to renew its line of credit.
- Creative was therefore forced to pay down its line of credit to show good faith and its financial stability.
- See Exhibit 8 – Letter from California United Bank's Loan Officer

Excerpts from Loan Officer Letter, Michael Melkin (Exhibit 8)

- *"I have recently met with the Chairman of our loan committee regarding the outstanding line of credit and various term loans with the bank."*
- *"He expressed concern regarding the litigious nature of your divorce proceedings and your spouse's unwillingness to sign documents."*
- *"Please contact us at your earliest convenience to discuss this continuing litigation."*

Pay-Downs of Long-Term Debt

- Again, Ms. Recipient's Slash and Burn discovery tactics have nearly destroyed Creative's banking relationships.
- Creative's bank requested that Ms. Recipient sign documents acknowledging that the marital estate had no financial interest or control in Creative, which is owned solely by my client. She refused.
- Creative is doing everything that it can to stabilize its relationship with the bank.

Forecasts Prepared by Creative Drilling

- The Company forecasts were done for internal purposes only.
- The Shell and Chevron contracts are speculative and should not be considered as recurring income.
- The Court cannot burden Mr. Payor with an order based on speculative income that he may not receive.

Bottom Line

- Creative had large cash outflow requirements in 2014 – those requirements are expected to continue through 2015 and 2016.
- Creative still has significant debt. Ms. Recipient's over-zealous discovery tactics are continuing and Creative will likely be forced to accelerate debt payments in 2015 and 2016 as well.
- Creative had a contract with Shell that ended in 2014. Ms. Recipient completely ignores that reality and simply speculates that recurring revenues will be similar to 2014.
- Worse, she expects support based on a speculative Chevron contract.

Income Report – Mr. Payor

Ln.	Source	Amount
1	Creative Drilling, Inc.:	
2	Cash Flow / Income	$ 600,000
3	Salary	300,000
4	Perks	25,000
5	Interest and Dividends	17,500
6		
7	Total - Annual	$ 942,500
8		
9	Total - Monthly	$ 78,542

Dissomaster™ – Mr. Payor

Input Data	Father	Mother
Number of children	0	2
% time with NCP	20%	0%
Filing status	Single	HH/MLA
# Federal exemptions	1*	3*
Wages + salary	25,000	0
401(k) emp. contribution	0	0
Self-employment income	0	0
Other taxable income	53,542	0
TANF plus CS received	0	0
Other nontaxable income	0	0
New-spouse income	0	0
Wages + salary	0	0
Self-employment income	0	0
SS paid other marriage	0	0
Retirement contrib if ATI	0	0
Required union dues	0	0
Nec job-related exp.	0	0
Adj. to income (ATI)	0	0
SS paid other marriage	0	0
CS paid other relationship	0	0
Health insurance	0	0
Itemized deductions	0	7,479
Other medical expenses	0	0
Property tax expenses	0	3,867
Ded. interest expense	0	3,612
Charitable contribution	0	0
Miscellaneous itemized	0	0

Guideline (2015)	
Nets (adjusted)	
Father	53,317
Mother	(3,845)
Total	49,472
Support	
CS Payor	Father
Presumed	9,372
Basic CS	9,372
Add-ons	0
Per Kid	
Child 1	3,515
Child 2	5,858
Santa Clara SS	18,947
SS Payor	Father
Total	28,319
Proposed, tactic 9	
CS Payor	Father
Presumed	9,372
Basic CS	9,372
Add-ons	0
Per Kid	
Child 1	3,515
Child 2	5,858
Santa Clara SS	18,947
SS Payor	Father
Total	28,319

Cash Flow Analysis	Father	Mother
Guideline		
Payment (cost)/benefit	(19,184)	24,475
Net spendable income	24,997	24,475
% combined spendable	50.5%	49.5%
Total taxes	25,225	3,845
# withholding allowances	0	0
Net wage paycheck/mo	14,800	0
Proposed		
Payment (cost)/benefit	(19,184)	24,475
Net spendable income	24,997	24,475
NSI change from gdl	0	0
% combined spendable	50.5%	49.5%
% of saving over gdl	0%	0%
Total taxes	25,225	3,845
# withholding allowances	0	0
Net wage paycheck/mo	14,800	0

Default Case Settings

Argument:
Ms. Recipient's Attorney John Harding

Ms. Recipient's Core Arguments

- Mr. Payor is exaggerating "business issues" in a Divorce Planning Ruse to avoid his support obligations.
- The lower Cash Flow of Creative is a temporary situation for 2014 which he engineered solely to dupe the Court.
- Even if these arguments of Mr. Payor were valid for 1 year (which they are not), they are not recurring. Cash flow will revert to normal in 2015 – plus additional revenues from the Chevron contract.
- Worse, while Mr. Payor is avoiding his support obligations he is also increasing the value of his own business.

Lower Receivable Collections

- Legacy Oil, Inc., which Mr. Payor alleges is having difficulty, is owned by Mr. Payor's brother.
- Legacy Oil is one of the most stable and reputable independent drillers in the industry. Mr. Payor has produced no evidence of Legacy's "financial issues" other than a letter from his brother.
- The letter from Mr. Payor's brother is nothing but a divorce-planning scheme to deceive the Court into believing that Creative will continue to have lower "cash flow".
- See Exhibit 9 – Report Extracts from Industry Expert

Excerpts from Industry Expert Report (Exhibit 9, Page 5)

- *"Based on my substantial experience consulting with companies in the oil and gas industry, it is my professional opinion that Legacy Drilling is one of the top 5 independent drilling and exploration companies in the United States."*
- *"I have reviewed the financial statements of Legacy Drilling for the years 2012, 2013 and 2014. In my professional opinion, Legacy is in superior financial condition, has no long-term debt, and has demonstrated 10% compound annual growth in both revenues and profits during the past 3 years."*

Accelerated Inventory Purchases

- The Shell "contract termination" risk is dubious. Shell has renewed this contract every year for the past 8 years.
- Creative will land the Chevron contract and has included revenues from it (along with the Shell contract) in the forecasts provided to its bank. That will lead to yet more revenues and income in 2015.
- Mr. Payor is exaggerating the "uniqueness" of the Shell and Chevron requirements. Even if Creative loses the Shell contract, it can sell its inventory to other companies or use it with its other customers (including Chevron).
- See Exhibit 9 – Report Extracts from Industry Expert

Excerpts from Industry Expert Report (Exhibit 9, Page 6)

- *"I have reviewed correspondence and proposals pertaining to the potential contract between Creative and Chevron."*
- *"Creative is in the final stages of this contract. Its law firm has reviewed three drafts of the proposed contract and, based on the correspondence and projections of Creative that I have reviewed, the contract is close to execution.*
- *"Creative has commenced procuring inventory and equipment to service the drilling rigs of Chevron."*

Excerpts from Industry Expert Report (Exhibit 9, Page 6)

- *"In my 28 years of consulting with companies similar to Creative, I have never observed a single instance whereby a company such as Creative would expend millions of dollars for equipment and inventory pertaining to a potential transaction that would be characterized as "highly speculative".*
- *"In the unlikely event that Creative does not secure this contract with Chevron, the inventory and supplies that it purchased would be usable for all existing customers that Creative services and/or could easily be sold to a third party."*

Prepaid Expenses to Vendors

- Pipe and valve supplies are <u>not</u> difficult to obtain from overseas manufacturers.
- There is no reason that Creative must prepay vendors. Creative has <u>many alternative vendors</u> from whom to purchase supplies.
- Regardless, these are "<u>one-time transactions</u>". In 2015, Creative will actually have <u>lower</u> cash outflow obligations than normal since it already paid its vendors in advance <u>in 2014</u>.
- See Exhibit 9 – Report Extracts from Industry Expert

Excerpts from Industry Expert Report (Exhibit 9, Page 8)

- *"There is no present 'shortage' of either vendors or pipe and valve supplies in the market."*
- *"I have not observed a single company that has been required to pre-pay vendors in order to procure such supplies on a timely and expeditious basis."*
- *"I am familiar with dozens of highly qualified vendors with ample stock on hand to fill orders from companies such as Creative."*

Accelerated Payment - Trade Payables

- Creative accelerated payments to vendors solely so that it would have lower "cash flow" to distribute to Mr. Payor.
- This was not a "core business requirement". Even if it was, the point is moot. Since Creative accelerated payments in 2014 it will have more cash flow available in 2015.
- Pipe and valve supplies are plentiful. There is no valid business reason to accelerate payments to vendors.

Accrued Bonuses

- Creative paid 2 years of bonuses in 1 year – 2014: Its 2013 bonuses that were expensed in 2013 plus its 2014 bonuses that it does not typically "pay" until the following year.
- This was solely a divorce-planning tactic to reduce the "cash flow" of Creative and its ability to pay Mr. Payor.
- Creative is growing and is in outstanding financial condition. There is no credible evidence to suggest that employees are "nervous" and may leave the Company.
- Even its own forecasts provided to the bank show dramatic growth.

Equipment Purchases

- Creative does not need to "re-tool its equipment" to handle Chevron requirements" even if the Court buys the dubious argument that the Shell contract will be lost.
- This acceleration of equipment purchases was done for 1 reason only: For Mr. Payor to lower his "cash flow" and avoid his support obligations while investing in, and increasing the value of, his own business.
- The requirements of Shell and Chevron are virtually identical.
- See Exhibit 9 – Report Extracts from Industry Expert

Excerpts from Industry Expert Report (Exhibit 9, Page 6)

- *"I would characterize the property and equipment of Creative as 'State of the Art'."*
- *"Moreover, the rig technology of both Chevron and Shell are best characterized as homogenous."*
- *"In other words, the equipment that Creative uses to service the rigs of Shell and its other drilling and exploration customers is the same equipment that it would require to service the rigs of Chevron – without modification."*

The Bank is Not Nervous

- My client has not engaged in "Slash and Burn Discovery Tactics". She simply deposed its loan officer, Michael Melkin.
- Mr. Payor has played golf with Mr. Melkin twice per week at their country club for the past 5 years.
- There is no credible evidence that suggests "Creative's bank is "extremely nervous" and numerous banks would line up to have an account like Creative.
- Mr. Payor admits to banks soliciting his business but has discarded that evidence.
  - See Exhibit 10 – Deposition Excerpts from Loan Officer
  - See Exhibit 11 – Deposition Excerpts from Mr. Payor

Depo Excerpts from Loan Officer (Exhibit 10)

- *Q Setting aside your personal experiences, has anyone at the bank informed you that Creative's line of credit will be reduced or that the bank will refuse to lend money to Creative in 2014 or 2015?*
- *A No…*
- *Q Do you play golf with Mr. Payor?*
- *A Yes.*
- *Q Approximately how often over the past 5 years?*
- *A It varies, but approximately twice per week.*

Depo Excerpts from Mr. Payor (Exhibit 11)

- *Q Has Creative been solicited by other banks for its lending and banking needs?*
- *A Yes.*
- *Q Have you pursued relationships with other banks?*
- *A No.*
- *Q Why not?*
- *A We have always had outstanding relations with California United Bank.*

Pay-Downs of Long-Term Debt

- Ms. Recipient cannot be expected to sign a document that the marital estate had no financial interest or control in Creative.
- Ms. Recipient may have equitable apportionment interests in Creative that will be proved at time of trial.
- Mr. Payor has produced no credible evidence that Creative is in jeopardy of losing its banking relationship.
- This is blatant "divorce planning" - to reduce distributions to Mr. Payor by instead using "cash flow" to pay the bank, hence increasing the value of his business.

Depo Excerpts from Loan Officer (Exhibit 10)

- *Q Did California United Bank require Creative to make payments on its term loans in excess of its contractual requirements at any time during 2012?*
- *A No.*
- *Q Is Creative in violation of any loan covenants today, as we speak?*
- *A No.*

Depo Excerpts from Loan Officer (Exhibit 10)

- *Q Did you write a letter to him requesting that my client sign a document stating that she had no financial interest in Creative?*
- *A Yes*
- *Q Did someone request that you do that?*
- *A Yes – his attorney Mr. Granberg.*
- *Q Did anyone at the bank request that you write this letter?*
- *A No.*
- *Q. Was that letter to my client a requirement for California United Bank to continue lending to Creative?*
- *A. No…*

Company Forecasts

- The Company forecasts were <u>not</u> done solely for internal purposes – <u>they were provided to the bank</u> (see Exhibit 10).
- The Shell and Chevron contracts are <u>not</u> speculative. Creative has renewed the Shell contract <u>every year</u> for the past 8 years.
- Creative has proven its confidence in obtaining these contracts <u>by purchasing inventory and equipment</u> required to service both of them.
- <u>Mr. Payor cannot have both</u> – reduced "current cash flow" and reduced future recurring income.

Excerpts from Letter to Bank Re: Forecast (Exhibit 12)

- *"As you know, we have an annual contract with Shell. We have renewed this contract for each of the past 8 years and are extremely confident in our renewal for the forthcoming year."*
- *"In addition, I have discussed the new Chevron opportunity with you over the past several months in connection with our increased acquisition of inventory and equipment. We are nearing the final stages of contract negotiations with Chevron and I anticipate that this 3 year contract will be executed in the very near future."*

Bottom Line

- The "cash flow" transactions of Creative in 2014 are nothing but a "divorce-planning ruse".
- If Mr. Payor succeeds in convincing the Court of his arguments, Ms. Recipient and the Children will face a dramatic change in their standard of living.
- Mr. Payor will then benefit by an enormous increase in the value of his own business through cash reinvestment.
- Mr. Payor is attempting to avoid his support obligations by lowering his "cash flow" when Creative is, in fact, thriving.

Income Report – Ms. Recipient

Ln.	Source	Amount
1	Creative Drilling, Inc.:	
2	Income	$ 6,200,000
3	Salary	300,000
4	Perks	25,000
5	Interest and Dividends	17,500
6		
7	Total - Annual	$ 6,542,500
8		
9	Total - Monthly	$ 545,208

Dissomaster™ – Ms. Recipient

Input Data	Father	Mother
Number of children	0	2
% time with NCP	20%	0%
Filing status	Single	HH/MLA
# Federal exemptions	1*	3*
Wages + salary	25,000	0
401(k) emp. contribution	0	0
Self-employment income	0	0
Other taxable income	520,208	0
TANF plus CS received	0	0
Other nontaxable income	0	0
New-spouse income	0	0
Wages + salary	0	0
Self-employment income	0	0
SS paid other marriage	0	0
Retirement contrib if ATI	0	0
Required union dues	0	0
Nec job-related exp.	0	0
Adj. to income (ATI)	0	0
SS paid other marriage	0	0
CS paid other relationship	0	0
Health insurance	0	0
Itemized deductions	0	7,479
Other medical expenses	0	0
Property tax expenses	0	3,867
Ded. interest expense	0	3,612
Charitable contribution	0	0
Miscellaneous itemized	0	0

Guideline (2015)	
Nets (adjusted)	
Father	360,500
Mother	(68,583)
Total	291,917
Support	
CS Payor	Father
Presumed	53,400
Basic CS	53,400
Add-ons	0
Per Kid	
Child 1	20,025
Child 2	33,375
Santa Clara SS	158,648
SS Payor	Father
Total	212,048
Proposed, tactic 9	
CS Payor	Father
Presumed	53,400
Basic CS	53,400
Add-ons	0
Per Kid	
Child 1	20,025
Child 2	33,375
Santa Clara SS	158,648
SS Payor	Father
Total	212,048

Cash Flow Analysis	Father	Mother
Guideline		
Payment (cost)/benefit	(134,594)	143,465
Net spendable income	148,452	143,465
% combined spendable	50.9%	49.1%
Total taxes	184,708	68,583
# withholding allowances	0	0
Net wage paycheck/mo	14,800	0
Proposed		
Payment (cost)/benefit	(134,594)	143,465
Net spendable income	148,452	143,465
NSI change from gdl	0	0
% combined spendable	50.9%	49.1%
% of saving over gdl	0%	0%
Total taxes	184,708	68,583
# withholding allowances	0	0
Net wage paycheck/mo	14,800	0

Default Case Settings

Court Order

Conclusion of Court

- The Court is not persuaded by either Petitioner's or Respondent's arguments.
- The Court rejects the Chevron contract and finds it as being speculative.
- The Court has used Creative's 2014 Net Income as the most predictive indicator of recurring income and rejects the arguments of Petitioner regarding cash expenditures.
- The Court presents its conclusion of income in following chart in comparison with the conclusions of Petitioner and Respondent.

Income Conclusion - Court

Ln.	Source	Per Payor	Per Recipient	Court
1	**Manufacturing Company:**			
2	Cash Flow / Income	$ 600,000	$ 6,200,000	$ 4,500,000
3	Salary	300,000	300,000	300,000
4	Perks	25,000	25,000	25,000
5	Interest and Dividends	17,500	17,500	17,500
6				
7	Total - Annual	$ 942,500	$ 6,542,500	$ 4,842,500
8				
9	Total - Monthly	$ 78,542	$ 545,208	$ 403,542

Dissomaster™ – Court

Input Data	Father	Mother
Number of children	0	2
% time with NCP	20%	0%
Filing status	Single	HH/MLA
# Federal exemptions	1*	3*
Wages + salary	25,000	0
401(k) emp. contribution	0	0
Self-employment income	0	0
Other taxable income	378,542	0
TANF plus CS received	0	0
Other nontaxable income	0	0
New-spouse income	0	0
Wages + salary	0	0
Self-employment income	0	0
SS paid other marriage	0	0
Retirement contrib if ATI	0	0
Required union dues	0	0
Nec job-related exp.	0	0
Adj. to income (ATI)	0	0
SS paid other marriage	0	0
CS paid other relationship	0	0
Health insurance	0	0
Itemized deductions	0	7,479
Other medical expenses	0	0
Property tax expenses	0	3,867
Ded. interest expense	0	3,612
Charitable contribution	0	0
Miscellaneous itemized	0	0
Required union dues	0	0

Guideline (2015)	
Nets (adjusted)	
Father	266,686
Mother	(47,237)
Total	219,449
Support	
CS Payor	Father
Presumed	40,036
Basic CS	40,036
Add-ons	0
Per Kid	
Child 1	15,014
Child 2	25,023
Santa Clara SS	114,997
SS Payor	Father
Total	155,033
Proposed, tactic 9	
CS Payor	Father
Presumed	40,036
Basic CS	40,036
Add-ons	0
Per Kid	
Child 1	15,014
Child 2	25,023
Santa Clara SS	114,997
SS Payor	Father
Total	155,033

Cash Flow Analysis	Father	Mother
Guideline		
Payment (cost)/benefit	(98,890)	107,796
Net spendable income	111,653	107,796
% combined spendable	50.9%	49.1%
Total taxes	136,856	47,237
# withholding allowances	0	0
Net wage paycheck/mo	14,800	0
Proposed		
Payment (cost)/benefit	(98,890)	107,796
Net spendable income	111,653	107,796
NSI change from gdl	0	0
% combined spendable	50.9%	49.1%
% of saving over gdl	0%	0%
Total taxes	136,856	47,237
# withholding allowances	0	0
Net wage paycheck/mo	14,800	0

Default Case Settings

Summary of Law: Statutes & Case Excerpts

(Case Reference for CA and Other States)

[Emphasis Added by Underline]

Child Support - Family Code §4058(a)

"The annual gross income of each parent means income from whatever source derived …and includes, but is not limited to:

(2) Income from the proprietorship of a business, such as gross receipts from the business **reduced by expenditures required** for the operation of the business."

The Court's **Discretion:** **Child Support - Family Code §4058**

(b) "The court may, in its **discretion**, consider the **earning capacity** of a parent in lieu of the parent's income, consistent with the best interests of the children."

The Court's Discretion: **Child Support - Family Code §4060**

"If the monthly net disposable income figure **does not accurately reflect the actual or prospective earnings** of the parties at the time the determination of support is made, **the court may adjust the amount appropriately**."

Spousal Support - Family Code §4320

The court should consider numerous factors, **including income**, in ordering spousal support.

Among other factors, the section states:

(a) The extent to which the **earning capacity** of each party is sufficient to maintain the standard of living established during the marriage…

(c) The ability of the supporting party to pay spousal support, taking into account the supporting party's **earning capacity, earned and unearned income**, etc.

The Court's Discretion:

Marriage of Riddle (2005) *

"The aim of section 4060 **is to give a trial court discretion to adjust** the annual net adjustable income required for a support order when dividing net disposable income by 12 "does not accurately reflect the **actual or prospective earnings** of the parties." (p. 1080)

125 Cal.App.4th 1075, 23 Cal.Rptr.3d 273

The Court's Discretion

Marriage of Riddle (2005) *

"From County of Placer v. Andrade (1997) 55 Cal.App.4th 1393, we learn that **the idea behind this stable number is to have a reasonable predictor** of what each spouse or parent will earn in the immediate **future**." (p. 1081)

125 Cal.App.4th 1075, 23 Cal.Rptr.3d 273

Should we Use "Income" or "Cash Flow"?
Marriage of Riddle **(2005) ***

"While we recognize that family lawyers and forensic accountants sometimes use the phrase **'cash flow'** as a **sloppy synonym** for the word **'income'** as it appears in the support statutes, **it isn't**." (p. 1080)

* 125 Cal.App.4th 1075, 23 Cal.Rptr.3d 273

Do Not Manipulate Business Income
Walker v. Grow **(2006) ***

"It is consistent with somewhat analogous Maryland case law to focus on whether **the corporation is being used to shield income**."

"…a court considering such issues must take special care to ensure that the parent is **not utilizing the S corporation to manipulate** his or her income to avoid child support obligations."

* 170 Md.App. 255; 907 A.2d 255 (2006)

Evaluating "Retained Business Income"
J.S. v. C.C. **(2009) ***

"First, a shareholder's **level of control** over corporate distributions-as measured by the shareholder's ownership interest-is a factor of substantial importance."

"Second, the judge should evaluate the **legitimate** business interests justifying retained corporate earnings."

"Third, the judge should weigh affirmative evidence of an attempt to **shield income by means of retained earnings**."

* (2009) 454 Mass 652, 912 N.E.2d 933

Importance of Historical Practices
***Taylor v. Fezell* (2005) ***

"Obviously, the **pre-divorce level** of corporate capitalization and the practice of retaining corporate earnings for future capitalization **provides a baseline** for the expectations of the obligor's income and a recognition of the corporate capitalization necessary for future business activity."

* 158 SW 3d (Tenn. 2005)

Burden of Proof – Retained Income
***Zold v. Zold* (2005) ***

"…**the shareholder-spouse should have the burden** of proving that the undistributed 'pass-through' income was properly retained for corporate purposes rather than impermissibly retained to avoid alimony, child support or attorney's fees obligations…"

"…**because he or she has the ability to obtain information** to establish the propriety of the corporation's actions."

* (2005) 911 So.2d 1222 (Florida)