

VALUATION ISSUES IN DIVORCE

Nancy Fannon, CPA*ABV, CBA, BVAL

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INTRODUCTION

Divorce valuation work is fertile ground for business appraisers, with divorce rates nationally up over 50%. A significant number of those divorces involve the ownership of a family business. If you further consider that there are often two valuations needed for each divorce (one for the husband, one for the wife, and sometimes even a third for the judge!), it is easy to see that divorce valuation will surely sustain our profession for many years to come.

Valuation for purposes of divorce can be one of the most interesting, and surely one of the most frustrating, areas of valuation. Despite the fact that it is the point of entry for many business appraisers into the field, it is really quite complex, and extremely sensitive to state and case law in the jurisdiction in which the divorce complaint is filed.

For this reason, it is difficult to effectively “teach” divorce valuation at a national conference, for what might be true in one state is just the opposite in another. Therefore, these materials will focus on identifying the key issues that tend to differ from one state to the next, so that you know what to look out for in your home state. It will also provide you with guidance for finding legal precedent in the states in which you practice, which will be critical to your credibility and competency in this field.

ISSUES THAT MAKE DIVORCE VALUATION “DIFFERENT”

There are a number of issues that make divorce valuation “different” from other valuation work. While there are some who argue that valuation for divorce should be no different than any other “fair market value” appraisal, the fact of the matter is that it is different, simply because that’s the law or legal precedent set in the state. While we can argue, or at least have an enlightening discussion about how divorce valuation should be done, in many states such discussion may be a moot point, because we will be bound by what has gone before us.

Having said that, however, in many states the door is still wide open, because there is no consistent legal precedent. In such cases, we as a profession are in fact “making it up as we go along”, setting the rules by arguing a point of view more effectively than the opposing expert argues. In these states, you need to take particular care to make sure that you are aware of the issues that have been grappled with not only in your own state but in other states as well. In this way, you can make an informed decision about your own opinion and be able to state it clearly and convincingly for the court or other trier of fact.

This section will discuss those issues that you need to look out for, to see what precedent has been set (or not set) in your own state.

What is “Marital Property”?

Generally speaking, marital property includes property that has been acquired during the marriage, regardless of how title is held. It generally excludes property acquired before the marriage or acquired by one spouse but not the other through gift or inheritance. It also excludes property acquired after the valuation date, or excluded by a valid anti-nuptial agreement.

This marital estate may include increases in the value of otherwise non-marital property, if such increases resulted from marital efforts from the date of the marriage to the date of the valuation for the divorce. Often, it is our charge in a divorce engagement to not only determine how much the value has increased during the marriage, but how much of that increase is due to marital effort, and not just circumstance, or the economy, or the efforts of a different key employee. Unfortunately, there is no straightforward, catch-all guidance on how this determination is made, but rather, it is up to your professional judgement to apply the best methodology you can to the situation at hand.

COMMUNITY PROPERTY OR EQUITABLE DISTRIBUTION STATE?

Valuators need to be aware of the property distribution laws in their state, as these laws vary from state to state. States generally follow either the community

property or equitable distribution standard. However, even knowing whether your state follows community property or equitable distribution isn't enough. Different states have different rules for characterizing property as marital or separate. While the answer to this question does not affect the value of the company itself, it may well affect the manner in which the asset is split among the marital community.

Generally, the concept of community property assumes joint and equal ownership of marital property acquired during the marriage. Depending on the state, the property may get allocated as either separate or marital using one of several methods, some fairly straightforward and some convoluted. Some states would include all of the increase in value; some only a proportion based on either who held title or the proportion of marital assets used to acquire the asset.

The concept of equitable distribution, which is more widely utilized, generally divides the marital assets based on the relative contributions made by each of the husband and wife during the marriage. While "fairness" is the goal, there is clearly far more room for latitude here. Taken into consideration in making this determination are non-monetary contributions, such as child-raising and homemaker duties, relative earning power before and after the marriage, etc.

Valuation Date

As with other matters, the issue of the “correct” valuation date is clearly settled in some states, and still quite vague and open to interpretation in others. Here, too, states can differ significantly in the date used for the valuation, and such differences can have a profound impact on the valuation outcome. There is at least one case in which an entire opinion of one spouse’s expert was thrown out, simply because the wrong valuation date was used.

Dates that are commonly used include:

- Date of separation
- Date of filing the divorce complaint
- Date of divorce

In many states, the date selected depends on the nature of the spouse’s involvement with, and effect on, the value of the marital asset. For example, if the wife had a significant impact on the value of her business, but the husband had nothing whatsoever to do with it, then that asset would most likely be valued at the date of separation, as that is the date at which joint marital efforts are deemed to have ceased.

Standard of Value

Probably nowhere is there more controversy in the divorce arena than in the selection of the appropriate standard of value. Many forces fuel this controversy, not the least of which is the lack of direction and improper use of terminology in judicial precedent. Many cases make no reference at all to the “standard of value” utilized, and of those that do, many call it one thing when it is, in fact, something else.

Most practitioners agree that “fair market value” should be the standard employed in valuing a closely held business. However, what “should be” and what “is” may differ from state to state, so you need to know your own judicial precedent.

Some practitioners argue for a standard referred to as either “divorce value” or “value to the marital community”. Using this standard, the hypothetical buyer is replaced with the current marital community, resulting in a form of investment value. This can have profound impact on the valuation outcome, including the treatment of:

- Personal goodwill, which some states treat as marital property and others do not;
- Discounts for minority interest and lack of marketability, which may have an impact if an actual sale is contemplated, but none if the asset is to stay with one spouse; and

- Tax consequences, which some states would ignore under equitable distribution principles.

You must know not only what divorce case law says in your state about standard of value, but also really understand the methodology employed in the valuation. In many states, the precedent is so vague that the door is still open to interpretation. Our job, and our responsibility to the profession, is to know where we stand on these issues so that we are consistent from one case to the next.

Effect of Buy-Sell Agreements

Before you undertake a divorce valuation engagement, be sure you understand what precedent has been set in your state, and be sure that the attorney understands it as well! In some states, buy-sell agreements take precedent, in others they are ignored, and in still others there are cases going both ways.

Adjustments To Financial Statements

As in any valuation, there are often a number of adjustments that need to be made to the financial statements. The most obvious adjustment is for owner salary, where the owner may have taken out too much or too little, compared to that which a hypothetical buyer would pay for a comparable employee. In some states the issue of the value of the business and the rest of the divorce settlement can become

entangled, and there is a risk of “double-counting” the owner’s excess salary, by capturing it in both the value of the business and in the calculation of alimony. Make sure you are crystal clear on the judicial precedent in your state, as well as with the attorney on how you are handling this.

Another common, and difficult, adjustment to financial statements is the case where the non-participating spouse tells you that the family business really produced more money than that which was reported on the company tax returns. Here, a difficult conundrum is raised: if you don’t include the under-reported income, you undervalue the company; if you do include it, the spouse (who no doubt signed the tax return) risks retribution from the IRS. This is obviously an issue you should discuss with counsel and carefully consider whether and how to include this in your value determination.

Valuation Methodologies And Their Varying Application

Generally speaking, all methods of valuation that would typically be relevant for a particular ownership interest are relevant for a divorce valuation—or rather, should be relevant under a fair market value standard. However, many jurisdictions frown on or outright disallow the use of certain methodologies.

Check to see what methods have been allowed or disallowed in your jurisdiction and how clear that guidance has been. For example, just because a judge disallowed the use of the discounted future cash flow method in one case, it does not necessarily mean that it should not be used in future cases, assuming there is a compelling reason for doing so.

Many divorce cases use the excess earnings method, which is a method many judges like and can understand. In particular, this method is widely used in valuing professional service firms because it provides a value for each of tangible assets and goodwill.

Treatment of “Practice” And “Personal” Goodwill

States vary widely on their treatment of goodwill. Some states include it only if it would be “saleable” in an actual transaction; some courts look for the existence of “practice” goodwill, separate and distinct from the goodwill associated with a particular owner; and still other states include all goodwill. The predominance of states include practice goodwill, but are split on the inclusion of personal goodwill.

In addition to knowing how your home state treats these issues, you also need to know what factors influence the existence of each of these types of goodwill.

- Practice goodwill is that which is associated with the entity itself. It takes into consideration issues such as location, qualified workforce, required licenses (separate from the individual owner);
- Personal goodwill is that which is associated with the individual. It takes into consideration the practitioner's age, health, personal reputation, and effort.

Generally, practice goodwill is considered to be “saleable”, but personal goodwill is not unless there is also the existence of an enforceable agreement that either requires the owner to continue working for the practice and/or prevents him from competing with the practice.

Covenants Not To Compete

It is very important that the appraiser consider the issue of covenants not to compete in arriving at his value. Covenants not to compete are not marital property in many states. If a considerable part of your value is predicated or would be allocated to a covenant not to compete with the spouse retaining the business, you need to be aware that part of the value may not be part of the marital estate.

This is clearly an issue you and your client don't want to be blind-sided by, so be sure you understand not only the issue of personal goodwill, but also how covenants not to compete are treated in your state.

HOW DOES A SPOUSE GET “BOUGHT OUT” OF THEIR SHARE OF THE BUSINESS?

In almost all cases, the court will award the business to one spouse rather than retain joint ownership. Rarely is a sale of dissolution of the entire business forced by the judge or mediator, who loathe to force the disruption of the family business.

While not impacting our participation in the proceedings as a valuation expert, as CPAs we are often called upon to advise on how to get one spouse “out of” the business as a part of the divorce settlement as well.

Caution: If you are asked to take on this additional work, your role can clearly switch from impartial non-advocate to an advocate for the client. The valuation issue should (perhaps ideally) be settled before this point. Now, you should begin operating under a new and distinct engagement arrangement with your client. Be careful though because if you are called back to testify or further opine on your valuation opinion, your continued impartiality (or lack thereof) can be called into question. It is sometimes better to refer this work to another CPA.

In structuring the transaction, planning and proper wording in the divorce decree is crucial. Attorneys (even those who regularly play in this field) are often woefully unknowledgeable and unprepared to watch out for the tax ramifications.

Generally, the stock is either acquired directly by the retaining spouse, or more commonly, the corporation redeems the stock. If the corporation is acting on behalf of the spouse who is retaining the business, courts have determined that the spouse whose stock is redeemed escapes tax liability on the amount received under the redemption. The spouse who retains the interest in the corporation will likely be viewed as receiving a constructive dividend.

However, there is wide room for latitude in the wording of the divorce document, which could cause the tax burden to shift to the non-retaining spouse. It could also result in a case in which neither spouse is taxed on the redemption.

The exclusion from gross income, which is found under Section 1041 of the Internal Revenue Code, applies to transfers between former spouses' "incident to divorce." A transfer is incident to divorce if (a) the transfer occurs not more than one year after the date on which the marriage ceases; or (b) the transfer is related to the cessation of the marriage.

If the redemption of the stock is found to be in satisfaction of the non-retaining spouse's obligations under the divorce decree, then the redemption will likely be nontaxable under Section 1041. The Ames case¹ further found that the retaining spouse did not receive a constructive dividend (even though the redemption of his wife's shares was found to be nontaxable), because his guarantee of, and the subsequent redemption of, her shares did not relieve him of his "primary and unconditional" obligation under the divorce decree.

In many cases, it is wise to suggest that the attorney include language indemnifying your client in the event of any unforeseen tax consequences.

There are other tax topics relating to the divorce that are completely unrelated to the business and its value but related to the division of the marital estate and the payment of alimony and child support. Such tax issues are outside the scope of this presentation, but the practitioner should take care to be knowledgeable about them if they get involved in this aspect of a divorce engagement.

LEGAL PRECEDENT IN YOUR STATE

If one thing should be eminently clear by now, it is the critical need to know what is going on in the divorce courts in the states in which you offer valuation

¹ Ames v. U.S. 981 F.2d 456 CA 9,19M

services. For many, this is a daunting task. So, this section will discuss how you find it, and once you do, what you do with it.

How To Find It

One of the most powerful tools we have available to us to find case law is the Internet. Westlaw and Lexis-Nexis are both useful resources, but can be costly alternatives, particularly for states that have many cases on-point. See the bibliography for how to find these services. Typically you would narrow the search to your state, and the words “divorce” or “marital dissolution”, and the words “company”, “corporation”, and “stock”. You may further want to look for cases with particular issues, such as goodwill, non-compete agreements, or buy-sell agreements.

If access to Westlaw or Lexis-Nexis is not an option for you, you can always ask the attorney—I have found most attorneys to be very helpful in this area, sometimes even providing copies of relevant cases.

The resources section of this report has further published sources of cases that provide valuable insight into the myriad of issues that you will face in this arena.

What Guidance Takes Precedence?

Generally, your state Supreme Court decisions, as the court of last resort, is where your primary guidance in resolving the question of how value is determined in the divorce arena should come from. However, you often have to go back to the Superior Court (sometimes called the trial court) case that led to the appeal in the Supreme Court, in order to find the details of the information that we need to guide us².

What To Do When You Find “Bad” Case Law

When we are hired to do an appraisal, we are asked for our opinion. To render our opinion, we rely on a combination of research and empirical data coupled with knowledge of business appraisal theory and our professional judgment. You may find yourself disagreeing with the decision that was made, or you may feel that if the appraiser in the case had made a more compelling case, the outcome would have been different.

What to do then?

Are you “bound” by bad case law? While you certainly need to know of the judicial precedent that has been set in your state, you may find that some of that

² A notable exception to this general statement is the State of New York, where the court of last resort is the Court of Appeals.

precedent has been predicated on a poorly rendered opinion of value. Whether or not you rely on that case law is for the attorney—not you—to decide. In some cases, the answer may be no. However, we ought to point such things out to the attorney.

RESOURCES—WHERE ELSE CAN YOU GO FOR GUIDANCE?

There are many other places, besides case law, that you can and should refer to when venturing into divorce valuation. These materials include a bibliography of books, articles, web sites, and sources of case law analysis and interpretation.

Besides your own research, don't be afraid to talk candidly with the attorney. The attorney has probably been on the front lines in numerous property settlements involving family businesses, and can give you insight into not only case law interpretation, but also into what he has seen happen in mediation and arbitration. In some jurisdictions, it can even be important to be familiar with the predilections of the particular mediator your client is going before—because that mediator may well have opinions as to how these matters should be settled that are separate and distinct from what the courts are saying. The attorney should know this, and you can gain from that knowledge.

HOW TO PROTECT YOURSELF

Non-Advocacy Role of Appraiser

The most painful mistake you can make is to act as if you were an advocate for the client, and get caught on cross-examination doing so. It can be difficult not to get caught up in the “Team” mentality with the attorney and the spouse he/she represents. Even worse though is being tarnished with the reputation of someone who will “give the attorney whatever number they want”.

As appraisers, we are brought into the divorce situation to act as valuation experts. Notwithstanding the desires of some attorneys to the contrary, our duty is to render our impartial opinion.

Strong Engagement Letter

No valuation engagement should be undertaken without an engagement letter, under any circumstances. If you haven’t already done so, your engagement letter should be reviewed by your own corporate attorney to make sure it is complete and legally sound.

Most valuation professionals require an up-front retainer as well. This is particularly important in the divorce arena where, almost no matter what you do, at least one party will be unhappy with your valuation conclusion. In addition, it’s good practice to require payment in full up front before deposition or trial testimony.

Be Consistent

One of the worst things you can do as a valuation expert is to handle a particular matter one way in a case where you are working on the side of the spouse who will retain the business, and then the opposite way when you work for the side of the spouse who will be giving up the business. If you do, you leave yourself open for a tough cross-examination, casting suspicion and doubt over your entire opinion.

Make sure the attorney knows of your opinions before you take the case.

SUMMARY

Divorce valuation work can be very challenging work for appraisers. Each state and each case has its own set of complications. We need to be sure that we understand what these complications are in order to be effective.

For many, divorce work is also their entrée into the litigation environment and provides an excellent forum for “getting your feet wet” in this further challenging arena.

And, as with many valuation areas, we can be assured that there will be plenty of work to go around for a long time to come.

DIVORCE VALUATION RESOURCES

On-line:

Business Valuation Resources (503-291-7963):

BVU On-line (www.bvupdate.com)

Judges & Lawyers on-line (www.bvulegal.com)

Judges & Lawyers disc available of Family Law Cases 1995-1998

Divorce.com (site “Coming soon”)

Lexis-Nexis (<http://www.lexis-nexis.com/lnc/>)

Westlaw (Westlaw.com)

Textbooks:

AICPA NBV 5 materials

Handbook for Divorce, James Alerding, Bob Kleeman and Ben Miller

Valuing a Business, Shannon P. Pratt

Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses, Gary R. Trugman

Digests and Newsletters:

Valuation Case Law Digest (248-324-1875)

Insights, Summer 1996

Business Valuation Resources:

Business Valuation Update

Judges and Lawyers Update

