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Valuation Issues and Divorce

The valuation of a closely held business for divorce purposes is based on valuation theory, state statute and case law. Since statutes and case law vary from state to state, there is no national standard for divorce valuations.

Standard of Value

The standard of value is how value is defined. In many states, the standard of value is not included within the statute for marital dissolution. Thus, case law must be referred to in order to establish the appropriate standard of value for the corresponding jurisdiction.

The most common standards of value are fair market value, fair value and investment value.

Fair Market Value is defined as "the price at which the company's stock would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts." It should be pointed out that this is the value of the business to a hypothetical investor and not the value to the specific current owner.

Fair Value is a term which is defined in various ways depending on its context. The definition of fair value when applied to valuations for marital dissolution purposes must be interpreted based upon established case precedence by jurisdiction. Fair value often excludes discounts for marketability and lack of control.

Investment Value refers to the value of a specific business or investment to the specific owner or investor. This value is often higher than fair market value because it takes into account the specific circumstances of the current business owner rather than the hypothetical transaction on which fair market value is based.

Marital vs. Separate Property

Marital Property is property attained during the marriage. Marital property includes real estate, personal property, intangible property, and retirement plans. Marital property also may include increases in the value of separate property due to either spouse's labor or contribution of marital money to the increase in the property's value during the marriage.

Separate Property is real, personal and intangible property from an inheritance; property owned before the marriage; income or appreciation on separate property that did not come from a marital contribution of either party during the marriage; a gift after the marriage date if proved to be made to only one spouse; and an award for personal injury (except any part of the award that compensates for lost wages occurring during the marriage, or medical bills from the injury paid with marital funds).

Therefore, the following information is necessary to determine if property is marital or separate property:

- Date of marriage
- Date business entity was acquired
- Source of funds invested in the business
- Contribution of labor by either spouse during the marriage
- Financial contribution by either spouse during the marriage

For example, if one spouse owned a two percent interest in a company prior to the marriage and didn't work at the company, then, at the time of the divorce, this interest would continue to be separate property. On the other hand, suppose the spouse was the CEO and owned 100 percent of a company that was worth $200,000 at the time of the marriage. Ten years later, at the time of divorce, the company is worth $3,000,000. The $2,800,000 increase in value during the marriage is a marital asset, but the $200,000 of value at the time of the marriage is not.

From this example, it is clear that the business may need to be valued as of two dates-the marriage date and the divorce date.

Owner's Compensation

Sometimes, owner/operators pay themselves higher than normal compensation. Other times, an owner takes out just enough to meet his current needs.

If a minority interest in a company is being appraised, it is often assumed that a minority shareholder cannot do much to change the actual compensation practices of the company. In that case, no compensation adjustment is made.

If a controlling interest is being appraised, then the fair market value standard implies that a controlling shareholder would operate the company in a manner that maximizes shareholder value. Under this premise, it is common to adjust owner's compensation to a level comparable with prevailing market rates.

Owner's compensation adjustments can impact value significantly. The value of a company is often estimated by applying a multiple of earnings. If the value is determined to be six times earnings, for example, an adjustment of $10,000 to owner's compensation will have a $60,000 (6.0 x $10,000) impact on the value of the company.

Therefore, selection of market-level compensation should be done with great care. Data sources used should be cited, and the appraiser should consider factors such as the size and financial performance of the company, industry and local conditions, and the specific duties of the individual. Market compensation should reflect what would be required to replace the subject individual.

Personal Goodwill vs. Professional Goodwill

Personal goodwill relates to the intangible value associated with an individual. It is considered to be difficult if not impossible to transfer.

Professional goodwill relates to the intangible value associated with a business. Professional goodwill consists of intangible assets that are owned by the company. Professional goodwill is not diminished with the departure of an individual employee from the business.

In many states, personal goodwill is not a marital asset while professional goodwill is considered to be a marital asset.

To ascertain whether personal goodwill exists, the intangible assets that generate value should be identified. These may include customer relationships, customer lists, distribution systems, proprietary processes, an established workforce, brand recognition, etc. To the extent that intangible assets are owned by the company, rather than the individual, then the intangible assets represent corporate, not personal goodwill. Key questions to consider include:

- Are trademarks and patents property of the company?
- Do key employees have employment contracts with the company?
- Are contracts with customers and vendors with the company?
- How much of the business's proprietary knowledge is transferable to another individual?
- Do important relationships interact with just the owner or with other employees?

Buy/Sell Agreements

Sometimes there are other owners of a business, in addition to the parties involved in a divorce. Discord relating to business ownership often results when there is no definitive method for dividing the entity. A buy/sell agreement can alleviate time and expense involved in the division of a business entity. Buy/sell agreements often include guidelines for the division of the asset, including a price or formula for determining the fair market value of the company's stock.

In estimating the fair market value of a business, the existence of a buy/sell agreement (or similar shareholder agreement) must be considered. The following questions should be considered to determine if the agreement is controlling:

- The terms of the agreement must be based on fair market value concepts.
- If the buy/sell agreement was followed for a transaction between independent businesspeople, then it may be the determining indicator of value in the divorce case.
- If the agreement has been used as the basis of a transaction between family members, it may or may not hold, since the parties are related.
- If the buy/sell agreement has never been followed, its impact is further weakened.

Conclusion

A knowledgeable valuation expert can be an important and useful resource for attorneys and their clients. An experienced valuation expert can assist an attorney by explaining the key valuation issues at hand. Communication between the appraiser and the attorney can also enhance the due diligence process. The appraiser should advise the attorney if important documents are not being provided. Any important issues need to be identified up-front because they cannot be introduced on appeal.

About the Author

Ms. Wilhelmy, ASA is a Director in ComStock Advisors' Cincinnati office. She has appraised closely held businesses for marital dissolution, litigation support, estate taxes and estate planning, gifting, mergers, acquisitions and lending. She also has extensive valuation experience working on behalf of ESOPs. Lori has experience both in deposition and testimony in valuation related to divorce. She has over 18 years of finance and valuation experience.

Additional information on ComStock Advisors is available on our website at www.comstockadvisors.com. If you have any questions, please feel free to contact me.

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