BUSINESS VALUATION in a Divorce Proceeding

By Russell Long

Divorce proceedings and the judicial infrastructure that governs them are inherently complicated, particularly when one or both of the parties own a business. Insofar as the Family Court bench and the attorneys who appear before them are not experts in business valuation, the credibility of the valuation expert's testimony and supporting valuation report become the basis for a judge's decision regarding the value of a business interest. As such, it is essential the valuation expert get involved early to weigh all the options and prepare a credible independent valuation report to assist the trier of fact with the disposition of the marital estate. The valuation expert must not only have the right answer, but he or she must have the respect of the judiciary and be able to explain the conclusion in concise, understandable terms to an arbitrator, mediator, and or a jury.

The threshold consideration for any valuation expert is the selection of a standard of value appropriate to the pending divorce. It is well settled that the three most common standards are Fair Market Value, Fair Value, and Investment Value. The peculiarities of State case-law and sometimes even local practice can have a significant impact on the expectations of the valuation expert's audience. The attorney and the expert should agree on the standard of value prior to beginning the valuation, both mitigating ambiguity and strengthening negotiations. The valuation expert should be familiar with the case law in the jurisdiction of the divorce proceeding to ensure the standard of value chosen is consistent with similar cases and/or judicial expectations in the jurisdiction.

Fair Market Value, as defined in the Internal Revenue Service Ruling 59-60, quantifies the worth of a business by contemplating a hypothetical sale, a voluntary arm's length transaction with a willing buyer and a willing seller, under no obligation to act. This method also considers discounts for lack of control and lack of marketability for minority interests.

A second alternative is the Fair Value standard, the method most commonly utilized in shareholder disputes and minority shareholder oppression cases. Fair Value is quite similar to Fair Market Value, however, it does not require the valuator to consider discounts for lack of control or lack of marketability.

A third viable and frequently explored method is known as "Investment Value," or owner's value. Indeed, Shannon Pratt, a respected valuation expert and author, explored this method in his article titled What is Value, "in marital property divisions, only a few states strictly adhere to "Fair Market Value" as defined, many more states lean toward what the business appraisal community defines as Investment Value." In the context of a divorce, Investment Value represents the value of the interest in the owner's hands with no contemplation of a sale. Therefore, utilizing the Investment Value standard requires consideration of all the same elements listed in the Internal Revenue Service Ruling 59-60, it ignores discounts that would otherwise disproportionately benefit the business owning spouse.

Ultimately, the valuation expert must be able to assess the applicable facts and defend his decision to employ a particular valuation method over another. In large measure the success of any business valuation is governed by the independence of the valuator's opinion, which leaves it impervious to cross examination or other exploitation by the litigation process.