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THE STANDARD OF VALUE IN DIVORCE BUSINESS VALUATIONS

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There are different standards of value that can be used in valuing assets, and a review of certain appellate cases reflects that different standards apply to different assets. This article will explain the primary standards of value, and then discuss which standards are to be used in divorce cases.

Liquidation Value

This is the net amount that can be realized from the sale of a business if the business is terminated and the assets are sold piecemeal. Liquidation can be either "orderly" or "forced". This standard of value assumes that the business will no longer remain as a going concern.

Fair Market Value

This is the value of an asset when there is a willing buyer and a willing seller when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts. This standard also includes the concept that the asset can be sold. Therefore, if fair market value were the standard to use in the value of a law practice, and if law practices could not be sold, as was true in the past, then there could not be a value established for the value of the law practice. If it cannot be sold, there could not be a willing buyer and willing seller, and therefore, using this standard, there could not be a value. Another example would be minority discounts. If, for example, someone owned 20% of a business, and other people owned the other 80%, that person has what is called a minority interest in the business.

Using the standard of fair market value, and assuming that the business was worth ten million dollars, that 20% interest would be worth less than two million dollars. That is because on the open market, willing buyers pay perhaps 15% of the total value for a 20% interest because they are subject to the control of the 80% owners.

Investment Value

This is the specific value of an asset to a particular investor based on individual investment requirements or the specific value of a particular business to another particular business or person. For example, Cingular recently acquired AT&T Wireless. They would probably have paid more for AT&T Wireless than Walmart would have paid, because Cingular could have integrated AT&T Wireless into their own business, in either a vertical or horizontal integration. This standard values the asset based on the economic value of the asset to its owner, regardless of whether or not the asset could be sold. Using this standard, a law practice could be valued even if it could not be sold, and it would be valued based on the income generated by the practice to the lawyer owner. Similarly, using this standard, there would not necessarily be any discount for a minority interest. One might value the 20% interest using the income stream that is earned by the 20% owner, and if he actually earns 20% of the total income, it is quite possible that his 20% interest is worth exactly 20% of the entire company.

California case law has tried to clarify which standard of value is to be used. A major principal was established by *In Re Marriage of Hewitson* (1983) 142 Cal. App.3d 874. That case rejected a fair market approach in that specific case because the methodology used was improper. In that case, an expert valued a business using data from publicly traded companies, and the court ruled that such a methodology was flawed because one cannot compare small closely-held companies with large publicly traded companies. Therefore, the court ruled that fair market value could not be determined - not that it should not be used - and therefore, to determine a "hypothetical market value", one should use the investment value standard of value. The court, to my understanding, was stating that fair market value should be used if possible, and if not, one should arrive at a hypothetical market value using an investment value methodology so that one effectively ends up with a fair market value equivalent.

The above principle was refined in the same year by In *Re Marriage of Sharp* (1983) 143 Cal. App.3d 714. That case rejected a standard of value which it described as "going concern" and ruled that the standard to be used in the valuation of a business was fair market value. Apparently, in that case, fair market was determinable, and the court overturned the trial court's usage of a going concern standard. Note that a going concern assumption simply means that the business will not be liquidated, but it could apply to both a fair market value standard or an investment value standard, which is presumably why the court rejected it. There is no standard per se of "going concern"; "going concern" is an attribute of other standards of values, and the lack of a "going concern" assumption is an attribute of the liquidation value standard.

The above concepts were then clarified further ten years later in the case of In *Re Marriage of Cream* (1993) 13 Cal. App.4th 81. The court ruled that

> *"In our view, the fair market value of a marketable asset in marital dissolution cases is the highest price on the date of valuation that would be agreed to by a seller, being willing to sell but under no obligation or urgent necessity to do so, and a buyer, being ready, willing and able to buy but under no particular necessity for so doing. We restrict the use of this definition to marketable assets because some marital assets are not marketable, but nonetheless may have to be valued."*

This opinion is consistent with, and clarifies, the above two cases. The standard to be used in divorce cases is fair market value provided that the business is marketable. If the business is not marketable, then, per *Hewitson,* the standard of value is the investment value - which itself is intended to arrive at a hypothetical fair market value.

There are many consequences of the above understanding, which will be listed below as specific examples.

Law Practice

A law practice can be valued whether or not it could legally be sold, or whether or not there is a market for law practices. If there is a market, and there are good statistics, then it seems that the standard of value to be used is fair market value, and the marketplace should be the basis for the valuation. In many cases, the law practice may be unique, and therefore the value may be difficult to determine using marketplace statistics, and then investment value should be used.

The use of investment value would require that one use excess earnings or some other methodology to determine the economic value of the law practice to the lawyer.

Minority Discounts

If the business is marketable, then fair market value is the standard of value, and therefore a discount should be applied to someone who owns a minority interest in that business. A 25% interest in a business would be worth, as an example, perhaps 15% of the value of the entire business. If the business is not marketable, then it seems that investment value should be used, and therefore no discount should be made for a minority interest. Under the investment value standard, one values the investment to that specific owner, and if he or she has a 25% share of the profits, for example, then one could value his or her interest as being 25% of the value of the entire business. Therefore, the value of the minority interest may differ greatly depending on which standard of value is being used. In certain situations, just as one has a bifurcated hearing to determine the date of valuation, there might be a need to have a bifurcated hearing to determine the appropriate standard of valuation.

Synergy or Special Value

There are businesses that are worth a certain amount on the open market using the fair market value, but they would have a higher value to another buyer because that particular business would fit in very well with their own business, such as the above example of Cingular and AT&T Wireless. In a divorce situation, where the family business may have synergistic value to certain businesses, and that value would be greater than the value determined using fair market value, it seems that if the business is marketable, the standard to use is fair market value and therefore, the lower value should be used. This could be particularly complicated in situations where the divorce proceedings are taking place at the same time as business merger or acquisition talks are being explored. It may be that the business is worth ten million dollars using a fair market value standard while at the very same time that the divorce proceedings are moving along, someone is offering to buy the business for fifteen million dollars. This type of situation may also warrant a special hearing to determine which standard of value is appropriate. (Of course, it often makes sense for both parties to agree that the business simply be sold at the higher value.)

Unusual Sale Price

Another example where the standard of value may have relevance is where the controlling spouse sold the family business at the time of the divorce proceedings, and the sale's price doesn't seem to make sense. It might seem to be below market value, if the out-spouse agreed to the sale, then there was a willing seller as both the in-spouse and out-spouse agreed to the sale price. However, if the out-spouse was left out of the negotiations, and did not agree to the sales price, then quite possibly the court would agree that fair market value should be used, and not the actual sales price. One would, therefore, not have to look for possible kickback arrangements or other explanations for the abnormal sales price. One simply values the business as if it wore not sold, using a fair market value standard (since the business was in actuality sold, it would have been a type of business that is marketable, and therefore the standard to use is fair market value).

In summary, the standard of value is a key issue in divorces that involve business valuations, and the resulting value of the business would depend on which standard is used.