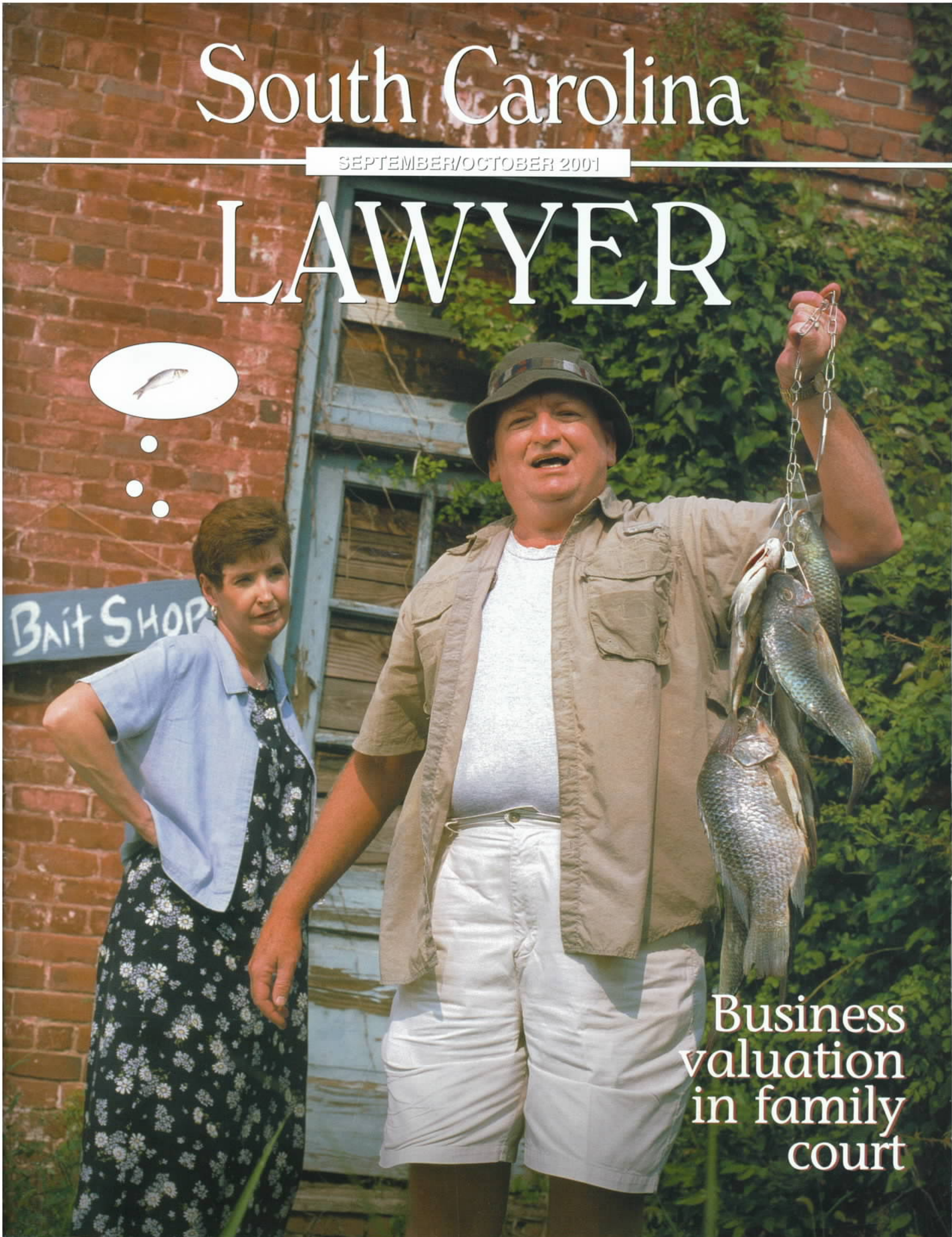
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Business valuation in family court

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It is easy for divorcing spouses to get sideways with one another when placing value on a small business or professional practice. Invariably, one spouse sees significant value while the other sees little or no value, and both can produce experts who will support their contrary views. How can this be?

It could be that both spouses are right, not equitably right or market value right, but right because *value* is one of those things that is largely determined based on perspective. This article focuses upon the family court's *equitable* perspective for valuing a business interest and demonstrates the court's flexibility in applying alternative valuation methodology in response to the overall economic dynamics of the marital dissolution.

Standard of value

Although not statutorily prescribed, many decisions of the family court and appellate courts have held that business interests should be valued from the perspective of *fair market value*. Many courts have defined *fair market value* as the cash price at which property would change hands between a willing buyer and seller, both being adequately informed of the relevant facts and neither being compelled to buy or sell. As clear-cut and reasonable as the *fair market value* standard may appear on its surface, it is a mistake to conclude the family court will adhere to that standard under all circumstances.

Universal application of the *fair market value* standard can produce questionable results in certain situations. For example, the court may question how a transaction-based view of value can be equitable in valuing a business interest that is clearly not going to be sold by the owner/spouse.

Sometimes it is more equitable for the court to focus upon value to the actual owner/spouse rather than value to a hypothetical market investor. Such a perspective on value is variously referred to as *fair value* or *investment value*. S.C. Code Ann. § 20-7-472 of South Carolina's Equitable Apportionment of Marital Property Act refers to it simply as "value," not specifying any particular universal standard. Obviously, no single standard could possibly encompass the multitude of considerations necessary for equitably dividing marital assets.

For example, the fact that a spouse will be awarded alimony may be a significant consideration in valuation of a business interest that is also the primary source of funds for payment of alimony. This issue, commonly referred to as *double dipping*, is not an issue that would be considered in a *fair market value* determination.

Another example has to do with buy-sell agreements that restrict the sale of business interests among co-owners. Such restrictive agreements may have a significantly negative impact on the *fair market value* of a business interest, but do they impact the *fair value* of the interest, particularly if it is unlikely to be sold? *Fields v. Fields*, 342 S.C. 182, 536 S.E.2d 684 (Ct. App. 2000), illustrates the court's discretion in strictly adhering to the *fair market value* standard when that standard produces an inequitable result. In *Fields*, the court held that a minority interest in a family business was worth more in the wife's hands than in husband's hands.

Furthermore, after "a detailed examination and thorough analysis of minority ownership as it relates to the control and marketability of corporate stock," the court viewed the interest as being worth more to the wife than to a typical market investor, a clear departure from the *fair market value* standard.

Fields does not signal an opportunity to play fast and loose with the standard of value. Nor does it signal a change in policy for use of *fair mar-*

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ket value as the standard. However, *Fields* does illustrate how the standard of value for business interests in the South Carolina family court is *fair market value, unless equity demands otherwise*.

Valuation approaches

Whether it is *fair market value* or *fair value*, our courts expect business valuation testimony to follow a *Santee Analysis* (*see Santee Oil Co. v. Cox*, 265 S.C. 270, 273, 217 S.E.2d 789 (1975)). A *Santee Analysis* follows a three-pronged approach based upon: (1) the value of assets owned by the business, net of liabilities, (2) the value of future income expected to be generated by the business and (3) the market value of the business interest. Because each approach will likely produce a different value indication, each is weighted based on its relative bearing upon the ultimate question of business value.

The theory behind weighting is that some valuation approaches produce a better indication of value than others based on case specific facts and circumstances. Thus, weighting involves more than simply averaging all the value indications; it requires an assessment of the reliability and relevance of each approach to the interest being valued.

Generally, the asset valuation approach (or the *net asset value approach*) is best suited to valuing businesses that have significant tangible assets and/or little or no goodwill value. Unless liquidation is imminent or foreseeable, this approach is best suited to valuing a controlling interest as opposed to non-controlling, minority interests that are incapable of causing liquidation and distribution of the business' assets.

The theory behind the future income approach is that value equals the present value of all expected future income. Reliability of the income approach depends upon the reasonableness and credibility of assumptions about future operations and financial results. Naturally, the more probable the forecast, the more weight this approach receives in the final value conclusion.

The market approach demonstrates the price at which a business interest would sell based upon actual trading prices of similar interests. The big problem with the market approach is finding transaction data for similar interests. Not only is it difficult to identify "similar" interests (i.e. similar in size, income, growth, profitability, leverage and liquidity), but it is also difficult to obtain complete information about usually private and isolated transactions. However, when quality data is found and the market approach properly applied, it produces compelling evidence of the market value of the business interest and the approach is weighted accordingly.

Minority and marketability discounts

Empirical studies of stock transactions in the public securities markets are persuasive of two major business valuation tenets. First, business interests that do not convey the rights to control (i.e. the right to hire and fire management, cause salaries and perks to be paid, merge, sell or liquidate the business, etc.), sell at discount (i.e. a minority discount) to those interests that do. Second, since investors prefer liquidity to illiquidity, illiquid business interests sell at discount (i.e. a marketability discount) to those interests that can be readily converted into cash.

There is no bright-line answer to whether minority and marketability discounts are appropriate for valuation of a business interest for purposes of equitable apportionment. In *Fields,* the Court of Appeals allowed no discounts for an 18 percent minority, non-marketable interest in a family corporation. Although the testimony in *Fields* pointed to the applicability of such discounts in an arms-length or *fair market* transaction, the court focused instead on the value of the interest to each spouse and allowed no discounts. On the other hand, in *McElveen v. McElveen*, 332 S.C. 583, 506 S.E.2d 1 (1998), the court gave full force and effect to the husband's 7.6 percent minority status and restrictions on his right to sell his interest in a medical practice.

Fields can be distinguished from *McElveen* based on the fact that the company valued in *Fields* was family-owned and no owners of the medical practice in *McElveen* were related. In *Fields*, the court applied the family attribution principle to equitably value what was ostensibly a minority, non-marketable interest as a controlling, marketable interest. The lesson here is that minority and marketability discounts must be equitable or will not be applied.

Goodwill

In valuing small businesses and professional practices, courts grapple trying to define precisely what business *goodwill* is, who owns it, whether it is transferable and its value, if any, to the marital estate. Sometimes it is easier to explain how to value goodwill than it is to explain exactly what it is. In a nutshell, the value of goodwill is equal to the difference between the total value of a business (based on results of a *Santee Analysis*) and the value of its specifically identifiable assets minus liabilities.

In 1987, the South Carolina Supreme Court, in a case of first impression on this issue, held "when the goodwill in a business is dependent upon the owner's future earnings, it is too speculative for inclusion in the marital estate. Moreover, these earnings are accounted for in an award of alimony," *Casey v. Casey*, 293 S.C. 503, 362 S.E.2d 6 (1987). In reaching its conclusion, the Supreme Court focused on two important factors. First, the Court found that the continued success of the business was largely attributable to one spouse's post separation efforts. Second, no expert testimony was presented to place a value on the business or its goodwill.

Rather than being read as a bar to inclusion of goodwill in the marital estate, *Casey* speaks to the sufficiency of evidence, or lack thereof, in proving business goodwill value. The Court of Appeals in *Casey v. Casey*, 289 S.C. 462, 346 S.E.2d 726 (Ct. App. 1986) said, "while a court may determine the value of a sole proprietorship by considering its earnings value, courts should be meticulous to distinguish between the entrepreneurial skills or potential future earnings of a spouse and the goodwill of the spouse's business."

To paraphrase the Supreme Court's *Casey* ruling, when business goodwill is valued based on the business owner's future earnings, it is too speculative for inclusion in the marital estate. In other words, given the risk that an owner may not produce the expected future earnings, it would be inequitable to divide the value of those earnings as part of the marital estate. Instead, those earnings may be considered in the award of alimony, which may be adjusted in the event that future earnings do not materialize. Therefore, goodwill valuation testimony must reliably distinguish the estimate of an owner's future earnings from the estimate of future earnings attributable to business assets, both tangible and intangible, including goodwill.

Conclusion

The appropriate standard of value, the applicability of discounts, weighting and a host of other issues are decided by the family court based upon equitable consideration of all the particular facts and circumstances of a divorce. There are no fixed valuation formulas; in fact, there are few valuation absolutes when business value depends upon equity. The guiding principle may be that valuation testimony must be reasonably accurate, reliable and fair to a client's interest. And, in the interest of fairness, counsel may be obliged to employ new, different or even previously rejected valuation theories.

John McDougall practices law in Columbia.

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