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Three Important Decisions You Must Make for Every Business Valuation Used in Family Court

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When you need a business valuation for a marital community-owned business, there are three key decisions that your business appraiser can't make for you. You need to understand and assess how these three key factors will affect the business value and how they will impact your divorce case.

The three decisions you will be asked to make are:

1. What level of valuation report?
2. What valuation date?
3. What standard of value should be used?

Each of these three decisions are discussed in detail below.

What Level of Valuation Report?

Do you want an opinion of value, or do you want just an estimate? Many times, clients just want a "rough estimate." However, a "rough estimate" may or may not be appropriate depending on the circumstances. It is critical that you know what level of work your appraiser is performing and what the implications are for each type of work.
In a full-blown valuation, an appraiser will do all the work necessary to come to an independent opinion of the value of the business. Alternatively, the appraiser can provide an estimate based on various assumptions provided and agreed to by the client, typically resulting in less work for the appraiser and a lower cost. This type of report is called a Calculation of Value. In a Calculation of Value, the appraiser has not done the independent work required to form an opinion as to the value of the business.

Because a Calculation of Value is highly dependent on the assumptions that are made, it is important to fully understand the assumptions that the appraiser is using in the calculation. It is even more important to understand the assumptions if the Calculation of Value is performed by a neutral appraiser as opposed to an appraiser working for you or your client. The appraiser is required by professional standards of the AICPA[1] to come to an agreement with the client as to the assumptions used. If the neutral appraiser does not rely on assumptions agreed upon by both parties, then you may be unpleasantly surprised by the resulting estimated value.

The benefits of a Calculation of Value are that it can be less expensive and can be done quicker than a full valuation. The downside is that if the opposing side commissions a full valuation, a Calculation of Value will likely be of little use at trial since it is not an expert opinion of value.

If you request a Calculation of Value, you likely won't be able to successfully use the analysis at trial if the opposing side has prepared a full opinion of value. Therefore, Calculations of Value are better suited to settlement negotiations in an attempt to avoid the time and expense of obtaining an opinion of value.

What Valuation Date?

It is not the appraiser's responsibility to choose the date of value. The appraiser can provide a value as of any chosen date, but the valuation date should ultimately be selected by the attorney.

The petition date is often used as an appropriate business valuation date. However, if the divorce proceedings continue for an extended period, it may be inequitable to value the business on the petition date if there are material changes to the business or the economy during the pendency of the proceedings.

An appraiser generally cannot take into account events after the date of value unless those events were known or knowable at the date of value. Therefore, if events after the petition date would significantly impact the value of the business, you may consider choosing a date of value after those events. Otherwise the appraiser either may not be able to consider the events occurring after the petition date, or would have to go through additional steps to determine if subsequent events were known or knowable as of the valuation date.

For example, a real estate holding company would likely be worth significantly more in early 2007 than one year later in 2008 when the real estate collapse was in full swing. An appraiser using a 2007 valuation date may have to exclude the downturn from the analysis unless he or she believed the downturn was known or knowable in 2007. These additional assumptions and analyses increase the complexity of the valuation, as there are more assumptions subject to scrutiny. Counsel should ask the appraiser to value the business on the date most supportable based on the facts of the case.

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[1] American Institute of Public Accounting. Not all appraisers are bound by the AICPA's standards.

A valuation date closer to the trial date (rather than the petition date) may be more equitable and supportable in certain circumstances; however, counsel must make that determination and may need to ask the Court to determine the date of value. Once a date of value is determined the appraiser can proceed accordingly.

What Standard of Value Should Be Used?

Standard of Value typically refers to Fair Market Value, Fair Value or Investment Value. The difference between these standards can be simplified for purposes of this article to discounts or no discounts. In Arizona, there is no statutory requirement to use any particular standard of value when valuing a business in family court. Therefore, it is necessary to understand the standards of value and inform the appraiser which standard he or she should use.

Put simply, Fair Market Value, for ownership of 50% or less of a business, will often include a discount for lack of control and/or a discount for lack of marketability, whereas Fair Value and Investment Value generally do not include these discounts. In short, Fair Market Value will often be less than Fair Value and Investment Value for the same non-controlling interest in a business. Fair Market Value assumes the market consists of third party buyers while Fair Value and Investment Value typically assumes the purchasing spouse buys out the exiting spouse.

The value of a 50%, or less, interest in a business is generally worth less if sold to a third-party buyer than the pro rata share of the whole business. Why? Because: 1) a third-party buyer would not be able to control the company thus making a 50% (or less) interest less appealing. The third-party buyer would have to come to acquiesce to the remaining spouse on all management decisions (assuming less than 50% ownership or would have to come to an agreement with the other owner on all decisions assuming 50% ownership) and 2) it is harder to sell a 50%, or less, interest than a whole company. Therefore, once a third-party buyer purchases the 50% interest, it is more difficult to sell the investment at a later time, i.e., the asset is illiquid. Because of these reasons, which make a non-controlling interest less appealing, discounts for lack of control and lack of marketability are usually applied to non-controlling interests when determining fair market value, resulting in a lower value than a pro rata share of the business.

Fair Value and Investment Value assume a pro rata allocation of the value of the whole business with no discounts for marketability or control. In a divorce the purchasing spouse will likely end up with 100% ownership of the company and therefore will have control and an easier time selling the entire company at a later date, than a 50% interest. Thus, the value of the company to the purchasing spouse is likely worth more to him or her than to a third party. Therefore, Fair Value and Investment Value do not apply any discounts for lack of control or lack of marketability typically resulting in a higher value than Fair Market Value. Note, there can be further distinctions between Investment Value and Fair Value; however further distinction is not necessary for purposes of this article.

Standards of Value and the related discounts are complex issues that are impacted by many other factors, such as restrictions in operating agreements and case law. Therefore, it is important to discuss these issues with a knowledgeable appraiser and evaluate the applicable case law so you can come to a conclusion that is appropriate for your situation.
Simon provides cost effective financial and accounting assistance in family court matters including business valuations, tracings and forensic investigations, assistance with spousal

maintenance assessments, determination of income for self-employed spouses (Federally Authorized Tax Preparer).

Feel free to give us a call if you have a quick question we can help with, or if you need help with financial and accounting matters in your case.