Valuation and Financial Considerations in Divorce:

Common Issues and Concepts

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Is Collaborative Divorce a Viable Alternative for You

Adversarial. Hostile. Inequitable. These are words commonly associated with traditional divorce proceedings. Typically, these proceedings include pre-trial negotiations and settlement procedures which are transacted under the shadow of the court, subject to the authority of the judge, who has the power to reject or amend settlements in cases where they may appear inequitable in the eyes of the court. The pre-trial process is typically adversarial in nature and business valuation experts are not usually involved (and neither are the divorcing parties themselves) beyond simply presenting their estimate of the value of any privately-held business.

Enter collaborative law.

Collaborative law is a form of alternative dispute resolution in which there is no arbitrator, judge, or jury – only the litigants, their lawyers, and selected "neutrals" that are brought in to aid in the dispute resolution process. A subset of collaborative law is collaborative divorce, an increasingly popular alternative to suing for divorce in family court. Collaborative law is closer in nature to mediation, in that it requires that the two parties to the divorce and their respective lawyers come together as problem-solvers rather than adversaries. Thus, the parties themselves are the true triers of fact and a business valuation expert can fill the role of an advisor to the divorcing parties, both individually and collectively.

The following list illustrates the primary roles and responsibilities of an appraiser engaged in collaborative divorce:

1. Expert is contracted as a neutral to both parties for the duration of the process
2. Expert signs an agreement to work as part of a team in resolving the divorce-related issues
3. Strict confidentiality is maintained – nothing made known in collaborative process may be carried over into a subsequent divorce action
4. In order to maintain neutrality, the expert must not have a continuing professional relationship with either party
5. Appraiser's report serves as a fact document, much like monthly brokerage reports and bank account balances
6. Ensure both parties understand what is driving the value of the business being valued and the impact that other decisions in the divorce process may have on the value of that business

Other considerations to be addressed in business valuations for divorce:

1. Future stability of cash flows from the business upon which child support, income, and alimony will be based
2. Double dipping – counting the cash that is generated from the business for alimony purposes in addition of using the same business income to justify a high value for the business in division of marital assets
3. Whether assets of the business or the business itself should be valued
4. How succession or estate planning is affected
5. How much of the value is rightfully contained in the marital estate (pre-marital vs. marital)
6. How the divorce affects the value of the business (e.g. loss of employee)

The Benefits of a Jointly-Retained Appraiser

In many lawsuits, the level of animosity between the parties involved is so high that it seems as if they would never be able to agree on anything. As a result, when disagreements between parties rise to the level that a lawsuit is filed, the likelihood of jointly retaining an appraiser may seem like a far-flung dream. The parties involved in these types of engagements, however, are often the ones that can benefit the most from the joint retention of a valuation expert (as opposed to each side hiring their own independent experts).

There are many benefits that can be realized from jointly retaining a valuation expert – a few of the most pertinent benefits are listed below:

Lower Fees – As the name implies, the costs for a jointly retained expert are normally accepted jointly by the parties involved in the dispute. Therefore, each party is effectively receiving a 50% discount compared to what their expenses would have been had they hired their own independent appraisers. In addition to these savings, if the parties agree to be bound by the value determined by the joint expert, significant fees can be saved by avoiding the lengthy battle that can ensue arguing over which experts' report is more "right" or more reliable. It is not uncommon for these costs to be significantly in excess of the cost of having the valuation report prepared.

Minimization of "Hired Gun" Image – Even if the valuation expert retained by a single party is offering a completely unbiased opinion, there may still be a perception that he or she is a "hired gun" for the retaining party. The use of a joint appraiser minimizes this perception (whether real or not) since it has more of an unbiased appearance by its very nature.

Quicker Resolution – Disagreements over valuations can significantly lengthen a lawsuit (which only increases fees, as discussed above). Therefore, not only does the joint retention of an appraiser reduce potential fees, but it can also bring the lawsuit to a conclusion more quickly and allow the parties to return to their normal responsibilities sooner than they might have otherwise.

As discussed above, even if the parties cannot agree on the issues that form the substance of a lawsuit, agreeing on the use of a joint appraiser can reduce the costs and headaches for everyone involved and help bring the disagreement to resolution sooner.

Asset Tracing in Divorce: Just Like Tracing as a Kid?

As children, we honed our hand-eye coordination and drawing skills by tracing pictures using extra-thin tracing paper. Believe it or not, tracing also has a role in the financial aspects of divorce. When a couple gets divorced, their assets are typically divided between them.

Understand Ohio's law regarding marital property

Under **Ohio law,** the assets of each spouse in a pending divorce may be classified as either "marital" property (divided between the couple) or "separate" property (retained by the owning spouse) depending on how the assets were obtained. Assets obtained prior to the marriage or received by gift during the marriage are generally considered "separate" assets. Assets obtained during the marriage with marital funds are generally considered "marital" assets.

Recognize the importance of dates and documentation

The tracing process for cash and investments in marketable securities can be relatively straightforward when the necessary documentation is available. Ideally, a bank or investment statement from just prior to the date of marriage can be used to substantiate the separate nature of an account. If marital assets are not added to the separate accounts, generally any appreciation or earnings are considered separate assets, as well. Things get a little more complicated when marital assets are commingled with separate assets. For example, assume that the husband had a 401(k) plan prior to the date of marriage. The balance in the account as of the date of marriage would be considered a separate asset, but any future contributions during the marriage would typically be considered marital in nature. Therefore, it is necessary to calculate the marital/separate portions of the 401(k) account at regular intervals over the course of the marriage so that any appreciation/depreciation can be appropriately apportioned as either marital or separate. The tracing process in this case typically involves the review of 401(k) statements from the date of marriage through the date of divorce.

Investment activities: determine involvement

Another wrinkle must be addressed when analyzing investments in companies in which a spouse is actively involved (typically privately-held companies, but publicly-traded companies may also apply depending upon the facts and circumstances of the case). If the wife has a separate investment in a privately-held company that is purely passive in nature (she has no input or impact on its operation), any appreciation during marriage is generally treated as separate in nature, similar to a pre-marriage investment account that holds various marketable securities. On the other hand, if the wife comes into the marriage with a separate investment in a privately-held company in which she is an active participant, any appreciation during marriage may be considered a marital asset. The tracing process in this case involves documenting when and how the wife received her ownership interest in the company as well as determining the value of the ownership interest on either the date it was acquired (if during the marriage) or on the date of marriage (if obtained before the marriage) . Therefore, tax returns and transaction documents are typically reviewed and the services of a valuation expert may also be necessary.

As with tracing any picture as a child, the more complex the picture, the more difficult the tracing. The same holds true for tracing analyses in divorce matters. Some tracing aspects in a divorce are simple, just like tracing a circle on a piece of paper. Complex tracing analyses, on the other hand, require a much more significant investment of time and resources.

Why Valuation Experts are Nosy About Owners' Compensation Numbers

"How much I make is none of your business!" This is a phrase valuation experts sometimes hear, particularly when gathering information in contentious domestic relations matters. Some business owners feel that when a valuation expert asks them how much they make (and how much they would pay someone else to do their job) that the valuator has crossed a line. "You're being too nosy – you don't need to know how much I make to tell me how much my business is worth." The typical business owner's response is not unreasonable, although we live in a society in which we broadcast loads of information about ourselves to the public (Facebook, LinkedIn, Twitter, etc.), our compensation is one of the last pieces of personal information that is still closely guarded. Most people do not realize, however, that adjustments related to owners' compensation often play a significant role in reaching an appropriate conclusion of value for ownership interests in privately-held companies.

If you and I ran absolutely identical businesses (same historical and projected operational activity), but you took out $100,000 in annual compensation while I took out $200,000, whose business is worth more? The answer is (assuming for the sake of the discussion that both businesses are identical) – they have the same value. See below for the proof:

	My Company	Your Company
Revenues	$1,000,000	$1,000,000
COGS	(500,000)	(500,000)
Gross Profit	500,000	500,000
Operating Expenses	(200,000)	(200,000)
Owners' Compensation	(200,000)	(100,000)
Net Income	$100,000	$200,000
Net Income	$100,000	$200,000
Normalizing Adjustment	100,000	-
Normalized Net Income	$200,000	$200,000
Earnings Multiple	5.00	5.00
Indicated Value	$1,000,000	$1,000,000

In many valuations, it is necessary for the valuation analyst to make normalizing adjustments for certain items in order to better reflect economic reality. One of these adjustments is typically for owners' compensation. While $100,000 may be the fair market value for the services provided by each of us, I may have chosen to pay myself an additional $100,000 since I have control of how my company's funds are used. This does not make my business any less valuable than yours; it simply means that I am paying myself more in compensation rather than directing these funds to myself through a dividend/distribution from the company.

When a valuation expert is probing about 1) how much a business owner pays himself/herself; and 2) how much the business owner would pay a third party to perform his/her job, it is because this information, used in conjunction with resources that valuation experts have regarding approximate owners' compensation for similar companies/positions, allows them to arrive at a reasonable normalizing adjustment for owners' compensation (if one is necessary at all).

For anyone hesitant to provide a valuation analyst with their compensation information, remember that we are bound by our professional standards not to communicate that information to anyone outside of the engagement. It can be a critical piece in the valuation puzzle, we are not trying to be nosy, we are simply trying to gather all of the pieces of information necessary to reach a supportable conclusion of value.

The Basics of Valuation Discounts

We, as consumers, love discounts. There are few things more satisfying for a savvy shopper than finding a deal on an item that he or she has been longing for. When it comes to valuing a business, some believe that "discount" is a dirty word and that it implies that the seller is not receiving fair market value for his ownership interest and that the buyer is getting a deal. This is not the case, however, as valuation discounts merely adjust the value of an ownership interest indicated by certain valuation methods for specific characteristics that need to be addressed before arriving at fair market value.

The most common discounts seen in valuation reports are for lack of control and lack of marketability.

Lack of Control Discounts

Lack of control discounts are appropriate for ownership interests in which the owner cannot unilaterally direct the company's operation. A lack of control discount is applied because a non-controlling owner cannot appoint management, set levels of management compensation, declare dividends or distributions, compel a liquidation of his or her ownership interest, set company policies, or purchase or sell assets, just to name a few things. These factors make a non-controlling interest less valuable than a controlling interest.

Marketability Discounts

Marketability discounts are also often appropriate in the valuation of privately-held businesses. There are certain marketability differences between an interest in a privately-held business and an interest in the stock of a publicly-traded company. An owner of publicly-traded securities can know at all times the market value of his or her holding based on the quoted price per share. He or she can sell that holding on virtually a moment's notice and receive cash, net of brokerage fees, within several working days.

This is not the case with ownership interests in privately-held companies, however. Liquidating or selling a position in a privately-held company is a more costly, uncertain, and time-consuming process than selling the stock of a publicly-traded company. An investment in which the owner can achieve liquidity in a timely fashion is worth more than an investment in which the owner cannot liquidate the investment quickly. Therefore, an ownership interest in a privately-held company with the exact same characteristics as a publicly-traded company would sell at a discount compared to the publicly-traded company.

What Does It All Mean?

Valuation discounts are not a simple matter, but they are an essential part of determining the fair market value of ownership interests in privately-held companies. The subjectivity in determining valuation discounts is often a source of contention in valuations for divorce, shareholder disputes, and estate and gift tax filings. Therefore, it is essential that your business valuation analyst have a well-reasoned and thorough discount analysis in order to stand up to challenge or scrutiny.

About the Author

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Sean is a Principal with Skoda Minotti's Business Valuation and Litigation Advisory Group. In this role, he is responsible for the development review and issuance of valuation reports, calculation of value reports, and expert reports under valuation and consulting standards. Sean has assisted a diverse client base in litigated matters, domestic disputes, shareholder disputes, estate and gift tax filings, and financial reporting valuation issues.

Additionally, Sean serves in Skoda Minotti's Accounting & Auditing department. He is primarily responsible for performing audits, reviews and compilations for companies in a variety of industries.

Sean earned his Master of Business Administration (with honors) from Case Western Reserve University and his Bachelor of Business Administration (with honors) from the University of Notre Dame. He is a member of the American Institute CPAs, the Ohio Society of Certified Public Accountants, the National Association of Certified Valuators and Analysts, and the Center for Principled Family Advocacy. Sean is the recipient of the 2010 Jeffrey R. Salins Report Writing Award and serves as Chair of the Marketing Committee on the Lake Catholic High School Advisory Board. He is also a member of the AICPA's ABV Exam Review Task Force, NACVA's Case Study Peer Review Team, and Q&A Review Team.