

DIVORCE AND THE CLOSELY HELD BUSINESS: A Practitioner's Guide to Understanding Valuation Theory and Precedent

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I. INTRODUCTION

The question of inclusion of a business asset in the marital estate is merely a threshold issue for business owners who divorce. The divorcing parties then face the daunting question of the appropriate value of the business asset for distribution purposes. The practitioner representing such parties must be able to identify the business assets, determine whether they are subject to an equitable distribution claim, and understand the vagaries of business asset classification and valuation methodologies in order to provide the client with sufficient facts upon which to base a settlement demand or claim for relief at trial. Family law attorneys must master these concepts in order to work effectively with valuation professionals and to enable the trier of fact to comprehend valuation issues.

II. INCLUSION OF THE BUSINESS ASSET IN THE MARITAL ESTATE

The family law practitioner presented with a client who identifies the existence of a business asset must first determine whether the asset is legitimately a part of the marital estate. This obligation is well established by the Virginia Code and case precedent.¹

If the parties acquire a business during the marriage, or if a party proves that marital assets or substantial marital efforts of either party contributed to the increase in value of a separately owned business, the business must be included in the marital estate for equitable distribution purposes absent rebuttal of the presumption that assets acquired during the

¹ A court entering a final decree is required, upon request of either party, to determine the legal title, ownership and value of *all* property of the parties. The court must also consider which of such property is separate property, which is marital property, and which is part separate and part marital property. VA. CODE ANN. §20-107.3(A)(2010)(emphasis added). All property acquired by either spouse during the marriage and before the last separation of the parties is presumed to be marital property. *Gilman v. Gilman*, 32 Va. App. 104, 116, 526 S.E.2d 763, 769 (2000). *See also, Duva v. Duva*, 55 Va. App. 286, 297, 685 S.E.2d 842, 848 (2009)(classification of property is determined as of the date of acquisition, with property initially classified as either separate or marital, although evidence may thereafter show a property to be hybrid in nature). In the case of separately owned property that increases in value during the marriage, the increase in value may be included in the marital estate when attributable to the contribution of marital property to the asset or to the substantial personal efforts of either party during the marriage. VA. CODE ANN. §20-107.3(A)(3)(a) (2010).

marriage are marital property.² Upon determination that a business asset is part of the marital estate, the value of the asset must be determined.

III. VALUATION OF THE BUSINESS ASSET

A. Equitable Distribution Analysis Follows Specific Procedures, But Business Valuation Methodology Varies Depending Upon the Facts of the Case.

The trial court must follow three basic steps in making an equitable distribution award: classification, evaluation, and distribution, taking into consideration the factors delineated in §20-107.3(E).³ This procedural process is applicable to the equitable distribution of business assets. While classification issues are similar no matter what species of marital property is being distributed, the nature of business assets, and the fact that business assets exist in myriad forms, gives rise to unique valuation issues within the context of equitable distribution.

The standard by which a trial court must measure the value of any asset at equitable distribution is the intrinsic worth of the asset to the parties upon divorce.⁴ In application of this term to the valuation of business interests at equitable distribution, intrinsic value is defined by the Virginia Court of Appeals as “the value of the business interest to its current owner given the owner’s use of the interest, current resources, and current capabilities for economically exploiting the business interest.”⁵

The parties bear the burden of providing the court “sufficient evidence” from which it can value their property.⁶ In its first application of this standard to the valuation of business assets, the Virginia Court of Appeals in *Bosserman v. Bosserman* declined to identify any particular valuation methodology as being most appropriate. Instead, the court held that, “[d]epending upon the circumstances of each case, different methods of valuation may reflect more accurately the actual value” of the asset to the parties.⁷ The *Bosserman* opinion reiterated in a footnote that there is no uniform rule for such valuations, and valuation must be tailored to meet the particular needs of each case.⁸ *Bosserman* was adopted by later cases,⁹ but it left

² See, for example, *Epperson v. Epperson*, 15 Va. Cir. 39, 39 (1999)(in evaluating the motion to dismiss and plea for collateral estoppel filed by an estranged husband in the action for dissolution of partnership filed by his wife outside of their pending divorce action, the Spotsylvania Circuit Court acknowledges that a business asset may properly be considered during equitable distribution, opining that a trier of fact “could make a determination regarding the existence or non-existence of a partnership in connection with a determination of property rights under §20-107.3.”).

³ *Alphin v. Alphin*, 15 Va. App. 395, 402 424 S.E.2d 572, 576 (1992)(citations omitted).

⁴ *Bosserman v. Bosserman*, 9 Va. App.1, 6, 384 S.E.2d 104, 107 (1989).

⁵ Robert R. Raymond, “Valuing Closely-Held Businesses for Virginia Equitable Distribution: Five Tips for Divorce Attorneys,” *The Virginia Bar Association News Journal*, October/November 2003, at 13 (citing *Howell v. Howell*, 31 Va. App. 332, 523 S.E.2d 514 (2000)).

⁶ *Bosserman*, 9 Va. App. at 5, 384 S.E.2d at 107 (citations omitted).

⁷ *Bosserman*, 9 Va. App. at 7, 384 S.E.2d at 109 (citations omitted).

⁸ *Bosserman*, 9 Va. App. at 8, 384 S.E.2d at 109, n. 1 (citations omitted).

⁹ See *Russell v. Russell*, 11 Va. App. 411, 399 S.E.2d 166 (1990), and *Howell v. Howell*, 31 Va. App. 332, 523 S.E.2d 514 (2000).

open for broad interpretation the question of the best means for parties and their counsel to present evidence as to the intrinsic worth of a marital business asset.

Whether evaluating tangible or intangible business assets, valuation professionals distinguish between approaches to business appraisal and, within those approaches, the methods applied to compute value. The income, asset and market approaches are the three most commonly employed approaches to business valuation.¹⁰ Numerous methods for valuation exist under each approach, and some methods may be applied under more than one approach.¹¹ *Bosserman* and its progeny permit valuation professionals to determine on a case-by-case basis which methods are best suited to their subject business assets within the general umbrella of the accepted valuation approaches.¹² The *Bosserman* line of case law leaves open the question of which valuation method or combination of methods is best applied to any particular business asset, despite the fact that certain valuation methods have been cited with favor in the eyes of Virginia courts.

B. Valuation Methods Must Be Applied to Tangible and Intangible Business Assets.

Virginia courts recognize that the value of a business asset may lie in tangible assets alone, or may also include the intangible value of good will.¹³ Section 20-207.3(A) of the Virginia Code mandates that courts address the tangible and intangible property of the parties during equitable distribution.¹⁴ Upon determining that a business asset is part of the marital estate for equitable distribution purposes, the court must identify the nature of the valuable assets of the business in order to ascertain the whole value of the business.

1. Indicia of Tangible and Intangible Business Assets

Tangible business assets include such items as real estate, inventory, and accounts receivable. Tangible value is the difference between adjusted asset value and liabilities.¹⁵

Intangible assets include customer lists and relationships, trained and assembled work force, and favorable relationships, and are commonly referred to as “good will”.¹⁶ In Virginia,

¹⁰ Raymond, at 15.

¹¹ Email from Robert R. Raymond, CPA/ABV, MAC, to author (Aug. 16, 2010).

¹² Raymond provides a concise explanation of the three approaches in his 2003 article: “The income approach calculates the value of a business based on the present value of an expected future income stream The asset approach is balance sheet oriented in that asset and liability accounts of the subject are restated to current amounts. Included in the process is the identification and valuation of unrecorded intangibles as well as the revaluation of assets and liabilities from net book (*i.e.*, accounting) values....The market approach is based on the assumption that the pricing relationship of observable sales of comparable companies can provide relevant indications of value (the Merger and Acquisition Method) or that data concerning publicly traded equities can be extrapolated to the subject enterprise to provide indications of value (the Guideline Company Method).”

¹³ *Russell*, 11 Va. App. at 416, 399 S.E.2d at 169.

¹⁴ “Upon decreeing the dissolution of a marriage... the court, upon request of either party, shall determine the legal title as between the parties, and the ownership and value of all property, real or personal, tangible or intangible, of the parties....” VA. CODE ANN. § 20-107.3(A) (2010).

¹⁵ Raymond, *supra*, at 14.

¹⁶ *Id.*

good will is defined by the Court of Appeals as “the increased value of the business over and above the value of its assets, that results from the expectation of continued public patronage.”¹⁷ Good will consists of two components: professional and practice good will. A business may have either one or both.

2. Distinction Between Professional and Practice Good Will

The existence of good will must be proven, and if it exists, its value must be proven.¹⁸ The Court of Appeals defines the types of good will as follows:

Professional good will (also designated as individual, personal or separate good will) is attributable to the individual and is categorized as separate property in a divorce action. Practice good will (also designated as business or commercial good will) is attributable to the business entity, the professional firm, and may be marital property.¹⁹

Of importance to note is the tenet of valuation theory that intangible value, or good will, cannot exist in the absence of a history or expectation of excess earnings.²⁰ A business without excess earnings or any expectation of excess earnings, therefore, will consist only of tangible assets.

Hallmarks of professional good will include individual skills and energy,²¹ and the individual’s reputation, work ethic, age, health, training, knowledge, experience, and expertise.²² Practice good will, on the other hand, is identifiable by characteristics such as an investment in capital, assembled and trained work force, facilities, size, name recognition, financial contracts, institutional referral sources, customer lists and management depth.²³ The divorce practitioner must be able to recognize the distinctions between tangible and intangible business assets and professional and practice good will, and understand the impact of each upon the client’s interests in the case.

3. Valuation Methods Used for Tangible and Intangible Business Assets

Upon identification of the nature of business assets, those assets must be valued. In evaluating the methodology for determining the intrinsic value of *any* marital property, the Virginia Court of Appeals requires that the parties “rely on accepted methods of valuation,” but

¹⁷ *Russell*, 11 Va. App. at 415, 399 S.E.2d at 168 (citations omitted).

¹⁸ *Howell*, 31 Va. App. at 340, 523 S.E.2d at 518.

¹⁹ *Howell*, 31 Va. App. at 344, 523 S.E.2d at 523.

²⁰ *Raymond*, *supra*, at 15.

²¹ *Marion v. Marion*, 11 Va. App. 659, 664, 401 S.E.2d 432, 435 (1991)(a portion of good will value accrued to professional practice of husband solely because of his skills and energy and was personal good will not allocable to the marital estate).

²² *Raymond*, *supra*, at 15.

²³ *Id.*

“the particular method of valuing and the precise application of that method to the singular facts of the case must vary with the myriad situations that exist among married couples.”²⁴

Likewise, the courts have found that there is no single, exclusively and universally acceptable method of good will valuation.²⁵ The party asserting the existence of practice good will bears the burden of proving its value by the greater weight of the evidence.²⁶ A valuation adopted by the trial court will be affirmed on appeal “if the evidence supports the findings and if the trial court finds a reasonable evaluation based on proven methodology and on the application of it to the particular facts of the case.”²⁷

a. Application of Valuation Methods to Tangible Business Assets

Case law addressing the question of appropriate valuation methods for tangible business assets is nearly nonexistent; the primary focus of extended business asset valuation disputes is the existence and value of good will.²⁸ Valuation of tangible business assets, though requiring complex accounting adjustments by the valuation expert, is based upon existing balance sheet items which are frequently not in dispute between the parties. The concept of valuation of tangible business assets is most simply summarized as the difference between adjusted asset values and liabilities.²⁹ Appraisals employing valuation methods that incorporate the generally recognized approaches to valuation (i.e., income, asset or market approaches) should meet the requirement that a party rely on accepted methods of valuation in presenting his or her case as to the intrinsic value of tangible business assets.

b. Application of Valuation Methods to Intangible Business Assets

Valuation of intangible business assets has been repeatedly litigated in Virginia, most frequently with reference to professional practices such as law firms and medical providers. The Court of Appeals maintains that there are a number of acceptable methods of computing the good will value of a professional practice, and that no single method is to be preferred as a matter of law.³⁰ Although consistently maintaining this position, the Court of Appeals has looked with favor upon certain good will valuation methods, including the capitalization of earnings method, the percentage of gross earnings method, and the market value method.³¹ In a decision that has been cited frequently, the Court of Appeals in *Russell v. Russell* fashioned the following definitions of these methods after hearing conflicting expert testimony:

²⁴ *Howell*, 31 Va. App. at 339, 523 S.E.2d at 518.

²⁵ *Russell*, 11 Va. App. at 413, 399 S.E.2d at 167.

²⁶ *Russell*, 11 Va. App. at 416, 399 S.E.2d at 168.

²⁷ *Howell*, 31 Va. App. at 339, 523 S.E.2d at 518 (citations omitted).

²⁸ See, for example, the opinions in *Bosserman*, *Russell*, and *Howell*.

²⁹ *Raymond*, *supra*, at 14.

³⁰ *Russell*, 11 Va. App. at 417, 399 S.E.2d at 169.

³¹ *Russell*, 11 Va. App. at 416, 399 S.E.2d at 169; *Ledwith v. Ledwith*, Rec. No. 0154042, 2004 WL 3391801 (Va. Ct. App. Oct. 12, 2004).

Capitalization of Excess Earnings. This method is based on the difference between what the spouse earned, after expense, and what he or she could earn if he or she went out into the marketplace as an employee and is calculated by taking the amount of gross income minus expenses of operation and then subtracting the amount the professional could earn as an employee. If a positive balance results, there are excess earnings which, when capitalized over the number of years the purchaser would be willing to pay in advance for good will, yield the good will value of the business or profession.³² This method falls under the income approach to valuation.³³

Percentage of Gross Earnings. The good will value of a business is determined to be a percentage of one year's gross earnings depending upon a variety of factors.³⁴ This method is most typically employed using a market approach to valuation, but is occasionally used with a rarely-used approach called "rule of thumb".³⁵

Market Value Method. The value of good will is determined by computing the difference between the price a business would sell for and the value of its non-good will assets.³⁶

4. Practitioners Must Understand and Remain Open to Valuation Methods Beyond Those Recognized by the Court of Appeals.

The Court of Appeals makes clear that its nod to the above-mentioned methods does not create an exclusive list of acceptable valuation methods; its strong preference is for the case-by-case application of valuation approaches and methods to determine business asset value for equitable distribution purposes. Counsel and the valuation professional must work together to ascertain which valuation method or combination of methods best applies to the facts in a particular case. Given the preferences of the Court of Appeals for case by case analysis in these matters, counsel should follow, and build the case around the approaches deemed most appropriate by the valuation professional based upon the individual facts of the case, rather than attempting to use, to the exclusion of all others, any methods previously cited with approval at the appellate level.

C. Reasonable Experts May Disagree

The Court of Appeals deliberately permits broad latitude in valuation methods that may be used by parties in proving the value of business assets at trial. Inevitably, reasonable experts will disagree. The trial court has discretion to resolve conflicting expert testimony to determine an asset's value.³⁷ Good will valuation will not be disturbed on appeal — we are led to believe — if it appears that the court made a reasonable approximation of the good will value, if any,

³² *Russell*, 11 Va. App. at 415-16, 399 S.E.2d at 168-69.

³³ Email from Robert R. Raymond to author (Aug. 16, 2010).

³⁴ *Russell*, 11 Va. App. at 416, 399 S.E.2d at 169.

³⁵ Email from Robert R. Raymond to author (Aug. 16, 2010).

³⁶ *Russell*, 11 Va. App. at 416, 399 S.E.2d at 169.

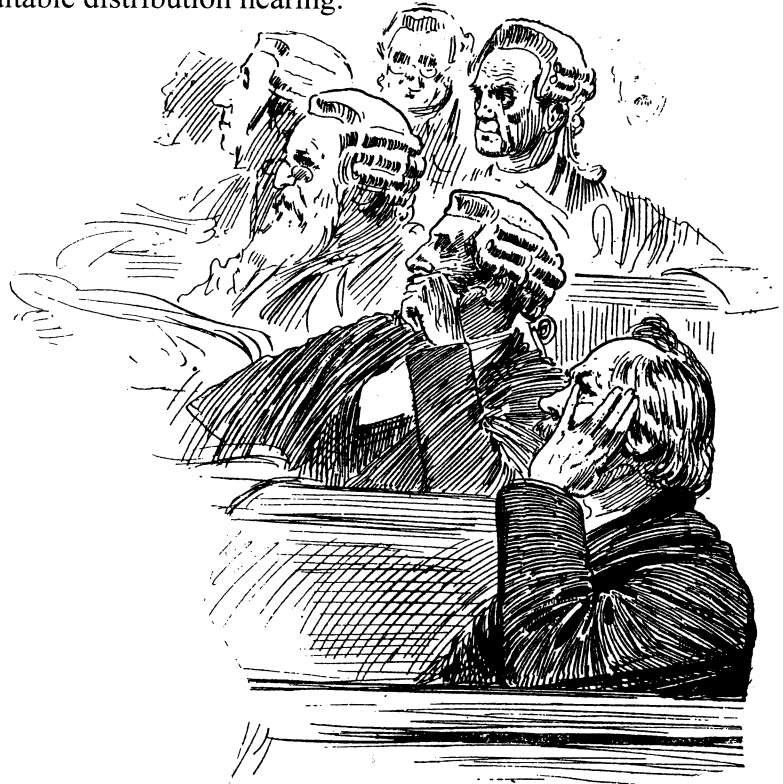
³⁷ *Howell*, 31 Va. App. at 341, 523 S.E.2d at 519 (citations omitted).

of the professional practice based on competent evidence and the use of a sound method supported by that evidence.³⁸

IV. CONCLUSION

Marital estates containing business assets present the parties and their counsel with unique issues at equitable distribution. Upon determining that the marital estate includes such assets, counsel must assemble proof of the intrinsic value of the business asset to the parties for equitable distribution purposes. Such proof requires the services of an experienced business appraiser. While Virginia courts permit great latitude in the methods by which such value may be established, the client is best served by an attorney who understands the essential vocabulary and theory underlying the work that is performed by the valuation professional. Counsel who understand the various approaches to business valuations, and the interplay of valuation methods with those approaches, are better able to convey useful information to the valuation professional; more facile at understanding and analyzing the information produced by valuation professionals; and better able to convey the information to the trier of fact, should the case fail to resolve short of an equitable distribution hearing.

Notes on Recent Appellate Cases



DIVORCE GROUNDS – SEPARATION INTENT – INCAPACITATED WARD’S 2006 STATE OF MIND – DISSIPATION OR NOT – PENSION-DIVISION DENIAL – APPELLATE DRAFTING NOT PROPERLY RAISING ISSUE. A recent Court of Appeals case concerned the divorce ground of statutory separation and the long-range assessment of the now-incapacitated husband’s permanent-separation intent as of several years back. The Court of Appeals said that it was not determining the legal question (Code §§ 20-91(9)(a), 37.2-1020 D) of whether divorce can be granted on the basis of a guardian’s determination that it is in his

³⁸ *Russell*, 11 Va. App. at 417, 399 S.E.2d at 169 (citations omitted).