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Editor's Column – Valuations for Divorce

Paul R. Hyde, EA, MCBA, BVAL, ASA, MAI

As we all know, getting a divorce is a traumatic experience. For a business owner, it is even more difficult because their life's work may now be in jeopardy. If there are substantial other assets, there may be some way to equalize things without looking to pull cash from the business; however, if the business is the largest marital asset by far, difficulties arise. Most small to medium closely held businesses do not have large amounts of liquid assets, certainly not to the extent to equal one-half of the value of the business. Also, many small to medium sized closely held businesses do not have the ability to borrow large amounts of money for a cash settlement to the non-operating spouse as part of a divorce settlement. Lenders seldom, with the exception of a loan with an SBA guarantee, accept a small to medium sized business as collateral for a loan. Also, loans with an SBA guarantee usually require the pledge of personal assets in addition to all of the business assets.

A business with two non-related 50% owners where one is getting divorced is the worst of all worlds. The 50% owner getting the divorce does not have the ability to cause the business to borrow to pay the settlement, nor can he or she typically force a sale of the business. Even if a sale could be forced, the sale of 50% business interest, except to the other partner, is typically not very realistic as there are very few buyers for non-controlling interests in closely held small or medium sized businesses. The other 50% owner, while often sympathetic, is not interested in putting the business at risk by allowing a loan for a divorce settlement and seldom has the amount of cash necessary for a buy-out of the other partner even if that option were desired.

With these problems outlined as background, what is the job of the business appraiser? The business operator spouse often requests the appraiser to take his or her potential payment problems or the problems a new loan would cause into account when valuing the business. This is not appropriate. The appraiser must value the business using the appropriate standard of value, which in many states is the fair market value standard of value.

IRS Revenue Ruling 59-60 defines fair market value "as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property."

The fair market value valuation must assume that the seller is willing to sell and not under any compulsion to do so. Most small to medium sized business sales involve a non-compete provision and cooperation from the seller as well as a well informed, willing and able buyer. In a divorce valuation, no sale is contemplated and rarely does one occur; however, the business must be valued "as if" the business were being sold as of the effective date with the cooperation of the seller.

Valuations for Divorce

Many business operator spouses make the claim that without them the business could not exist. In a few rare cases, this is probably accurate. However, in most businesses, a cooperative business operator could be replaced without damaging the business. Obviously, if the business interest were sold and the business operating spouse retired, someone would take his or her place. In valuing the business, the appraiser must consider the reasonable compensation of what would need to be paid to an operator as an ordinary expense of the business in determining its value.

In addition to using the fair market value standard of value, most small to medium sized closely held businesses valued for a divorce are valued as a "going concern." We sometimes get challenged by the operator spouse by an auction house appraisal of the business' fixed assets. Again, the standard of value used must be considered. Most auction house equipment appraisals use some type of liquidation standard of value. There is a big difference between the value of equipment in place, in use in a profitable operating business, and the value of the same equipment "as if" sold at auction one piece at a time.

While it is understandable that the business operating spouse wants to pay his or her soon to be ex-spouse as little as possible, under the fair market value standard of value, the business interest must be valued the same way it would be valued as if it were being sold to facilitate the operating spouse's retirement. We have found a huge difference between what the operating spouse feels the business is worth when getting divorced versus what it is worth when being sold.

The appraiser in a divorce engagement must be independent and derive a value using the appropriate standard of value without regard to the difficulties associated with funding a divorce settlement. How the marital assets are divided is not the concern of the business or real estate appraiser. That job belongs to the attorneys and CPA advisors and their clients.

Paul R. Hyde, EA, MCBA, BVAL, ASA, MAI is the President of Hyde Valuations, Inc., a business and real estate appraisal firm with offices in both Boise and Parma, Idaho. His firm is also a member of the National Business Valuation Group network.

Please submit articles for *Business Appraisal Practice* by email to: prh@hydevaluations.com.