'D-I-V-O-R-C-E'

(APOLOGIES TO TAMMY WYNETTE)

A primer on business valuation and classification of property for equitable distribution in divorce.

CPAs *for* LIFE series

This is the third article in our 2017 series "CPAs for Life," which investigates how CPAs can serve their clients through many of life's changes and challenges. This article complements the previous article, "Til Death (Or Divorce) Do You Part," from the July/August issue, available at disclosures.vscpa.com.

By Harold G. Martin Jr., CPA/ABV/CFF, ASA, CFE

Country music fans know that every (well, almost every) country song has a recurring theme: A guy loses his girl, his dog leaves him, he wrecks his pickup truck and now he spends his nights at the local honky-tonk drowning his sorrows. There is also the parody in the Rascal Flatts' song "Backwards" about what happens if you play one of these songs backwards: the guy wins his girl back, his dog returns, his pickup truck is magically restored — although the priority of events may differ depending on the guy.

Unfortunately, in more than 40 percent of marriages, country songs such as Tammy Wynette's "D-I-V-O-R-C-E" present a real-life storyline. When these matters involve ownership by one of the parties in a closely held business, CPAs may assist as consultants or serve as expert witnesses in litigation to quantify the value of the propertied spouse's interest. This article presents an overview of the applicable Virginia statutes, case law and professional standards, as well as the key concepts with which a CPA should be familiar when valuing a business and classifying property for equitable distribution in divorce.

EQUITABLE DISTRIBUTION AND CLASSIFICATION OF PROPERTY

The Code of Virginia §20-107.3 defines the standard for the division of assets between spouses in divorce as "equitable distribution." However, the Code does not specifically define the standard of value for purposes of determining a propertied spouse's interest in a closely held business. Consequently, the definition of the standard of value has been left to the interpretation of the courts and is defined in case law as is further discussed below.

The Code §20-107.3.A states that the parties' property is to be classified into three types: 1) separate, 2) marital and 3) part separate and part marital (i.e., "hybrid"). The classification of property in divorce (including an ownership in a closely held business) is dependent upon the following factors:

- The classification of the property at the date of marriage
- Whether or not there was appreciation in the value of property
- Whether the appreciation was attributable to active or passive factors
- When the appreciation occurred (i.e. between the date of marriage and date of separation or, alternatively, between the date of separation and date of trial)

Separate property is defined in the Code §20-107.3.A.1 as:

- Property acquired before marriage
- Property acquired during marriage by gift from a source other than spouse
- Property acquired during marriage in exchange for (or from proceeds of) separate property
- Portion of hybrid property (discussed below) classified as separate
- Insubstantial increase in value of separate property due to any factor
- Substantial increase in value from separate property: ▶

Highlights

- While the Code of Virginia defines "equitable distribution" of assets in divorce, it does not specifically define a standard for determining a spouse's interest in a closely held business.
- Case law provides a standard of value for determining a spouse's interest, but it is inconsistent. The landmark case often cited as the basis for standard of value for divorce in Virginia is *Bosserman v. Bosserman*.
- The three recognized valuation approaches (income, market and asset) should be considered for purposes of valuing the propertied spouse's ownership interest in divorce, though there are nuances to each.

> During marriage if due to passive factors, to active efforts of other parties or insignificant personal efforts of a spouse

> After separation if due to passive or active factors

Marital property is defined in the Code §20-107.3.A.2 as:

- Property titled in names of both parties, unless property is classified as hybrid
- Portion of hybrid property (discussed below) classified as marital
- Property acquired during marriage that is not classified as separate
- Increase in value of marital property:

> During marriage if due to passive or active factors

> After separation if due to passive factors

- Substantial increase in value of or income from separate property:

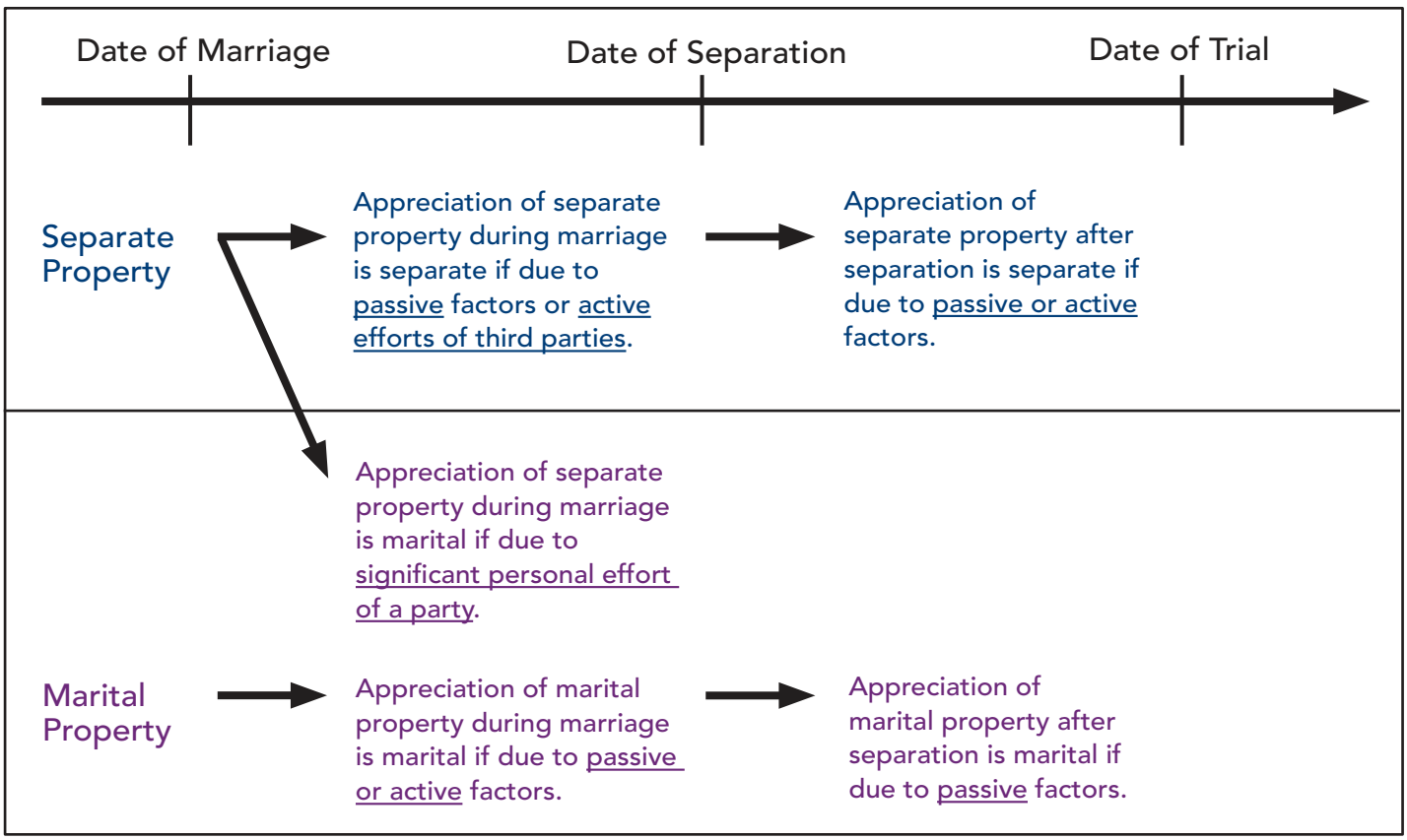
> During marriage if due to significant active efforts of a party or spouse

"Hybrid property" is property with both separate and marital components. Separate property can transmute into marital property in the following circumstances, according to the Code §20-107.3.A.3.a:

- Income from separate property becomes marital property if such income is attributable to the significant personal efforts of either spouse.
- Appreciation of separate property or income from separate property becomes marital property if such appreciation is attributable to the significant personal efforts of either spouse and the appreciation is substantial.

In determining whether or not separate property has transmuted to hybrid property during the marriage, as discussed in the Code §20-107.3.A.3.a and most recently in the Supreme Court of Virginia's decision in *David v. David*, the non-owning spouse has the burden of proving that: 1) significant personal effort was expended, and 2) the separate property increased in value. Once this initial burden of proof has been satisfied, the owner spouse has the burden of proving that the increase in

EXHIBIT 1: CLASSIFICATION OF PROPERTY FOR EQUITABLE DISTRIBUTION IN DIVORCE



value was not due to personal efforts, but instead was due to the efforts of other third parties or passive factors.[1]

Exhibit 1 (page 26) illustrates the application of the guidance provided in the Code regarding how property is to be classified.

The Code does not specifically address whether or not the appreciation of marital property after separation is separate if due to active factors, and the courts have been inconsistent in their rulings on this issue. In an unpublished case, *Campbell v. Campbell*, the court ruled that such appreciation was separate property.[2] However, in another unpublished case, *Peck v. Peck*, the Virginia Court of Appeals ruled that "by statute, marital property remains marital property, subject to equitable distribution."[3] It would stand to reason that if an expert can quantify how much of the appreciations is due to post-separation efforts of the party, the court might accept that proof and rule with that separate increase in mind; however, most of the time, that task is not undertaken or the proof is unpersuasive, as was the court's determination in *Peck v. Peck*.

The following example illustrates how the classification of property can impact the value for equitable distribution. If a propertied spouse owns the business as of the date of marriage, the value of the business at that time is separate property. However, if the value of the business increases during the marriage as a result of the significant personal effort of either spouse, then the appreciation in value is a marital asset and the property becomes a "hybrid asset." Conversely, if the appreciation in value is attributable to passive factors (e.g., economic or market conditions) or the active efforts of third parties (e.g., the efforts of other owners in the business), then the increase in value remains separate property.

A Virginia divorce case that illustrates the application of this principle is *Rowe v. Rowe*. In *Rowe*, the Virginia Court of Appeals ruled that the appreciation in separate property attributable to the efforts of others or passive factors such as population growth and inflationary growth should not be classified as marital property.[4] The court made a similar finding in *Congdon v. Congdon*.[5]

STANDARD OF VALUE

The standard of value defines the party(ies) for whom the value is to be determined. That is, it answers the question "value to whom?" The value of a business may be worth one amount to the owner and, at the same time, be worth a different amount to a prospective purchaser. In other words, value is in the eye of the beholder.

As previously noted, the Code does not define the standard of value for divorce. Instead, the standard of value has been left to the interpretation of the courts and is defined in case law. Unfortunately, the case law has been inconsistent, as the courts have used numerous terms to describe the standard of value such as "value," "fair value," "fair market value," etc. The landmark divorce case that is often cited as the basis for the standard of value for divorce in Virginia is *Bosserman v. Bosserman*. In *Bosserman*, the court defined the applicable standard as "intrinsic worth":

> The purpose of Code §20-107.3 is to fairly divide the value of the marital assets acquired by the parties during marriage with due regard for both their monetary and nonmonetary contributions to the acquisition and maintenance of the property and the marriage … Trial courts valuing marital property for the purpose of making a monetary award must determine from the evidence that ***value which represents the property's intrinsic worth to the parties*** upon dissolution of the marriage.[6] [Emphasis added]

In another case, *Howell v. Howell*, the court cited the *Bosserman* case and reaffirmed that the applicable standard of value was "intrinsic value":

> **Intrinsic value is a very subjective concept that looks to the worth of the property to the parties.** The methods of valuation must take into consideration the parties themselves and the different situations in which they exist. The item may have no established market value, and neither party may contemplate selling the item; indeed, sale may be restricted or forbidden. Commonly, one party will continue to enjoy the benefits of the property while the other must relinquish all future benefits. Still, its intrinsic value must be translated into a monetary amount. The parties must rely on accepted methods of valuation, but 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.[7] [Emphasis added]

The key concept in the court's definition of "intrinsic value" in these cases is that the value to be determined is the *value to the user* (the owner) — as opposed to the *value in an exchange*.[8]

VALUATION DATE

The valuation date is the effective date of the business valuation. The selected date is critical as it determines what information is to be considered by the business appraiser in performing the valuation. As discussed in the American Institute of CPAs (AICPA) *Statement on Standards for Valuation Services No. 1, VS Sec. 100* (SSVS), a business appraiser "should consider only circumstances existing at the valuation date and events occurring up to the valuation date."

For purposes of divorce, Code §20-107.3.A states that the effective valuation date is to be determined as follows:

> The court shall determine the value of any such property as of the date of the evidentiary hearing on the evaluation issue. … Upon motion of either party made no less than 21 days before the evidentiary hearing the court may, ▶

for good cause shown, in order to attain the ends of justice, order that a different valuation date be used.

Consequently, the valuation date is to be the date as of the hearing (or practically, the date nearest to that date as reasonably possible). However, if one of the parties can demonstrate that using this date would be unjust, then an alternative date may be requested. For example, the non-propertied spouse might argue that the propertied spouse has intentionally run the business into the ground since the date of separation in order to decrease the business's value (i.e., "wasting of assets"). To value the property as of the date of trial would be unjust and, therefore, the non-propertied spouse has the right to file a motion with the court to petition it to change the date to another date (e.g., the date of separation).

Other facts and circumstances may require that the business be valued on multiple dates. For example, if the business were classified as separate property as of the date of marriage, but as a result of the significant active efforts of one of the parties the business appreciated in value, then it would be necessary to value the business at two points in time: 1) the date of the marriage to establish the value of the separate property, and 2) the date of trial (or separation) to determine the appreciation in value.

VALUATION APPROACHES AND NORMALIZATION ADJUSTMENTS

In general, the three recognized valuation approaches (income, market and asset) and the related methodologies should be considered for purposes of valuing the propertied spouse's ownership interest in divorce. However, there are nuances in valuation for divorce that require consideration.

As an initial step in the valuation process, business appraisers must analyze the business's financial statements and make a determination whether the statements reflect the "true" economic performance of the business. If not, the appraiser must then determine if "normalization adjustments" are required. Examples of common adjustments include non-operating and non-recurring items. As is further discussed below, other adjustments may also be required to derive the appropriate "level of value" for the ownership interest being valued; however, case law may exclude consideration of such adjustments.

In applying the income approach, there are two common methodologies used in practice. The capitalization of economic income method is used when growth is assumed to have stabilized. A value is calculated by dividing the expected future economic income (e.g., net cash flow) by a capitalization rate. The discounted economic income method is used when growth has not yet stabilized. A value is calculated by projecting net cash flow for each year to a point where growth assumed to stabilize, and then a terminal value for net cash flow for the remaining years into perpetuity is calculated. The present values of each of the projected future net cash flows and the terminal value are then discounted to a present value as of the valuation date using a discount rate.

Certain courts have expressed a preference for the capitalization method under the premise that the method does not rely on a projection and is therefore less speculative. However, both the capitalization and discounted economic income methods are based on estimates of expected future results — the key difference between the two methods is simply the point in time at which the rate of growth is assumed to stabilize.

There are also two common methodologies used in applying the market approach. The first method is the guideline public company method in which the prices at which the stocks of comparable public companies are traded are used as proxies to value the subject company. In determining whether or not to use this method, consideration must be given whether the selected public companies are truly comparable to the propertied spouse's business in terms of line of business, size, growth, profitability, etc. In litigation, courts tend to use stricter interpretations of "comparability."

The second method is the guideline transaction method in which actual market transactions are used to determine pricing multiples. This method is subject to the same issue of comparability. Further, given that the court's interpretation of intrinsic value as "value in use," the use of this method may be inappropriate if the transaction price represents a "synergistic" value that represents a "value in exchange," as well an "investment value" standard of value that is particular to the *buyer* — not the propertied spouse.

The asset approach is generally considered more applicable to valuing holding companies in which the value is dependent on the underlying assets.[9] A value is calculated by restating the value of the assets and liabilities (which are recorded at historic costs) to current market values and deducting the resulting value of total liabilities from total assets to derive the net asset value. Consideration must also be given to whether unrecorded assets and liabilities exist. Some appraisers do not consider this approach to be appropriate for valuing service-oriented companies, particularly when valuing a minority interest that does not have the ability to liquidate the assets to realize their value. However, in those instances where the value derived using and income or market approach is less than the value realized using an asset approach, certain courts consider the value of the net tangible assets to be a "floor" value.

There is also a hybrid of the income and asset approaches that is commonly known as the excess earnings method. This method is often used to value personal

goodwill and the courts have accepted the use of this method for this purpose.

OWNERSHIP CHARACTERISTICS, DISCOUNTS/PREMIUMS AND "DOUBLE DIPPING"

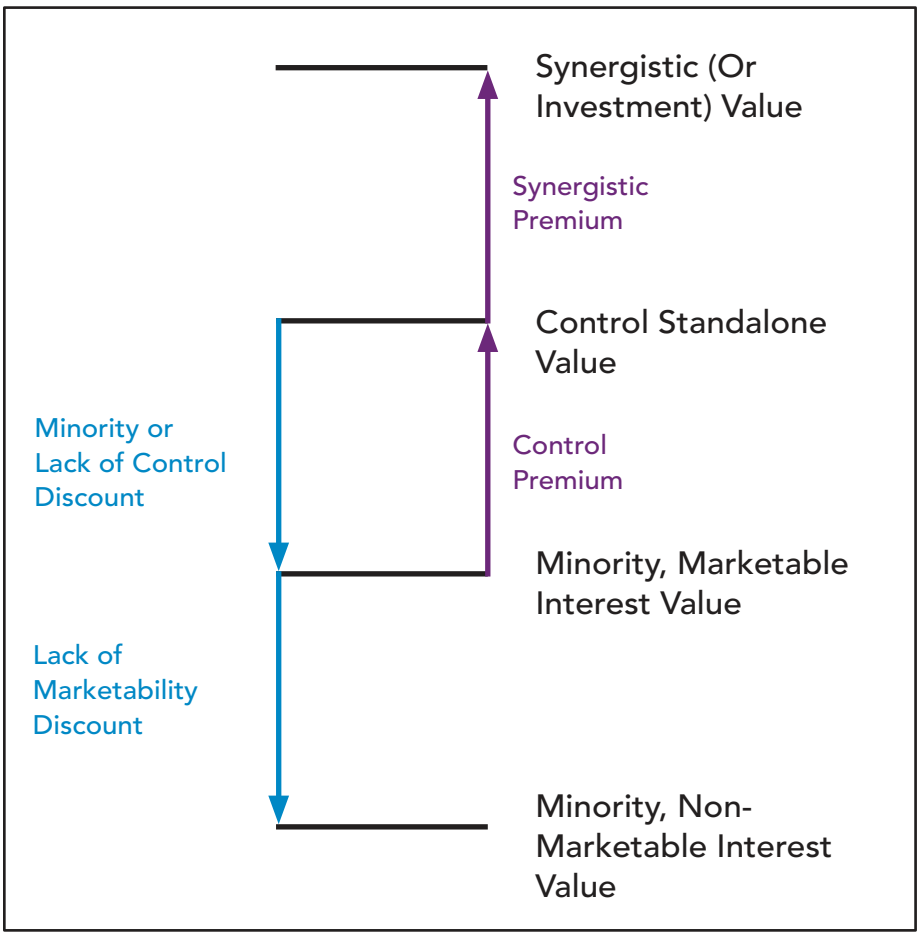
Ownership interests include the following characteristics as defined in the *International Glossary of Business Valuation Terms*:

1. **Minority:** An ownership interest less than 50 percent of the voting interest in a business
2. **Control:** The power to direct the management and policies of a business.
3. **Marketability:** the ability to quickly convert property to cash at minimal cost.

Exhibit 2 presents the alternative "Levels of Value" that represent these different characteristics.[10]

The valuation approaches and methods used to value the business, as well as the types of normalization adjustments made to the financial statements, determine the resulting level of value. Depending on the level of value derived, premiums or discounts may be required to derive the applicable level of value for the ownership interest being valued. For example, if the valuation approach and normalization adjustments made by the appraiser result in a control level of value and the ownership interest being valued is a minority, non-marketable interest, then discounts for lack of control (e.g., minority interest) and lack of marketability would normally be deducted.

EXHIBIT 2: LEVELS OF VALUE



However, in certain cases, Virginia courts have rejected discounts for lack of control and lack of marketability (e.g., *Howell v. Howell*). This would imply that if the selected valuation approaches and normalization adjustments produce a value other than a control standalone level value, then an adjustment would be required in order to derive this level of value. After deriving a control standalone value, the propertied spouse's ownership percentage would then be multiplied by the control standalone value to derive the pro rata value of the ownership interest.

However, when the propertied spouse is a minority owner, this approach may result in an overvaluation of the propertied spouse's interest because the resulting value does not reflect economic reality. The primary difference between a control standalone value and a minority level of value is attributable to the amount of compensation paid to the controlling owner and resulting net cash flow available for distribution as a dividend. Where the controlling owner receives compensation in excess of the market rate, the excess compensation must be added back as a normalization adjustment to derive a control standalone value. However, a minority owner cannot compel the control owner to change the compensation structure and distribute more dividends and, consequently, the adjustment is contrary to the factual situation.

If compensation is normalized to derive a control level of value, another issue also arises in the form of "double dipping." Any increase in the value of the business attributable to normalizing compensation is captured in the value of the equity that is subject to equitable distribution. If the actual (not normalized) compensation ▶

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of the propertied spouse is used for purposes of determining alimony, support or maintenance payments, then the non-propertied spouse is receiving the value of the excess compensation again — hence, the term "double dipping."[11] Despite this seeming incongruity, in *Hoebelheinrich v. Hoebelheinrich*, the Court ruled that spousal support should be determined on all assets, including business assets.[12]

PERSONAL VS. ENTITY GOODWILL

The *International Glossary of Business Valuation Terms* defines goodwill as "that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified." There are two types of goodwill: 1) personal (professional) goodwill which is attributable to the individual, and 2) entity (practice) goodwill which is attributable to the business enterprise. The distinction is important for purposes of classifying property as separate or marital in divorce.

In *Russell v. Russell*, the court defined goodwill and drew a distinction between goodwill and the reputation of an individual and future earning capacity:

> (1) Goodwill has been defined as "the increased value of the business, over and above the value of its assets, that results from the expectation of continued public patronage." Oldham, *Divorce, Separation and the Distribution of Property*, § 10.03, at 10-20 (1989). The reputation of an individual, as well as his or her future [Page 416] earning capacity, are not considered to be components of goodwill.[13]

In *Howell v. Howell*, the court further defined goodwill as comprising "professional goodwill" and "practice goodwill" and stated that professional goodwill is a separate asset, whereas practice goodwill may be a marital asset.

> The value of goodwill can have two components. Professional goodwill (also designated as individual, personal, or separate goodwill) is attributable to the individual and is categorized as separate property in a divorce action. Practice goodwill (also designated as business or commercial goodwill) is attributable to the business entity, the professional firm, and may be marital property.

It is of interest to note that the court's classification of personal goodwill as separate property conflicts with its definition of the intrinsic value standard of value. As previously discussed, intrinsic value is based on the premise of "value in use." Personal goodwill is based on the concept that it cannot be transferred to another party which implies a premise of "value in exchange." Despite this inherit contradiction, the courts have consistently ruled that personal goodwill is a separate asset.

SHAREHOLDER AGREEMENTS

Often, the value of a propertied spouse's interest is set forth in a shareholder or buy/sell agreement. For example, professional services firms such as accounting firms, law firms, etc., often have such agreements which establish the value of an owner's interest upon a triggering event such as admission of a new owner or the retirement of an existing owner. While the propertied spouse is bound by such agreements under contract law, the courts in divorce matters (which are courts of equity) are not bound by these agreements.

In both *Bosserman v. Bosserman* and *Howell v. Howell*, the courts indicated that such agreements should be considered, but are not necessarily conclusive as to value. For example, in *Howell*, the propertied spouse was an attorney subject to a buy/sell agreement with his law firm. The value of the attorney's interest under the buy/sell was materially different from the value ultimately determined for equitable distribution by the court. The economic reality is that the propertied spouse may have no ability to extract the difference in value from the business and, if the value determined in accordance with the buy/sell agreement is not used, the non-propertied spouse may realize a windfall. In *Kaufman v. Kaufman*, the court recognized that such agreements are binding and the court cannot simply ignore the contract.[14]

SUMMARY

The ultimate objective of the CPA expert is to assist the trier of fact in understanding the evidence. In divorce litigation, the opinion expressed by the expert who demonstrates an understanding of, and conducts his work in accordance with, the legal principles and case law, professional standards and concepts applicable to divorce may be perceived by the court as more credible. Consequently, his or her testimony may be given more weight by the court in determining the value of an interest in a business for equitable distribution. ■

Author's Note: I wish to thank David Roop, Jr., Esq., of Roop Xanttopoulos Babounakis PLLC, for reviewing this article and providing his insights. Any errors are solely my own.

1. David v. David, *287 Va. 231, 754 S.E.2d 285 (2014)*.
2. Campbell v. Campbell, *Record No. 1629 10-2, 2011 Va. App. LEXIS 264 (Va. Ct. App. Aug. 9, 2011)*.
3. Peck v. Peck, *Record No. 0587-13-4 (Va. Ct. App. March 25, 2014)*.
4. Rowe v. Rowe, *33 Va. App. 250, 532 S.E.2d 908 (2000)*.
5. Congdon v. Congdon, *40 Va. App. 255; 578 S.E.2d 833 (2003)*.
6. Bosserman v. Bosserman, *9 Va. App. 1. 384 S.E.2d 104 (1989)*.
7. Howell v. Howell, *31 Va. App. 332, 523 S.E.2d 514 (2000)*.
8. *It should also be noted that the courts' definition of "intrinsic value" is equivalent to "investment value" to the owner/seller as that term is used in the business valuation profession. However, in the courtroom, case law often prevails.*
9. *Rev. Rul. 59-60, 1959-1, CB 237, Sec. 5.0.*
10. *James R. Hitchner, ed.,* Financial Valuation: Applications and Models, *4th ed. (Hoboken: John Wiley & Sons, Inc., 2017), 393.*
11. *R. James Alerding,* "Standards of Value and Personal Goodwill and Double Dipping in Divorce Cases," *Financial Valuation and Litigation Expert (Ventnor City, NJ: Valuation Products & Services, June/July 2015) 16.*
12. Hoebelheinrich v. Hoebelheinrich, *43 Va.App. 543, 600 S.E.2d 152 (2004)*. Hoebelheinrich *also stands for the juris prudential proposition that an appellant cannot contend a ruling constituted an error of law without citing a case supporting the proposition that it is error. The propertied spouse claimed that the trial court erred in "double-dipping," but cited no case law. The Court of Appeals ruled that it was within their rights not to analyze a claimed legal error without having before it some case or precedent suggesting it is legal error.*
13. Russell v. Russell, *11 Va. App. 411, 415, 399 S.E.2d 166, 168 (1990)*.
14. Kaufman v. Kaufman, *7 Va. App. 488, 375 S.E.2d 374 (1988)*.

Harold G. Martin Jr., CPA/ABV/CFF, ASA, CFE, is the partner-in-charge of Valuation and Forensic Services for Keiter in Richmond, and an adjunct faculty of The College of William and Mary Raymond A. Mason School of Business, where he teaches forensic accounting in the Master of Accounting program. He has testified numerous times as an expert witness in federal and state courts, and also served as a court-appointed neutral business appraiser and forensic accountant. He is a member of the Disclosures *Editorial Task Force, and created and chairs the VSCPA Business Valuation, Fraud, and Litigation Services Conference.*

hmartin@keitercpa.com
connect.vscpa.com/Harold Martin