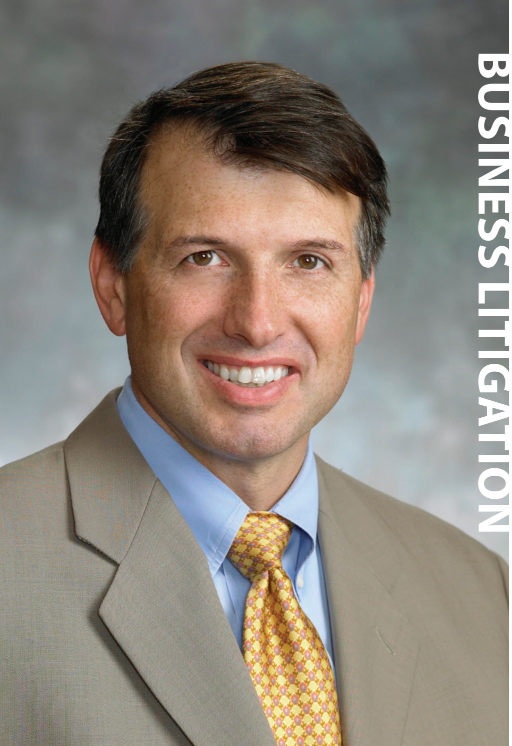
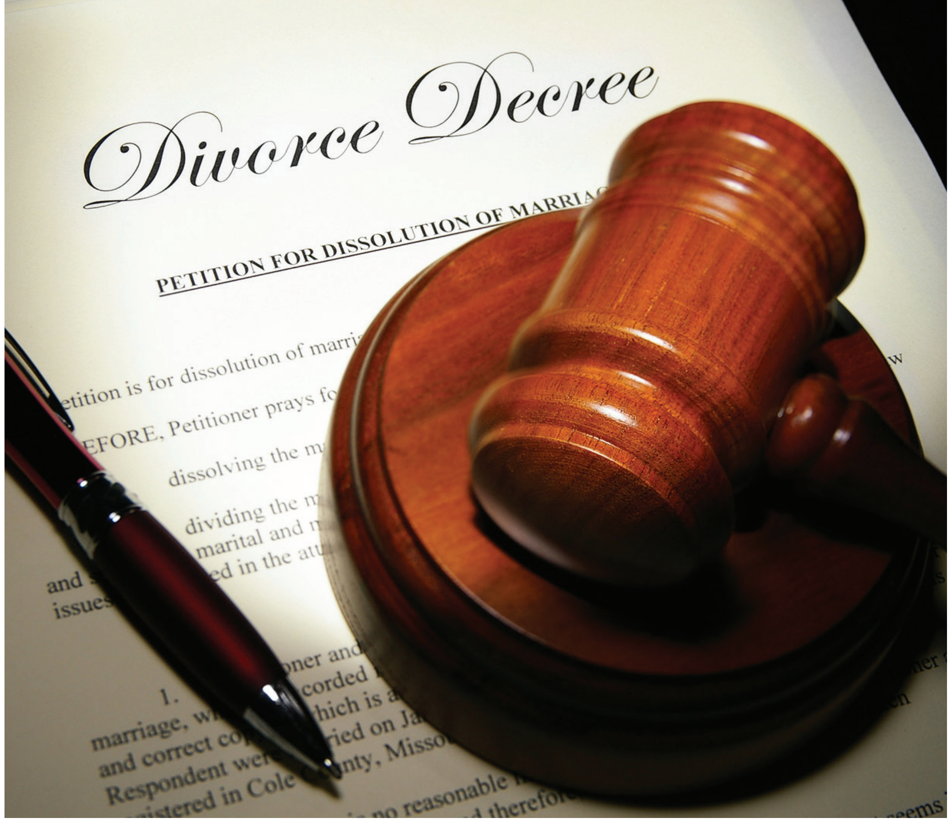
BUSINESS LITIGATION





Business Valuations in Marital Dissolutions

By Vincent Louwagie

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One of the most factually and legally complex areas of divorce litigation is the valuation of a closely-held business owned wholly or in part by the parties. While business valuation can be complex in any area, because the distribution of assets in a divorce context is to be equitable, additional analysis may be required. Many judges have limited experience with business valuation, making the quality of the lawyer and the presentation of expert witnesses more important.

A threshold question is whether the business, in whole or in part, should be excluded from the value of the marital estate. Generally, the value of a business that was owned by one spouse at the formation of the marriage is not a marital asset. The spouse claiming that a part of the business is not a marital asset bears the burden of proving that value. Unless the business keeps good records, that burden can be difficult to meet.

In cases where the business is a personal service business (such as an accountant or lawyer) one spouse often claims that part of the business's value is "personal goodwill" which belongs to one of the spouses and should not be distributed to the other spouse. The concept is similar to a "key person" discount. The argument is that to the extent the value of the business is attributed to the skills of the employee-owner, the court should not capitalize the future efforts of that employee-owner and award the other spouse half of that future effort. Of course, an award of spousal maintenance may have a similar effect, but is made for different reasons.

Another significant question is whether to "tax-effect" the earnings of an entity (such as a limited liability company or S-corporation) that is itself not taxed, but whose earnings are taxed at the owner level. There is significant academic debate on the subject and only developing judicial authority. Because most closely-held business valuations rely primarily on the discounted cash flow method, the decision on this issue can significantly influence the result.

Minnesota appellate courts have not directly addressed this issue. There are only two Minnesota state district court cases which have ruled on the subject, each deciding not to tax-effect the earnings of the pass-through entity. The United States Tax Court, which has addressed the issue on several occasions, however, has consistently held that it is not appropriate, for estate and gift tax purposes, to tax-effect an entity's earnings. In addition, the Delaware Chancery Court addressed the issue in a 1991 case and, on the record before it, declined to tax-effect earnings. Although the analyses of these courts is quite involved, the rationale for not tax-effecting the earnings of these entities is essentially that to do so would be to impose a fictitious tax, at a fictitious tax rate.

Nonetheless, a noteworthy Delaware Chancery Court opinion and some commentators have urged that it is appropriate to impose a fictitious tax rate on an entity's earnings. While many commentators agree that it is not appropriate to simply apply a C-corporation rate to earnings (business owners choose the pass-through form because there is added value to that form) some argue that, depending upon who owns the entity, it is likely that the earnings will be taxed at *some* level. The Delaware Chancery Court, rejecting the expert approaches before it, has addressed this issue by applying a hybrid, admittedly fictitious rate, which it estimated would recognize the tax benefits of a pass-through entity but still impose some tax. That approach has been followed

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by some Massachusetts courts, but has not gained widespread acceptance.

Add to these complex issues the usual valuation factors, such as the existence (or lack thereof) of comparable companies or transactions, the appropriate discount rates to apply, and the valuation of assets held by the business and you get what can be a very technical and difficult problem. In many marital divorces, this is the most financially significant and highly contested issue.

The court has broad discretion when differing expert witness opinions are presented. However, in the final analysis the court is directed by statute to make an equitable distribution of the marital assets. What is equitable, of course, can be the subject of differing opinions. An equitable distribution of a closely held business, more often than not, turns on the quality of the cross examination of the competing experts. It is in this area that a trial lawyer familiar with the complexities of business valuation can be a "difference maker."