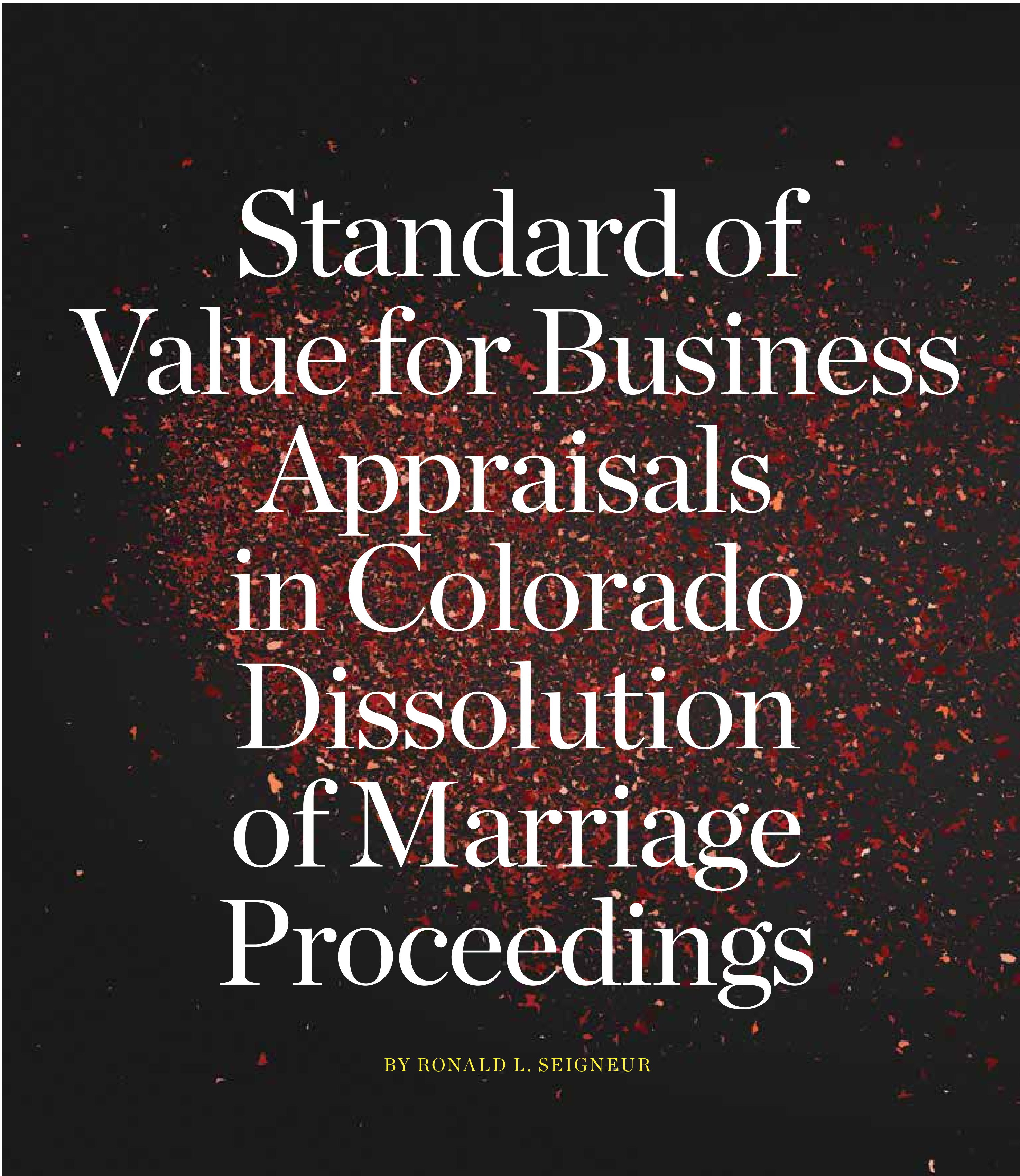

Standard of Value for Business Appraisals in Colorado Dissolution of Marriage Proceedings

BY RONALD L. SEIGNEUR

This article addresses the application of different standards of value for business appraisals in Colorado dissolution of marriage proceedings and discusses how the standards affect the concluded value of a closely held business or professional practice ownership interest.

There is relative consensus in the legal and financial expert communities that the selection of the applicable standard of value in a business or professional practice appraisal in a Colorado dissolution of marriage proceeding is a legal issue to be determined by the trial court. Unfortunately, there is also a relative consensus in the Colorado family law community that there is not a clear, established standard of value that applies to a Colorado dissolution of marriage case. The burden this uncertainty levies on the trier of fact to weigh conflicting legal precedents creates inefficiencies and extra costs in many dissolution proceedings involving formal business appraisals. This article explores the issue of selecting a standard of value in dissolution of marriage proceedings and provides insight into how the different standards affect valuations in business and intellectual property appraisal matters.

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Overview of the Standard of Value

Before a business appraisal can be completed, a standard of value must be established. The business community has several well-established definitions of various standards of value to fit different circumstances. Various credentialing organizations recently compiled an update to the *International Glossary of Business Valuation Terms* (*Glossary*),[1] a resource widely accepted among financial experts. The updated *Glossary* includes the following definitions:[2]

- *Fair market value* represents the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, each acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of relevant facts.
- *Fair value*[3] consists of different definitions, depending on the context and purpose. Fair value is typically defined or imposed by a third party (e.g., by law, regulation, or contract, or for financial reporting/attestation standard-setting bodies).[4]
- *Investment value* represents the value of an asset or business to a particular owner or prospective owner for individual investment or operational objectives. This is also known as *value to the owner*.

Notably, at least among the business appraisal community, value to the owner is referenced as a subset to the more universally accepted investment value standard and is not otherwise defined as a separate identifiable standard of value. Investment value considers the value to an identified owner and/or buyer of a business interest, while fair market value assumes an unidentified hypothetical willing buyer and/or seller with no relationship to the subject business or professional practice. Each standard can produce vastly different results.

When a propertied spouse in a dissolution proceeding[5] is an identified seller, the standard immediately shifts from a fair market value to an investment value, and it becomes critical to consider the motivations and circumstances of that identified individual, no different than when there is an identified buyer of the interest that has unique motivations and economic attributes.

The *Glossary*'s definition of fair market value is like that set forth in IRS Revenue Ruling 59-60,[6] which 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.

Issued in 1959, Revenue Ruling 59-60 has become a guideline for other valuation purposes and has been accepted by the valuation community as a key analytical framework for valuing closely held businesses.

Additionally, court decisions frequently state that the hypothetical willing buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and the market for such property.[7]

Seller and Buyer Characteristics

The definitions of fair market value from the *Glossary* and Revenue Ruling 59-60 assume the following:

- The buyer and seller are hypothetical parties and not specific buyers or sellers.
- The hypothetical buyer and seller are prudent and act in their own best interests.
- The hypothetical buyer is without the synergistic benefits that may be available to the identified owner of the subject interest.
- The business will be exposed for sale on the open market for a reasonable period of time.
- The consideration paid for the property is in cash or its equivalent.
- The business will continue as a going concern and not be liquidated unless evidence to the contrary suggests that the highest and best use of the property is liquidation.

The hypothetical buyer under the fair market value standard is a financially motivated buyer, not a strategic buyer. That is, the hypothetical buyer contributes only capital and management experience equivalent to that of current management. This excludes the hypothetical buyer who, because of other business activities, brings some value-added benefits to the business that will enhance the business being valued and/or the buyer's other business activities (e.g., being acquired by other businesses in the same or a similar industry). This also excludes a buyer like a stockholder, creditor, or related or controlled entity who might be motivated to acquire the interest at an artificially high or low price due to considerations not typical of the arm's length financial buyer. It also excludes a synergistically motivated buyer, such as a competitor looking to expand market share or someone looking to vertically integrate an existing business.

The definitions of fair market value also assume the following attributes of the hypothetical willing buyer:

- The buyer will analyze feasibility of the purchase, perform due diligence, and analyze valuation scenarios in determining the price they are willing to pay for the ownership interest and will negotiate that price with the seller.

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- The buyer may seek assurances from the seller regarding certain aspects of the business and will seek assistance from the seller in transitioning the business, including post-transaction employment and possible seller financing, although contracts for such post-transaction services will typically be at current market compensation rates.
- The buyer will not breach confidentiality or make threats.

The seller, under the preceding definitions of fair market value, is also hypothetical and has knowledge of all relevant facts (i.e., the influences on value exerted by the market, the investment characteristics specific to the business's risk drivers, degree of control, lack of marketability, and other relevant considerations). The preceding definitions of fair market value also assume the concept of a hypothetical willing seller—one who may assist the buyer in transitioning the business by providing post-transaction employment and training, assistance with employee retention, and other necessary support in return for market-based compensation.

Two Methods for Determining Legal Standard of Value

Beyond the definitions generally accepted in the business community, legal practitioners must understand how Colorado courts use standards of value in dissolution proceedings.

The applicable Colorado statute on disposition of property in a dissolution proceeding[8] does not define a legal standard of value to be used in valuing a closely held business or professional practice. Colorado case law has established two fundamental choices for the legal standard of value in Colorado dissolution proceedings: (1) fair market value; and (2) value to the owner, although the latter is not a clearly defined standard in the business valuation community.

It is not unusual for legal counsel in Colorado dissolution proceedings to request that business appraisers prepare analyses and expert reports applying both a value to the owner and a fair market value standard. The appropriate standard of value that will apply in any given proceeding is for the trier of fact to determine, and typically this is not adjudicated until permanent orders unless agreed to in advance by the parties and their respective legal counsel. The added time and cost to the appraiser always depends on the facts and circumstances of the particular matter, but costs for preparing valuations using multiple standards of value can be 20% to 50% more due to the differences in underlying assumptions.

The following landmark Colorado appellate court cases give guidance in valuing goodwill in a closely held business and, in turn, guidance on the appropriate standard of value for the trial court to apply in dissolution proceedings:

- *In re Marriage of Martin*, later reaffirmed by *In re Marriage of Graff*, established that goodwill "is not necessarily dependent upon what a willing buyer would pay for such goodwill . . . [but] whether the business has a value to the spouse over and above the tangible assets."[9]

- The Court in *In re Marriage of Huff* stated that "the excess earnings valuation method is an appropriate valuation in a dissolution proceeding because it provides the present value of the partnership interest to the participating spouse . . . ."[10]
- *In re Marriage of Thornhill* addressed whether marketability discounts could be applied in dissolution cases.[11]

In *Thornhill*, the trial court allowed for a 33% discount for lack of marketability, using a fair market value standard, on a 70.5% controlling interest in an oil and gas service business. On appeal, the non-propertied spouse argued that application of a marketability discount was prohibited under *Pueblo Bancorporation v. Lindoe, Inc.*, a case that dealt with discounts in dissenting shareholder valuations.[12] The Colorado appeals court rejected appellant's challenge to the use of a discount, finding *Pueblo Bancorporation* inapplicable in a dissolution proceeding for several reasons.[13]

Instead, the court noted it was "persuaded by the decisions of numerous other jurisdictions that have concluded marketability discounts may be applied in valuing shares in closely held corporations in dissolution proceedings."[14]

Therefore, *Thornhill* expanded Colorado trial courts' discretion. In dissolution cases in Colorado, courts may now apply either investment value/value to the owner (pursuant to *Martin*, *Graff*, and *Huff*); or fair market value, with discounts for lack of marketability and, when less than a controlling interest is at issue, lack of control/minority interest (pursuant to *Thornhill*). The resulting difference in the concluded estimate of value of the subject interest to the marital estate can be extreme.[15] The essence of value to the owner is captured in the question: What is the propertied spouse—the owner of the business or professional practice—willing to pay into the marital estate to retain the rights and benefits of the business or professional practice?

A Practical Example

To help put this issue into context, consider a recent dissolution proceeding in which both spouses retained experienced financial experts. The propertied spouse owned roughly an 80% controlling interest in a family business with operating revenues exceeding $60 million annually as of the date of appraisal, up from about $2 million at the date of marriage. The key challenge in valuing the propertied spouse's ownership interest as a martial asset was determining its increase in value during the tenure of the marriage.

Both experts valued the business using both a value to the owner standard of value and a fair market value standard of value at both the date of marriage and the current appraisal date. The difference in the results from each method was significant. The expert for the propertied spouse estimated the value of the subject controlling interest as of the appraisal date to be roughly $8 million under a fair market value standard and roughly $6.5 million under a value to the owner standard—$1.5 million less in value as compared to what the controlling interest would be worth to a non-synergistic hypothetical buyer. Uniquely in this instance, the expert for the propertied spouse essentially argued that the control owner did not have the ability to operate the business as efficiently as a market buyer could and would therefore have higher operating risk and have less access to lower rate debt, and concluded the subject interest had less value to the owner as compared to the value of the interest on the open market.

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Valuing Closely Held and Controlling Interests

A sound valuation will be based on all the relevant facts, but the appraiser must apply the elements of common sense, informed judgment, and reasonableness when weighing those facts and determining their significance.[16] A critical factor in valuing a business interest is whether the subject ownership interest is controlling. Regardless of whether evidence exists of an impending exchange of the ownership interest as is assumed under the fair market value standard, the value that a controlling owner of the interest could achieve in an open exchange is highly relevant because it sets the floor value of the interest.

The owner of a controlling interest has the right to make key management and operational decisions, including generally having the unilateral right to determine when and if to liquidate their ownership and realize the market value of their interest. Under a fair market value standard, a non-controlling interest in a closely held business or professional practice may also be subject to significant discounts for lack of marketability and for lack of control, which is also referred to as a minority interest discount.[17]

Whether the ownership is controlling is key, because the value to a controlling owner in a business or professional practice will rarely, if ever, be lower than the enterprise market value of the controlling ownership interest in an arm's length exchange under a fair market value standard. The value of a controlling interest to a specific owner is often significantly higher than fair market value, though this is contrary to the position taken by the business appraiser in the example outlined above. This is because the controlling owner typically has the advantage of significant synergistic benefits and privileges—unavailable to an uninvolved, unidentified hypothetical fair market value buyer—that may produce a greater economic return. The controlling owner likely has well-established relationships with key employees, customers, and vendors, and often has knowledge about operational issues that may not be apparent or accessible to the average fair market value buyer. Therefore, investment value/value to the owner may be the best standard to use when assessing the value of a controlling owner's interest.

Some valuation analysts may refer to value to the owner as a subset of the fair value standard of value, particularly when evaluating non-controlling ownership interests, which is inaccurate. This confusion may stem from the lack of consideration of discounts when the subject ownership interest is not a controlling interest and a sale of the overall enterprise is not imminent. Under the usual application of value to the owner in Colorado family law courts, minority interest discounts and a discounts for lack of marketability are typically not considered, contrary to the application of these discounts for a non-controlling interest under a fair market value. But the lack of application of discounts does not change a value to the owner standard to a fair value standard.

Like an owner of a controlling interest, an owner of a closely held interest will often enjoy unique economic benefits due to a combination of relationships with clients or customers, loyalty and recurring patronage from those clients or customers, strategic relationships with vendors and suppliers, and relationships with key employees that cannot be replicated by a hypothetical willing buyer. These benefits can be significant and evident regardless of whether the owner of the interest is a controlling owner or a minority owner and often result in a calculated value of the subject ownership interest that far exceeds what a fair market value buyer would be willing to pay without the benefit of these relationships. Therefore, an investment value/value to the owner standard may also be proper here.

Management decisions such as how the business is capitalized, whom to do business with, how much to pay employees, and how to handle billing and collections can affect business profits. If a controlling owner of a closely held business or professional practice chooses to retain his or her interest, their decisions may also result in lower profits for the business compared to what a market buyer could achieve. But if the proper standard of value is applied, these decisions should not diminish the market value of the subject interest to the marital estate for purposes of a dissolution proceeding.

Conclusion

The legal standard of value used in a dissolution proceeding can significantly impact the underlying appraisal of assets of a marital estate. Practitioners should understand the various standards of value, strive to provide guidance on the appropriate standard(s) of value to apply to the valuation analyst early in a dissolution proceeding, and seek early guidance from the court if they have questions about which standard applies to the case. CL

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NOTES

1. Laro and Pratt, *Business Valuation and Federal Taxes: Procedure, Law, and Perspective*, App. A (2d ed. 2011).
2. These standards of value are the three choices credentialed business appraisers consider when undertaking an appraisal engagement of a closely held business or professional practice.
3. In Colorado, the landmark case of *Pueblo Bancorporation v. Lindoe, Inc.*, 37 P.3d 492 (Colo. 2003), establishes that statutory fair value in a dissenting shareholder action is essentially defined as fair market value without the application of discounts for lack of marketability and lack of control.
4. Fair value for financial reporting purposes is defined in the International Financial Reporting Standards (IFRS) and under Generally Accepted Accounting Principles (GAAP), which define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
5. "Propertied spouse" in this instance refers to the actual owner of the interest in the business or professional practice that is subject to the appraisal analysis, though both spouses have an economic interest in the business or professional practice as it pertains to the marital estate in the dissolution proceeding.
6. IRS Rev. Rul. 59-60, 1959-1 CB 237.
7. For examples of applicable case law, *see* Fishman et al., "Standards of Value in Divorce," ch. 5 in *Standards of Value: Theory and Applications* (2d ed. 2013).
8. CRS § 14-10-113.
9. *In re Marriage of Martin*, 707 P.2d 1035, 1037 (Colo.App. 1985); *In re Marriage of Graff*, 902 P.2d 402, 405 (Colo.App. 1994).
10. *In re Marriage of Huff*, 834 P.2d 244, 256 (Colo. 1992).
11. *In re Marriage of Thornhill*, 200 P.3d 1083 (Colo.App. 2008).
12. *Pueblo Bancorporation v. Lindoe*, 37 P.3d 492 (Colo.App. 2002).
13. *Thornhill*, 200 P.3d at 1087.
14. *Id.*
15. A 33% discount for lack of marketability is unusual on a 70.5% controlling interest, but the Colorado appellate courts did not consider or comment on the size of the discount. *See also* Clarke and Seigneur, "*In Re Marriage of Thornhill*: Emerging Issues in Standard of Value Determinations for Family Law Matters," AICPA *CPA Expert* newsletter (Spring 2009), https://egrove.olemiss.edu/cgi/viewcontent.cgi?article=1359&context=aicpa_news.
16. *See* IRS Rev. Rul. 59-60, *supra* note 6.
17. While a controlling interest in a closely held business is also not as marketable as a publicly traded security, the controlling owner retains the economic benefits of the interest during a possible extended period to market the controlling interest at the election of the control owner. Therefore, a discount for lack of marketability is typically not taken on control positions, although a smaller discount for lack of liquidity, often calculated as the cost of brokering and selling the enterprise, is appropriate.