Forum

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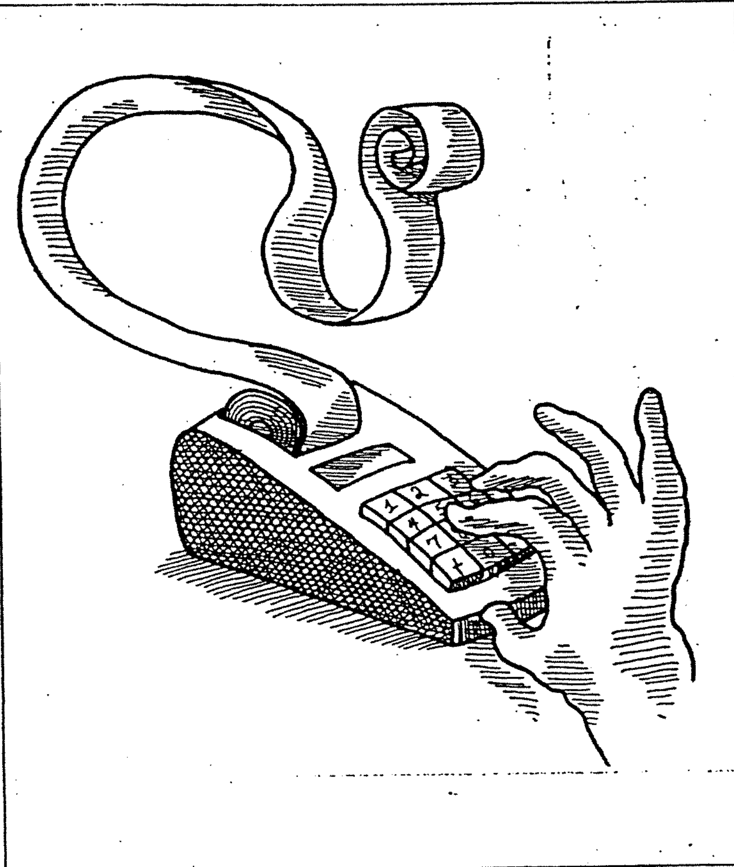
Arbitrary Asset Appraisal

Market Value Doesn't Figure In Division of A Business for Divorcing Pair

By Fred Silberberg



California is one of nine states that abide by the community property system, derived from Spanish civil law. In California, assets that are owned by a married couple are presumed to be community property, meaning the parties own an undivided half-interest in the assets unless one of the parties can establish that an asset is separate property. Unfortunately, although this part of the law is settled, how these assets are valued in California is up for grabs, which makes for unfair divorce judgments for both parties.

For the most part, separate property is something one has before marriage or receives during the course of the marriage by gift or inheritance absent a prenuptial agreement. The presumption in favor of community property is so strong, however, that even in cases where a party owned an asset before marriage, that asset can become "mixed" property, having community and separate components. The best example of this is a business started before marriage that increases in value during the course of the marriage. In a divorce, the valuation of this asset as to its separate and community components must be determined.

In California family law cases, valuing certain types of assets, particularly business assets, is most problematic. There are no true guidelines that dictate how things are to be valued. There are numerous approaches to valuation, and in a divorce trial where business assets are involved, expert witnesses testify for hours upon hours regarding how they value a business and which approach is the proper one to use in the particular situation.

There is one certainty in the context of evaluating a business asset in a divorce, however. The value that is ascribed to the asset usually has no relation whatsoever to the actual value of the business in the open market. In fact, Evidence Code Section 822 precludes the introduction of an offer to purchase into evidence.

As a divorce lawyer, I frequently try to explain to a client that a value will be placed on his or her business. Normally, the response is, "Well, that won't be too much of a problem. I couldn't sell it for much because there's no market for it." Most people don't realize that, when they go through a divorce, suddenly there is a market for everything. It is a rather unusual market, for it's probably the only time that the business owner bids, seeking to buy back his or her own asset, many times for much more than a "willing buyer would pay a willing seller," as your law school contracts professor undoubtedly preached.

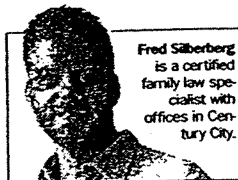
Take, for example, something near and dear to us all, a law practice. Some lawyers spend many years working hard to develop their practices. Nonetheless, the possibility of hiring a business broker to sell such a practice and realizing any kind of a decent return is slim to none. Yet, when it comes time to get divorced, the practice suddenly has substantial value. California law even provides that the accounts receivable of a business, such as a law firm, are to be valued and divided between the parties as well, and this is sometimes done in addition to determining the value of the business for divorce purposes.

Clearly, the policy of the law here is to maximize valuation in order to reward the other spouse for the efforts put into the asset during the marriage, particularly where the spouse who operates the business will continue to do so into the future. Such assets should be divided fairly, and spouses should receive the benefit of having supported someone through the development of his or her business. However, it seems inappropriate that these valuations may bear no relationship to the value of the asset in the open market.

The failure to use the open market as the benchmark of valuation is antithetical to our capitalist principles. The fact that businesses are valued in a vacuum, with no real relationship to what they are worth, is truly inequitable. The determination of an asset's value by what it would bring in the open market is a fundamental premise of our economic system. In any other context, this method is used to determine the value of just about anything. Before you sell your house, you check out comparable homes in your area to determine what is a fair selling price. Before you sell your car, you look at the sales of similar vehicles. The failure to apply these same basic principles in determining the value of a business in a divorce is an aberration.

It is even more puzzling that, in a divorce, the determination of the value of just about any other asset is based on that asset's market value. The family residence is a classic example. If one spouse wants to keep the house, we determine its fair market value less any encumbrances, and the spouse who wants to keep it buys the other spouse's equity interest. There is no reason that this same principle shouldn't apply to business valuation.

The absurdity of this situation is even more apparent when you consider that, if an intact married couple decides to sell a business, it will get no more than the market will bear. There is no reason that, in the context of a divorce, this should be handled any differently. This is yet another example of how divorce laws and logic seem at times to have no relationship to each other.



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