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ECONOMY'S ROLE IN VALUATION DATES FOR BUSINESS ASSETS IN DIVORCE CASES

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In selecting a proper valuation date for an active business asset that needs to be equitably distributed as an incident to a divorce, judges and matrimonial practitioners alike now recognize they can no longer rigidly apply archaic law to our incontrovertibly new, unpredictable and often volatile economic times.

Historically, the courts applied a simple test in determining whether a particular asset should be valued as of the date of commencement or the date of trial. Essentially, if the asset's growth or decline was attributable in part to the efforts of the spouse in control of that asset, then the proper valuation date was almost universally set as of the date of the commencement. In contrast, those assets that grow or decline based solely on market fluctuations, were and continue to be valued as of the date of trial.[FN1]

Domestic Relations Law §236 Part B, Subdivision 4, paragraph B provides: ‘As soon as practicable after a matrimonial action has been commenced, the court shall set the date or dates the parties shall use for the valuation of each asset. The valuation date or dates may be anytime from the date of commencement of the action to the date of trial.‘

The New York State Legislature in its memorandum that accompanied this legislation in 1980 recognized the flexibility that courts must have in fixing a valuation date this way: ‘An important aspect of the legislation is the flexibility which is incorporated due to the tremendous variation in marital situations and the equities involved. Flexibility, rather than rigidity, is essential for the fair disposition of a given case.‘

While DRL §236(B)(4)(b) appears to invite motion practice, until recently, practitioners observed seemingly hard and fast valuation date rules that obviated that motion practice. Businesses were almost uniformly valued as of the date of commencement and real property, which usually grows or shrinks in value due to market forces, as of the date of trial. Yet, even before the now pronounced economic crisis gripped this country in late 2008, many judges intellectually grappled with those socalled ‘hard and fast‘ rules.

New Realities

The predicate for these now mutable rules was to protect the non-titled spouse from a downward manipulation of the value of a business during the pendency of the action and to benefit the titled spouse from having to share postcommencement appreciation due solely to the titled spouses' efforts. However, as we have learned by our collective misfortune, not every decline in the value of a small business is orchestrated, nor every success a product of an owner's efforts. That reality has led the more circumspect among the judiciary to embrace context over regimen.

For example, in Wegman v. Wegman,[FN2] the Second Department realized that with some otherwise active assets, affixing a commencement date value to them may be inappropriate. In Wegman, the action was commenced in 1981 and the trial on the economic issues did not occur until four years later, in 1985. In analyzing the issue as it related to the biological development business being valued, the court thoughtfully appreciated how fairness should be defined in selecting a point in time that best signifies an asset's value:

During a delay of this kind, many assets, particularly businesses such as that involved in the case at bar, may experience fluctuations that might dramatically change the logic of the distribution. Under such circumstances, the valuation of assets close to the time of trial may result in the formulation of an award consistent with the purpose of equitable distribution and insure that each spouse receives a fair share of the family assets accumulated while the marital relationship endured.

Similarly, in Butler v. Butler,[FN3] the court valued the husband's business as of the date of trial, holding that:

The Husband's business was properly valued at the time of trial in divorce action where the valuation at date action was commenced would have been inequitable; husband filed for bankruptcy after commencement of action but before trial, a valuation as of commencement of action would have resulted in inaccurate income, revenue and asset valuations, due to the forced sale of business assets at an auction ordered in the bankruptcy proceeding, and the bankruptcy was not attempt by husband to avoid financial consequences of divorce.

In the advent of the 2008 catastrophic collapse of AIG and Lehman Brothers, among many other privately held and publicly traded businesses, a new valuation order emerged that acknowledges that economic fluctuations affect the value of a spouse's business just like real estate market fluctuations affect the value of our homes. Virtually all small businesses have had to endure the ripple effects of a down economy that they did not create to shortchange their embittered spouse. Consequently and currently, many divorcing business owners have suffered an unavoidable and bona fide diminution in revenues that legitimately crippled some and destroyed others. Acknowledging that the traditional approach would prove inequitable, judges have now become more receptive to that reality and more flexible in their approach to the valuation date issue.

Commenting recently in their New York Law Journal article, ‘Setting Valuation Dates for Marital Property in a Global Economic Crisis‘ Oct. 14, 2009, NYLJ 4, (col.1) about the need for a new approach to valuation, Allan E. Mayefsky and Alyssa A. Rower stated:

The obvious weakness with the ‘active/passive‘ analysis is that it takes courts away from an individualized, case by case analysis and toward a rigid, inflexible approach that ceases to produce equitable results when economic conditions change. As Ralph Waldo Emerson has written, ‘A foolish consistency is the hobgoblin of little minds.‘ There is growing evidence that bubble and crashes are not anomalous and a steady framework is needed. Between 1945 and 2001 the average business cycle, the periodic but irregular up and down movement in economic activity was a little over 5.5 years. Therefore, a New York divorce that takes more than two or three years is likely to overlap a major shift in the economy. A rule that disregards business cycles and assumes the rise and fall in the value of ‘active‘ assets is always caused by the efforts of one spouse is untenable.

Similarly, in a New York State Bar Association Family Law Review article written by forensic accountant Martin P. Randisi entitled ‘How to Apply the Principles of Business Valuation During This Recession,‘ (Spring

2009, Vol. 41, No.1), Mr. Randisi opined:

It has often been said that the simplest explanation of value is ‘The value of a business is the present value of the future cash flows.‘ The emphasis here is on the future cash flows. The fear in this recession is that appraisers, attorneys, and judges may just think the typical valuation report which uses the historical past as a proxy (such as the average earnings of the last five years) to estimate cash flow is the only way to do it. Well, in today's recession that method will most likely not be accurate.

Experts and Judges

While attorneys are obligated to make their best valuation case through the use of a handful of dedicated forensic accountants, one of the more prominent valuators was recently excoriated for apparently doing his job in Maria C. v. Dominick C.[FN4]

In advancing his polemic against the husband's expert, Joel Rakower, Justice Andrew Crecca, of Suffolk County Supreme Court, embraced the generally accepted principle of valuation and Revenue Ruling 59-60 that active assets should be valued as of the date of commencement, despite the fact that in the Maria C. case, there was ‘no question that the defendant's home improvement business suffered from financial losses in 2008 and 2009.‘ However, Mr. Rakower's willingness to markedly discount the significance of the historical earnings of the defendant's business in computing its value, which is no more than an accountant's guess as to the value of the future earnings of the business, apparently ignited the court's condemnation.

Clearly seeing the active asset valuation issue as cataclysmic, Justice Crecca abrasively dismantled Joel Rakower's valuation expertise, based primarily upon Mr. Rakower's choice of a valuation date different than the court's preference:

... [I]n valuing the defendant's husband's business based solely upon the six-month earning period between January-June 2009, Mr. Rakower appears to have ignored fundamental principles employed in conducting business evaluations, such as considering the historical earning performance of a company over a period of more than 5 years (see IRS Revenue Ruling 59-60). His decision to value the business based solely on its performance over a six month period flies in the face of the various factors that need to be considered for a proper analysis (see, IRS Ruling 59-60). Rather than performing an objective analysis, Mr. Rakower appears to have been blinded by the defendant-husband's theory of the case. Not only does the Court reject testimony and conclusions reached by Mr. Rakower; but such testimony was so absurd and one-sided that it has caused the Court to question his reliability and validity as an expert in the field of business evaluations.

The expert in Maria C., like many other capable forensic accountants, attempt to opine values for businesses that do not have an actual marketplace of comparable businesses being bought and sold from which to draw data. As a result, most of the forensic valuators of small businesses adopt the excess earnings approach, which simply looks to see how much more money the business is making for the owner than he may otherwise make in a similar business working as an employee.

Notwithstanding the flexibility that has been accorded to the court like Justice Crecca, in determining valuation dates, most judges are still apt to select the date of commencement as the appropriate valuation date for a small business. Despite that inclination, the court is also obligated to rely on the factors set forth in the equitable distribution statute in making an overall determination as to the percentage of a value that is to be given to the non-titled spouse. For that reason, most attorneys, like the husband's attorney apparently did in Maria C. v. Dominick

C., direct that their experts provide to the court a value that best suits their client's circumstances, which includes the diminishment in the value of a business that takes place after commencement.

Forensic experts are engaged to give the court choices, not to decide the ultimate but very thorny valuation issues. This advisory status of the typical forensic evaluator is confirmed by the appellate courts' analogous mandate that health care forensics refrain from testifying as to their recommendation on custody, which is the ultimate issue for the court to decide. Moreover, and contrary to Justice Crecca's interpretation of IRC 59-60, the equitable distribution statute more than begs the question as to what burgeoning facts should be considered in equitably distributing marital assets.

Clearly, judges should carefully consider a decline in the value of a business not due to any nefarious machinations by the owner but due to market forces or serendipity in crafting an equitable distribution award. Some businesses fail because the owner-spouse is distracted by the matrimonial situation; others fail due to poor business judgment. However a business may react to changing times. Under Factor 14 of the Equitable Distribution statute, the court is broadly empowered to consider any thing or event that might make sense to consider in equitably distributing marital property.

A pendente lite decline in a business value may or may not be deemed significant. Notwithstanding, those who innocently present unpopular or radical valuation views need not be condemned for doing their jobs. Who knows whether a pendente lite decline in value will spark a favorable appellate reaction? If experts are deterred from doing their jobs in fear of a judicial upbraiding, the approach to valuation will become stagnant.

Had the Court of Appeals not appreciated accountant ingenuity in O'Brien v. O'Brien,[FN5] New York's revolutionary view of marital assets might never have evolved. Hence, before the judiciary too harshly judges the efforts of the forensic accountants who provide opinions which the court is free to either embrace or reject, they may want to consider how it would read if the Appellate Division publicly rebuked one of their decisions as reflective of their fitness to sit as a judge.

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FN1. See Grunfeld v. Grunfeld, 94 N.Y.2d 696, 731 N.E.2d 142 (2000); McSparron v. McSparron, 87 N.Y.2d 275, 662 N.E.2d 745 (1995).

FN2. 123 A.D.2d 220, 509 N.Y.S.2d 342 (2nd Dept. 1987).

FN3. 256 A.D.2d 1041, 683 N.Y.S.2d 603 (3rd Dept. 1998).

FN4. New York Law Journal, July 30, 2010 29, col 3 (Sup. Ct. Suffolk Co.).

FN5. 66 N.Y.2d 576, 498 N.Y.S.2d 743 (1985).
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