Business Valuation In Divorce Engagements

By
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By any measure, one of the fastest growing segments in the U.S. economy is the small closely held business. More and more Americans are choosing the lifestyle of a self-employed person. According to a 1998 U.S. Department of Labor survey, about 6% of all households (6.1 million) have home based businesses. 23.3 million people work at home.[1] According to the Small Business Administration, 842,357 new firms were formed in 1996. This represented a record increase for the fourth straight year.[2]

While small businesses and the number of self-employed persons increases, the divorce rates in the United States are again on the rise. In 1990 the divorce rate per 1,000 people in this country was 4.7. In 1997 the rate had dropped to 4.3. The most recent statistics indicate that the rate of divorce has risen to 4.95 per 1,000.[3]

The combination of small business growth and the increase in the divorce rate leads to an obvious conclusion: for a firm that prepares business valuations, family court represents a tremendous growth opportunity. As valuation professionals recognize and pursue such opportunities, it would be wise to consider some of the unique traps involved in preparing valuations in the context of divorce litigation.

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Common Problems

There are unique problems in completing a divorce valuation engagement. These problems are prevalent and seen in many cases.

Access to records is difficult, expensive and/or impossible. It seems there is no litigation that involves more emotion than divorce. There is usually anger, sorrow, fear, malice, accusations, denials, money, and children all wrapped up in a legal matter requiring great patience to sort through and untangle. Adding to the difficulty is the usual situation of the un-moneyed spouse, who is not involved in the business, hiring the expert to value the business. So the expert is hired by someone who can give little or no assistance in understanding the business, requesting relevant documents, or establishing a basis to form an opinion about the value of the business. All of that information must come from a spouse who is hostile, protective, and motivated to delay the process if not impede it altogether. Unfortunately, legal counsel is skilled in assisting the hostile spouse in that endeavor. And, all too often, the courts

allow the case to get mired in procedures, motions, and time allowing the stalling spouse to, by inaction, financially last longer than the un-moneyed spouse. After all, such a spouse cannot afford to pay for the attorney's time as well as the valuation expert's time at multiple non-productive court hearings.

Another problem is the lack of understanding by the courts as to the business valuation process and costs. This is not unique to family court, but it seems to be more the norm and much more of an obstacle than in other courts. It is normal, for example, for the court to order the valuation but reserve the issue of who will pay the fees to the end of the case. This leads to unpaid fees and the specter of justifying fees to the court after all the work has already been done. This displays a failure to understand, on the part of the court, that independence and the appearance of independence is critical to the relevancy and reliability of a business valuation.

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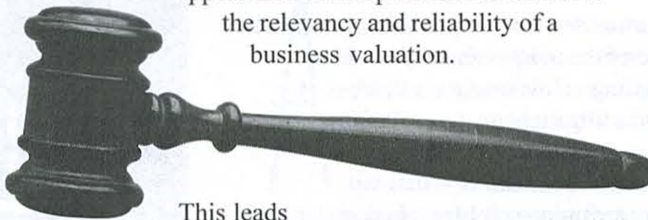

This leads to another common family court case scenario: early settlement. In California, there is enormous pressure from the bench to settle cases before trial. All too often, the court has ordered a valuation, reserved fees, and then exerted enormous and successful pressure to settle. The case then settles, often with the exception of the matter of expert and legal fees. Many times, the court does not want to deal with the question of fees even though it reserved the issue when ordering the valuation. Then, the court wants to know why fees should be awarded for a valuation that was not necessary for the settlement.

As in any other court, the trier of fact is often inexperienced in the science of business valuation. The dockets are so full in family court, the judges are reluctant to take the time to read and understand a detailed valuation report. It is a common complaint among attorneys in family court they cannot even get a judge to read their briefs. That same reality applies to the work done by valuation experts. Many times the court would rather send competing valuations to mediation or a forced settlement conference than hash it out in their courtroom while the docket grows. And certainly, with overloaded dockets, it is rare to find a judge who has actually read the report, much less understood it. By referring the competing experts to mediation/settlement conference, the court looks good by moving more cases through the system. The valuation experts, however, are rarely heard from in court.

SUCCESS IN FAMILY COURT

Unfortunately, bad experiences happen in family court as they do in any other court. However, lessons can be learned so that mistakes are not repeated. The first rule is the expert should not commence work on a valuation in family court unless the judge has ordered it. Because of the high rate of pre-trial settlement and the relative lack of funds available to fund the valuation process, few valuations are ever ordered. Generally, the expert should expect to serve as a consultant to the attorney both in acquiring the relevant documentation and in giving reasonable valuation ranges within which a settlement can be negotiated. In the event the client wants a formal valuation performed, it is highly recommended fees be collected in advance of completing the engagement. Retainers as high as 50% - 75% are advisable before beginning work. I advise the finished report not be delivered except in exchange for the final unpaid 25% - 50%.

In addition, it is imperative a signed engagement letter be obtained along with the retainer. The engagement letter should designate the valuation date, the expected fees, the required retainer, and the basis of valuation. If any of the elements of the engagement change in the course of the work, a new engagement letter should be prepared and signed. This is just "good business" in any context. However, it seems in the context of family court, it is critical to assuring the understanding of all the parties as well as eventually getting compensated for the work.

Finally, an "accountants' lien" (referred to hereinafter as a lien) can be a useful tool in several types of litigation, but none more consistently or effectively than in divorce engagements. A lien requires the signature of the attorney and client and designates valuation

fees are to be paid directly by the attorney from the proceeds of the case. In a property settlement, the lien directs the attorney the expert's fees come off-the-top before any distributions are made to the client. By itself, the lien could have the appearance of contingent fees. Wording must be clearly included in the engagement letter and the lien stating the valuation expert does not guarantee the results and compensation for work done by the expert is not conditional based on the outcome of the case. If such wording is included in the engagement letter, the lien has not caused an appearance of contingency.

An example of lien language is:

> I hereby authorize and direct you, my attorney, to pay directly to said firm such sums as may be due and owing the firm for services rendered to me both by reason of this litigation and by reason of any other bills that are due this office and to withhold such sums from any settlement, judgment or verdict as may be necessary to adequately protect said firm. And I hereby further give a lien on my case to said firm against any and all proceeds of any settlement, judgment or verdict which may be paid to you, my attorney or myself as the result of the above referenced litigation matter.
>
> I fully understand that such payment is not contingent on any settlement, judgment or verdict by which I may eventually recover said fee.
>
> Dated: ______________ Signature: ________________________
>
> The undersigned being attorney for the above named client does hereby agree to observe all the terms of the above and agrees to withhold such sums for any settlement, judgment or verdict as my be necessary to adequately protect said center named above.
>
> Dated: ______________ Signature: ________________________

All of the above are tricks and traps of a litigation consulting practice. However, in the context of divorce, it seems the traps are deeper and more numerous. This makes the tricks all the more useful and important. I believe the best policy is one should not accept a business valuation engagement in the context of divorce litigation unless and until a judge has ordered it. Until that happens, there is a very real possibility the work will not be compensated, appreciated, or evaluated. It should not only be your policy, but you would be doing your clients a favor by counseling them that way early in the case. ■

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[1] Source: (Labor Department study) *Work at Home in 1997*, Bureau of Labor Statistics, U.S. Department of Labor, Labor Force Statistics from the Current Population Survey, March 11, 1998

[2] Source: Small Business Administration: www.sba.gov

[3] United States Center For Disease Control