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Notes and Comments

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Leveling the Playing Field . . . at Last!

The Appellate Division, Second Department, on March 31, 2009 decided *Penavic v. Penavic*,[1] an extraordinarily important decision to unmonied spouses and their counsel. The appellate court, in no uncertain terms, condemned the practice by some IAS judges to refer *pendente lite* counsel fee application to the trial court, especially where the moving party makes far less than his or her spouse, or is a stay-at-home mom or dad without employment income.

The facts are interesting and must be reviewed in-depth in order to understand the reaching effect of this decision. The parties were married for 14 years and had four children, when the wife commenced an action for divorce. Both parties had graduate degrees, but the wife had left her employment shortly after their marriage, to essentially become a homemaker and raise their four children. The husband's career as a hedge fund executive flourished and his income as early as 1998 exceeded $1 million a year. Such income afforded the family an opulent lifestyle that included frequent luxurious trips to Europe and other foreign countries, household help, an *au pair*, expensive vehicles, and the other trappings of an exceedingly upscale standard of living.

When the wife commenced her action for divorce in 2003 the parties' pre-separation standard of living had already been cast. Sometime later in the litigation, the husband advanced to the wife the sum of $250,000 against her equitable distribution entitlement and agreed to supply her with $12,000 a month in support for her and the children, in addition to paying for health-care costs, educational and extra curricular activities for the children, and a one-year payment of $25,000 to defray the wife's travel and vacation expenses. A so-ordered stipulation was executed. At that time, the husband's income surpassed $2.7 million per year, so he was well able to make these generous payments, and at the same time continue to enjoy his own luxurious lifestyle.

A year later, the wife had gone through these funds, and was unable to pay for certain home repairs and the taxes on the marital residence. She also had incurred substantial legal fees during this hotly contested litigation, and owed her counsel $250,000. She then moved for an upward modification of maintenance and child support, and a *pendente lite* award of counsel fees in the

Inside

NYSBA

How to Apply the Principles of Business Valuation During This Recession

By Martin P. Randisi

The purpose of this article is three-fold. First, it is to give the matrimonial Bar some perspective on the challenges that valuation experts face in a recessionary economy when valuing a businesses, property, and stock options. Second, it is to show how the principles of valuation can be used to support issues related to the selection of the valuation date. Finally, through a case study I hope to generate some ideas on how to navigate a business valuation through the current economic climate.

> Many forecasters expect that the U.S. economy will recover as 2009 progresses. But a return to healthy economic growth next year is unlikely. The chances for a sustained recovery depend largely on the progress of stabilization in the financial markets, making the ever so-evolving outlook more uncertain than usual, with risks weighted to the downside.[1]

Given this scenario, how are matrimonial attorneys to advise their clients as to issues related to the value of a business?

Before I summarize the principles most applicable to business valuation in a recession, let me introduce the case study to you.

Divorce Fact Pattern and Problem

It is June 2008 and Mary tells her attorney Madison that she wishes to file for divorce from her husband, who is a major plumbing subcontractor in New York City. She is confident that now is the time to file because their 2007 tax return showed that her husband earned $1.9 million. Meanwhile, a few blocks over on Lexington Avenue, Joe the plumber is explaining to his attorney, Johnson, that his accountant said now is a good time to get divorced because commercial construction jobs are declining by 60%. What should the attorneys tell their clients? By the way, the business was begun in 1925 by Joe's grandfather.

Those of us working in the New York metropolitan area had little concern answering these questions in 2007 and even in the first half of 2008. But since September of 2008, the answers to these questions are now very complicated. To help answer these questions, let us first look at some valuation rules and practices. After that, I will return to the case study to demonstrate how the attorneys for the titled and non-titled spouse can advocate for their clients with a better understanding of valuation principles.

Valuation Principles

Internal Revenue Service Ruling 59–60, often quoted in equitable distribution matters, reminds us that valuation results and fair market value ("FMV") will change with changes in economic conditions:

> The fair market value of specific shares of stock will vary as general economic conditions change from "normal" to "boom" or "depression," that is, according to the degree of optimism or pessimism with which the investing public regards the future at the required date of appraisal. Uncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future. The value of the shares of the stock of a company with very uncertain future prospects is highly speculative. The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting value.

This Revenue Ruling is reminding us that we must understand the economy's impact on a business and consider the risk of achieving future earnings. In other sections of the Revenue Ruling, the use of publicly traded securities to determine value is discussed. Thus, in the New York market, we must be concerned with the prices of publicly traded companies because of their impact on stock options and other forms of incentive compensation to highly paid executives, and on the pricing of privately held businesses.

We were reminded of the phrase "from boom to depression," as quoted in the Revenue Ruling, when just over a year ago, Bear Stearns' stock price tumbled from $90 a share to $10, almost overnight. In the fourth quarter of 2008, venerable institutions such as Lehman Brothers and Merrill Lynch either went bankrupt or had to find a buyer. The once secure accounting profession also took major hits, as thousands of accountants assigned to the Lehman Brothers engagement were given pink slips. Thus, the words of the Revenue Ruling are a very real reminder that we have to understand the economic environment and decide if we are in a period that is normal, boom or recession at the time of the valuation.

Another valuation principle is that a valuation is at a point in time. This means that the value will be different at different dates, e.g., if you sold Bear Stearns' stock in October 2007 you had $90 per share; in February 2008, you only received $10 per share.

In estate and gift matters, the tax court affords no flexibility to change a date (e.g., for the individual who made a gift of 20,000 shares of Bear Stearns one month before its crash, the IRS expects taxes to be paid on the $90 per share value). However, in the equitable distribution of property, the valuation date has flexibility and the courts might consider a valuation date after the crash, when it was worth $10 per share. For the advocate in a matrimonial action, this recession presents a greater need to understand the duration of the recessionary cycle on the subject business when petitioning for a specific date.

While the tax court has no flexibility to change the valuation date, some tax court cases have considered subsequent events that occurred after the valuation date. (*Business Valuation and Taxes, Procedures, Law and Perspective*, written by Shannon P. Pratt and Tax Court Judge David Laro, has an excellent discussion on the topic of subsequent events in Chapter 2.) Generally accepted appraisal practice recognizes that subsequent events can be considered in a valuation if they were known or could have been known at the valuation date. While I will not discuss it in this article, a review of Estate and Gift Tax case law and the Federal Rules of Evidence may give the matrimonial advocate some ideas as to how subsequent events could be used to their advantage in an equitable distribution valuation if the valuation date cannot be moved.

More background on the admissibility of subsequent events as evidence of value can be found in the Federal Rules of Evidence 401 under Rule 143(a). Also, the *Noble* case of January 6, 2005 (*Estate of Helen M. Noble v. Commissioner*, T.C. Memo 2005-2), which is the leading case providing guidance on use of a subsequent event as evidence of value, is thought-provoking. Thus, if a subsequent event is relevant to a valuation, the advocate will have to work very closely with the appraiser to explain how the subsequent event influences the valuation decision and the best way the facts can be presented.

Value Is the Present Value of the Future Cash Flows

Let us now put these ideas about the valuation date into context with the definition of value. 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 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. Yes, the future earnings will be a challenge for the expert to estimate, but much can be gained if the advocate can convince the court that the cash flow was arrived at in a clear and objective manner.

We are all more than a bit skeptical with economic predictions, because we saw how many institutions and companies did not read the tea leaves on our present economic failure. However, this is a time when, as we will soon see as the case study plays out, experts will have to face the music and drive in the fog to find what the proper cash flows are that the business can generate in the future. Again, recall that in the Revenue Ruling the emphasis is on the future earning, not what is in the historic financials during the boom economy.

This is why both the expert and advocate have to understand the client's business cycle, how it relates to the economic outlook, and that the cash flow conforms to objective data.

Valuation Is at a Point in Time

In the course of a two-year period within which a typical divorce takes place, the value can be dramatically different, at different valuation dates. The chart in Figure 1 shows how the valuation of a major public company can change. Valuation is determined by multiplying the earnings (in billions) times the Price Earnings (P/E) multiple for that company at each valuation date.

Figure 1—Valuations Based on Changed Dates

	June 2007	Nov. 2008	June 2009
Earnings	$1,000	$700	$100
P/E	x 30	7	10
Value	**$30,000**	**$4,900**	**$1,000**

These models show the relationship of earnings and the P/E multiple on values. If an appraiser was asked on January 20, 2009 to determine the value at June 2007 or November 2008, historical data are readily available. If asked in January 2009 to estimate the value at June 2009, the outlook would be more difficult. However, securities analysts make these calculations every day by using forecasts.

Let's now turn back to our case study and I will illustrate how to apply valuation principles in this recession to help you navigate through the stages of an equitable distribution matter in an uncertain economic environment.

Return to the Case of Mary and Joe the Plumber

In today's economic world, valuation experts and attorneys do not have all the answers. Indeed, it is important for us to make clear to our clients that our predictions for future earnings are tentative at best. However, appraisers and economists can help clarify the impact of the economy and business cycles on the valuation. Appraisers need to explain how the economy, industry, and company actions can drive a valuation higher or lower. However, what is clear from the events of the past year is that we cannot predict when valuations will change once an action for divorce has begun, or whether a judge will consider subsequent events and change the valuation date.

Let me now give you a hypothetical playback of our case study:

Stage 1—Making the Decision to Commence an Action

Madison, on behalf of Mary, postulates that Joe's business will have another strong year and anticipates a June 2008 cutoff date. He made a few calls and the appraisers gave him a $7 million to $8 million valuation range. Madison calls to get an index number and starts an action. Of course, we are back in June 2008 and no one believes we are headed for a crash.

Johnson decides to double check what Joe told him and reviews the financial statements, and has the controller break out the numbers by quarter. He also sees the backlog has dropped dramatically. He then calls a few large general contractors who confirm the New York market is drying up quickly. Johnson comments to his client that he hopes Mary serves him with papers in the near future. Of course, Johnson realizes that he must convince the court that a current valuation date is more equitable.

Stage 2—Discovery

Joe is served. It is now December 2008, five months into the matter and each side realizes there are issues. Neither attorney expected the downturn to be this bad. Each retains his own expert, as opposed to requesting a neutral appraiser, because there are very different perspectives that must be addressed. Johnson supplements his valuation expert with economists and industry experts. There is a lot of nail-biting:

1. Madison's expert says he has no idea when a recovery will begin; Madison tries to withdraw the action and delay it.
2. Johnson petitions the court to adopt a trial date for a current valuation due to the impact of market forces.

Stage 3—Trial

The court declines to rule on the motion to fix a valuation date but sets the trial date for June 30, 2009. Clearly the economy is not better. The burden of proof seems to be more on Johnson to have the court consider current conditions. Obviously, Madison sticks to the June 2008 date and explains to the court that when he filed for divorce there was a boom economy and the husband was given every opportunity to settle. His expert supports the position.

Johnson brings in charts to show Joe's backlog was dropping at the date of action, and business was decreasing as early as the first quarter of 2008. A problem Johnson has is that there are no articles admitting to the recession in June of 2008 because of politics and the Presidential election.

Stage 4—The Expert Reports

Judge Center reads the two expert reports and, as expected, the experts both prepared what appeared to be credible valuation reports if you assumed they had the correct valuation date.

	Mary	*Joe*
Valuation Date	**June 2008**	**June 2009**
Earnings	$1,000,000	$200,000
Multiple	6	3
FMV	**6,000,000**	**600,000**

Summary and Observations

The wife's expert averaged the last five years' earnings and used a multiple at the high point of the market in June 2008. The husband painted a tale of gloom and doom and predicted the company was taking its last breath.

The approaches used polarized the results, leaving Judge Center disturbed that each was too extreme. What caught his eye was the fact that this particular business was begun before the crash of 1929 and has survived numerous business cycles.

It is clear that in this case each side should have recognized the longevity of the company and referred to the Revenue Ruling on business cycles. This judge indicated that based on the expert presentation by an economist and industry expert, he was going to consider changes due to market forces but was not looking for either side to achieve a windfall. This is a case where the court understood the husband was going to stay in this business and not sell it. We are in a new world. Valuation principles do have flexibility when they are applied to the facts of each case. Matters like this in today's uncertain future call for compromise and willingness to cut deals contingent on the future. If settlement cannot be had, the expert who takes the high road could be more convincing for his or her client. Let me explain:

1. While valuation is at a point in time, the appraiser is trying to determine the future earnings and risk associated with those earnings.

2. The Revenue Ruling speaks in terms of normal conditions, boom or depression. Explain where the company is today, that it is in the valley. Both sides should play out that they recognize it's more a matter of when momentum resumes. Again, recall this company survived the days of depression and many recessions.
3. Rather than using a fixed earnings amount, either appraiser could have explained that the discounted cash flow ("DCF") model is a recognized valuation method based on future earnings, as the Revenue Ruling discusses.
4. Each expert could have used low earnings for 2009 and 2010 but then increased it as normal times return in 2011 and beyond.
5. Different risk-adjusted rates could have been applied to the recession years and normal years.
6. A DCF method would have moved each valuation to a higher degree of credibility rather than leaving the court with two extremes.
7. Ultimately, in today's recession, there are those businesses that will not survive and others that will.
8. The attorney has to rely on experts who can help him decide if the company will be a survivor or will go out of business. Then implement a credible position.

This case example is about how to be successful for your client with a business that is expected to survive by getting behind the deeper meaning of Revenue Ruling 59–60 and applying valuation principles with different methods tied to the facts of the specific case at hand.

I only touched on the broader principles in this article. Look for the experts who have been through a few recessions to help you build a better case.

Endnote

1. "After Rocky 2008, U.S. Consumers Seek Stable Ground in 2009," ECONSOUTH, Volume 10, Number 4, Fourth Quarter 2008.

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