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THE FAIR TREATMENT OF "OUT SPOUSES" IN FAMILY BUSINESS BUY-OUTS

By Gregory W. Herring; 2014

Especially in light of the recent Supreme Court cases, *Citizens United* and *Hobby Lobby*, folks have been focused on the rights of those owning closely-held family businesses. In family law (and other) cases, those rights often involve valuation issues when one spouse buys-out the interest of the other. Often the managing spouse claims that the business has little to no inherent value, as "it would fold without me." Another still-heard argument is that the business has no "real" value because it lacks any potential "outside" buyers.

In cases where those might actually be the facts, California law achieves fairness by treating the "out spouse" as a "silent partner" who is entitled to an "investment value" buy-out.

The analysis starts with the basic principle that property acquired during marriage is presumably community property. (See *Fam. Code* §760.)

It builds on the mandate that a trial court "shall" divide a community's estate equally. (*Id.*, §2550.)

"The distinctive feature of California marital property law is that the marital community is viewed as a partnership in which the spouses are equal partners. It has long been recognized in California 'that the marriage, in respect to property acquired during its existence, is a community of which each spouse is a member, equally contributing by his or her industry to its prosperity, and possessing an equal right to succeed to the property after dissolution.' [Citation.] ... The equal division of the community property of the spouses, upon dissolution of marriage, appears to be an implicit recognition of this equality in interest that prevailed during marriage." [Citation.] (*In re Marriage of Brigden* (1978) 80 Cal.App.3d 380, 389-390.)



The ideal is a mathematically equal division: “[T]he fundamental objective of the Legislature with respect to the disposition of community property upon dissolution of a marriage was to provide for an equal division thereof as an additional way of advancing its primary no-fault philosophy.... [¶] Under the Family Law Act clearly the ideal is a mathematically equal division.” (*In re Marriage of Juick* (1971) 21 Cal.App.3d 421, 427.)

In dividing marital interests, a court should value a closely-held business based on its “investment value” to the operating spouse because the asset is non-marketable. The seminal case holding this was *In re Marriage of Hewitson* ((1983) 142 Cal.App.3d 874).

A civil case, *Ronald v. 4-C’s Electronic Packaging, Inc.*, referenced *Hewitson* in distinguishing Investment Value from “fair market value” (“FMV”): “...We concluded that if an active market existed for the stock, its **market value** could be determined, but if none existed then its **investment value** should be determined. (*Ronald v. 4-C’s Electronic Packaging, Inc.* (1985) 168 Cal.App.3d 290, 298 (emphasis added).)

California family law guru, Garrett Dailey, puts it this way: Investment Value differs from FMV in that Investment Value measures the value of the business to a specific buyer, e.g., the operating spouse, rather than to a hypothetical buyer, as required for FMV.

A leading American Bar Association (Family Law Section) treatise on business valuation issues contrasts Investment Value with FMV as follows:

“The primary distinguishing characteristic of investment value is that it denotes value to a particular owner or investor. This is in contrast to FMV, which is a concept of value in exchange, assuming hypothetical, typically motivated buyers and sellers. In other words, **investment value is the value to a particular individual or entity, considering that individual’s or entity’s situation, perceptions, and motivation, not necessarily value in the marketplace....**” (*The Lawyer’s Business Valuation Handbook: Understanding Financial Statements, Appraisal Reports, and Expert Testimony*, 2000, by Shannon P. Pratt, at pp. 8) (emphasis added).)

The decision as to whether to use Investment Value or FMV in a family law case is determined by whether the asset being valued is marketable. *In re Marriage of Cream* specifically restricted the use of FMV to marketable assets “because some marital assets are not marketable, but nonetheless may have to be valued.” ((1993) 13 Cal.App.4th 81, 89.)



Other opinions have recognized this concept without specifically stating that they are using Investment Value. For instance, *In re Marriage of Foster* recognized that the value of goodwill in a medical practice might be more than its FMV.

From the idea of investment value follows the principle that the non-operating spouse is entitled to a full buyout as a withdrawing "silent partner" even when non-transferable assets and rights are involved.

In their treatise, *Complex Issues in California Family Law*, Steve Wagner and Dawn Gray put it this way: The Investment Value approach has for decades acknowledged that the professional practice or small business in which the operating spouse's skills, efforts and talents are both the (1) key to the value of the business and also (2) truly not transferable to a third party will still have value to the operating spouse, which may include goodwill. **This is because the day after the case is resolved, "... the operating spouse will walk to the front door, turn the key and an ongoing business will be in place, just as it was the day before."**

Thus, the Silent Partner concept is part of the Investment Value approach for a close corporation as outlined in *Hewitson*, above. Several cases, including *Brawman v. Brawman* ((1962) 199 Cal.App.2d 876), have expressly used the "Silent Partner" term and have required this approach.

Closely-held family businesses are typically not suited to FMV valuations. That is in part because they have unique Investment Value to the "in spouse" that cannot be appraised based on any open market. *Hewitson* and its progeny have, for decades, recognized this valuation problem and then solved it through the Investment Value and Silent Partner approach. Even though managing spouses may genuinely feel this way, the "I'm the business and therefore don't have to buy her out at full value" argument has long been untenable in family law property divisions.

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