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DIVORCE AND THE FAMILY BUSINESS BY RICHARD F. IGLAR, ESQ.

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Divorce and the Family Business

By Richard F. Iglar, Esq.

A family business is typically a closely held corporation--a business which is not publicly traded and for which there is no open market. Where the interest was purchased during the marriage, its value will be subject to division in the divorce. The major question which presents itself, however, is how will the value be determined.

Brown v. Brown, 348 N.J. Super. 466 (App. Div. 2002) determined that the governing standard of value to be applied is "fair value," and not "fair market value." Fair market value is the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts. Fair market value takes into consideration a discount for lack of marketability or liquidity which is a discount based on the inability to sell an ownership interest in a business. Fair market value also takes into consideration a minority interest discount which is a reduction in value due to the lack of control which can be exercised by an owner with only a minority interest.

On the other hand, fair value is a context and geographically-sensitive term which basically equates to fair market value without discounts for lack of control or lack of marketability and liquidity, barring extraordinary circumstances. In Brown, the trial court accepted the "fair value" standard used in dissenting/oppressed shareholder cases and held that discounts should only be applied in extraordinary circumstances. Id.

While the Courts have determined that "fair value" is the value to be utilized in the valuation of a business, "[t]here is no single formula that will apply to each enterprise." Bowen v. Bowen, 96 N.J. 36, 44 (1984). New Jersey courts permit three (3) differing approaches: (a) capitalization/income method, (b) market approach and (c) cost approach method. Steneken v. Steneken, 180 N.J. 290 (2005). The first method involves the capitalization of earnings at a reasonable return on investment based on relative risk and current interest rates. This method involves determining the "reasonable compensation," the theoretical amount which a buyer would have to pay someone to perform the owner's tasks in running the business. The difference between the owner's actual compensation and reasonable compensation is the excess earnings of the business. After determining a capitalization rate and applying a multiple, the valuation expert can arrive at a value.

The market approach requires a comparison with price earnings ratios of publicly traded companies in the same or comparable industry. Typically, this method is utilized in the appraisal of real estate and equipment and machinery when known markets exist. As a result, the market method is less likely to be applied in the valuation of intangible assets.

Finally, the cost approach method requires an appraisal of all underlying assets, tangible and intangible, with adjustment for existing liabilities. It operates on the premise that a willing buyer will not pay more for a used asset that he or she would pay for a new and identical asset. That "new value ceiling" is typically the upper limit for the cost of the asset with all liabilities, deterioration, etc. being deducted therefrom to arrive at the ultimate valuation.

Valuation techniques, regardless of the approach selected, are to be measured against a reasonableness standard and will depend upon the judgment and experience of the valuation expert and the completeness of the information upon which the conclusions are based.

Bowen, 96 N.J. at 36. Given the variety of options and extreme level of detail and complexity involved in valuing a business or closely held corporation, the discretion of the valuation expert can be a critical factor. Choosing a strong, experienced valuation expert is essential for success in this area of divorce litigation.



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