VALUATION METHODOLOGIES

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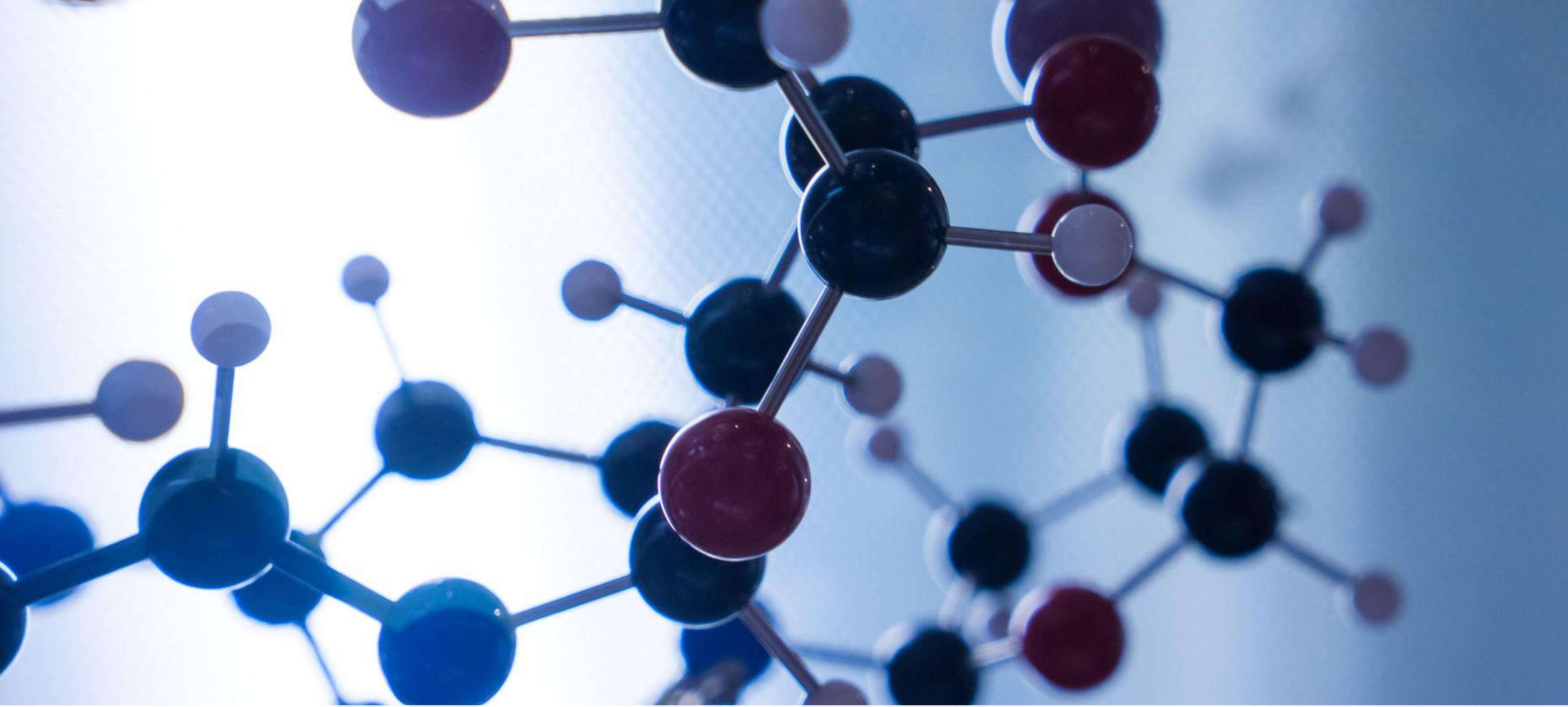


ARE VALUATIONS BASED IN ART OR BASED IN SCIENCE?

- "A good valuation is 75% art and 25% science because it takes into account the story behind the numbers of a business… It's based not on just what happened, but on why things happened."

NECESSITY OF VALUATION: WHY IS VALUATION IMPORTANT?

- Only those assets and debts that are classified as marital property and **valued** are subject to distribution under the Equitable Distribution Act. Grasty v. Grasty, 125 N.C. App. 736, 740, 482 S.E.2d 752, 755 (1997).

STANDARDS OF VALUE: WHY ARE THEY IMPORTANT?

- The standard of value used is critical because it establishes the guidelines under which the valuation will be performed.
- Different standards may produce vastly different values.
- In many valuation situations, statutes or case law dictate the standard of value.

WHAT ARE THE DIFFERNT TYPES OF STANDARD OF VALUE?

FAIR MARKET VALUE

- The IRS defines fair market value as 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 knowledge of the relevant facts.
- Commonly used for gift and estate tax, purchase or sale, buy-sell agreements, and divorce valuations.

FAIR MARKET VALUE IS **NOT NECESSARILY**

- Fair market value is **not necessarily** equivalent to:
  - Purchase price
  - Replacement value
  - Book value
  - Going concern value
  - The amount received in a recent sale of similar property

FAIR VALUE

- A judicially determined concept of value that can vary widely in its interpretation in each state.
- Fair Value is also used for financial statement reporting.
- Accounting Standards Codification (ASC) 820 defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

APPROACHES TO BUSINESS VALUATIONS

- When valuing a business or an economic interest in a business, there are three general approaches:
  - Asset Approach
  - Market Approach
  - Income Approach

ASSET APPROACH

The International Glossary of Business Valuation Terms defines the asset approach as "a general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets net of liabilities."

This approach is usually of greater importance when valuing companies that are marginally profitable or have no earnings history.

This approach generally applies to a company with little value beyond the value of its tangible assets.

INCOME APPROACH

- The International Glossary of Business Valuation Terms defines the income approach as ”a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.”
- The income approach is often applied by use of a discounted future benefits methods and/or a capitalization of benefit methods.
  - These methods estimate the value of a company based on its expected benefits stream.
  - Generally, this can be accomplished by the capitalization of benefits stream over one period or discounting future benefits forecasted for a period of years.

INCOME APPROACH CONTINUED

Under the income approach, some measure of cash flow is used to estimate value.

The capitalization of cash flows is a method within the income approach whereby cash flow for a representative single period is converted to value through division by a capitalization rate.

MARKET APPROACH

- The International Glossary of Business Valuation Terms defines the market approach as “a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.”
- This approach develops a value based on direct comparison to completed transactions of similar companies, by use of publicly traded stocks, or by use of the prior transactions of interests in the Company.

RELEVANT VALUATION DATE

- Marital assets must be valued as of the date of separation. See, e.g., Miller v. Miller, 253 NC App 85 (2017)

PASSIVE AND ACTIVE APPRECIATION

Passive appreciation: Appreciation that happens regardless of the action of either spouse.

- Examples include:
  - Market forces, inflation, efforts of third parties, etc.

Active appreciation: Appreciation that is the result of the action and hard work undertaken by either of the spouses.

- Examples include:
  - Contribution of funds, talent, or labor by either spouse.

APPRECIATION ISSUES

DOM to DOS: If the appreciation on a piece of separate property is considered to be "passive," the property remains the separate property of the husband or wife.

If the appreciation is considered to be "active," part of the asset (the active appreciation) becomes marital property and, is thus, subject to division.

DOS to Date of Trial (DOT): If the appreciation is considered to be "active," the active appreciation is separate property.

If the appreciation is "passive," the passive appreciation is marital property.

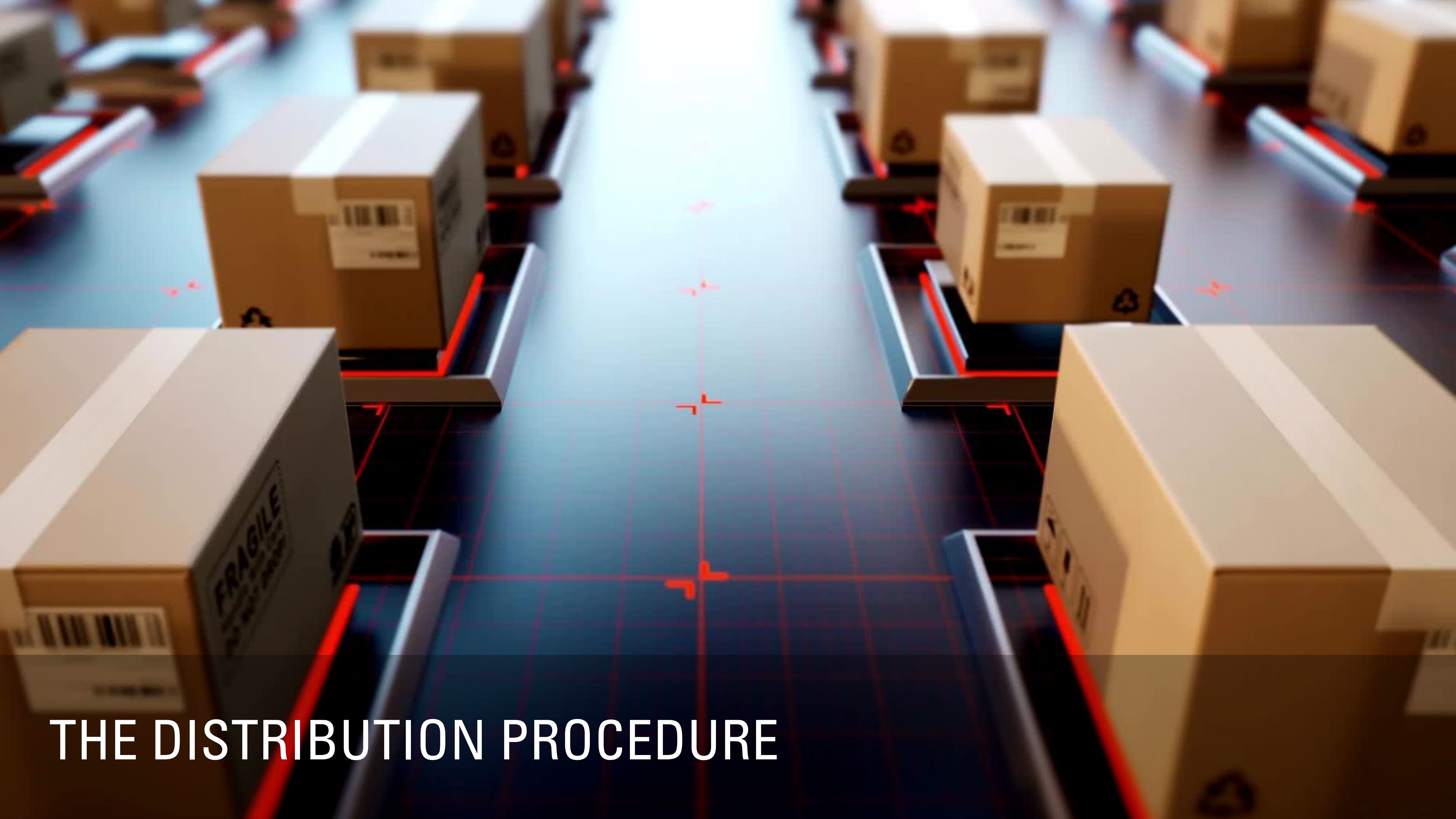
ACTIVE VS. PASSIVE APPRECIATION IN REAL ESTATE

ACTIVE VS. PASSIVE APPRECIATION IN REAL ESTATE

- North Carolina Courts are required to value real property owned by one of the parties prior to marriage; or acquired by bequest, devise, descent, or gift during the course of the marriage. Although labeled "separate property," the marital estate is entitled to a fair return on its investment when it invests labor and funds in improving "separate" real estate. (Active appreciation)
- Turner v. Turner, 64 N.C. App. 342, 345, 307 S.E.2d 407, 409 (1983).
    - Husband acquired title to home before marriage, and wife contributed to improvements and mortgage payments during the marriage. The resulting increase in value could be marital.

ACTIVE VS. PASSIVE APPRECIATION IN REAL ESTATE (CONT.)

- Lawrence v. Lawrence, 75 N.C. App. 592, 596, 331 S.E.2d 186, 188 (1985).
  - Husband contributed his labor and Wife paid for materials and hired laborers to make repairs, alterations, and additions to the Wife's separately owned house.
  - The Court held that part of the real property consisting of the unimproved property owned by Wife prior to marriage should be characterized as separate, and that part of the property consisting of the addition, alterations, and repairs provided during the marriage should be considered marital in nature.



THE DISTRIBUTION PROCEDURE

CLASSIFY THE PROPERTY AS BEING MARITAL, DIVISIBLE, OR SEPARATE PROPERTY

CALCULATE THE NET VALUE OF THE MARITAL AND DIVISIBLE PROPERTY

- Net value is not defined in the statute, but North Carolina Courts have defined it as “market value,” if any, less the amount of any encumbrance serving to offset or reduce market price.

NET VALUE: WHAT IF THERE IS NONE?

- Parties will likely be unable to agree on the disposition of intimate personal items having only sentimental value, such as family picture albums.
- Whenever possible, the Court should make some disposition of all items in order to make as full and final a judgment as possible.
- However, the Equitable Distribution Act does not require the distribution of articles that have no net value. McManus v. McManus, 76 N.C. App. 588, 590, 334 S.E.2d 270, 272 (1985).

DISTRIBUTE EQUITABLY THE MARITAL AND DIVISIBLE PROPERTY

WHICH DATE OF VALUATION SHOULD I USE?


WHAT ROLE
DO EXPERTS
PLAY IN
VALUATION?

- Experts may testify as to the value of real and personal property on the date of separation, although their examination of the property took place months later, where there was:
  - (1) No evidence that the expert considered post-separation occurrences;
  - (2) The expert demonstrated familiarity with the market values of such property at the date of separation; and
  - (3) There was no evidence that the condition of the property had changed between the date of separation and the date of the appraisal.

WHAT IS THE ROLE OF THE TRIAL JUDGE?

- Assess credibility
- Assign weight to evidence
- Consider and/or make findings of fact, based on competent evidence, in support of its conclusions
- List marital assets and value each
- **IMPORTANT: Valuation method is within judicial discretion, but the approach must be sound and supported by evidence. The court must state whether it finds a goodwill component, value of, or how the court arrived at the value.**

WHAT IF THE PARTIES DO NOT INTRODUCE SUFFICIENT EVIDENCE?

- The Court can appoint an expert to value. However, if the Court chooses not to appoint an expert, and is unable to value the asset, the asset is not subject to distribution.
  - Bright-line rule illustrated in Grasty v. Grasty, 125 N.C. App. 736, 740, 482 S.E.2d 752, 755 (1997).

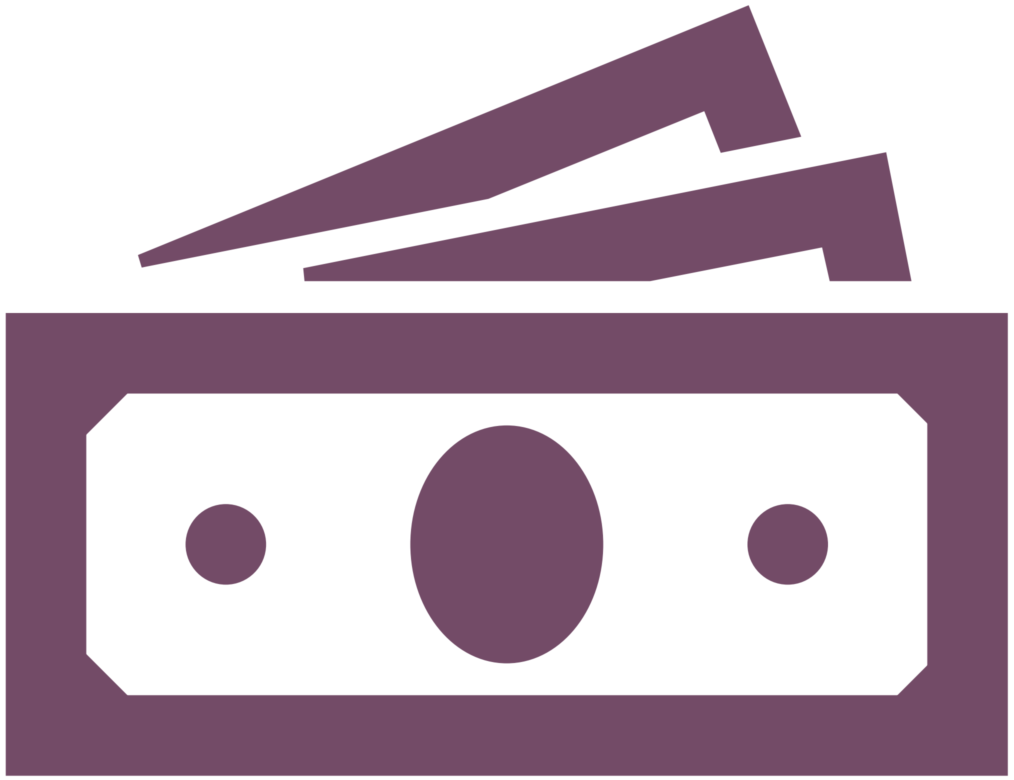
COURT-APPOINTED EXPERTS

- The trial court may appoint an additional expert if the court is not satisfied by the testimony of either expert offered by the parties.
- Courts can second guess experts and determine its own valuation if the court can identify the methodology and make a separate finding supporting the valuation.
  - See <u>Offerman v. Offerman</u>, 137 N.C. App. 289, 297, 527 S.E.2d 684, 688 (2000) where the trial court properly used the expert's approach, adjusted some of his figures, and recalculated the asset's value.

VALUATION OF DEBTS

A marital debt is defined as a "debt incurred during the marriage for the joint benefit of the parties."

The party claiming the debt is marital has the burden of proving its value of the date of separation. Pott v. Pott, 126 N.C. App. 285, 288, 484 S.E.2d 822, 825 (1997).



VALUATION OF SPECIFIC ASSETS

VALUATION OF SPECIFIC ASSETS: REAL ESTATE

- There are three different approaches to value real estate
  - Cost Approach
  - Income Approach
  - Market Approach

COST APPROACH

- Involves a determination of the fair market value of the (vacant) land, the cost of reproduction of the buildings of modern design and materials less depreciation.

INCOME APPROACH

- When property is generating income, the income approach is often used.
- This approach is criticized as not being the most favorable indication of value because it is based upon a formula and fails to consider other appropriate criteria, such as the age of the building, assessed valuation, continuation of present use, actual income as opposed to square foot rental, location of property, single special value, and absence of viable market.
- Other cons are the court must understand the factors relied upon by the appraisers and parties in order to fulfill its function of determining the credibility of the witnesses and the weight to be afforded to their testimony.
    - The court may arrive at a "middle figure," but may not guess at such a figure.

MARKET COMPARISON APPROACH

When a marital home is being valued, the appraiser will investigate the market for sales of reasonably similar properties, i.e. similar in location, type, zoning, desirability, amenities, conditions and size.

Cons: No two parcels of land are exactly alike and locating similar properties to compare in valuing commercial properties is often difficult, especially in smaller communities.

VALUATIONS OF SPECIFIC ASSETS: HOUSEHOLD GOODS

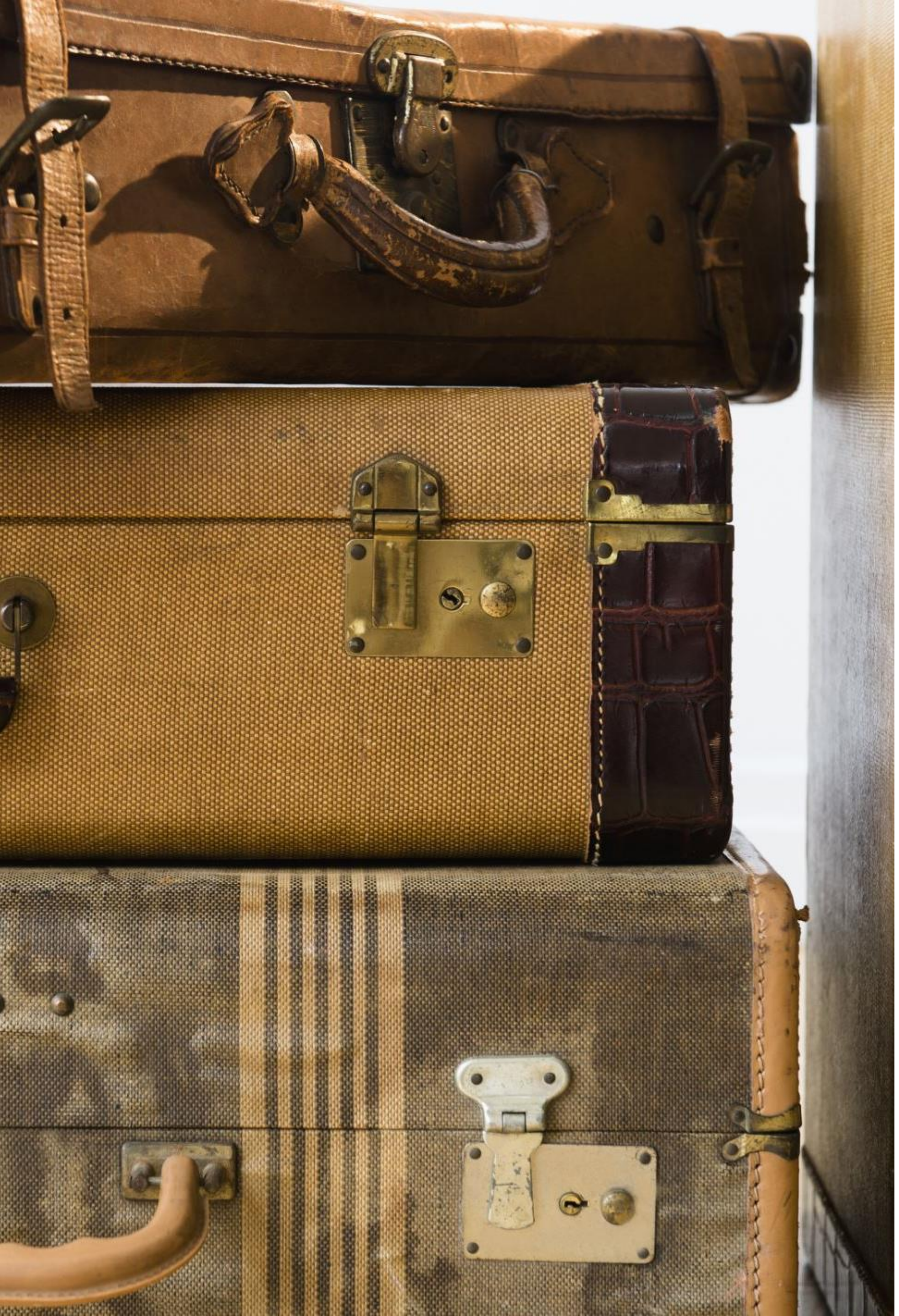
The court does not need to indicate its valuation method in valuing personal effects and household property. However, it may not merely "split the difference" between the estimates.

Either the court accepts either's value or the court values the item on its own with supporting findings of fact.

If the court takes one of the parties' value, the court does not have to include other findings of their reasonings. See Mosiello v. Mosiello, 285 N.C. App. 468, 479, 878 S.E.2d 171, 181 (2022) (quoting Lawing v. Lawing, 81 N.C. App. 159, 183, 344 S.E.2d 100, 116 (1986)).

VALUATION OF SPECIFIC ASSETS: AUTOMOBILES

- Valuation types such as the Kelly Blue Book and NADA are admissible as an exception to the hearsay rule.



VALUATION OF ASSETS: ANTIQUES AND COLLECTIBLES

- Parties will often have inaccurate ideas of their value, and the court is unlikely to reach a fair market value without expert help.

VALUATION OF SPECFIC ASSETS: BUSINESS INTERESTS (PUBLICLY TRADED)

- In prior times, the valuation of the shares could be determined by certain newspapers and trade journals.
- Google is now everyone's best friend. The internet can be used for finding accurate closing prices on the date of marriage, date of separation, and date of trial.

VALUATION OF SPECIFIC ASSETS: BUSINESS INTERESTS (CLOSELY HELD)

- There is no single best approach to valuing a professional association or practice, and various approaches or valuation methods can and have been used.
- If the trial court adopts an approach that reasonably approximates the net value of the partnership interest, the decision is likely to be affirmed on appeal. The court should note the valuation method(s) that it relies upon.
  - The court should consider: (1) fixed assets including cash, furniture, equipment, and other supplies; (2) other assets including accounts receivable and value of work in progress; (3) its goodwill, and (4) liabilities, if any.
  - The court should clearly state whether it finds the practice to have any goodwill, and if so, its value, and how it arrived at that value. Poore v. Poore, 75 N.C. App. 414, 424, 331 S.E.2d 266, 273 (1985).

VALUATION OF SPECIFIC ASSETS: BUSINESS INTERESTS (CLOSELY HELD) VALUATION APPROACHES

- If the practice is conducted as a partnership, and the value of the practice or an interest therein is set in a partnership or redemption agreement, then the value set in the agreement should certainly be considered, but it should not be treated as conclusive. Sharp v. Sharp, 116 N.C. App. 513, 449 S.E.2d 39, *review denied*, 338 N.C. 669, 453 S.E.2d 181 (1994).

VALUATION OF SPECIFIC ASSETS: PENSIONS AND RETIREMENT RIGHTS

In classifying a pension, it must be remembered that any compensation earned by a spouse during marriage is presumed to be marital property. Lund v. Lund, 244 N.C. App. 279, 283, 779 S.E.2d 175, 178 (2015) (quoting N.C. Gen. Stat. § 50 -20(b)(1) (2014)).

In accordance with this general rule, the right to receive pension benefits that are earned during the marriage is presumed to be marital property, even though the pension benefits are not be received until well after the date of separation. Id.

PENSIONS: DEFINED BENEFIT PLAN VS. DEFINED CONTRIBUTION PLAN

- The method for valuing a pension depends on whether the pension is a defined benefit plan or a defined contribution plan.
- A defined contribution plan is a pension plan "which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account." Bishop v. Bishop, 113 N.C. App. 725, 733, 440 S.E.2d 591, 597 (1994).
- A defined benefit plan is defined by the Internal Revenue Code as "any plan which is not a defined contribution plan."

PENSIONS: DEFINED CONTRIBUTION PLANS

- Valuing a defined contribution plan merely requires determining the value of the employee-spouses' account in existence on the date of separation. Bishop, 113 N.C. App. at 729, 440 S.E.2d at 595 (1994).

PENSIONS: DEFINED BENEFIT PLANS

- The court has adopted a five-step process for evaluating defined benefit pension plans as outlined in Bishop v. Bishop.
  - (1) The trial court must calculate the amount of monthly pension payment the employee, assuming he retired on the date of separation, will be entitled to receive at the later of the earliest retirement age or the date of separation.
    - The calculation must be made as of the date of separation and shall not include contributions, years of service, or compensation which may accrue after the date of separation.
    - The calculation will include gains and losses on the prorated portion of the benefit vested at the date of separation.
  - (2) The trial court must determine the employee-spouse's life expectancy as of the date of separation and use this figure to ascertain the probable number of months the employee-spouse will receive benefits under the plan.
  - (3) Using an acceptable discount rate, the trial court must determine the then-present value of the pension as of the later of the date of separation or the earliest retirement date.

PENSIONS: DEFINED BENEFIT PLANS CONTINUED

- (4) The trial court must discount the then-present value to the value as of the date of separation.
  - Determine the value as of the date of separation of the sum to be paid at the later of the date of separation or the earliest retirement date.
- (5) The trial court must reduce the present value to account for contingencies such as involuntary or voluntary employee-spouse termination and insolvency of the pension plan.
  - This calculation cannot be made with reference to any table or chart and rests within the sound discretion of the trial court.

DISTRIBUTION OF PENSIONS

- Absent an agreement between the parties, there are only two methods by which a vested pension may be distributed by the trial court, which are codified in N.C. Gen. Stat. § 50-20.1(a)(3) and (a) (4). Lund v. Lund, 244 N.C. App. 279, 292, 779 S.E.2d 175, 184 (2015).

THE PRESENT VALUE OR IMMEDIATE OFFSET METHOD

Codified in N.C. Gen. Stat. § 50-20.1(a)(3)

Allows the trial court to award one hundred percent (100%) of the future pension benefits to the employee-spouse and to “offset” this award by awarding a larger percentage of the other marital assets to the non-employee spouse.

THE FIXED PERCENTAGE OR DEFERRED DISTRIBUTION METHOD

Codified in N.C. Gen. Stat. § 50-20.1(a)(4)

Allows the trial court to award the non-employee spouse a "fixed percentage" of the marital portion of the pension benefits as they are paid out in the future.

QUESTIONS?