The Art of Business Valuation

Most matrimonial practitioners confronted with a divorce case involving a complex business valuation often wisely turn to their favorite business valuator for help. While historically a business valuator could rely on a normalized five year financial look back to establish an estimate of future cashflows and, therefore, potentially opine an approximate value for a company. The rapidly changing faces in today's business world have rendered valuators far less confident about their opinions than they were a decade or so ago. And with good reason.

To uncover how the business unknowns have exponentially grown, one need not drive very far. For example, contrary to the expectations of many investors counseled by allegedly erudite industry experts, the previously inclining value of a NYC Taxi Medallion literally dropped like a stone once Uber found its innovative way into the public transportation market. Those attorneys who reflexively traded off the inflated value of a taxi medallion for a stable marital asset of equivalent value are still to this day dodging their clients' irate Monday morning calls over their lack of prescience.

Divining the worth of a niche business or one challenged by an unforeseen adversity often requires that the court consider a multitude of factors that may affect future cashflows, such as emerging economic and technological factors that may influence future revenue and profitability. Virtually every business owner in today's frantic world is worried about what the future may bring. When in the throes of a divorce, a business owner naturally hopes to convince the court that a profitable past is not a reliable indicator of future value. General and specific industry risks now more than ever drive the valuation mantra. As most seasoned matrimonial litigators can attest, how well an attorney is able to explain to the court the legitimacy of those risks that threaten a company's future vitality can potentially make a multi-million dollar difference in the ultimate outcome of a divorce action.

1. Neutrals

The first decision an attorney usually must make in a case where a business needs to be valued is whether to agree with her adversary to the designation of a neutral business valuator. Too often, an attorney's impulse is to leave the valuation issues in the hands of a neutral accountant. However, because that valuator's potentially unbiased, misguided or financially crippling opinion may be readily adopted by an arithmetically challenged jurist anxious to avoid a battle of alleged 'hired guns', a true advocate best serves his client by respectfully opposing the engagement of an unconstrained and costly neutral and hiring his own expert with whom he can collaborate in producing an opinion on value that can be factually and logically justified and that also simultaneously achieves the client's litigation objectives. As will be explained, while a neutral is certainly capable of aggregating and simplifying the historical financial data of a business, to persuasively articulate where extrinsic business and economic factors may steer a business in the future, an advocate needs to enlist an expert who is ready to embrace your client's vision of the future.

2. LB

For the didactic purposes of this article, we selected a family owned lighting business ("LB") to value. In this example, the husband started LB during the marriage, which as of the date of the commencement of the parties' divorce action, maintains two suburban retail locations. LB has been in business for twenty strong profitable years but recently suffered a significant decline in revenue due in large part to the advent of intense internet competition and the grand opening of a Home Depot a quarter mile from their primary revenue producing location. Although strategic moves are being contemplated to address the loss of customers to internet based purchases, that often beat the prices LB charges, and the new price competitive and highly visible Home Depot that just moved into town, the timing of the parties' divorce from a valuation and, therefore, judicial perspective, could not be worse. The key for an attorney looking to take advantage of the uncertainty that will necessarily permeate the valuation process is to learn everything he can about the business and then play cynic.

3. The Amazon Effect

With the marketplace chaos that imperils many businesses as its backdrop, the business community has identified a phenomena known as the Amazon Effect, which has proven to be as devastating to small businesses as Tom Hank's mega bookstore in "You've Got Mail" was to Meg Ryan's neighborhood bookstore, The Shop Around The Corner. Small businesses are obviously not alone in their vulnerability to the Amazon Effect, a fact to which Borders will readily attest.

Diagnosing the business impact of the internet and of other technological advances on the valuation process calls for a thoughtful fact-based analysis. In our example, it requires that the wife's attorney collaborate with her expert to figure out how best to leverage the intangibles of the business and minimize the risks that the internet, competition and the future may hold to increase the value of LB and thereby enhance the wife's equitable interest. Conversely, it necessitates that the husband's attorney work with his expert to discount the historical financial data of LB and maximize the specific risks that LB is likely to confront in the future to ensure that the wife's award does not turn into a windfall. The conclusions drawn by the judge from the relevant business and economic information you furnish through your expert's testimony in a case where value can only be determined by capitalizing the expected future cashflows of the business can be quite dramatic, as the disparate valuations presented in the Arizona Ice Tea partnership dissolution case revealed.

4. RAIDS

The responsive cry to an owner spouse's lament over the Amazon Effect or some other business hindrance is the shrill sound of the mnemonic known as RAIDS, or Recently Acquired Income Deficiency Syndrome. Once that mnemonic caught the attention of the Matrimonial Bar a few decades ago, a husband whose career was honestly on a decline could not buy a break before incredulous jurists infected by the RAIDS virus.

After a number of highly publicized business collapses, the judiciary's reluctance to seriously entertain the distinct possibility that a husband was actually telling the truth about his Glengarry Glen Ross moment gradually began to lessen. Whether the judge is fascinated or intimidated by the valuation chore, it is fair to say that the judiciary's view of matrimonial landscape has radically changed. Today's judges have prudently concluded that the risks of a business can no longer be disregarded. The world has gone full circle. And it is the attorney's obligation to work with his expert to convince the court to appreciate or discount the risks most responsible for the variations in each party's expert's valuation opinion.

5. **Internal Revenue Ruling § 59-60**

Most accountants begin their valuation analysis by quoting Internal Revenue Ruling § 59-60, which defines the fair market value of a business as " the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts." Although initially presented for use in estate and gift tax calculations, this 57 year old Revenue Ruling remains the definitive outline of the approach, methods and factors to be considered in valuing privately held businesses. A key element of R.R. 59-60 is a "sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance." Cognizant of the need for flexibility in connection with the valuation of a privately owned business, this Revenue Ruling acknowledges that, "[p]rior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten-year averages without regard to current trends or future prospects will not produce a realistic valuation."

6. **SSVS**

In every business valuation report, the valuator identifies and defines the different valuation approaches recognized by the Statements on Standards for Valuation Services ("SSVS") as appropriate for the valuation of a small closely held business. The three approaches are the Market Approach, the Net Asset Value Approach (or Cost Approach) and the Income Approach.

A. The Market Approach looks at comparable business sales for guidance. It is a reliable method provided several similarly situated businesses were recently sold in the same geographical area and your valuator is privy to the circumstances surrounding those sales, thereby supporting the use of the same valuation equation for the subject business. This approach is most commonly used in valuing real estate. Rarely can one find small businesses that have the comparability that residential real estate enjoys.

B. The Net Asset Value Approach, is another name for the breakup value of the business. This approach is best where the sum of the assets less its liabilities is greater than the value determined by the Income or Market Approaches.

C. The Income Approach looks to capitalize an income stream to derive a value. This can be done under a single period method known as the Capitalization of Cash Flows or the multi-period method known as the Discounted Cash Flow method. The Income Approach requires that the appraiser calculates a proper income stream and divides that income stream by a capitalization rate to determine the value.

7. Excess Earnings Approach

Where the business produces a profit in addition to having a net asset value, the appraiser can elect to use a hybrid method of the Asset and Income approaches known as the Excess Earnings Approach. Simply stated, this method adds the value of a company's goodwill to the value of the company's net tangible assets. The spin on this methodology, like all income-based valuation methodologies, makes for an interesting challenge for the judge, namely, how to determine what constitutes the excess income of the business and, second, what should be the multiple of that excess earnings stream to properly reflect the goodwill of the business.

Like political pundits trying to take the public's pulse in this year's Presidential election, in employing the Income Approach, business valuators are being effectively asked to predict the future. But as history has taught us, the economy is hardly predictable. It is through that prism that the presentation of your expert must be carefully choreographed.

8. Qualifying the Expert

We begin the business valuator's examination at trial by qualifying him as an expert whose opinion on value should be admitted into evidence. Usually an accountant, this part of the examination primarily focuses on the expert's education, work experience, valuation experience, and courthouse experience. Before the Court will deem your witness an expert, however, your adversary will be permitted to challenge, probe and seek to discredit your expert's credentials to prevent the introduction of his testimony. While some attorneys enjoy poking fun at the expert during their voir dire, courts seldomly decline to deem a Certified Public Accountant an expert in valuation, especially one whose testimony in other cases has been admitted by colleagues on the bench.

After calling and having the expert sworn, the proponent's examination should proceed as follows[1]:

Q: Good Morning, Mr. Expert.

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[1] You will notice that many of my questions appear to be objectionable as being arguably 'leading'. Judges who are inclined to streamline the matrimonial process usually do not prohibit attorneys from utilizing leading questions on matters that will not compromise the Court's fact finding role. For example, matters that are preliminary in nature or not subject to dispute lend themselves well to leading questions. The contents of a CV falls into that category. Other compound questions are posed in this article that are also technically objectionable to expedite the introduction of preliminary and undisputed evidence.

Were you engaged by the Plaintiff in this divorce action pursuant to a written retainer agreement?

A: Yes

Q: I show you what has been marked as Exhibit "29" for identification and ask whether it is the original retainer agreement you executed in connection with your engagement in this case?

A: Yes.

After offering Exhibit "29" into evidence, usually admitted by the trial judge without objection, which would never be sustained in any event, you should follow up in this way:

Q: Exhibit "29" reads in part that your opinion as to the value of the Business would not be influenced by the fact that the plaintiff has agreed to pay you for your services. Is that a term that is to be taken seriously?

A: Absolutely. My reputation as a witness that judges and attorneys can trust depends upon their favorable perception of my integrity and credibility. No one case would ever be a good trade for that.

Obviously, preemptively dealing with the 'hired gun' branch of your adversary's anticipated cross can be further elongated by having your expert rattle off the names of fellow judges who have deemed him an expert and the prominent attorneys from the local bar who have engaged his firm . Most of the matrimonial bench are familiar with the players in the business valuation community and usually err on the side of admitting expert testimony to allow for appellate review, and thereafter decide how much, if any, weight to give to the testimony.

At this point the expert's curriculum vitae should be identified by your expert and be offered into evidence. To the extent you wish to amplify the information contained in your expert's CV, you should do so. For example, you may wish to have your expert testify about cases where he was deemed an expert in connection with the valuation of a similar business or about valuation seminars in which he participated in the county the case is pending or about the frequency your adversary has utilized his services. Once you complete qualifying your expert, you can then make a request that the Court deem your witness an expert and permit him to testify as to what the value of the business is as of the date of commencement and as of the date of trial, unless you believe you can justify selecting a different but more advantageous date. The witness will then be tendered to your adversary to voir dire. A typical but condensed voir dire from your adversary may sound something like this:

Q: Did you testify as an expert in Cole v. Cole?

A: Yes.

Q: Are you aware that in her decision after trial, Justice Curmuggia not only rejected your opinion as to value but also found that you had employed the wrong valuation methodology? Did I read that decision correctly?

A: Yes you did.

Once your adversary finishes his voir dire and lodges his objection, you will respond that your adversary's objection goes to the weight to be given your expert's testimony, not to its admissibility. Indeed, in every contested case, the court is free to adopt one expert's opinion over another's. That decision favoring one expert's opinion over another does not disqualify the expert whose opinion was rejected from ever testifying as an expert in the future; otherwise, every expert whose opinion is rejected by a judge, who himself may be wrong, would be precluded from testifying as an expert in any future proceeding. We turn now to the substantive testimony that needs to be elicited from your expert.

9. Valuation Testimony

Q: What business did you value in this case and what was the valuation date utilized?

A: I was asked to value LB as of the date this divorce action was commenced and as of the date of trial.

A. Setting a Valuation Date

The expert's answer assumes that the Court had not already designated a specific valuation date in a pretrial order, which should only be rarely done on consent, given how precarious the time spent litigating may prove to be relative to the value of the business. Always critical to your expert's testimony is the valuation date that you want the court to adopt in rendering its decision as to the value of the business. Pursuant to DRL §236B(4)(b), the Court is encouraged to set a valuation date for the parties' marital assets as early in the litigation as possible. That date can be any date between the date of commencement and the date of trial. As suggested above, given the volatility of the marketplace and the chance of an unforeseen business bonanza or catastrophe, the Court should be encouraged to defer a determination until as close to trial as possible. To appreciate this admonition one need only imagine stipulating early in the litigation to set the date of valuation on the date of commencement . Then imagine a hurricane like Sandy wiping out your client's business the day before trial. Under existing law, what happens after a valuation date is agreed upon is irrelevant. Despite the fact that something might happen that the parties simply did not anticipate, the Court does not have the inherent power to modify an agreed upon valuation date order. To avoid a litigation crisis, the court's valuation date determination needs to be deferred to the latest date possible to keep your options open.

B. Moving a Valuation Report into Evidence

At this point, the expert's report should be offered into evidence, subject to your adversary's cross-examination. Most judges will accept the report into evidence, while some may deny or defer admission until after the expert's testimony concludes. If the judge chooses to be 'old school' and cling to the rules against the admission of hearsay, even if the report actually does not constitute inadmissible hearsay, given that your expert is available for cross-examination on the Report, you can always plod through the report by questioning your expert about exactly what he did and what he read or considered in developing his valuation opinions.

Q: I show you Exhibit "31" which was previously marked for identification and ask whether this is the Valuation Report you prepared and whether it contains the values you attributed to the Business on the two valuation dates selected and also sets forth the information you relied upon in reaching your opinions on the two values?

A: Yes.

Q: Judge, I move Exhibit "31" into evidence.

C. Valuator's Methodology & Opinion

Q: Can you state with a reasonable degree of accounting and business valuation certainty the value you attributed to LB in your expert opinion, as of the date of commencement and as of the date of trial?

A: Yes. As of the date of commencement, I valued LB at $1 million and as of the date of trial I valued it at $500,000.

Q: Does your Report identify the documents you reviewed and the people you interviewed and relied upon in reaching that opinion?

A: Yes.

Q: Does your Report also include your analysis of those documents and the valuation methodology you employed in opining the value of LB on those two dates?

A: Yes.

Q: What valuation methodology did you employ in arriving at your opinion of LB's value?

A: I utilized an income approach that is based on the capitalization of the expected future cash flows of LB. The expected future cash flows of LB are capitalized by an appropriate risk rate derived from the application of the 'Build Up' method.

Q: Before you explain what the Build Up method entails, what other valuation methods were considered?

A: The Market approach and the Net Asset Value approach.

Q: Why did you choose to employ the Income approach rather than the Market or Net Asset Value approaches?

A: The Market approach is a reliable way to value a business when data regarding the sale of comparable businesses is available. Unfortunately, I could not find a comparably sized business situated in a comparable business environment that had been sold in the last five years from which I could extrapolate LB's value. As a result, since the identification of comparable businesses is a condition precedent to the use of the Market approach, it was not a viable valuation methodology here.

Q: What about the Net Asset Value approach?

A: The Net Asset Value approach is a valuation methodology for businesses which derive their value from the sum of the parts of the business as if it was being liquidated, which is not the case here. That left me the only viable and reliable valuation option for a business like LB, which is an approach that measures cashflow and then attempts to apply a capitalization rate to yield the value of the business.

Q: Please take us through the Income approach calculations and considerations that led you to your opinion as to the date of commencement and the date of trial values you attributed to LB.

A: To begin, the wife's expert and I agreed that the normalized level of income generated by LB before compensation to the owner is $500,000. This amount includes direct and indirect income to the husband last year. By direct income, I mean the combination of the husband's salary and of the profit reported by LB. Indirect income is comprised of the husband's perks. Utilizing the income approach, my next step was to determine what the husband would make as reasonable compensation for the job he performs at LB. Toward that end, I researched in ERI and RMA databases. Based upon that research, I determined that the annual reasonable compensation for the husband's annual overall management and sales work is $150,000. This estimate also took into consideration the actual amount he paid to his other managers and part-time sales people. Subtracting the husband's reasonable compensation from his average annual earnings over the past five years, we arrived at profit before taxes figure of $350,000. After applying a tax rate of 40% I calculated a profit after tax of $210,000. We then adjusted the profit after tax for needed working capital, depreciation and amortization, capital expenditures, and tax impacted interest expense. After those adjustments are made, we determined the net free cash flow to be $300,000, which was then used as a proxy for the future expected net cash flow of LB to which to apply the build-up rate and opine the value of the business, before consideration of discounts for lack of marketability and lack of control.

Q: Was your employment of the Build Up method in this case consistent with SSVS (Statements on Standards for Valuation Services)?

A: Yes. Utilizing the Income Approach here is also consistent with the principles contained in other widely relied upon texts such as, Valuing a Business, 5th Edition: The Analysis and Appraisal of Closely Held Companies, written by Shannon Pratt. The Build Up method is the best way for valuing businesses like LB.

Q: Please take us through your computations in valuing LB.

A: LB's value is calculated by capitalizing a net free cash flow from LB by a capitalization rate determined under the build-up method. The computation requires that the $300,000 net cash flow be multiplied by the expected growth rate and then as divided by the capitalization rate. The capitalization rate is derived by adding together the long-term treasury bond rate, the equity investment premium over bonds, a size premium, the specific industry risk premium, and the company specific risk premium, less the expected growth rate.

Q: Explain why it makes sense to adopt this valuation equation and inform the court from where the data emanates that determines the rates and premiums set forth above?

A. Since the goal in calculating the value of a business is to opine how much a hypothetical buyer would pay to benefit from the future cash flow of LB, we utilized information from the market that showed us what return a typical investor could expect when investing in the market on the safest investment (long-term treasury bond). We added to that rate the additional perceived risk when investing in a large publicly traded stock and the additional return premium expected when investing in a small publicly traded company and the additional risk associated with the specific industry in which LB operates which are statistics found in Ibbotson Associates, Duff& Phillips LLC Risk Premium Report 2015. In view of the fact that investing in a small privately-held business is far riskier than investing in a long-term treasury bond or in a large or publicly traded business, small privately-held companies must also be adjusted for the specific industry risks that are likely to be confronted before a buyer would be willing to part with his hard earned money on a purchase. The consensus of accountants who endorse this valuation methodology believe a buyer would want a return far greater than what he could earn in a market-based investment. That is where the company's specific risk premium comes in to play.

Q: How is the specific company risk premium percentage determined?

A: From everywhere, at least potentially. In determining the percentage associated with a specific company risk, a valuator is to look at company specific factors, such as, the ferocity of the competition, imminent taxation and regulatory changes, relevant technological developments, among many other factors that might alter the risks that impact the confidence of our projections about LB's future cash-flow.

Q: Is there an authoritative set of accounting or business guidelines that provides us a chart for the specific company risk premium you used for LB?

A: Actually 'no'. Common usage of this statistic ranges from a low of 10%, where the perceived risks are low, and 1%, where the business looks like it is about to go out of business.

Q: If I understand your Report, the first four factors in the Build-Up of LB's value remained relatively constant while the company specific risk premium doubled in the two years this action has been pending, correct?

A. Yes.

C. Specific Industry Risk

What comes next is the guts of your argument, depending on which side of the caption you are representing. Because no rule book exists for determining the company's specific risk premium, it is attorney advocacy in the same brand as the conflicting advocacy that takes place in personal injury cases on the issue of damages, but here the jury is the judge. Perhaps the issue should be properly decided by a jury, given the enormous difference a judge's calculation to the company specific risk premium may have on the value attributed to the business. But this is not the only area of valuation where the court is asked to analyze conflicting financial data and statistics in applying the Income approach , as the questioning below reflects.

Q: Let me digress for a moment and return to your calculation of the central figure in the valuation equation, the net free cash flow of the business, also referred to as the return on the owner's investment in the business each year. How do you justify your decision to ignore two of the past five year's tax returns in calculating the average net income figure that you used in your valuation equation?

A: Based on my experience. Which is the same reason why I weighted the three years I did consider differently, given that I felt that the earnings generated in the last year deserved the greatest weight in comparison to the earnings generated four years ago, which was the year LB opened its second location. The earnings from five years ago were disregarded because only one store existed then and the earnings from two years ago were of limited value because one third of LB's main store was destroyed by Sandy.

Q: Revenue Ruling 59-60 states that a valuator should look at the five years that precede the date of valuation, does it not?

A: Revenue Ruling 59-60 was written in 1959. Our economy is changing far more rapidly than it did back then. In any event, Revenue Ruling 59-60 should be viewed as a helpful guide but not as a set of valuation commandments.

Q: What was the percentage you attributed to LB's company specific risk and how was it calculated?

A: 5%. My thought was that LB is experiencing a change in their business model whereby they are moving away from brick and mortar stores to a more internet based platform. The future of LB will be dependent on their ability to adapt and change. Their historical cash flow is just that historical. In predicting whether LB will realize that level of profit in the future will be dependent on their ability to

change I have assigned a risk factor that I believe is sufficient to account for the uncertainty about LB's future profitability.

11. Attorney Advocacy

As the above exchange reflects, valuing a small business is far more an art than a science. Too many attorneys think that a valuation is nothing more than an accounting assignment. To the contrary, valuation is a thinking assignment that has elements of accounting to consider, but has logic, common sense, and an exacting business climate scrutiny as its driving force. The best business valuation is the product of a Socratic-based collaboration with your client, together with an appreciation of his company specific risks and the utilization of your expert accountant to chart out LB's financials and act as a conduit for the valuation perspective that favors your client and that can be intelligently justified.

In the end, it is the attorney's obligation at the very outset of a case to determine whether a business lends itself to a logical, measurable or tangible business risk that can be leveraged into an appreciably different and more favorable company specific risk percentage. In those niche business valuation situations, an attorney armed with the most persuasive argument on how the specific industry risk factor should be determined has the advantage. What needs to be appreciated is the fact that in some situations valuation is the greatest form of advocacy. Where the valuation range is substantial the company specific risk premium should properly be a battle of experts no less than the battles opposing expert physicians engage in medical malpractice actions. Like a jury in a medical malpractice case, in cases where a complex business valuation is at issue, a trial judge is positioned to make a multi-million dollar decision favoring one party or the other that has only limited appellate review. That is an extraordinary responsibility to impose on a jurist. And that is an extraordinary risk to be taken by a litigant wary of a judge's hidden predisposition on the valuation issue.

12. Wait and See

A better way of managing the distribution of the value of a niche or unpredictable business is through a classic earn out approach, often utilized when the future prospects of a business are murky. In those cases where the parties are confident in the legitimacy of the financial documents and tax returns of the business but nervous about what the future may hold, rather than selecting a value derived from a valuator, it would behoove litigants to adopt a wait and see approach that ties the value to be equitably shared to the actual performance of the business. Unfortunately, a wait and see approach in matrimonials has yet to catch on like it has in most private business sales. If divorcing spouses could only learn to trust one another based on the business oversight safeguards set up by their attorneys, the anxiety connected with having a lone jurist speculatively decide their financial fate could be dramatically lifted.