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It's All About the Multiples

By Peter Galasso

I recently appeared before an esteemed Suffolk County Supreme Court Justice to whom my client's divorce action had been transferred. He immediately noticed that the original judge's file reflected that the parties had not designated a "neutral" to value my client's interest in a privately held business that he and his two partners had established about six years prior to commencement. With a tinge of condescension, the judge inquired about why the parties would choose to pay two accountants when only one was needed. I respectfully confessed that it was my idea. Based on the court's tone, I naturally felt slightly rebuked for unnecessarily complicating the case and for wastefully enriching the accounting community. I then obsequiously asked the judge whether he thought every forensic accountant was in valuation lock step or whether he felt that it was ever appropriate for an attorney to decline to stipulate to the appointment of a neutral. The court then looked at me curiously. Seeing an opening, I explained my rule of thumb. Succinctly stated, the decision to utilize one's own expert over stipulating to the appointment of a neutral was all about the multiples.


Peter Galasso

In the absence of discovering data regarding the sale of a small business that is truly comparable to your client's business, most businesses are in large part valued by multiplying the company's historical EBITDA — Earnings Before Interest, Taxes, Depreciation, and Amortization — by an often arbitrary multiple that a forensic accountant opines. This two-part valuation methodology is relatively easy to apply. Virtually any accountant can calculate the EBITDA of a business, plus or minus minor differences over whether the business owner mischaracterized his personal expenses as legitimate business expenses. In the end, but for those matrimonial practitioners who never opt for compromise, we all eventually agree that paying for your daughter's Sweet Sixteen party through the business is probably not a proper business deduction and should be added to the EBITDA. In the end, determining the EBITDA to be used in valuing a small business usually does not instigate much debate.

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Agreeing on the second component, i.e. the multiple, is the tricky part. And that is why divorce attorneys representing business owners are best advised to urge that your client finance an inexpensive "down and dirty" valuation before a Preliminary Conference is held. If you fail to secure appropriate insight about whether alternative methodologies exist for valuing your client's business, you cannot intelligently assess the risks connected with stipulating to the appointment of a neutral.

In valuing small to medium-sized privately held niche companies, forensic accountants frequently find little help online because transactions involving publicly traded corporations, where financial data readily exists, may be relevant to the hypothetical sale of a billion-dollar company, but is completely inapplicable to the sale of a business that generates $10 million in annual revenue. In determining a proper multiple by resorting to the market approach, it is axiomatic that the size of the comparable matters. Alternatively, experts will turn to other business information gathering sources that provide the same dubious guidance.

For example, in a recent case I tried in Westchester, one of the experts turned to Centerview Partners, an independent investment banking and advisory firm, for statistical data on the multiples being applied "on average" in determining the value of like-minded companies that purportedly resembled our client's business. Had my adversary's accountant been appointed as a neutral in that case, the judge would have likely run with his statistical average approach, which our expert persuasively contended at trial was way too high given the unique business challenges our client faced that negated industry averages as a reliable valuation tool. Rejecting the generalized data of Centerview Partners as irrelevant in determining the value of our client's business, our expert turned to the Godfather of valuation, Shannon Pratt,[1] in defending his methodology for selecting a multiple that he had dutifully discounted in accordance with Ms. Pratt's methodology. Two very different methodologies that produced two dramatically different values.

Had we committed at the outset to a neutral that adopted a methodology that inflated the value of my client's minority interest by relying on industry data that was arguably disconnected from our client's company's historical data and infrastructure, a subsequently engaged expert would have necessarily placed second behind whatever the neutral opined, even if our valuation argument made more accounting sense. Without a dog in the fight, the expert opinion of a neutral is all too frequently reactively viewed by the judge to be more credible and, therefore, more accurate, than the opinion of an expert whose testimony is potentially clouded by the client's willingness to pay him to testify.

To avoid being second-guessed about why you consented to the appointment of a neutral whose later opined a value that caused your client to go into cardiac arrest, the right answer to the court's question at a Preliminary Conference regarding whether to stipulate to the appointment of a neutral is "it depends." If the "down and dirty" opinion you obtain before the PC reveals that the range of values reasonably applicable to your client's business interest is relatively wide, you must decline to surrender your client's best interests by agreeing to the appointment of a random neutral on the court's forensic expert short list, who you later learn views the future of your client's business through rose colored glasses.

In representing the business-owner spouse, the last thing you would want to do is agree on a neutral who later opines an unrealistically high multiple. As all seasoned matrimonial practitioners know, disabusing the court from adopting the neutral's opinion under such circumstances over the valuator you retain after being advised of the neutral's overly optimistic multiple will be near impossible. That's why an attorney's bold decision to oppose the appointment of a neutral may be the most important decision rendered on a client's behalf. Just remember, it's all about the multiples.

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[1] See Valuing a Business, 5th Edition: the Analysis and Appraisal of Closely Held Companies by Shannon Pratt