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Appraising the Value of a Small Business in a Divorce

By Jason V. Owens | September 12, 2019

Divorce

Attorney Jason V. Owens reviews valuing business interests for the division of assets in divorce cases.

Determining the value of a small business in a divorce case is among the most complex tasks that family law attorneys face. Accurately calculating the value of a company for the division of assets often requires the use of a CPA, as well as access to the company's financial records including tax returns, bookkeeping files, and records pertaining to inventory, assets, cash flow and debts. Even if a CPA is formally retained as an expert to value the business, however, the knowledge and experience of a party's divorce attorney can be critically in cases involving small business valuations.

In my experience, divorcing spouses are consistently surprised by the value assigned to a spouse's business interest in the divorce context. Even sole proprietorships, for which the self-employed spouse is the company's only employee, are frequently found to have *some* value in the division of assets context. Similarly, courts frequently assign significant values to a spouse's minority interest in a small business or partnership, even if the spouse would struggle to sell his or her partial interest on the open market.

The analytical models used by valuation experts to assign a value to a business can be complex. Below, we review the main valuation methodologies, as well as a few "rules of thumb" that attorneys use to estimate a “quick and dirty” value for a business based on limited information. You may want to skip around this blog to find the information you are looking for, since we cover a lot of ground.

The Three Business Valuation Methods: Income, Asset and Market Approaches

There are three principal business valuation methodologies used by most CPAs and/or business valuation experts. The first is the “income approach”, which uses the company’s anticipated future profits and/or cash flow to calculate a current value. Although this method is complex, it is the approach preferred by investors who are deciding whether to purchase a business. Next is the “market approach”, which seeks to value the business based on comparable sales of similar businesses within the same geographic region and time frame. The market approach works extremely well when good comparable business sales are available; however, finding strong comparables is often challenging. Last is the “asset approach”, which is most often used if the first two methods fail to generate a value, if the business is struggling to generate a profit, or if the company holds substantially valuable assets, such as heavy equipment, real estate or unsold inventory.

We explore each of the three business valuation approaches in more detail below.

The Income Approach to Business Valuation

If you took a survey of divorce attorneys, many would answer that the income approach to value a business is the single most complex analytical issue that we face under the law. It also happens to be the most favored method of valuing modern businesses.

Within the income approach, there are two methodologies used by valuators, and each is complex in its own right. Each income approach methodology uses the company’s past business performance (net profits or cash flow) to estimate the future earnings of the business. The projected future income of the business is then used to calculate its present value.

The capitalization of earnings approach is generally used for stable companies that generate (or are expected to generate) relatively steady earnings in the future, with slow and stable growth. This valuation approach is relatively simple, at least compared to its more complex cousin, the discounting of cash flow method.

The discounting of cash flow method is used for companies with future earnings that are expected to fluctuate. The cash flow method also uses past performance to project future income of the company. However, the valuator incorporates “discounts” into the analysis based on investor risks. The valuator accomplishes this by modifying his or her capitalization equation based on the debt and equity held by the company. (A good example might be a company that has substantial debt, and where the company’s net income has fluctuated by jumping and falling in recent years. An investor buying such a company must be concerned about covering the company’s debts if the business has a down year. The discounting of cash flow method of valuation discounts the value of the business based on the potential risks to the new buyer.)

Each “income approach” depends on the valuator being able to calculate cash flow and sustainable earnings. For small businesses in which the owner acts as CEO or manager of the business, calculating “cash flow” usually means applying a discount that deducts the owner’s reasonable salary from the company’s cash flow, leaving only “profit” for the calculation of future value.

Even experienced family law attorneys struggle with the accounting concepts embodied by the income approach methodologies of valuation.

The Market Approach to Business Valuation

If a business is likely to be sold in the near future, many business valuators will be attracted to the market approach to valuation. The market approach works a lot like a real estate appraisal. The valuator analyses the business, then compares the company to similar businesses in the region that have recently sold. The market approach is particularly useful for franchise businesses, like Dunkin Donuts stores, where the valuator has a large volume of similar businesses to compare the company to.

The market approach is not as simple as it might seem, however. In order to compare the company to similar businesses sold in comparable market conditions, the valuator must determine the profitability of the business. Depending on the business, it may be possible to establish comparables based on fairly simple criteria such as gross sales. For other businesses, however, the valuator will need to use many of the same methods used in the income approach to calculate cash flow and income.

In order for the market approach to work, the valuator must be able to locate (a.) recent sales of (b.) companies from within the same industry with (c.)

similar earnings within (d.) the same geographic region. Again, if you are talking about a Dunkin Donuts in the metro Boston area, the market approach will probably work. The market approach also tends to work well for companies that are being sold, or are about to be sold, since the availability of a willing buyer is a real-world concern in such cases, instead of a mere projection conjured up by the valuator.

In the end, valuators often decline to apply the market approach due to difficulties establishing comparable sales. The need to match industries, recent local sales and businesses with similar profitability is simply asking too much in many cases.

The Asset Approach to Business Valuation

The third approach to business valuation is the adjusted net asset method, or simply the “asset approach”. As one might imagine, the asset approach focuses on recognizing the difference between the fair market value of the assets and its liabilities. The asset approach is most often used in the following scenarios:

- When the valuator is unable to generate a value using the income approach, which most often occurs when the company generates insufficient current income or cash flow to capitalize into a future value.
- When the valuator is unable to generate a value using the market approach, which occurs because the valuator is unable to establish comparable sales.
- When the value of the business’s assets simply exceed the values projected by the income or market approaches.

In general, the asset approach is best suited for (a.) companies that are struggling to earn profits or (b.) companies that own a large fleet of equipment, real estate or an expensive inventory of assets. Of course, generating a value using the asset method is only possible if the company’s assets are worth more than its debts.

Although the income or market approaches are generally favored for valuating business interests in the context of the divorce, the Massachusetts Appeals Court held that the adjusted net asset method was an appropriate alternative approach when other valuation methods were not applicable in its decision in Caveney v. Caveney (2012).

Business Valuation "Discounts": Bernier v. Bernier (2007)

In 2007, the Massachusetts Supreme Judicial Court (SJC) announced its landmark decision in Bernier v. Bernier (2007). Since becoming law, Bernier has taken on an almost legendary status among Massachusetts divorce practitioners due to the complex subject matter covered in the case. For divorce practitioners who are familiar with the above business valuation methodologies, however, the main holding of Bernier is deceptively simple.

Put simply, the main holding in Bernier prohibits valuators from applying certain "discounts" when valuing a company that the business owner does not intend to sell anytime soon. Such businesses are known as "ongoing concerns", and for decades, business appraisers who have valued such businesses have decreased the value of such companies based on "discount", including:

- **Minority discount** – A minority discount applies when a business owner holds a minority share in business. Minority shareholders often lack the right to demand a sale of company, thereby forcing the shareholder to sell his or her interest back to the business at a discounted rate. In Bernier, the SJC held that valuators should not apply minority discounts when valuing a spouse's interest in a business in a divorce.

- **Marketability discount** – A marketability discount is similar to a minority discount, but can also apply to majority shareholders in a small business or partnership. Unlike publicly traded companies, for which shareholders can easily sell their shares, shareholders in small and closely held businesses cannot easily sell their individual shares in a business on the open market. Even if the shareholder has the right to sell his or her shares to an outside buyer, the value of the shareholder's interest is likely to be substantially less than the amount the shareholder would receive if the entire business were sold. In Bernier, the SJC held that valuators should not apply minority discounts when valuing a spouse's business interest in a divorce. In Bernier, the SJC held that valuators should not apply marketability discounts when valuing a spouse's interest in a business in a divorce.

- **Key man discount** – A "key man" discount is applied when the business owner is so crucially important to a company's success that value of the business would be reduced if it were sold. Key man discounts are most applicable when valuing small businesses in the trades, like plumbers and contractors, as well as small medical, dental and legal practices. (For example, if a pluming company is called "Al Johnson Plumbing", and the owner, Al Johnson, sells his business, one can assume that some of the customers might leave.) In Bernier, the SJC held that valuators should not apply marketability discounts when valuing a spouse's interest in a business in a divorce, if the business will not be sold in the near future. (The Court left open the possibility that a key man discount may be appropriate if the owner plans on selling the business relatively soon.)

In addition to prohibiting these discounts, Bernier also held that valuators should not discount business values for S corporations or partnerships using the (higher) tax rate for C corporations, and held that valuators applying the income method should generally include some level of continuous growth into his calculation unless there is clear evidence suggesting the company will not grow in the future. Notably, the Appeals Court applied many of the new lessons articulated in Bernier to valuations using the "asset approach" in Caveney v. Caveney (2011).

For business owning spouses, the Bernier decision is frustrating, since there *really are* barriers to selling shares in a small business on the open market, and a key man discount is likely to affect the sale price of a business, if and when it is finally sold. By restricting these discounts, Bernier unquestionably increased the values assigned to business assets in divorce cases.

Business Reference Guide (BRG): Rules of Thumb for Estimating Business Value

Before diving headlong into a full-blown business valuation, attorneys and CPAs may use rules of thumb suggested by the highly respected Business Reference Guide (BRG) to calculate a rough estimate of a company's value. The BRG is widely considered an industry standard for business valuations. (As of the date this blog was originally published, a subscription to the online version of the BRG is $23/month.) The BRG provides business transaction professionals with up-to-date rules of thumb and pricing information for 700+ types of businesses.

For example, for a construction-excavation company, the BRG rules of thumb for estimating enterprise values are as follows:

- 25% of sales plus inventory – If a construction company averages $1 million in gross sales and has $250,000 in inventory, the estimated value of the company would be $500,000.

- 200% x times EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization) – If the construction company's tax return shows gross earnings of $500K before deductions for taxes, depreciation or amortization are applied, the estimated value of the company would be $500,000.

The BRG's rules of thumb are not perfect or precise, but they are a highly effective means of determining whether a business is likely to have significant value in the division of assets context. Moreover, the BRG rules of thumb also allow attorneys and litigants to quickly estimate the business's value using limited documents, such as a single tax return or profit and loss statement. BRG estimates are no substitute for a full business valuation, but they are often a great way to start the investigation process in divorce cases involving a spouse-owned business interest.

Hiring a Business Appraiser and/or Business Valuation Expert

Lawyers can do a lot of things in a divorce case. What we can't do, however, is offer testimony – much less *expert* testimony – on behalf of our clients. In order to offer an opinion of value for a particular asset, a witness must be admitted by the court as an expert. This means the witness must have training, education and/or background in the area in which he or she intends to offer testimony. In the business valuation context, such testimony must generally come from a business appraiser or valuator (note: "appraiser" and "valuator" are often used somewhat interchangeably for these experts.)

As a trial attorney, I have yet to encounter a judge who did not demand expert testimony in a case involving a business valuation. The judge is often the first to admit that he or she is going to struggle to calculate the value of a business based solely on documents like tax returns and QuickBooks files. Few (if any) Probate and Family Court judges have an accounting background and asking a judge to determine the value of a business based solely on financial records like tax returns is very risky indeed.

Many business appraisers/valuators are CPAs whose backgrounds are not limited to offering expert testimony in court cases. Most of these experts also value businesses outside of the courtroom, such as valuations performed on behalf of investors who are determining whether or not to acquire an existing business, or for business owners exploring a sale or seeking loans or financing.

Performing a full-blown valuation is a big job. It often requires interviews with management, reviewing thousands of pages of documents, extensive analysis, and keeping a sharp eye out for inaccurate bookkeeping entries. The job may also include appraising the value of real estate or equipment, which may require the CPA to subcontract with other appraisers. A valuator's written report can easily exceed 50 pages, and experts are frequently deposed and/or asked to testify at trial.

The cost of a valuator in a significant divorce case can easily exceed $50,000. Even relatively simple valuations often exceed $25,000. However, experienced divorce attorneys can sometimes arrange for experts to conduct their analysis in stages, with smaller outlays of cash for a more limited report, which can be expanded later if necessary. Of course, these price tags are easily justified if the expert's opinion impacts the division of assets by hundreds of thousands (or even millions) of dollars.

The Divorce Attorney's Role in the Valuation Process

Although the divorce lawyer does not perform the business valuation directly, it is important for the attorney to have a detailed understanding of the valuation process for several reasons. First, an attorney's understanding of business valuation is incredibly important to answering crucial threshold questions early in the divorce process, such as:

- Does this business have significant value?
- Can a preliminary value be calculated using a rule of thumb?
- Is a business valuation expert necessary?

- How much will an expert cost, and who is most qualified for the job?

Equally important, an attorney's knowledge of business valuation is a crucial part of conducting discovery to obtain important business records, guiding and directing the client's expert witness, and critiquing the opinion of the other party's valuation expert. Most "meat and potatoes" divorce cases involve a custody and support order and the division of marital home and some retirement accounts. An attorney who knows his or her strengths can make a good living sticking to these straight-forward cases – while avoiding more complex cases that involve difficult math, business analysis, CPAs and dueling expert opinions. If your case involves valuing a business, you should seriously consider finding an attorney with experience in more complex elements of divorce litigation.

Calculating Self-Employment Income for Child Support and Alimony Purposes

Last but not least, I wanted to add a word about business income and support orders. Some of the most frustrating cases encountered by divorce practitioners involve disputes over calculating a small business owner's income for the purposes of child support and alimony. It is no mystery that small businesses offer a wide variety of opportunities for owners to write off personal expenses and conceal taxable income in ways that fly below the radar of tax authorities like the IRS and Massachusetts DOR.

The uncertainty surrounding self-employment income creates challenges for both the business-owning and non-business-owning spouse. Business owning spouses often face far greater scrutiny over their income than, for example, a W2 employee with similar earnings. Meanwhile, the party who does not own the business frequently suspects that the business owner is underreporting his or her income, both to pay less taxes and to gain an advantage in the alimony or child support determination.

In 2011, I wrote a comprehensive law review note for the Suffolk Journal of Trial & Appellate Advocacy entitled Determining Self-Employment Income for Child Support Purposes: the Massachusetts View Compared with the National View. Although nearly a decade has passed since my note was published, surprisingly little changes have occurred in the law surrounding self-employment income and support payments in Massachusetts.

Simply put, the subject of calculating self-employment income for child support or alimony purposes deserves its own blog. Although similar in a few key ways, there are major differences between valuing a business for division of assets purposes and analyzing the business owner's income in the support context. If readers would like me to write a blog that condenses and updates my 2011 note, shoot me an email and let me know.

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