Valuation Issues In Divorce

By Robert E. Kleeman, Jr., CPA/ABV, ASA, CVA

OnPointe Financial Valuation Group, LLC
An Affiliate Firm with OnPointeValuation, LLC
8310 South Valley Highway, 3rd Floor
Englewood, CO 80112

bobkleeman@onpointevaluation.com

(303) 771-8100

www.OnPointeValuation.com

ONPOINTE VALUATION, LLC

Introduction

The large asset marital dissolution case presents a number of important valuation issues that may or may not exist in the smaller case. Because of these issues, the attorney needs to have a better understanding of these valuation issues, and must be comfortable that the valuation professional has the experience and expertise to fully develop the issues and to communicate these complex issues to the Court.

I am defining the large asset case as one that includes closely held business interests in excess of $2,000,000 in fair market value. The problem with this definition is that rarely is the closely held business interests shown in the personal financial statement with "fair market value", but rather have some sort of historic valuation number. Simply put, this is true because individuals that have asset values of this magnitude do not need to provide a "fair market value" for any purposes. These individuals are wealthy!

Where the parties' wealth is in publicly traded securities, or other similar assets, the valuation issues may be limited. However, the attorney should never lose sight of the fact that even thought the entity is publicly traded; the ownership interests (including options, etc.) of the parties may have a different value that the value shown in the daily trading information of the underlying stock.

In this article, we will focus on several of the key issues that tend to be found in large asset cases. These issues include:

- The complexity of the financial structure of the entities.
- Valuation methodologies to be used.
- Appropriate application of discounts and/or premiums.
- Key person issues.
- Is there a standard of value issue?

Our goal is to provide an exchange of ideas on these issues. Reasonably competent business valuation professionals can disagree on some of the analysis and risk factors. However, if we understand and can reconcile the disagreements, we can provide the Court with real issues than can be decided.

Do More Commas in the Value Equate to More Problems in the Valuation?

On the surface, the short answer is NO! Larger cases usually involve a more sophisticated operating entity. Financial information is usually more complete, and the company may have executives that are not part of the family dispute. Industry data, and guideline company information is usually better, and more easily compared to the subject company's data. However, that being said, there are many issues in the larger valuation that can lead to problems for both the valuation professional as well as the attorney managing the case.

From a practical view, the larger case needs a more sophisticated valuation expert. Rarely are the so called "formula approaches" appropriate to the larger valuation. Although we might have better financial information that information is usually much more sophisticated and needs greater analysis to fully understand the operations of the entity. There may be more "perks" or other benefits available to the business owner that are not available in the smaller company. Larger business interests are more subject to the future growth and operations of the entity. The need for capital to grow these entities must be identified and taken into consideration in determining the current "fair market value" to the holder of the security.

The larger marital dissolution also requires greater involvement in the valuation process by the attorney. Because the issues are more complex, there will be issues relating to discovery that are out or the norm. Additionally, because the valuation will be more complex, it will be necessary for the attorney to become much more familiar with the valuation experts methodologies.

The following are some of the issues that must be addressed when dealing with the larger valuation matter.

- <u>The Complexity of the Financial Structure of the Business may require different approaches to the valuation</u>. – It is not uncommon in larger businesses to find multiple classes of stock (common and preferred) and in some cases, so called "phantom stock" issues for non-family, key executives in the organization. The business may not be solely owned by the parties to the divorce, other non-parties may own substantial blocks of stock. Where multiple classes of stock exist, not only must the business be valued, but also each of the classes of stock must be separately valued.

- The divorcing parties might not own controlling interest in the entity, with non-family owners involved, and detailed financial information may not be readily available. – This is not an uncommon issue in large asset dissolutions. Where financial data is not available for the operating entity, the valuation professional may have to use a valuation methodology that values the minority shares without performing a valuation of the operating entity. Where the operating entity is distributing economic benefits to the shareholder, this is easier than when the operating entity is not distributing, or is retaining significant economic benefits at the corporate level.

- The entity may be closely held by a family unit, but the divorcing party may be a minority owner – This can raise interesting discovery issues. Can the divorcing party gain access to the financial information? Has the divorcing party in the past received this same or similar information? The valuation professional operating under this scenario will need to provide some addition investigative services to be certain that the information being used in the valuation is appropriate regarding historical data.

- The valuation methodology will usually be fairly sophisticated and require greater analysis. – It should be obvious, but the Excess Earnings Method is not normally an appropriate method for valuing a larger company. As described by the IRS, the excess earnings method is a method of last resort, used only when no better methodology is available. On large cases, I cannot imagine a matter where no better methodology would be available, and hence Excess Earnings would be appropriate.

Valuation Methodologies in the Large Case

Normally, large case valuations are driven by one or more of the following methodologies. Each one of these methods will be discussed briefly.

- Discounted Future Cash Flow – This is the theoretically best method of valuing an entity. The difficulty of this method is having the company prepare operating projections that truly reflect the expected future economic benefits available to the appropriate shareholder. If the entity being valued is expected to have high growth, or inconsistent earnings, this method is one of the better indicators of the actual value of the entity. However, where reasonable projections are available, the valuation professional should consider using this method.

Where the entity is a sophisticated company, the valuation professional needs to measure prior projections with the actual operating results of the entity to determine the ability of management to accurately project future benefits. This is a key part of the DCF methodology. It is imperative that the valuation professional take into consideration the degree of accuracy and precision which management has displayed relative to providing information regarding future expected cash flows. The DCF method is only as good as the underlying inputs. It is critical that the forecast be believable and reflects both the historical as well as the future of the business.

Caveat – Many jurisdictions do not allow for the DCF method to be used because they feel that the future efforts of the divorcing party are no part of the current value.

- Capitalization of Earnings – This method should be considered on most valuations. The only caveat regarding this methodology is that "the historical benefits must be a proxy for the expected future benefits." Where historical benefits are not a proxy for the expected future benefits, this method will not provide a reliable indicator of the value of the holdings. If the company being valued is not mature and providing stable earnings, the Cap of Earnings method may not capture the real value of the entity.

- Guideline Company Method – Where the company being valued is large and in an industry that has meaningful information available, the valuation professional certainly should consider the use of this methodology.   However, when using the guideline methodology, the valuation professional must determine the impact of the "beta" and other company specific factors as they relate to the company being valued.

Discounts and/or Premiums: Real or Imaginary?

One of my pet peeves when it comes to the application of discounts or premiums to a valuation conclusion is that after 20 pages of analysis of the financial issues surrounding the entity, discussions of the economy and the future, the valuation professional reduces the value of the business from 30% - 50% by applying a single paragraph that states that the valuator believes a discount for marketability and minority should be applied.

Before we can begin a meaningful dialogue regarding whether discounts or premiums are or not appropriate when valuing a business, we need to first discuss and understand the concept of "levels of value". Generally, there are four recognized "levels of value". These are:

- Synergistic or Strategic Value – this is a value that is not normally part of a "fair market value analysis, because by definition, this value is specific to a buyer, and therefore is outside the accepted definition of fair market value. This is usually considered to be the highest value of an entity.

- Control Value – as the name implies, this is the value of a 100% ownership block of stock in the entity. The block does not have to be held by one individual, but the assumption is that the block can and will be traded as a single unit.

- Minority / Marketable Value – this is the value of a minority (less than 50.1%) block of stock. This level of value assumes that the block of stock is freely traded as if it were publicly traded stock.

- Minority / Non-Marketable – this is the value of a minority block of stock that cannot readily be traded. In most large asset valuations, this is the type of stock that we are valuing.

  The "level of value" concept, simply put, is that certain valuation methodologies provide an indication of value at a stated entry level. Since certain methods assume a stated level of value, our application of discounts and/or premiums will always be driven by the entry level of value indicated by the methodology. (i.e. if we use a methodology that results in a minority / marketable level of value, it would be inappropriate to take a minority discount from that level of value).

One of the most common mistakes found in any valuation is the use of a valuation methodology that assumes a certain "level of value", and then misapplying a discount or premium because the "level of value" already implicitly contains that assumption.

For most situations, there are two potential discounts/premiums that are expected.

- Minority / Control Issues – It is a well established business valuation principal that a minority interest in an entity is worth less than a controlling interest in that same entity. Control can offer the interest holder greater access to the success of the entity. The question really becomes, what is minority and what is control?

  Clearly a 100% ownership interest in the equity of an entity is absolute control. However, there are many levels of effective control. An individual that owns a large enough block of stock to effectuate liquidation or other corporate actions based on state law may have a large element of control. In some instances, 50% + 1 share might be enough to have effective control of the organization.

  In larger matters, it is not uncommon to have multiple classes of stock. These various classes of stock may have significantly different voting rights, and the "control" of the entity might not have any relationship to the number of shares owned, but rather by the number of votes that are controlled by the stock interest being reviewed.

  Finally, the valuator must look at the effective control of the entity. There may be indications of control of voting blocks less than 50%. Situations could include a large minority block, with the remaining shares held in very small blocks by a large number of individuals. In that case, it may only be necessary for the large block holder to get one or two individuals to vote with the large block in order to obtain control.

  The Minority Discount is **<u>NOT</u>** normally 35%. This has become a self-fulfilling prophecy. Every time 35% is used, it just supports the erroneous thought that 35% is the average. The Minority discount should be carefully reviewed by the valuation expert to reflect the reality of the marketplace. The size of the block being valued will impact the application of the minority discount. In short, a 1% block normally has a greater minority discount than a 40% block. The valuation report should clearly discuss the factors that support the discount taken in the valuation.

- The Swing Vote Issue – In some instances, there may be a minority block that has greater value than the same percentage ownership in another entity. For instance, let us assume that there are three shareholders in an entity. 2 of the shareholders each own 49%, and the 3rd shareholder owns the remaining 2%. If the two 49% holders are friendly and in agreement as to how the company is to be run, and how the benefits of the company are distributed, the 2% ownership interest would probably carry a very large minority discount. However, if the two 49% holders are largely in disagreement, the value of the 2% block increases significantly because the addition of that 2% block by either of the 49% owners gives that owner control. These issues need to be reviewed where we are valuing a small minority interest.

- Marketability Discounts – Some commentators have opined that a 100% interest in an entity would not be subject to any marketability discount, however most of the business valuation community does not agree with that position. The Marketability discount is nothing more than recognition of the present value of money. It is based on the premise that if we own shares in a publicly traded entity, we can offer the shares for sale today, and have our cash within 5 business days. As anyone who has ever worked with a client to sell an interest in a closely held business, there clearly is a time period between the time the business owner puts the ownership interest up for sale, and the time that the business owner receives the cash proceeds from that sale. The Marketablity discount needs to identify and quantify this time value of the proceeds. Clearly, the smaller the block of stock being offered for sale, the longer that the potential period of finding a buyer, consummating the sale, and receiving the proceeds may be.

  The issue of buy-sell agreements and other agreements needs to be addressed at the same time that the Marketability discount is determined. Buy / Sell agreements do not necessarily negate a marketability discount. Unless the holder of the security has a "put" right (and the company has the where with all to purchase), the Buy /Sell agreement has little value relative to the marketability discount.

  Rights of first refusal to purchase the stock also have an impact on the marketability of the security. Most commentators will tell you that a right of first refusal has a chilling impact on the marketability of the security. As we deal with larger entities, potential buyers do not want to become involved in the due diligence process where the entity has a right of first refusal.

Key Person Issues

We have all heard the statement "I am the business, without me, there would be no business". While this may be true in very small, service based businesses, as the business gets larger, this issue becomes less important. Yet at the same time, even in very large businesses, an owner may have a very material impact on the business. This is a fact and circumstances based decision. It is incumbent on the valuation professional to completely explore the impact of the business owner on the business, and the ability of the business to replace that owner / executive.

Most business valuation professionals believe that the impact of a key person should not be addressed through the use of a separate discount, but should be addressed in the capitalization rate through the specific company risk factors. It is important that you as the attorney understand how the impact of a key person is addressed in the valuation, and that you are comfortable with the analysis of that impact.

Compensation Issues

This issue goes hand in hand with key person issues. We all have seen the valuation report where the compensation of the owner/spouse has been adjusted for purposes of determining the "fair market value" of the entity. Then subsequently, for purposes of determining maintenance and/or child support, the actual salary of the individual is used. This clearly is a case of double dipping. In the large case, this can be a significant issue. At the same time, we look at what corporate executives in large publicly traded entities are earning today, and we need to ask if the compensation of the equity owner is appropriate in light of compensation of that same person in another entity. This is not a simple issue.

In the larger case, compensation is usually a major part of the business valuation, and the inappropriate analysis of this issue can result in millions of dollars of value being created or destroyed. We have all seen cases where the compensation of the equity holders is reasonable in light of the duties performed relative to other individuals holding similar positions in publicly traded entities. Yet at the same time, there are equity holders that take large amounts of compensation in lieu of dividends in the entity. The equity holder may not be providing any meaningful services to the entity.

Compensation issues are a significant item in the large case. These issues need to be carefully reviewed not only by the business valuation professional, but also need to be addressed with the attorney and the client.

Robert E. Kleeman *is Managing Director of OnPointe Financial Valuation Group, LLC. His practice concentration includes business valuation and litigation support. In addition to be being a well-known speaker, he co-authored The Handbook for Divorce Valuations and has written several business valuation articles.*

bobkleeman@onpointevaluation.com
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