05/05/2020 Business Valuations

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Jake: Alright, so this week I think we want to talk about business valuations, which is an issue that comes up quite often in divorces when one spouse or both spouses together own a business. I want to start by talking about why we do the valuation in the first place, and why it's important in divorce that people figure out what the actual value of the business is, and why we need that as part of the property division.

So Brian, can you start by talking to us about what is the overall goal of getting an evaluation on the business and how that plays out the property division. Then we can kind of talk about the logistics of how that gets accomplished.

Brian: Sure. So when you're getting divorced, if you have community property, it needs to be divided. One of the questions besides "is it a community property?" is how much is it worth assuming that it is? Or it could be a little bit of both community and separate properties.

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So, it's not like a bank account that's got $2,500 in it where you can say, well, that's where $2,500 you've got to go and go and value it. Again, it's not for people who are saying "Hey, I own 5% of a publicly traded company." We can go to the stock exchange and see what that's worth on a given day. These are non-publicly traded companies and it can be difficult to value them.

Jake: Yeah. I was trying to remind people when we talk about value, essentially what we're doing is coming up with a spreadsheet. Anytime you think about a divorce and property division, try to think that at the end of the day, you're going to have a spreadsheet that has every single asset the family owns on it, all the way from the marital residence to cars, bank accounts like you were talking about Brian, all the way down to if the furniture has any value on it.

That's all on the spreadsheet. So, when you think about property division we're really just trying to build that spreadsheet.

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In these disputes this can sort of spur from tons of different aspects of the divorce, but the goals are to identify all the assets, to figure out the character of the property like you were saying, Brian, where there could be community or separate or mixed property and then figure out the value of them.

Whenever we put these on a spreadsheet, they must have values on them. Like you were saying, Brian, my chase account, I could see that the chase account has $10,000 net. There's a value. That's easy. The house, you get that appraised. There's a value on it. That's easy.

Now a business can be quite a bit more complicated, but it's going to have to have a value on it because we've got to remember that we're not going down with a carving knife and splitting every single asset half and half. Assets are being pushed onto different columns.

You know, if it's the wife's business and she's a doctor and she owns her own medical practice, the medical practice is gonna go in her column. It's not like the medical practice is going to be awarded to the husband. In fact, most buy, sell agreements would prohibit that.

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It's actually going to be awarded to the wife. Okay, then what's the value of it? We're going to have to compensate the other spouse for the value of it to achieve the division that we want. So that's why that's an important thing that we get an accurate value on it [the business].

It's interesting to me because me on property division one of the more interesting things that we do is talk about business valuations.

I don't know about Brian, but I've seen really good experts, be $10 - $20 million apart on the evaluation of our business. If you think about it for property division, when you're doing a 50/50 property division, and we're $10 million apart on a business valuation, that right there is a $5 million dispute.

So it really does matter and people sort of forget or I think don't pay enough attention to how big of an issue business valuations could be of a divorce. Brian, how often do you think you see business valuations come up in your divorces?

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Brian: Pretty regularly, and I think you really hit the nail on the head when you said if you're having a medical practice or part ownership of a business, even if you're the sole owner, it's almost certainly going to go to one of the parties either by agreement, or just practically speaking.

And so a lot of times when you have valuation disputes over, let's say a piece of real estate or something else like that, you kind of just say "Well, whoever thinks it's worth the most you get it." And so that's a disincentive to inflate the value. But if you know who's going to get it in advance, it sets you up for conflict right there.

So, a lot of times people that are otherwise pretty amicable with each other and are pretty reasonable with people can get into these conflicts over that issue. We see it as a common source of conflict, in cases in Houston, at least. I think it's the same in Austin.

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Jake: And of course our, our Dallas office sees, sees the same, you know, it's exactly what you're saying. You know, if I have a half a million dollar house and my spouse goes "well, I think it's worth a million." Oh, great. I'll give it to you on your spreadsheet, your side of the spreadsheet for $900,000, and that's the easiest way of dealing with that, but you're right.

It kind of at times puts us in a box where we have to have this fight about what it's worth, because you have a spouse we all know who's going to get the practice or the business. And I think I alluded to this a few minutes ago; a lot of times there's actual buy, sell agreements.

There's three partners in a business, they'll all sit there and they'll sign what's called a buy-sell agreement. And if they do it right, they'll actually have the spouses sign it. In a typical buy-sell agreement it says “Look in the event of the divorce the ownership in the business is going to maintain with the spouse whose name it's in.”

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In other words, if I've got two partners with me: me, Brian, and a friend of ours, call her Jessica. If Me, Brian, and Jessica, form a business together, me, Brian and Jessica don't want to be business partners with the other partner's soon to be ex-spouse. So it's typical for us to sign something that says you can't transfer these business interests and the divorce court can't can't do it.

Or if the divorce court does do it, it says that I have a right of first refusal to purchase it back at fair market value. So always sort of coming back to this, what's the valuation question? And I would like to just say that's a huge question.

So I think next, we want to sort of talk about the importance of hiring an expert because I think Brian, you and I understand business valuations. We deal with them all the time.

I can read them. I can interpret them. I can cross examine on them, but I'm not the one that's going to be valuing your business. It's not the divorce lawyers job. You wouldn't want me or Brian telling you your business is worth X. You go out and hire an expert witness to value the business.

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A lot of times I'm having the conversations with clients about why they have to go hire someone. Like, why can't I just get my CPA to do it? I got my buddy, I think he can value it? Or we have an internal formula that we use, so why do I need to hire an expert?

So what do you say? It's a fair question. I get why people ask that. But, what do you tell clients whenever you hear that question from them? When they are looking at having to pay a bill to hire an expert, witness expert CPA, to value their business?

Brian: The main reason is that the way you value a business in a divorce is different than you would do it in any other way.

You know if you're trying to take a company public, you're going to value it one way. If you're going to sell, like the example you had, if I want to sell my share of the business that I'm with you and Jessica, we would look at it one way, but when you're doing it in a divorce, it's a different set of rules.

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Therefore there's only a few people in the state that really understand that and are qualified to make those valuations and be able to defend them in a courtroom.

Jake: I think that last bit is the biggest part. Defending it in the courtroom is how to do it. That kind of leads into the discussion on what's what's unique to the divorce process and valuing a business.

The divorce process in Texas has what's called personal Goodwill. So, you know, back to this analogy where me, Brian and Jessica owned a business. It'd be typical if we're going to sell it to whoever the buyer is, they're going to require what's called a noncompete. Basically that says, "Brian, Jake, Jessica, I'm going to buy your business and I'm going to make you guys sign something that says you can't go across the street and compete with me doing frankly the same damn thing that you're doing right now." Otherwise why would they buy your business If you're just going to go compete with them?

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It's a typical thing in a business transaction in Texas, and not every single state's like this, but in Texas, the way we value businesses is we don't include the value of what's called personal Goodwill. This is what I, myself, bring to the business. You have to think about as if I'm selling this business and literally handing the buyer the keys and the metaphorical keys, you saying here's the business I'm going to cross the street and I'm going to compete with you because I'm taking me out of the business, the valuation, the personal Goodwill.

So that's why we have businesses like a law practice. It's the law office of, you know, a single lawyer, or dental practice. And it's just Dr. Johnson. He is the dental practice, that's basically it. Most of that value of that business is going to be the personal Goodwill, that individual, , as opposed to, you know, Walmart. With Walmart, you're not paying for any individual.

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I don't care who owns Walmart. I'm paying for the corporate Goodwill of the name, Walmart. And you know, if you have a CPA that doesn't understand that, or even worse, if you have a divorce lawyer that doesn't understand that issue in a divorce, you could have wildly different numbers come out.

If you've got a business that as an ongoing concern would be worth $10 million, but one expert puts an 80% personal Goodwill discount, all of a sudden you've gone from $10 million to $2 million. Well, then the other expert puts a 20% personal Goodwill discount, $10 million to $8 million. And right there, you've got a $6 million dispute just on what's the personal Goodwill of this business, how much of this business is attributable to the individual, the individual personal Goodwill, as opposed to the corporate Goodwill.

I guess that leads kind of into the last part of this topic. This, this is one of my favorite topics to talk about, Brian. I know you love this stuff. It's fascinating to us but now it kind of leads into the last thing I wanted to talk about which is the different valuation methodologies that they use.

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I think we talked about this on our website. We just brush on how it's done there. The experts obviously go much deeper than we do on our website and deeper than we do on the podcast. But, it's important for people to have a general understanding of how businesses are valued in a divorce, just so you can follow what the experts are doing and also understand the concept behind how you record these businesses.

There's lots of different nuances to it, but overall there's three main approaches to valuing a business. There's what's called the asset approach, the market approach and the income approach.

What we see most of all is the income approach, but, let’s talk briefly about the market approach and the asset approach. The market approach is if we have actual market analysis, so we can see a very similar business that's been sold on the market recently, then you could use that analysis to value the business.

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It's rare to see the market approach used. I don't think I've ever seen it used by any experts.

The asset approach is just if you were doing a business that's mostly personal Goodwill where it doesn't have an ongoing revenue stream as an ongoing concern. Then you may see the asset approach. And that's just when we look at what are the hard assets in the business? Let's look at equipment that's owned by the business. Let's look at money in the bank, real estate own accounts receivables I would think are actually going to be collected.

It just essentially just pulling a balance sheet. There might be some discounts and depreciation and various other things apply, but it's really just looking at what the hard assets are, almost as if you're doing a fire sale or just liquidating the business.

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The most interesting approach, and the one that I think that it's the most complex and used the most, is the income approach. That's valuing a business as an ongoing concern. When you buy a business you think about how much a business is worth. A business is not just worth the money in the bank.

If Brian has a hardware store, and it does $5 million in net profit each year, that's worth more than just the money in the bank. That corporate Goodwill, that ongoing concern of the business is worth something.

That's where you see a lot of work done on these business valuations, where we're looking at what the actual income is for these businesses. Applying what's called a capitalization rate on it. Applying discounts, looking at personal Goodwill. I don't know about you, Brian, but I think it's always fascinating to me looking at these business valuations, how many judgment calls there are that the expert has to make.

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And also we can all look at a tax return or look at a P and L and see how much a business makes in profit, at least what they're claiming to make a profit, and then how many triggers there are and different ways that the experts can sort of depart.

Depending on their valuation methodology you can create, you know, wildly different numbers all the way from what's the capitalization rate that you use to the lack of control discounts to marketability discounts, personal Goodwill, all that stuff can just shoot all over the place. If there really are different numbers you can end up in court in front of a judge or a jury arguing over the stuff if the experts can't get on the same page.

Is that kind of how you see things when you do these?

Brian: I do. And it is hard. The example used for personal Goodwill is a good one. What is a person's reputation worth? How many customers is it bringing in? It's just hard to stay. And of course what we've seen in the past few weeks with the economy it just goes to show you there's unpredictable things out there that no one can even see coming.

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And you've got to include some sense of all of that. For example, right now we just thought we settled a case about a couple months ago.

It was for a really large company in the oil services business, out in the fracking fields. Well, that was before oil went down to negative value and before the economy largely shut down. Suddenly the number we had then, it doesn't make any sense. The purchase was going to be done with some future income from the company that’s not going to be there anymore. They'll probably be in bankruptcy

So, these things can be mindbogglingly complex and that's probably a subject of a whole other podcast. Once you agree or get court to pick a number, how do you actually get paid?

Jake: Yeah. You don't want to just walk away with a slip of paper that’s not secured by anything.

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I mean, yeah. I think that's a good point about the level of complexity that this can go down. I never know what the business valuation what the different nuances are going to be like. What's going to cause the numbers to be apart from both sides on this?

What I do know though in every single case is I encourage my clients to make sure that you hire a lawyer that understands business valuations. And it's something that I love doing. I know that Brian loves doing it and it is fascinating to me. Sometimes it’s frustrating because I think there's some practitioners out there that it's just not something that they like doing, or they just don't have a business sense.

The confusion that that causes if you have a lawyer involved that doesn't understand business valuations, things can go really, really poorly. I always use the example from when I was when I was an associate, we had a business valuation and the expert on the other side was fine.

I’ve seen some people use this expert in Austin quite a bit, but the lawyer didn't understand business evaluations. The expert had just frankly, done a mathematical error on the way he valued the business. He essentially put a positive sign where there was supposed to be a negative sign.

The details aren't really too important, but it's suffice to say that there was a $300,000 adjustment for working capital. That's supposed to be a negative. He counted as a positive. You apply the capitalization rate to a positive $300,000.

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That should have been a negative -$300,000. All of a sudden it's valuation dropped $2 million. And we caught it right away. I mean, our expert caught it, we caught it, but the lawyer on the other side didn't catch it and his expert had messed up and he didn't understand business valuations. And he didn't understand businesses enough to know looking at this business that probably netted a couple hundred thousand dollars a year and his expert just came up with a $4 million valuation.

Me and Brian would have got that. We'd be going “Ah, that's something's wrong here, I wasn't expecting that number”, but this lawyer didn't see it coming and had his expert just gutted in a deposition. And then the court struck his expert and we're just left with our expert.

What I know in every single case is that you want a lawyer who understands these things, and then you want to hire the right experts. I mean, at the end of the day, anytime being Brian have a case for a business valuation, we always give clients options.

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You know, I've sent an email this afternoon to a client saying here's the three different people that could value your business. I always give people the options of hiring the best in the state. We have really close relationships with the best CPAs in the state, and frankly, that's sometimes a more expensive option. It doesn't always make sense for the business, but we always start with that option.

Then we talk through other options for businesses where that may not make sense, but hiring an expert and hiring the right expert and having a lawyer who has those relationships is vital. It can be a multimillion dollar question or it could be a few hundred thousand dollar question, but it's an important and expensive question to answer in a divorce.

And it's a conversation that frankly needs to start in the initial consultation and then sort of continue on as the case goes on. It's something that we always have our ears open for.

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It's obviously something that we like talking about a lot, which is why we wanted to do a podcast on it. I really enjoy it when I get those phone calls.

If I have a case with these questions in it or somebody is bringing me in on this co-counsel or does it help them consult with how to handle these things? It really is one of the more fascinating things that we see show up in property division. And really one of the more important questions that we'll see show up from property division.

So, if you folks have questions about it, we have more information on our website. Like Brian said, we'll do more podcasts talking to more detail about how you actually affect these divisions and go into more details. But I think that's what we want to do for an overall this, this week, talking about that issue in divorces.

So unless you have anything to add, Brian, I think we'll leave it at that

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Brian: Sounds good.

Jake: All right. We'll talk to you next time. Next time. Take care.