

Valuation in family law

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After Howard's first job as an Army bomb-disposal officer, everything else seemed dull — teaching economics and environmental studies (at Western Washington University), regulating utilities (for the State of Oregon), teaching accounting (at Simon Fraser University), managing accounting research (for the Certified General Accountants). Then he discovered dragonboat racing and litigation accounting.

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Valuation in family law matters

**A seminar for the Trial Lawyers Association of B.C.
Friday, May 22, 1998**

Valuing a business or professional practice arises in a family law matter when one spouse has such a business or practice or an interest in one, which the *Family Relations Act* makes a matrimonial asset subject to division. Analysts can help determine the value of the asset, if any, according to economic principles; you and the Court divide the family assets and obligations, including this one, between the parties.

We'll *sketch* the main approaches to valuation — comparable sales, assets, and earnings — along with professional practices, salable and personal goodwill, special purchasers, shareholder loans, ownership structures and restrictions, sale of shares or of assets, what experts can disagree about, and the information and cooperation required. First we ask what is being valued, and when.

I. What's being valued, and when

Identify the matrimonial asset or collection of them that the couple (i) own and (ii) could theoretically sell. The identity isn't always obvious, particularly when a set of businesses interlock, have several owners, or have several distinct classes of debt and shares. If the asset is 100% of a business, the analyst can examine the issue of notionally selling shares or assets, but if the asset is a partnership or other part-ownership, the assets-or-shares question, too, requires careful analysis.

Agree, if possible, on the date of the valuation, which is often the date of separation. A valuation requires financial statements at or near the valuation date. It's convenient for the analysts if the date falls at a fiscal yearend, but hardly anyone is tidy enough to separate then. Collecting and interpreting the accounting information usually requires at least two months, which puts the valuation date at least two months before the trial or settlement.

II. Approaches to valuation

A valuator usually estimates *fair market value*, thus:

Fair market value denotes the highest price available in an open and unrestricted market between informed, prudent parties acting at arms' length and under no compulsion to act, expressed in Canadian dollars. Readers should be advised that the value arrived at may not apply to these assets at other times or under other conditions, nor to the assets of apparently similar firms, and that an actual sale would likely occur at a somewhat different price, depending upon the circumstances of the sale and of the buyer and seller.

The fair market values of the firm, shares, or assets valued by any method have to reflect *taxes* on their notional disposition. Taxes can also affect distributions from the company to its owners. When an actual liquidation is not imminent, these taxes can be discounted, say by half.

As noted, there are three main approaches.

(a) Comparable sales

The best indicator of fair market value is what such businesses, professions, or interests sell for — in much the same way that appraisers value real property. If Kerrisdale has, say, 237 one-doctor veterinary practices and several sell every month for around \$100,000, according to the quality of the waiting-room decor and the external debts, then the value is the \$100,000 adjusted for the quality of the waiting-room decor and the external debts.

You seldom have the luxury of such lavish information. Some common rules of thumb (accounting practices sell for, say, six ~ 18 months billings) don't meet the definition. But where comparable sales have occurred, they should be identified and analyzed.

The other approaches begin by restating the business's balance sheet to the fair market value of the several assets and liabilities. If a business or practice has a positive value, at least some of that value will show up when the balance sheet is stated at fair market value.

(b) Asset or liquidation approach

This approach assumes that the business can be taken apart, its assets sold off without undue haste or distress, and its obligations (including any taxes) paid. This exercise determines the value, typically, when the business is a holding company for real property or marketable securities or when it owns real estate that has appreciated and that its earnings do not match. It requires current real property assessments and appraisals.

Table A (below) shows a simple example. Before considering the fair or current asset values, the firm has a negative net worth, and the shares and any shareholder loan would be worthless.

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II. Approaches to valuation

Table A
Nogoodwill, Ltd.
Financial position as at the yearend, March 31, 1998

| | [\$000] | Book value | Adjustment | Fair market value |
|---|---------|------------|------------|----------------------|
| Assets | | | | |
| Current | | | | |
| Cash and equivalents | | 6 | | 6 |
| Accounts receivable | | 32 | | 32 |
| Inventory | | 12 | | 12 |
| | | 50 | | 50 |
| Noncurrent (net of depreciation) | | | | |
| Land and buildings | | 175 | 205 | 380 |
| Plant and equipment | | 25 | (5) | 20 |
| | | 200 | 200 | 400 |
| Total assets | | 250 | 200 | 450 |
| Liabilities | | | | |
| Current | | | | |
| Bank line of credit | | (80) | | (80) |
| Accounts, wages, and taxes payable | | (35) | | (35) |
| Current portion of long-term debt | | (10) | | (10) |
| | | (125) | | (125) |
| Noncurrent — mortgage | | | | |
| | | (140) | | (140) |
| | | (265) | | (265) |
| Owner's equity plus shareholder loan | | (15) | 200 | 185 |

(c) Earnings or going-concern approaches

If the business earns a profit beyond a normal return on its assets — an economic profit — and if it will continue to do so, that profit can be capitalized, and the amount by which this gross value exceeds the total identified assets is called *goodwill*. Goodwill represents the capitalized value of the going concern’s operations.

This approach addresses the firm’s earnings, adjusting them for any transitory factors and for any outlays that won’t or needn’t continue. Table B shows the example of management perks (in which the spouse might have shared). Expenses do include normal compensation for owner-managers.

Then the earnings stream is capitalized at a rate that reflects the cost of capital in the market generally plus the risks and opportunities of the firm. Comparable sales can also help to identify the discount factor for earnings-based methods.

| Table B | | | |
|---|-----------|--------------|------------|
| Hotstuff, Ltd. | | | |
| Estimation of gross value and goodwill | | | |
| Income statement [\$000] | Actual | Adjustment | Normal |
| Revenues | 900 | | 900 |
| Operating expenses except owner’s perks | (450) | | (450) |
| Owner’s perks | (400) | 200 | (200) |
| Income taxes | (13) | (62) | (75) |
| Sustainable income | <u>37</u> | <u>138</u> | <u>175</u> |
| Gross value | | | |
| Sustainable, normalized income | | 175 | |
| Capitalized @ | | <u>25%</u> | |
| | | <u>700</u> | |
| Goodwill | | | |
| Gross, going-concern value | | 700 | |
| Less identified net assets at fair market value | | <u>(185)</u> | |
| Goodwill | | <u>515</u> | |

The exact approach varies. Determination of sustainable income usually requires considerable analysis of current, prior, and forecast or projected years. A difference between depreciation expense and required reinvestment suggests capitalizing net cash flows instead. Future earnings growth or variation suggests discounting the specific years’ cash flows. The business might have *redundant* assets that can be notionally sold off (with any net income removed) and added to the gross operating value, or it might need a capital injection to reduce debt or finance operations.

(d) Professional practices as going concerns

One method of valuing a professional practice is to estimate its net income beyond the average earnings of members of that profession. Earnings data come from salary surveys by professional bodies as well as Statistics Canada and Human Resources Development Canada.

If, say, the practice cleared \$100,000 per year while the average member of that profession earned \$70,000, then it would have an economic profit of \$30,000. (A practice that cleared less than the average would have no value.) Then the economic profit is capitalized.

This can also be applied to a degree or professional designation earned during the marriage.

III. Some complications

The previous sections noted some complications, including identifying just what the family asset *is*, at what date it is valued, and some ways taxes affect value. This section will consider some more, beginning with who might buy the goodwill.

(a) Salable and personal goodwill

The goodwill estimation in §II(c) presumed that a qualified outsider could step into the shoes of the person notionally selling the interest and reap the same benefits. That means that the goodwill was salable or *commercial*, say deriving from a brand-name, or from an organization that will remain able to solve complex engineering challenges, or an existing clientele that will continue with the new owner or practitioner. New practitioners buy existing practices, hoping for this.

It may happen, however, that the goodwill is *personal*, coming from “the trust and confidence which persons may repose in [a barrister’s] integrity and ability to conduct legal affairs. [*Austen v. Boys*. (27 LJ Ch. 714, 1858)].” All of us hope that we have so organized our practices that another might step in, take over, and keep the clientele — or else our goodwill is personal, not salable.

(b) Special purchasers

Say a business is for sale. If a competitor, customer, or supplier bought it, the buyer might be able to realize some synergies by combining some aspects of the two operations. Such a *special purchaser* could afford to pay more for the business than someone without potential synergies. But if there were only one special purchaser, the business would bring only a nominal premium because nothing would cause the buyer to reveal and pay it. Two or more potential special purchasers, though, should suffice to include such synergies in the valuation.

(c) Shareholder loans

Owners of private companies often pay in minimal capital stock, making most of their investment through shareholder loans. These loans make it easier to withdraw funds — write a cheque, credit cash, and debit shareholder draws — than it would be to withdraw paid-in capital.

Table A distinguished the shareholder loan from external debt, treating the shareholder loan as though it were equity. In a matrimonial dispute, this shareholder loan would be a matrimonial asset.

It may happen that the valuation estimates the value of the shareholder loan, rather than of assets or shares, when assets would not suffice to cover all the debts.

(d) Ownership structures and shareholder agreements

Firms can incorporate and, if so, can set up several classes of shares, with differing rights. They might do this for tax or estate planning, to provide for nonparticipating family members or silent partners, or to maintain majority control even without majority ownership. The value of shares depends on their rights to receive dividend and liquidation proceeds — and sell the shares — as well as on the expected proceeds.

Shareholder agreements can affect even a single class of shares, and similar conditions can affect partnership interests. Having several companies, some of which own interests in others, can complicate the analysis still more.

Premiums for control blocks and discounts for minority positions and illiquidity can arise, and the fact that a relatively few shares of the company might be traded publicly does not really affect the valuation.

(e) Sale of shares or of assets

Tax considerations make it more attractive to *sell* shares of qualifying farms and small businesses (exempting up to \$500,000 of capital gains) but to *buy* assets (depreciate the new fair market values rather than the old book values). This becomes an issue if the couple have the choice of which to sell.

The value of an asset for tax purposes might not equal its book value, either. This could arise if the firm accounts for deferred income tax expense, say, or if the owners had transferred assets to the company while deferring the capital-gains taxes.

Any actual sale needs the advice of an accountant and a solicitor.

(f) What experts can disagree about

Experts, using plausible assumptions and professionally acceptable methods, can arrive at quite different values. It's tempting to rank the *basic approaches* in terms of potential disputes and the range of values advanced, provided everyone uses the same method, roughly, thus:

Relatively narrow — The fair market values of assets and external liabilities give relatively few grounds for disagreement, so if everyone uses an asset-based approach, this could arrive at the smallest range. Issues could include the selling prices or realizable values of assets and the tax effects.

Still relatively narrow — With the comparable-sales method, the issues could include the fundamental, comparable sales and the adjustments.

No holds barred — An earnings or cash-flow method introduces the estimated maintainable earnings and the adjustments to arrive at it, as well as the discount rate, any future growth, and redundant assets or capital investments required. These admit vast scope for professional judgment.

Such complications as personal goodwill (if any), special purchasers (if any), restrictions on asset or share sales or rights of classes of shares (if any), premiums or discounts (if any), and tax effects — all expand the grounds and scope for disagreement.

Experts can even err. You'll want to watch for such fundamental errors as assumed facts or approaches that are inconsistent with the body of evidence or inconsistent internally.

(g) Information and cooperation required

Valuing a company requires several years' tax returns and financial statements. It also requires information beyond the returns and statements, if only to interpret the statements. This demands the cooperation of people who have a marital dispute, as well as their partners, associates, and lawyers and accountants. Some examples:

The public accountants — Adjusting assets' carrying values, normalizing revenues and expenses, and identifying redundant assets all require the sort of detail that the firm's accountants might maintain in working papers: this requires professional cooperation.

The solicitors — The analyst might need information or assurances from the firm's solicitors.

Ex-spouses and associates — At least one owner-manager will likely be an unhappy spouse, from whom the analyst will want information; other managers might be friends or relatives of one or both spouses.

Ex-spouses and public accountants — It will take both the accountants and the managers to produce the interim financial statements, unless the firm is valued at its most recent yearend.

Counsel for the two parties should arrange for the analyst's enquiries and might have to manage exchanges.

IV. Some final thoughts

(a) Not every business has a positive value

High costs or low earnings, operating or environmental problems, obsolete technology, minimal assets, heavy debts — for many reasons, a firm might have no material value.

(b) If the business and its owners have used aggressive tax planning ...

The analysis begins with the financial statements attached to the tax returns. Some income-splitting is normal and can be undone for the analysis.

A wife might assure the analyst that her ex assured her that he was making more than his tax returns showed. Unless family expenditures can be traced to the business, though, that becomes another perquisite that disappears with the marriage partnership.

(c) If Hell will freeze before ...

When each side has its own greybeard, if the parties can work with them, and if the greybeards can cooperate, we offer the opportunity to devolve the easy, money part of the settlement to us.