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How to value a small business when getting a divorce

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Harold is a lawyer, and for many years has been operating a small law firm where he is joined by an associate attorney and a few staff people. For all of these years, Harold has been married to his wife, Wendy. Harold runs an efficient operation, is well known, and has a reputation for handling high-stakes matters that give him a very large income. Harold and Wendy have decided to divorce and Harold has taken the position that the law firm is a worthless asset in the divorce because if he stopped working, the firm would cease to exist. In other words, he says, "the business is worthless without me."

The entrepreneurial spirit in California is hot. The Small Business Administration, Office of Advocacy, reported in its 2015 California Small Business Profile, that small businesses employed half or 6.5 million of the state's private workforce in 2012 and that almost all firms with employees are small (making up 99.2 percent of all employers in the state). Because the divorce rate in California is reported to be quite high (although California does not track statistics on divorce), it is safe to assume that many divorces involve a small business that has been operated by one or both spouses and was the source of their income. This tells us that the valuation of a small business is a big issue in California divorces.

An expert must be hired to determine the value of a business. Putting aside the methodology used by the expert to value the business, the very first thing to be determined in the valuation of any business (whether for estate planning, merger and acquisition or divorce purposes) is the proper standard of value.

The standard of value in California for purposes of divorce has been known as the value to the holder (sometimes referred to as investment value). This means the business need not be marketable in order to have value, as the value may simply be in the benefits to be received from the current owner. Therefore, so long as Harold is running the business, the business will be valued. The standard of value is what tells us that Harold's assertion, "the business is worthless without me," likely has no merit in the context of divorce in California.

Business valuation cases, though prevalent in the trial courts, do not often result in published opinions from the Court of Appeal, but recently one was handed down. In *Marriage of Honer*, 236 Cal. App. 4th 687 (2015), the Court of Appeal gives a comprehensive description and analysis of what experts use to value a business in the context of a divorce. Though the husband's expert in *Marriage of Honer* coined the standard of value to be the "marital value," the expert defined this standard as the "economic value of the business to the spouse retaining it, and who will continue to operate it in the future." The expert seemed to differentiate the marital value from investment value because no discounts were taken for lack of marketability or lack of control. The court's opinion does not discuss the fact that discounts are in fact rarely accepted in the valuation of a business for the purposes of divorce and therefore there is little difference between the marital value standard and the value to the holder standard (again, sometimes called the investment value standard).

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The expert in *Marriage of Honer* coined a new term and applied an amalgam of valuation methodologies to arrive at his opinion on marital value. In reality, marital value is not different from the value to the holder standard routinely used in California divorces. The Court of Appeal in *Marriage of Honer* acknowledges that the husband's expert's approach was in fact not novel; however, even if it was novel, the expert's opinion can be accepted by the court, because the testimony would go to the weight not the admissibility of the opinion.

Marriage of Honer can assist lawyers and experts in explaining to a client why the business may have value despite the possibility of having no future value if the operating spouse left the business. The reason value is placed on the business when the spouse continues to operate the business at the time of divorce is because of the ongoing ability to continue to earn a living from the business. That defines the value to the holder and thus is why this is the standard of value used in California to value a business in the context of a divorce. As the Court of Appeal stated, "[t]he court observed that family businesses 'do not simply represent an investment in capital; they are also an investment of sweat, toil, worry and hopes.'"

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