Unequal Distribution of Family Business Stock Requires Discounts

***In re McCulloch v. McCulloch,* 2013 RI. LEXIS 113 (June 25, 2013).** When three financial experts declared themselves unable to put a definite value on two closely held businesses, the trial court decided to assign an in-kind minority interest in both entities to the wife without valuing the considerable assets before distribution. The wife appealed.

At the core of "a protracted, if not epic, battle" (the court's description) for divorce were two family-owned businesses that "comprised an enormous portion of the marital estate." One entity was a manufacturer of fabric at which the husband served as president and CEO; all of the company's stock was in his name. The other was an affiliated company that owned equipment and real estate in which the first company had a 10% interest. Sometime after 2007, the fabric manufacturer became involved in "the China venture," a plan to buy a controlling interest in a printing and dyeing company in China. Both the husband and CFO of the company testified that the project was vital to the survival of the business, which had been losing money each year.

Economic crisis thwarts valuation. At trial, in late 2008, both sides presented experts, and the court appointed a neutral, third expert to help it determine the value of the businesses. The wife's expert initially prepared a report that placed the value of the first entity as of Dec. 31, 2007, at about $126.4 million. At the time, the expert stated that she "couldn't place [a] value o[n] the China investment" because she lacked the requisite data to determine its impact on the company. In later testimony, she said she had not completed an updated valuation for the company and any numbers related to the China investment were merely estimates. She concluded she was unable to "provide an opinion of value with respect to the China venture." She cautioned, however, that any valuation had to account for the state of the economy.

The husband's expert rebutted that there was no justification for the $126 million value; rather, he concluded the value was $106 million. He also said he lacked information about the China venture because at the time of valuing the company "the deal was not closed."

The court-appointed expert testified that since the December 2007 valuation date, "there ha[d] been a meltdown in the financial market." Job losses and reduced consumer spending dramatically changed the economic situation in countries to which, or in which, the company would sell. Considering the parties' experts had received incomplete information, this expert also lacked the data necessary to "place a value or an economic benefit on the China venture" at the valuation date.

The trial court took judicial notice of the global economic crisis that had taken place since the valuation date. (The opinion does not provide details on valuations, if any, for the second company.)

The trial court decided the stock of the first company was a marital asset. As to the second company, a fraction short of 50% was marital property because the husband had acquired the remainder before marriage or received it as a gift. It stated it did not have any "credible evidence upon which to base a fair and reasonable valuation of the value of the stock in th[e] corporation" because of the "extraordinary change in circumstances that could not have been contemplated by the parties" since the valuation date. The global financial crisis, the fact that the China venture had not been completed, and the fact that "[n]one of the experts had given any detailed consideration to the potential impact" of that project, the court said, made it impossible

to accurately value the two businesses. For all these reasons, it ordered an in-kind distribution of the stock of the first company and an in-kind distribution of a partnership interest in the second company, instead of a sum in cash.

As to what percentage of stock to award to the wife, the court noted that it "would be completely inequitable" for her to receive the same portion as the husband considering her minimal contribution "towards the acquisition, preservation or appreciation of the corporate assets." The husband's "blood, sweat and tears and contributions by his family" were responsible for the company's past and perhaps future success. Accordingly, it gave the wife a 25% interest in the fabric manufacturer and a 25% interest of the portion that was marital property in the second business. The husband received 75% of the two assets.

A case for valuing assets. The wife appealed to the Rhode Island Supreme Court on a number of grounds, particularly because (1) the trial court declined to value the assets before it assigned to her a percentage of them; and (2) the trial court's distribution of stock rendered her a minority shareholder in a closely held corporation.

Regarding the first issue, the husband argued that state law did not require a valuation of marital property before distribution.

The appellate court agreed with him that there was no bright-line rule imposing a valuation requirement on trial courts, and it declined to adopt one. At the same time, it decided that in this case the trial court had abused its discretion in failing to value the companies before assigning interests in them for two reasons.

First, the assets at issue made up "the vast majority of the marital estate." Experts for both sides stated a range between $106 million and $126 million as of the end of December 2007. Even assuming fluctuations in value since then, there was no question as to their importance.

Second, the law generally disfavors assigning stock in a closely held corporation in a way that makes one spouse a minority shareholder. Even if this type of distribution is not error per se, it was in this case, the appellate court continued, because the parties received unequal percentages. "[A] 25 percent minority share of a closely held corporation will likely not be the equivalent of 25 percent of the total value of the company" because that type of stock lacked liquidity considering "there is no established public market for the stock." Also "a minority shareholder lacks control over the company, and therefore, the value of his or her stock is diluted in comparison to that of a majority shareholder.

It was true that the court itself earlier had adopted a rule not to apply a minority discount or a discount for lack of marketability (DLOM) in the context of an action for dissolution of a closely held corporation. But, the high court said, "we believe that such discounts are appropriate, and even necessary, when valuing an in-kind distribution of a minority share of a closely held corporation in a divorce action." Considering the illiquidity of the wife's asset and her lack of control over the business, it ordered the lower court on remand to apply both a minority discount and a DLOM when valuing the assigned portions. Finally, it pointed out that if the trial court had granted the wife the "cash equivalent of her equitable ownership interest in the companies" or "had crafted some other assignment, such discount would not be necessary."

2nd Post-*Bernier* Court Says Income Approach May Be Preferred, But Not Exclusive

***In Palmerino v. Palmerino* 2011 WL 1450359 (Mass. App. Ct.) Unpub. (Apr. 15, 2011).** After a 35-year marriage, the parties filed for divorce. By far, their largest asset was the husband's one-third interest in Big Bunny Market, Inc., a closely held grocery store business founded by his father in 1947.

Expert changes his opinion at trial. The parties' joint expert, a CPA and professional business appraiser, valued the husband's stock in the S corporation at $557,000, based on the net asset approach and after the application of a 20% discount for lack of marketability and a 20% discount for lack of control. At trial in 2007, counsel for the wife asked the expert about the then-recent case, Bernier v. Bernier, 449 Mass. 774 (2007). The expert testified that valuation professionals were still "wrestling" with the import of Bernier, but in light of its holding - which barred marketability and minority discounts absent evidence of an imminent sale or other "extraordinary" circumstances - he said that discounts were "likely" no longer applicable in this case. Accordingly, he adjusted his valuation of the husband's shares in the closely held corporation to roughly $870,000.

After the expert changed his opinion, the trial court permitted the husband to present a rebuttal expert, a CPA and certified valuation analyst. The husband's expert criticized the joint expert for improperly including leasehold improvements in his valuation and for using the net asset approach, which improperly equated net book value of the ongoing business to fair market value. He believed that the more "accurate and accepted measure" of such a business was the income approach, which the joint expert had discussed in his report but dismissed "without explanation," the husband's expert said. Applying the income approach to the same data that the joint expert used, the rebuttal expert calculated the value of the husband's 33% interest at $534,00. Notably, the rebuttal expert excluded minority and marketability discounts from this value, agreeing that they were inapplicable after *Bernier*.

Notwithstanding this second opinion, the trial court adopted the $870,000 value by the parties' joint expert, and the husband appealed. The judge erred by failing to apply discounts, the husband argued; he distinguished *Bernier* by its reliance on direct evidence that the grocery store in that case was "not for sale at any price." The husband also claimed that the trial court erred by applying net asset value to a going-concern enterprise.

Implicit fair value standard applies. The appellate court disagreed on both counts. First, the absence of direct testimony indicating that the family supermarket would not be sold was "inconsequential" in light of other indirect evidence, including the husband's statements that the next generation was being groomed to take over the business. Further, the Bernier court made it clear (albeit in dicta) that "neither a marketability nor a minority discount should be applied absent extraordinary circumstances," the court held. In particular, the trial court should be careful to treat the parties as "not as arm's-length hypothetical buyers and sellers in a theoretical open market, but as fiduciaries entitled to equitable distribution of their marital assets," the court said, citing *Bernier* and its reliance on *Brown v. Brown*, 348 N.J. Super 466 (2002).

Second, the trial court's reliance on an asset-based valuation did not undermine its ultimate decision, the appellate court held. "While the income approach has emerged as the

dominant approach in business valuation, the weight of authority does not support the husband's assertion that it is the only appropriate measure of [the grocery store's] value or that the use of any other methodology is clearly erroneous," the court explained, citing Shannon Pratt and Alina Niculita, *The Lawyer's Business Valuation Handbook* (2nd ed. 2010). (See the discussion by the Mass. Supreme Judicial Court of the direct capitalization method as the "preferred" method for valuing corporations, stocks, and similar interest in the *Adams* decision).

"The valuation of an S corporation is an inexact science," the court added, citing *Bernier* again. "There is no standard method for the valuation of shares in close corporations." In the absence of a determinable market value, the court said, "experts commonly value a closely held business by the assignment of value to the assets of the business (as was done here) and by the capitalization of earnings (as was done in *Bernier*)." The court also quoted at least one authority for the proposition that the return-on-investment method can often by speculative and therefore "a dubious basis" for evaluating business assets in the context of divorce.

Accordingly, the court affirmed the undiscounted value of the husband's interest in the grocery store business as reasonable and within the range of evidence at trial. *Note*: Unlike the *Adams* case, the *Palmerino* opinion does not indicate whether tax-affecting the S corporation ever came up at trial, leaving appraisers and attorneys to keep wrestling with the issue, in Massachusetts and beyond.

During these tough economic times, parties and their attorneys may often request a business appraiser to perform a preliminary "calculation valuation" for settlement purposes. Although the majority of cases do settle, the following recent case highlights problems of presenting anything less than a complete valuation in court.

In re Marriage of Hagar, 2010 WL 4807559 (Iowa App.) (November 24, 2010). The husband and wife owned three dry cleaning stores, which they bought from his parents for $300,000 with a promissory note. Over the marriage, they paid down the note to nearly $121,000, but when the relationship deteriorated, the husband defaulted and his mother threatened forfeiture, so the wife borrowed money to pay the arrears. At trial, the court faulted the husband for wanting to "ruin the parties' financial picture," and valued the business at $95,000, or the midpoint of a range of $71,000 to $120,000 provided by the family's longtime CPA.

On appeal, the husband pointed out that the CPA actually testified that the business was worth between $71,000 and a *negative* $120,000. However, the wife pointed out that the CPA had offered his figures as a mere calculation of value, using "rules of thumb" and industry standards that didn't require the same professional judgement as a complete valuation.

The appellate court agreed that the CPA expressed his $120,000 value as a negative number. "However, we do not use [his] calculations because he admittedly did not 'use judgment.'" The CPA also failed to recognize the family relationships that affected value. Based on the couple's purchase of the business for $300,000 and their creation of equity of paying the note down by $140,000, the appellate court valued the business at this higher amount and confirmed its award to the husband.