Valuation Verdicts®

Current Valuation & Taxation Rulings Regarding Divorce

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Can Personal Goodwill Apply to a Commercial Firm Value in Divorce?

***Cummings v. Cummings, Inc.*, 2009 WL 331436 (Ark. App.)(Feb. 11, 2009)**

This Arkansas case began with the court appointing a neutral expert, a CPA, to appraise the husband's interest a family owned commercial enterprise. (The appellate court opinion does not detail the specific nature of the business or its industry.) Based on the excess earnings method, the neutral expert valued the company at $421,000. His value was six to seven times the actual value of its tangible assets, he said, a difference he ascribed not to "goodwill" but to the company's "earning capacity."

Under cross-examination, the neutral expert admitted that he did not consider what would happen should the husband leave or be unable to continue operating the business. He also did not account for any "personal goodwill" attributable to the husband, or consider his presence as a "key man" in any assessment of risk, which could have lowered his valuation. On redirect, the neutral expert distinguished the husband's business from professional practices that, in his experience, depended on the presence of a particular licensed professional. The husband's business, he said, obtained worked based on submitting the lowest bid.

The parties retain their own experts. The wife presented a CPA expert, who used a similar income approach to value the husband's business at $430,000. This expert considered the husband's presence in the business as part of her "company-specific risk rate," which would decrease the value of the company, she said. She also conceded that 80% of her valuation was based on the husband continuing to operate the business, without having to pay someone else to do it. Since she had only seen personal goodwill valued in relation to professional practices, she did not assign any to the husband's commercial enterprise. "[A]n owner can establish a successful business, but that does not make it personal goodwill," she said. That a former employee left to start his own business and was beating the husband's company on bids indicated to her that any "[excess value] was corporate goodwill, not personal to the husband."

By contrast, the husband's expert (also a CPA) said the business was worth only $60,674, based on net asset value and how "cheap' it was to enter the particular market. The company had no goodwill, he added. The only reason it earned more than similar businesses was due to the husband's presence and his ability to invite bids. Thus, any buyer would "demand" that the husband remain under an employment contract.

The trial court found that both the neutral and wife's expert valued the company as a going concern, with "business" goodwill. Only the husband's expert used a liquidation value, believing that any goodwill was personal to the husband (and thus non-divisible). This was contrary to Arkansas case law, the court found, which deducted personal goodwill only when valuing professional practices. Without finding a specific value for goodwill, the court averaged the values of the neutral and the wife's expert to conclude the husband's business was worth $425,500.

The husband appealed, reasserting his argument that much of that value was due to his presence and should be deducted as personal goodwill. However, the cases he cited concerned professional practices, the appellate court observed. "Husband could have asked for specific findings of fact concerning the goodwill" of the business, but failing that, the value was within the range of the evidence at trial, and was affirmed.

Kentucky Adopts Majority Rule in Distinguishing Goodwill in Divorce

***Gaskill v. Robbins*, 2009 WL 425619 (Ky.)(Feb. 19, 2009)**

The wife in this case was a well-established oral surgeon. To value her practice, her CPA collected data from business records, spoke with staff during a site visit, and prepared a detailed financial and accounting report. After explaining why certain valuation approaches did not apply to a sole professional practice (no prior sales of this or similar business, and no plans to liquidate), he valued it using an asset-based approach at $221,610. He also assigned a zero value to good-

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will, because the wife's role amounted to a "non-marketable controlling interest." To illustrate, he asked, "Why would a purchaser pay more than fair market value of the tangibles if [the doctor] can take her patients, go down the hall, and set up a practice?"

The husband's expert did not conduct a site visit. Instead, he took the financial data from the wife's expert and applied four different valuation methodologies: excess earnings, capitalized earnings, market approach, and adjusted balance sheet. Finding all reliable but none determinative, he averaged the four values to conclude the practice was worth just under $670,000, which also assumed a non-compete agreement and goodwill.

The trial court adopted the $670,000 valuation, in large part because it interpreted prior state precedent as requiring it to assign some value to goodwill. The wife appealed—and the Court of Appeals reversed. But given the question of first impression, it sought interim review by the state Supreme Court for whether the goodwill of a closely held or sole proprietorship can have both personal and enterprise values when determining its worth in a divorce case.

Important questions to ask in every valuation. "The valuation of a business is complicated, often speculative or assumptive, and at best subjective," the Kentucky Supreme Court observed:

> This is particularly true... [when] the business is a professional practice with only one practitioner, clients or patients come to the business to receive that particular person's direct services, the business is not actually being sold, and the success of the business depends upon the personal skill, work ethic, reputation, and habits of the practitioner.

To help determine the fair market value of any business in divorce, a trial court should ask:

1. What is the value of the hard assets? (real estate, equipment, client lists, cash accounts)
2. What could the business earn over a reasonable time, including transferable goodwill?
3. What are the values of accounts receivable and remaining staff (or cost to replace)?

Of these, valuing the goodwill of a professional practice has been "a source of contention for many years." Prior state precedent generally accepted a firm's goodwill was a factor for the trial court to consider—but the cases had never considered whether goodwill could be allocated between the practice and the professional.

Clearly, the practice is, in general, marital property, and therefore subject to division, but how are we to divide a person's reputation, skill, and relationships? To what extent can a buyer of a business assume that his performance will equal that of the present owner? To what extent can he take on the seller's reputation in the community?

To some extent, the court observed, a firm may be able to establish value beyond fixtures and accounts receivables. Nevertheless, in most professional practices, goodwill—like the practitioner's advanced degree—will not have any "objective transferable value on the open market." These two concepts have led courts in several jurisdictions to recognize a distinction between *personal* and *enterprise* goodwill. In particular, the court discussed *May v. May* (W.Va. 2003) and *Yoon v. Yoon* (Ind. 1999) for their summary of the now-majority rule that while personal goodwill is non-marketable and non-divisible, enterprise goodwill belongs to the business and is allocable in divorce.

The court found the *May* and *Yoon* cases "compelling." The distinction between enterprise and personal goodwill "has a rational basis that accepts the reality of specific business situations." In cases such as this one, there was little doubt that the skill, personality, work ethic, reputation, and relationships of the doctor were "hers alone," the court said, and could not be sold to a subsequent practitioner. "To consider this highly personal value as marital would effectively attach her future earnings, to which [the husband] has no claim." Moreover, if he or someone similarly situated were awarded maintenance in addition to a portion of the practice's value, then this would amount to "'double dipping,' and cause a duel inequity to [the wife]."

Finally, the distinction between enterprise and personal goodwill is just as susceptible to expert valuation as goodwill on the whole is, the court ruled, and held as a matter of law that trial courts should consider the distinction in divorce.

Wife Loses Discounts in Divorce Battle, Tries to Win the War on Appeal

***Grelier v. Grelier*, 2008 WL 5265056 (Ala. Civ. App.)(Dec. 19, 2008)**

The primary dispute in the Greliers' divorce was how to allocate the husband's 25% interest in a consolidation of closely held, family-owned real estate development companies. In response to the wife's request—and an order drafted by her attorney—the trial court appointed a special master, "for the purposes of identification and determination of the fair market value of all business entities in which the [husband] possesses any interest."

One expert turns into three. At trial, the husband testified that despite owning real estate worth more than $59 million, his businesses had suffered financial difficulties for more than five years, including poor sales, overdue loans, and forced debt. Acknowledging these liabilities, the special master valued the husband's 25% interest in the businesses at just over $1 million, without applying any minority or marketability discounts.

Each of the parties contested the valuation at trial. The wife's financial expert testified that the special master had "seriously" undervalued the interests by relying on outdated real estate appraisals, but he agreed that discounts did not apply. But the husband's financial expert argued that by neglecting discounts, the special master failed to comply with his court-ordered directive to determine fair market value. The husband had never owned a majority interest in any of the underlying businesses, his expert observed. Moreover, he could not act independently from the majority-interest holders, including converting his interests into cash. Thus, his expert applied a 25% discount for lack of marketability and 25% minority interest discount, which, when combined, reduced the value of the husband's interest to just over $350,000.

After hearing all the expert testimony and soliciting briefs on the subject, the trial judge accepted the special master's $1 million valuation for the husband's 25% interest, but applied a combined discount of 40%.

Wife argues fair value. The wife appealed, arguing that discounts were inappropriate when valuing business interests in the context of a divorce. The Alabama Civil Court of Appeals acknowledged that the question regarding which standard—fair market value or statutory fair value—applied in divorce cases would be a matter of first impression in the state. However, it did not need to reach the issue in this case, for several reasons:

1. The wife's attorney drafted the order specifically instructing the special master to determine "fair market value" of the husband's minority interests.
2. During trial, both parties presented expert and legal opinions regarding the application of discounts.
3. In her legal memorandum, the wife challenged only the application of discounts to a proper determination of fair market value; she did not challenge the use of the fair market value standard, but waited until the appeal to raise the issue for the first time.

"Having instructed the special master to determine the fair market value of the husband's business interest, the wife cannot now assert on appeal that the trial court should have applied a different standard," the appellate court held, in confirming the discounted value. "[A] party may not induce an error by the trial court and then attempt a reversal based on that error."

1Q2009 Economic Outlook Update

Despite a surprising rise in consumer spending, the U.S. economy suffered its second biggest slowdown since 1982 during the first quarter of 2009. One of the largest contributors to the first quarter slowdown, the cut-back in business inventories, could actually boost the economy in upcoming quarters as business will likely be forced to ramp up production once consumer demand increases. While the first quarter economic decline was worse than most economists forecasted, many now predict some modest improvement for the remainder of the year.

According to Consensus Economics, Inc., publisher of *Consensus Forecasts - USA*, the real GDP is expected to decrease by 2.1% in the second quarter of 2009, but gain 0.1% in the third quarter of the year (percentage change from previous quarter, seasonally adjusted annual rates). In 2009, the real GDP growth rate is expected to decrease by 2.7%, while increasing by 1.8% in 2010 (average percentage change on previous calendar year). In the long term, the real GDP is expected to grow by 3.1% for 2011-2019 (average percentage change over previous year).

According to the survey, consumer prices will decrease 0.7% in 2009 and increase 1.6% in 2010. In the long term, *Consensus Forecasts - USA* also predicts consumer prices will grow by 2.3% for 2011-2019 (average percentage change over previous year). Producer prices are expected to decrease 3.5% in 2009 and rise by 1.5% in 2010.

Interest rates on three-month Treasury bills and 10-year Treasury bonds will rise over the next year, according to the forecasters of *Consensus Forecasts - USA*. According to the survey, three-month Treasury bills will rise from 0.3% at the end of July 2009 to 0.5% by the end of April 2010. The yield on 10-year Treasury bonds is expected to rise from 2.8% at the end of July 2009 to 3.5% by the end of April 2010. According to the survey, the three-month Treasury rate will average 3.8% for the years 2011-2019, while the 10-year Treasury bond yield is expected to average 5.0% over the same time period.

The forecasters polled by *The Livingston Survey* in December 2008 posted less optimistic expectations about the level of the S&P 500 index in 2009 and 2010 than they did in the June 2008 survey. *The Livingston Survey*, which reports the median value across the 36 forecasters on the survey's panel, predicts that the S&P 500 index will rise steadily during the next two years, but at a much slower pace than previously predicted. The December 2008 survey estimates that the index will reach 950.3 by June 30, 2009, while the June 2008 survey estimated the index would reach 1496.5 over the same time period. The index is projected to rise to

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1052.5 by December 31, 2009 and to 1165.0 by the end of 2010. The growth rate in after-tax corporate profits is expected to decrease by 4.9% in 2009 followed by an increase of 6.4% in 2010.

The FOMC decided to establish a target range for the federal funds rate of 0% to 0.25% last quarter—and made no modifications to this range during the first quarter. In their last meeting, the FOMC affirmed that the U.S. economy was in a weakened state, resulting from job losses, tight credit conditions, and declining equity and housing wealth. They also confirmed that major trade partners have fallen into a recession, causing a decrease in U.S. exports. Regardless of the weak economic outlook, the Committee felt confident "that policy actions to stabilize financial markets and institutions, together with fiscal and monetary stimulus, will contribute to a gradual resumption of sustainable economic growth."

The next meetings of the FOMC are scheduled for April 29 and June 24, 2009.

This newsletter is a publication of Barrett Valuation Services, Inc. This firm specializes in providing business valuation services for closely-held companies, primarily for estate planning and litigation support purposes. John E. Barrett, Jr. is a Certified Valuation Analyst and a member of the National Association of Certified Valuation Analysts (NACVA), a Certified Business Appraiser and a member of the Institute of Business Appraisers (IBA), and an associate member of the American Society of Appraisers (ASA). This firm subscribes to the Uniform Standards of Professional Appraisal Practice (USPAP) and has experience in providing valuation conclusions that are supportable and defensible. For further information on how BVS can serve your business valuation needs please call.

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