

Valuation Verdicts[®]

Current Valuation & Taxation Rulings Regarding Divorce

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Divorce Roundup: How to Use your Business Valuation Experts to Best Advantage

A summary of recent divorce cases reveals how a business appraiser can best serve the client, counsel, and the court to maximize efficiencies and values in a marital dissolution case.

First, use a qualified BV expert.

In *Brooks v. Brooks*, 2010 WL 2219199 (Conn. App.) (April 13, 2010), the husband owned minority interests in his family's limited liability companies (LLCs), which held commercial property. At trial, the wife presented the companies' financial statements and a real estate expert, who appraised the LLC's underlying property at \$61 million. Notably, the expert testified that his appraisal was only the first step in a fair market valuation (FMV), which required assessing the companies' outstanding debt and closely held stock. At the close of the wife's case, the husband decided not to call his BV expert, saying there was "no valuation testimony" to rebut. Instead, he presented only the operative buy-sell agreements plus his tax returns, which essentially showed a book value of \$400,000 for his LLC interests.

The court asked the wife if she wanted to call the husband's expert to testify regarding the LLCs, including the effect of non-marketability and minority shares, but she declined. Thus the court was faced with the buy-sell and book values, on one side, and the broad real estate appraisals and financials on the other. Finding the former "simply would not do justice," the court took the appraised value of each property and multiplied it by the husband's share in the LLC, less the mortgage debt on each property plus the value of cash-on-hand.

The husband appealed, claiming the trial court improperly equated the FMV of the properties with that of his LLC interests, thereby ignoring three "critical" features: lack of marketability, lack of control, and the effect of the restrictive buy-sells. The wife argued that

since he'd neglected to present valuation evidence at trial, he couldn't complain about its omission—but the appellate court disagreed. The husband had "vigorously objected" to the wife's real estate appraisals at trial, and her own expert conceded a lack of expertise to value the husband's interests. The wife also rejected the chance to call the husband's BV expert. At the same time, the trial court failed "to follow some reasonable path" in ascertaining FMV, which required assessing the marketability and minority aspects of the husband's interests as well as any contractual restrictions, and the appellate court remanded the case for a new trial on valuation.

Second, use your expert to facilitate proper discovery and disclosure.

In *Hissa v. Hissa*, 2010 WL 2637905 (Ohio App. 8 Dist.) (July 1, 2010), the husband's expert valued his orthopedic practice at approximately \$320,000. By contrast, the wife's expert valued it at \$650,000, based in part on a comparison to industry averages. Both experts relied on the applicable FMV standard, and both agreed that accounts receivable (AR) were an important element. However, the husband failed to provide the wife's expert with the same information concerning AR that he'd given his own expert, forcing the wife's expert to estimate their value. The husband also provided flawed tax and financial information to both experts, and a result, the trial court found his evidence *less* convincing than the wife's, and adopted her expert's value.

The husband appealed, alleging the trial court erred by crediting the wife's expert over his own. But, "the [trial] court determined that [the husband's] failure to be forthcoming about his business expenses led it to discredit the information he provided his own expert," the appellate court found, "particularly given his expert's valuation of

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the medical practice at nearly one-half of what [the wife's expert] determined the value to be," and it affirmed the latter's value.

Third, use the expert to educate the court.

In *In re Marriage of Armour*, 2010 WL 2114052 (Cal. App. 2 Dist.)(May 26, 2010)(unpublished), the vast majority of the parties' wealth was tied up in the husband's 50,000 shares of stock in his employer, which were subject to the company's right of redemption at a below market price. Like many jurisdictions, California family courts prefer an in-kind division of marital assets unless economic circumstances warrant another method. Here, the wife's valuation expert analyzed the consequences of an in-kind division: Assuming the husband retained his stock for a reasonable time until retirement, his 50% share would produce a present value of \$36 to \$40 million, but the wife's share would net only \$18 million at the forced redemption price.

Despite this evidence, the trial court ordered a simple in-kind division and the wife appealed. Based on the wife's valuation evidence, the appellate court found this "disregarded economic realities" and ordered a division that ensured an equal result for both parties.

Finally, use your expert to rebut the other side.

In *Gupta v. Gupta*, 2010 WL 2540487 (Tex. App.-Austin)(June 24, 2010), the husband owned three medical practices and an imaging center in rural Texas. At trial, his expert valued the practices at \$359,000 and the imaging center at zero, due to its significant debt service and operating losses. By contrast, the wife's expert valued all the businesses at \$780,000, excluding goodwill and a marketability discount.

In addition, the wife's expert submitted a separate report to rebut the husband's expert, highlighting his errors regarding valuation of revenue, AR, equipment, depreciation, and his misuse of historical financial statements. As a result, the trial court accepted the wife's expert value, and the husband appealed, claiming the wife's expert failed to visit the practices, interview his staff, or view the equipment. She also misclassified his practice, comparing it to "specialty medical practices" rather than a "general physician office," and failed to factor the debts and losses of the

imaging center. His rebuttal was too late, however, and the appellate court upheld the wife's expert evidence in full.

Court Considers Discounts, Stock Sales, and Prior Valuations in Divorce

Doe v. Roe, Inc., 2010 WL 2535138 (Hawai'i App.) (June 23, 2010)

A confidential protective order sealed this divorce file, which makes it difficult to discern the specific business interests at stake. A summary of the appellate court's three major findings is notable, however, to confirm the challenge of trying to overturn valuation decisions under the broad, "clearly erroneous" discretionary standard afforded the trial courts:

Recent sales provide better evidence than aged buy-sell. The husband owned 834 shares in a closely held corporation as of the date of marriage. To assess their appreciation, the wife urged the trial court to rely on the company's stock redemption agreement, which provided for repurchase at 0.5 times annual revenues and would have made the husband's holdings worth nearly \$924,000. Instead, the trial court relied on evidence from other stockholders who sold their shares shortly after the repurchase agreement was executed for 1.5 times annual revenues, the then-industry standard. The wife claimed this incorporated the value of non-compete agreements, but the trial court found tax considerations played a more important role and used the 1.5 multiple to value the husband's holdings at \$2.5 million as of the marriage. In addition, the husband's financial statements at the time valued his stock at \$2.5 million, and the stock repurchase agreement was cancelled in 1998. *Held:* The trial court valuation was supported by substantial evidence.

Expert has to explain prior valuation. The parties agreed on the value of the husband's 7% interest in a second private entity as of the date of the marriage. However, the wife challenged the husband's expert valuation of the interest (at roughly \$88,000) as of the 2006 trial date claiming the same expert had appraised it at a higher value four years earlier. Although the earlier valuation was

based on “predicting [the company’s] future income,” the husband’s expert explained, actual results four years later were “significantly less,” he said. The trial court accepted his valuation, noting the wife’s expert declined to value the same interest. *Held*: The appellate court affirmed.

Discounts applied to 20% interest in real estate holding company. Prior to the marriage, the husband’s parents established a company to hold residential property, allocating each of their five children a 20% interest. The husband’s expert assessed the fair market value of his shares using discounts for lack of marketability and lack of control, but the wife’s expert believed discounts were not appropriate. The trial court credited the husband’s expert and adopted the discounted value. *Held*: “It is axiomatic that reconciling conflicting testimony is beyond appellate review,” the appellate court said, and confirmed the trial court’s application of a double discount.

Effect of Partnership Agreements on Valuation of Law Practices in Divorce

Two recent cases—both concerning law practices—highlight the effect the operative agreements can have in valuing the practitioner’s interest for purposes of division in divorce.

Identifying the applicable valuation standard is important, too. In *Hartley v. Hartley*, 2010 WL 2071444 (Ala. Civ. App.)(May 21, 2010), a buy-sell agreement limited the repurchase of a departing partner’s interest to \$10 per share; or in the husband’s case, a mere \$1,000. When the wife requested supplemental discovery for the firm’s financial records and client accounts, the husband objected, claiming the buy-sell agreement made her requests irrelevant “as an evidentiary matter,” because any valuation of his interest would be limited to the buy-sell formula. The wife claimed that under applicable law, the buy-sell did not control the valuation in divorce—but the trial court disagreed, limiting discovery to only the husband’s compensation and tax returns, in addition to the buy-sell. “If he leaves the firm, he has contractually agreed to get \$1,000.00,” the court said. “If the firm dissolves in the future, the speculative value of any profit or loss cannot be determined at this point.”

In an interim review by the Court of Appeals, the wife claimed the “majority rule” in the U.S. holds that a buy-sell agreement does not control the ultimate value of a shareholder’s interest in a private practice. After

the parties briefed the issue, the same court adopted the equitable “fair value” standard in divorce (see *Grelier v. Grelier* 2009 WL 5149267 (Dec. 30, 2009)). Under this standard, “We need not ... conclusively determine for all cases the proper valuation of an ownership share of a partnership of legal-service providers,” the Court of Appeals explained. Rather, the crucial inquiry in divorce cases was “to determine the *fair value* of the parties’ assets rather than to adhere in all cases to their ‘fair market value,’ i.e., to the price that the general market might assign to them,” it said (emphasis added).

Accordingly, any discovery that was reasonably tailored to obtain information related to an asset’s “fair value” fell within the scope of the state’s version of Rule 26. In this case, the trial court’s order prevented the wife from obtaining discoverable materials by effectively limiting the “fair value” of the husband’s law partnership interest to the buy-sell price, “even though the law firm will almost certainly remain a going concern for an extended period after a final judgment,” the court said. That position “makes little sense,” it added, and granted the wife’s requests for additional discovery.

Applying the appropriate earnings period. In *In re Marriage of Ross*, 2010 WL 1693552 (Cal. App. Dist 2)(April 28, 2010)(unpublished), the husband-attorney earned over \$700,000 per year prior to the couple’s separation and over \$1 million afterward. At trial, both parties’ experts used the law firm’s year-end financial information closest to the separation date, and both used the capitalization of excess earnings method to determine goodwill. Only the husband’s expert did not include the value of his capital account (\$456,000), because the operating partnership agreement did not give it to him on withdrawal or retirement. The expert also used the husband’s average earnings over the five years prior to separation to assign a range of values for his interest, from approximately \$205,000 to \$473,000.

The wife’s expert included the value of the husband’s capital account, because the partnership agreement made the funds available to the husband throughout his employment. Further, he used the husband’s 2003 income as the “most representative” of his earning power at the end of the marriage, ultimately valuing the law practice interest at just over \$1.2 million. The trial court adopted this value (adjusted to \$941,000), and the husband appealed, claiming his expert’s calculations better represented his earnings, which “fluctuated wildly” during the marriage.

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Effect of Partnership Agreements
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But adding the value of the partnership account to the expert's top value would have produced an overall value of approximately \$1 million, the appellate court observed. Moreover, the operative agreement addressed a partner's rights on departure; it did not deprive the husband of a "present, possessory interest" in the account. Because the trial court assessed the husband's interest in the law practice for purposes of divorce (not his contractual rights on withdrawal), the appellate court upheld its \$941,000 valuation.

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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