Valuation Verdicts®

Current Valuation & Taxation Rulings Regarding Divorce

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Valuing Goodwill in Divorce: Communication and Consistency are Critical

Two recent divorce decisions demonstrate how important communication among the client, counsel, and financial expert(s) can be in any given case, especially when the primary asset is a professional practice. Calculating a credible goodwill value requires the expert to have adequate disclosures, accurate data, and a complete understanding of appropriate methodologies.

Husband's expert gets a surprise at trial. In re Marriage of Theurer, 2009 WL 3823648 (Cal. App.)(Nov. 17, 2009)(unpublished) considered a well-established orthodontist with 14 people on staff, all the latest technology, and up to 150 patients per day. The practice grossed $2.6 million, earning the husband $1.3 million before tax. Notably, he averaged 921 new patients per year—more than three times the average.

At trial, the wife's expert used the excess earnings approach, estimating the husband's reasonable compensation at $500,000, a goodwill value of $2.5 million and an overall practice value of $3.0 million. Similarly, the husband's first expert used the earnings approach, but applied a lower cap rate and higher compensation ($776,000) to reach a goodwill value of approximately $990,000, plus tangible assets. He then deducted patient prepays as a liability (over $1.1 million), for a final practice value of only $126,905.

The husband's second expert was a broker; he said the excess earning approach was not normally used to value professional practice goodwill. Instead, he used two industry rules of thumb, a multiplier of net income and a multiplier of gross revenues, to reach a value between $1.3 and $1.5 million. He did not deduct patient prepays, and though new patient starts were important, he said, he had not received this information from the husband. (The court opinion does not explain why.) On learning that the husband received 866 new starts that year, the expert was "visibly shaken," saying that would make a buyer "clap his hands."

The trial court found that the husband's two experts effectively impeached each other, on the use of an appropriate methodology and patient prepays. The second expert also lost credibility when he showed such evident surprise on the stand. The court accepted the wife's expert value, reducing the cap rate to reflect the practice's "substantial" dependence on the husband's skills. This led to a goodwill value of $1.9 million, or roughly midway between the three experts' numbers—and the husband appealed.

"There is no absolute rule specifying how goodwill of a particular practice should be valued and any reliable method is acceptable if warranted by the facts," the appellate court held, stating the broad rule, applicable in most jurisdictions. Indeed, the excess earnings approach, discredited by the husband's second expert but utilized by his first (and the wife's expert), "is a method that is commonly used to determine the value of goodwill in a professional practice." In this case, the evidence amply supported the trial court's determination, especially given the lack of consistency, information, and agreement among the husband's two experts.

Good use of rebuttal expert. Compare Helfer v. Helfer, Inc., 2009 WL 3644001(W. Va.)(Sept. 9, 2009), in which the husband also retained two experts to value his solo chiropractic firm, using the first as a primary witness and the second only in rebuttal. The first used a straight excess earnings and cost approach, to value the practice at $41,000, excluding any goodwill.

In contrast, the wife's expert used the same approach to value the practice at $388,000, finding "some" practice goodwill, including the value of its location, facilities, telephone numbers, patient lists, and other data. However, he also acknowledged that clients and revenues had recently fallen and failed to assign a specific dollar amount to the practice goodwill.

Interestingly, the husband's rebuttal witness criticized the excess earnings method, because in this case, the firm's liquid assets (cash and accounts receivable) were already subject to marital distribution. Further, the wife's expert failed to obtain a tangible asset appraisal, relying instead on the wife's opinion that they were worth over $53,000. By comparison, the husband's expert followed IRS guidelines to calculate

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their depreciated value at less than $7,000.

The wife's expert also failed to consult comparative salary data or the parties' income tax returns to estimate reasonable compensation, using small business studies instead. He also noted the firm's "great location" in his goodwill calculation, but pegged its rental cost at only $10 per square foot (compared to $18 by the husband's expert), which effectively raise earnings. In fact, the practice goodwill had no value, the rebuttal expert said, and the trial court agreed, valuing the practice at $41,000.

On appeal, the wife claimed the husband's primary expert failed to calculate any value for goodwill; likewise his rebuttal expert failed to provide an independent value. Thus the trial court erred by relying on the combination of testimony to assign a zero value to goodwill.

The rebuttal expert reviewed both expert reports, however, and was "clearly knowledgeable" with their calculations, the appellate court held. Moreover, he clearly detailed the "serious" flaws in the wife's expert calculations and the more credibility findings by the husband's primary expert, including the lack of excess earnings. Based on this consistency among experts, the trial court was well within its discretion to conclude a zero value for goodwill.

Can a Trial Court Value a Restaurant Based on Cash Flow, but Ignore Gross Sales?

Foppe v. Foppe, 2009 WL 5155996 (Ohio App. 12 Dist.)(Dec. 30, 2009)

After 22 years of marriage, the Foppes owned several real estate and restaurant entities—but only one posed problems during their divorce. At trial, the wife presented an expert to value the husband's 60% interest in a restaurant (the court opinion does not describe the size or type of service). Her expert said the entire restaurant was worth over $650,000.

The husband retained two experts to value the restaurant. The first used a "blended" approach (percentage of cash flow and percentage of gross sales) to find that the restaurant was worth $691,000—or nearly $40,000 more than the price determined by the wife's expert. The husband's second expert adjusted this value to take into account cash, deposits, accounts, and notes payable as a going concern to reach an "adjusted value estimate" of $279,494. She then applied a discount for lack of control, because the husband's interest would fall to 50% soon after the valuation date as a result of a loan and restructuring agreement.

Trial court may have misunderstood expert. The trial court started with the husband's first expert—but the judge may have misheard his testimony, believing he said a restaurant valuation could be based on a percentage of gross sales or a percentage of cash flow (instead of the expert's blended approach). Restaurants "tend to sell for a percentage of a sale or a percentage of cash flow," the trial court wrote in its final orders. In this case, a buyer would most likely prefer to buy at two times cash flow, but the seller would prefer a multiple of three. Because this business was a successful, ongoing enterprise, it would sell "at least 2.5 times cash flow," the court concluded, or approximately $795,000.

However, this exceeded the first expert's value—so the court added the difference ($104,000) to the second expert's adjusted value to find the restaurant worth just over $384,000. It declined to apply a discount, because the husband's still owned 60% at the stipulated valuation date. The husband appealed, claiming that the trial court incorrectly relied on a portion of his first expert's calculation (cash flow) instead of accounting for the entire valuation, including gross sales.

However, the husband's first expert actually relied on a range of gross sales and cash flow to determine the restaurant's value, the appellate court noted. He then averaged both ranges to create an average gross sales valuation ($586,705) and an average cash flow valuation ($794,652). Finally, he then blended these averages to reach a final value determination. "An astute buyer is not going to pay more than three times cash flow for a business," the husband's expert testified; more likely, a buyer would pay 2 to 2.5 times cash flow. He also emphasized that cash flows would be the primary sales driver, and his values reflected "the range restaurants…sell for."

"Thus, there is support for valuing [the restaurant] based on cash flow alone," the appellate court held. Although the trial court may have "misstated" the expert's valuation methods, its decision to value the restaurant based on an average of annual cash flow was supported by credible, competent expert evidence, including the success of the business and its steady revenue growth. The trial court also correctly declined to apply a discount for lack of control based on the appropriate valuation date.

Divorce Court Says AICPA Standards are Instructive but not Binding

In re Marriage of Devries, 2009 WL (Cal. App. 2 Dist.) (Feb. 9, 2009)(unpublished) After 27 years of marriage, the

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Devries filed for divorce. Their chief asset: the husband's construction business. The court appointed a forensic accountant to value the business. In addition to conducting an asset valuation, the expert used three methods to value goodwill. Under the excess earnings and capitalization of earnings approach, she concluded the goodwill had no measurable value. Her third method, using three months of past gross profits, rendered a goodwill value of $100,000.

At trial, the expert explained that gross profit represented the "cleanest" number from the profit and loss statement. She also compared the $100,000 to cash flow and wages. The husband was earning about $119,000 per year; gross income for the first six months of the applicable year amounted to $148,000. Cash flow averaged $68,000. In addition, California case law permits goodwill to be valued in a variety of ways, as long as it is based on historical rather than future earnings. In particular, the expert relied on precedent that valued a medical practice based on three months of receivables. The trial court agreed, adopting the $100,000 goodwill value in addition to the $750,000 asset value for the business, and the husband appealed.

SSVS-1 generally discourages rules-of-thumb. The husband argued that the expert's method for valuing goodwill was ratified by the AICPA's Statement of Standards on Valuation Services, No. 1 (SSVS-1). In fact, the standards disapproved of the expert's "rule of thumb type formula using three months gross profits," he said. Moreover, his own expert (also a forensic accountant) testified that under SSVS-1 it was improper to rely solely on a rule of thumb valuation; industry benchmarks should only be used as a reasonableness check against other methods. Although the business had some goodwill, under the "accepted" formulas of valuation, the husband's expert believed it equaled zero.

The husband further maintained that California courts have recognized the applicability of the AICPA standards "to the determination of legal issues." To support this proposition, he cited a single case discussing an accountant's failure to abide by AICPA standards regarding disclosures to prospective investors in limited partnerships.

In that case, however, the expert supported an extreme deviation from the applicable standards, sufficient to raise a contested issue (i.e., one that would defeat the pending motion for summary judgment). "The court did not embrace the AICPA guidelines as the benchmark for the applicable standard of care for accountants," the Devries court noted, "and nowhere did the court suggest the guidelines should trump established case law."

"We have before us a large body of case law holding goodwill is property of an intangible nature," the court added. These decisions have not laid down any "rigid and unvarying rules" for determining the value of goodwill, but they indicate that each case turns on its own facts, circumstances, and evidence that "legitimately establishes value." Accordingly, the court held that the AICPA standards were instructive but not dispositive in this case. Notably, SSVS-1 took effect on January 1, 2008—nearly two years before the expert valued the husband's business. Given these facts and the precedent that used three months of accounts to value medical practice goodwill, "it was reasonable for the [trial] court...to accept the expert's goodwill valuation based on three months of gross profits."

Alabama Case Clarifies 'Equitable' Fair Value Standard in Divorce

Grelier v. Grelier, 2009 WL 5149267 (Ala. Civ. App.) (Dec. 30, 2009) In what could serve as precedent for states that now apply the broad, equitable standard for valuing businesses in divorce, the Alabama Court of Appeals just considered a case in which the husband owned a minority (25%) interest in several closely held, commercial real estate companies. A court-appointed expert valued the husband's interests a little over $1 million; the trial court adopted this value, but then applied the 40% combined discount for lack of marketability and lack of control advocated by the husband's expert, to reach a value of roughly $602,000. This reflected the "reality of the financial condition of the parties," the court held, including their substantial personal and business debt and the negative value of some of the company's properties.

Appeal based on statutory fair value. The wife appealed, arguing that it was inappropriate to apply marketability and minority discounts to closely held, ongoing business values in divorce. In addressing the issue of first impression, the Alabama Court of Appeals first considered case law from jurisdictions that apply a "fair market value" (FMV) standard in divorce. In those cases, "it makes sense to apply... discounts because those discounts reflect the economic reality that, unlike the case with publicly traded companies, no ready pool of willing buyers exists to purchase an interest in a private business organization that does not carry with it the ability to control that organization."

However, Alabama has adopted the broader equitable standard of value in divorce, requiring determinations to be fair to the parties under the facts of the case. When spouses hold a minority interest and one contemplates continuing the business after divorce, "it makes little sense to determine fair value by the measuring stick of a hypothetical sales price," the court said. That would artificially reduce the value of the marital asset, granting an unfair price to the divested spouse and a windfall to the continuing owner.

Further, cases from other jurisdictions—led by Brown v. Brown (2002), the landmark New Jersey Supreme Court decision—have held that liquidity concerns do not apply when the business will continue as a going concern after divorce. The situation is analogous to the sale of a minority, dissenting shareholder's stock in a closely held corporation.

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Alabama Case (cont. from page 3)

In those cases, "fair value cannot be fairly equated with the company's fair market value," the Brown court said, and discounts are not appropriate because they do not fully compensate the minority owners.

Like New Jersey, Alabama recognizes the statutory fair value standard in the dissenting shareholder context; case law precludes discounts because the minority owner is not acting as a willing seller. "Because the Alabama Supreme Court has adopted the same reasoning that is applied in New Jersey in dissenting shareholder cases, it seems reasonable to conclude that it would follow the same reasoning in divorce cases involving minority ownership of closely held business organizations," the Grelier court held

Accordingly, it remanded the case for a redetermination of value by the trial court—but its presumption of the state Supreme Court's ultimate ruling on the issue leaves the door open for an interim appeal. Moreover, a single judge on the appellate panel dissented: "I would prefer to leave the trial courts of this state with the discretion to determine, on the specific facts at issue in each divorce action, whether or not to apply discounts in valuing various types of business interests."

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