Valuation Verdicts®

Current Valuation & Taxation Rulings Regarding Divorce

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Round up: Critical Issues in Medical Practice Valuations

Five recent decisions highlight the continuing challenges in proving the value of physician and dental practices in divorce, including the effect of buy-sell agreements and the distinction of enterprise versus professional goodwill.

1. Does a buy-sell agreement determine value? The husband in Garcia v. Garcia, 2010 WL 174149 (Fla. App. 2010) owned 25% of a hematology practice. The shareholders' agreement valued any transfer of shares at $45,000. At his divorce trial, the husband argued the buy-sell agreement determined value. Because there was no state law on point, the Florida trial court looked to two decisions from two other jurisdictions (Va. and N.J.). These cases held that the buy-sell agreements were not conclusive but only a consideration on determining value, and that the net asset value (NAV) method was appropriate.

Accordingly, the wife's expert valued the husband's 25% interest under the NAV method at nearly $900,000. He declined to discount the value due to the restrictive buy-sell agreement, saying it was "artificial and unrealistic." The husband's expert also determined NAV, but arrived at a value of approximately $563,000. The trial court adopted the wife's value, and the husband appealed, arguing that the court should have discounted NAV to account for the restrictive buy-sell agreement. But his expert did not calculate such a discount, the appellate court observed. As such, "the trial court was left with the values it was given" and determined that the wife's expert provided the more credible assessment. Accordingly, its valuation was affirmed.

2. What if the buy-sell specifically provides for divorce? Compare Mandell v. Mandell, in which the husband's buy-sell agreement for an oncology practice specifically provided for a repurchase price of only $11,000 on a shareholders death, disability, or departure—including divorce. Notably, neither the husband nor his wife signed the agreement (although the husband signed an employment contract). Like the husband in Garcia, Mr. Mandell argued that the buy-sell value was controlling in divorce—and this time, the trial court agreed, precluding the wife from presenting expert testimony regarding practice value. The wife's offer of proof indicated her expert would have testified to a range of value, from $794,300 (book value) to $1.1 million (fair market value).

On review, the Texas Court of Appeals found that the buy-sell agreement controlled because it specifically covered the incident of divorce. Precedent concerning buy-sell agreements for partnership practices did not apply to the husband's closely held association. Although the wife did not sign the buy-sell agreement, the agreement nevertheless bound the husband to an $11,000 price and furnished proof of comparable sales value at $11,000, the court held.

3. Do a doctor's skills boost value of urgent care clinic? In Amaraneni v. Amaraneni, 2010 WL 502958 (La. App. 2010) (unpublished), the husband owned an urgent care clinic. The husband insisted the clinic had no value apart from goodwill attributable to his professional skills—but he failed to provide the court-appointed expert with specific details or documents in support. At trial, he confirmed the clinic didn't own its building and he didn't keep a regular practice there or work regular shifts. The clinic wasn't named after him and patients couldn't schedule an appointment with him. A manager supervised the day-to-day operations and staff.

Based on this evidence, both the expert and the court concluded the clinic's goodwill value was not attributable to the husband's particular skills. The husband appealed, reasserting his argument that any goodwill was professional and not subject to disposition at divorce. The appellate court rejected these arguments. Having failed to provide appropriate disclosures, the husband "forced" the trial court and its expert to use the available evidence, including the value of the clinic's goodwill.

4. Should South Carolina adopt the majority rule? In Dickert v. Dickert, 2010 WL 98698 (S.C. 2010), the trial court valued the husband's dental practice at $360,000, including $256,517 of "enterprise" goodwill. The husband appealed, citing South Carolina precedent for the proposition that the

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goodwill of a medical practice is simply too speculative to value. By contrast, the wife urged the court to adopt the current U.S. majority rule, which distinguishes enterprise goodwill from professional goodwill values in divorce cases. The South Carolina Supreme Court declined to overturn longstanding precedent, however, and remanded the case for a redetermination of value.

5. What happens when Kentucky adopts the majority rule? By comparison, just last year, the Kentucky Supreme Court adopted the majority rule regarding the disposition of enterprise versus professional goodwill in divorce. At about the same time, the trial court decided King v. King, 2009 WL 2475214 (Ky. App. 2009) (discretionary review denied 2010) (unpublished). There, the husband owned an OB/GYN practice, working over 100 hours per week and earning more than $700,000 annually. These amounts exceeded the "peer" doctor, his expert said, who calculated an adjusted value of the husband's practice at $636,000, without specifying goodwill. The wife's expert used medical survey data to adjust the husband's earnings and valued the practice at just over $1 million, including nearly $800,000 of goodwill.

The trial court adopted the valuation by the wife's expert and the husband appealed, claiming his expert's valuation was more credible for incorporating his excess hours and earnings. The Kentucky Court of Appeals agreed, but for different reasons. The state's "new rule" requires trial courts to distinguish between professional and enterprise goodwill in dissolution actions, the court held. In remanding the case, it noted the trial court should exclude any value of the husband's practice attributable to personal goodwill, including his work hours in excess of the norm.

Five Keys to Protecting Your Financial Expert's Credibility in Court

Attorneys are becoming increasingly sophisticated about business valuation, making it easier for the best of them to pick apart an expert witness's testimony. It's not enough that your expert is qualified by credentials and credibility. To "bullet proof" your expert witness in court against even the most aggressive cross-examination, take note of these five quick tips:

1. Avoid "puffery." One of the easiest ways to discredit financial experts is by identifying areas subject to "puffing"—i.e., where they have exaggerated or overstated their qualifications. For example, if an expert boasts he has 25 years of business valuation experience, a good lawyer will ask methodical, detailed questions about that experience. If, at the end of the questioning, it turns out that the expert has been working for 25 years but has only performed four appraisals of the type at issue in the litigation—that's puffing, and it can damage the expert's credibility.

2. Avoid overconfidence. Financial experts want a court to take their qualifications seriously, but in an effort to impress the trier of fact, they may take an overly confident or "blustery" approach. ("I've been doing business valuation forever and I know everything" is an exaggerated example.) Make sure your experts aren't caught trying to look as though they have more experience than they in fact do.

3. Affirm the data. There are two aspects to reliable expert evidence. First, an expert's valuation must be based on reliable underpinnings. The witness must be able to answer the questions, "Where did you get the data?" "Do you know how the data are collected and compiled?" It is up to the expert to substantiate the source of the inputs supporting his or her opinion, and to disclose (per the Federal Rules) all the documents and data that went into that opinion. Practice tip: Ask your testifying experts to come up with a working list or chart of what they need to form their ultimate opinions and discuss any materials that may not be available or forthcoming. Revisit the list later in the litigation to make sure the expert received the materials and reviewed them.

4. Affirm the methods. Second, an expert's methods must be reliable. For example, courts may be skeptical if an expert fails to perform a discounted cash flow analysis when conducting an enterprise valuation, or fails to explain why it wasn't appropriate in the particular case. If your expert does conduct a DCF, make sure the analysis conforms to valuation authorities' and generally accepted techniques.

5. Reaffirm educator role. Remember that the role of your financial expert is to assist the judge or the jury in understanding a complicated, specialized area of knowledge. The bar against unreliable, irrelevant testimony is high, so make sure your experts rely on generally accepted valuation methodologies and omit anything novel or unproven. In addition, make sure your experts can describe their credentials and experience fairly and accurately, without overstatement. Finally—help them disclose and obtain all the materials they need to support their expert opinions, or risk surprise and loss of credibility at trial.

Roundup on Divorce Cases: Discounts, Valuation Dates, & the Economic Downturn

Is the severe economic downturn sufficient reason for a divorce court to revalue business assets? Does the statutory fair value standard preclude marketability and minority discounts in divorce? And what happens when a trial court combines the income and market approach to valuing a business? The following four recent divorce cases answer these questions and more.

An unprecedented recession. In Mistretta v. Mistretta, 2010 WL 547149 (Fla. App. 1 Dist)(Feb. 18, 2010), the trial court valued the parties' restaurant at $845,000, based on expert appraisals conducted in 2007. Not long after the divorce was final, the husband filed a motion to reconsider. The economic recession caused the restaurant to lose nearly $57,700 in 2008, the husband claimed, and this "newly discovered evidence" merited a new trial and valuation. The trial court granted the motion, finding the 2007-2008 recession was "totally unforeseen."

The wife appealed, arguing that the economic downturn was merely a change in circumstance, and the appellate court agreed. Business valuation is a forward-looking exercise, based on financial facts currently in existence as well as projected revenues and cash flows. "Economic recessions, like other vagaries in the business cycle, are contingencies appraisers must take into account in valuing a business," the court said. Although no valuation expert could have predicted the severe economic crisis, the trial court's order did not explain why, on rehearing, these same experts were more likely to accurately predict future economic conditions. "A cloudy crystal ball is no basis for a new trial," the court held, and it denied the motion.

Application of discounts and the statutory fair value standard. In Lemmen v. Lemmen, 2010 WL 454959 (Mich. App.)(Feb. 9, 2010), the husband owned a minority (25%) interest in a profitable, privately held oil and gas business with his brothers. The husband's expert valued his interest at $5.5 million; the wife's expert said it was worth $17.5 million.

The trial court rejected the husband's valuation expert, finding that he incorrectly applied a discount rate to the company's dividend stream rather than net cash flows. This left testimony from the wife's expert, who declined to discount his $17.5 million value for lack of marketability or lack of control because the company enjoyed exceptionally strong cash flows, low debt, and a substantial cash base. Four years prior to the divorce, however, the same expert had valued the same company for one of the co-owners, applying a 25% minority discount and a 30% marketability discount. He did so only at the behest of the lawyers, the expert explained; it was not his general practice to discount the valuation of closely held stock. Nevertheless, the trial court applied the expert's prior discounts to his current valuation in divorce, and valued the husband's 25% interest at $11 million. Both parties appealed.

The appellate court deferred to the trial court's broad latitude to determine the value of stock in closely held corporations and accepted its valuations, including discounts. It also rejected the wife's arguments that the statutory fair value standard should apply to divorce cases. One judge on the panel dissented, which may set the case for an appeal to the state Supreme Court.

Emphasis on the correct date. In Goodwin v. Goodwin, 2010 WL 669244 (Tenn. App.)(Feb 25, 2010), the parties owned and operated a steel detailing business together. The husband's expert valued it at $385,000, excluding goodwill. Importantly, he valued the company as of the date the wife stopped working for the company as a bookkeeper, in 2007, and the husband took over sole operations.

By contrast, the wife's expert concluded that the steel business was worth $1.65 million, valued as of December 31, 2008—just months before the parties' trial. After considering the evidence and applicable law, the trial court adopted the value as calculated by the wife's expert, and the husband appealed.

Resolving such a wide range of values is "one of the main roles of a trial court," the appellate court said. A trial court is free to value a marital business within the range of evidence presented, and "that is exactly what [this] court did." Further, state law requires valuing a marital business as close as "reasonably possible" to the date of trial. Since the wife's expert valuation was 19 months closer to this date than the husband's, the wife's evidence was more in line with the law, and the appellate court confirmed the lower court's $1.65 million valuation.

A mix of valuation methods. In Rozenman v. Rozenman, 2010 WL 845924 (Ariz. App.)(March 11, 2010)(unpub.), the husband owned a separate cigar business, which appreciated during the marriage (2003-2008). As a start value, the trial court adopted a net asset valuation of the business at $177,000, not because an asset value is generally superior to an income or market approach, it said, but simply because it was the only evidence available.

The parties each presented experts to value the business at the end of the marriage. The husband's expert relied on a net asset approach ($274,000); he also applied a market approach ($518,000) but said it wasn't "financially feasible." By contrast, the wife's expert preferred the market approach

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because the comparables were good and the method adequately accounted for the business's strong, ongoing operations, its workforce, and goodwill.

The trial court adopted the market approach by the husband's expert ($517,800) and the husband appealed, claiming the court should have adopted a net asset value to measure the business both before and after the marriage. Under the circumstances, however, the rationale of the trial court was reasonable, the appellate court held, especially given the lack of market analysis for the start-up business at the beginning of the marriage.

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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