Valuation Verdicts®

Current Valuation & Taxation Rulings Regarding Divorce

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Divorce Courts Still Caught In 'Quagmire' of Goodwill

Dividing the value of professional practice goodwill is still creating a "quagmire for courts," according to the first of these recent decisions. Are corporate and professional goodwill truly distinct? How does a non-compete agreement affect the distinction? Should there be a rule against considering the professional's earnings in both the practice valuation and the maintenance award? Whether these four cases help answer the questions or deepen the quagmire, only time (and future litigation) will tell.

Wisconsin may have crafted a new standard. In *McReath v. McReath*, 2010 WL 2943198 (Wis. App.)(July 29,2010), the husband bought his orthodontic practice during the marriage for $930,000. During divorce, his expert valued the practice at only $415,000, but the trial court rejected this value, based largely on the husband's buy-in price and his consistently high earnings. It adopted the $1 million valuation by the wife's expert, attributing a substantial portion to professional goodwill, and used the husband's earnings to award the wife substantial maintenance. The husband appealed, arguing that state law precluded the division of professional goodwill and, further, it should not be used as a basis for spousal support when it was also factored into the overall practice value (the "double dip"). The wife's argument was simple: because the husband's professional goodwill was all *salable*—i.e., subject to a non-compete agreement—it was all divisible marital property.

The appellate court agreed that a non-compete would effectively transfer a substantial portion of the husband's goodwill to a potential buyer. Prior case law precluded the division of non-salable goodwill, but said nothing about "salable" goodwill, the court noted. Fairness considerations might also support dividing such salable goodwill. For example, what if the husband planned to retire and sell his practice the day after divorce? Under a per se rule prohibiting the division of all professional goodwill, the wife wouldn't share in the practice's full value, but the court would set maintenance knowing that retirement was imminent. Alternatively, a court could include salable goodwill in the property division and adjust maintenance accordingly, but without expert evidence to explain the correct offset, the court could not make such a determination or remand the case with adequate guidance. As a result, it confirmed the trial court's approach, "to include all salable goodwill, both corporate and professional, as a divisible asset and then, essentially, ignore . . . that [the husband's] earnings are intertwined." A single, strong dissent would have remanded the case for a fairness review of the maintenance award vis à vis the division of assets.

Tennessee court excludes patient files as professional goodwill

In *McKee v. McKee*, 2010 WL 3245246 (Tenn. Ct. App.)(Aug. 17, 2010), the wife owned a long-standing dental practice with two partners, one of whom recently bought his share for $749,000, allocating 45% to professional goodwill and 34% to patient files and records. The wife's divorce expert appraised her 33% interest at only $97,000, however, because state law required the exclusion of all professional goodwill, which he believed included the patient records. By contrast, the husband's expert classified the patient files as a separate asset from professional goodwill. This view was consistent with the two prior valuations for the partnership buy-ins, which he relied on to apportion the goodwill value between the business and the professionals, ultimately appraising the wife's one-third interest at $460,000.

The trial court adopted the $97,000 value, because in its opinion, the only salable assets would be the equipment and accounts receivable. It also found the patient

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records "had no value without a non-compete." The court awarded 75% of the marital property to the wife and 25% to the husband—and the husband appealed, but the appellate court deferred to the lower court's factual findings. It also found that state law excludes personal goodwill from the valuation of a professional practice, and confirmed the $97,000 value of the wife's interest.

Ohio court limits professional goodwill to value of non-compete

In *Banchefsky v. Banchefsky*, 2010 WL 3527578 (Ohio App.)(Sept. 9, 2010), the husband sold his solo cosmetic dentistry practice for $580,000 during the divorce, specifically allocating $20,000 to patient records, $15,000 for a non-compete, $416,000 for unspecified goodwill, and the remainder to tangible assets. At trial, the husband's expert said the value attributed to the non-compete in the purchase agreement was "arbitrary." Using a quantitative model, the expert allocated $215,000 to the non-compete as professional, non-divisible goodwill. The trial court accepted the model, but found it didn't apply due to the arm's length sale of the practice. It valued the husband's professional goodwill at $15,000 and divided the remainder of the sale proceeds ($565,000) equally between the parties.

On appeal, the court confirmed, finding 1) under state law, a covenant-not-to-compete constituted professional goodwill and was a non-marital asset; and 2) evidence of an actual sale and assigned value supported the trial court's $15,000 valuation of the non-compete and distribution of the remaining sale proceeds.

Iowa declines to rule against the 'double dip'

Finally, in *In re Marriage of Barten*, 2010 WL 2598333 (Iowa App.)(June 30, 2010), the wife owned her own law practice, earning just $44,000 per year from about $88,000 in gross revenues and reported earnings of $8,000, after payroll and expenses. The wife testified her practice had no value and operated at a loss, supported by her credit cards. "It is essentially like a job to me," she said. The husband estimated the practice was worth $200,000, based on his estimate of the firm's gross. Neither party retained an appraisal expert.

The trial court valued the practice, its law office fixtures plus the wife's earnings, at $56,000. The wife appealed, arguing that state law precluded the court from considering her earnings (professional goodwill). The Court of Appeals disagreed, citing Iowa cases that acknowledge precedent from other jurisdictions that permit divorce courts to value goodwill. Moreover, the Iowa cases that declined to value professional goodwill did consider the practitioner's earnings to determine child and spousal support. "Contrary to [the wife's] position, Iowa courts are not prohibited from considering goodwill or future earning capacity when determining the value of a professional practice," the court held, and confirmed the lower court's value.

Court Prefers Expert with BV Experience and Better Application of FV Law

***California DHI, Inc. v. Erasmus*, 2010 WL 3278224 (C.A. 10 (Colo.))(Aug. 20, 2010)(unpublished)**

In the early 1990s, a veterinarian formed a company to develop an animal food supplement with two partners, including the defendant. When the company discovered the defendant was creating a competitive supplement based on the same formula, it sued and won an $800,000 verdict. Six months later, the company merged with a California firm and the defendant invoked his statutory right to dissent and demanded purchase of his shares. Not surprisingly, the parties were unable to agree on the fair value of his 33% interest and found themselves back in court.

The parties' experts proposed widely divergent fair value appraisals. The company's expert was an experienced business appraiser who valued the enterprise at approximately $3.7 million. The defendant's expert, an investment banker with experience in the natural foods industry, valued the company at more than twice that amount—or $7.6 million. The federal district court ultimately adopted the lower value by the company's expert, finding it more reliable for several reasons, including her "significant appraisal experience; her application of the fair value standard as reflected in Colorado law; her reliance on [the company's] financial records; and the thoroughness with which she explained and duplicated

her methodology." By contrast, the court noted several "gaps" in the methodology used by the defendant's expert, questioned his choice of comparable companies and products, and discredited his anticipated growth rate calculation.

The court accepted the defendant's assertion that the company's $800,000 judgment against him was too contingent on collectability to be included as an asset. However, the court declined to subordinate the company's debt to the defendant's share, and ultimately reached a going concern value of roughly $2.3 million—or just $800,000 for the defendant's 33% interest (ironically, just about the same amount as the defendant owed the company in the prior lawsuit).

After an unsuccessful request for reconsideration, the parties appealed to the U.S. Court of Appeals for the Tenth Circuit. On "careful" review of the record and the applicable state law, the 10th Circuit summarily dismissed all claims. The district court correctly determined the valuation date and the more credible valuation. It also correctly decided that the $800,000 judgment in favor of the company was too contingent to include in the fair value appraisal, but that all corporate debt should be included before an award of the defendant's proportionate share.

Fair Value Standard in Divorce May Not Be Gaining National Traction

Two recent appellate decisions suggest that the majority rule may be trending away from the fair value standard in divorce, preserving (where applicable) the trial courts' broad, equitable discretion to dispose of marital assets according to the particular facts of the case.

Court discounts an LP interest. In *Alexander v. Alexander*, 2010 WL 2006427(Ind. App.)(May 20, 2010), the wife held a 5% limited partnership interest in a family-owned farming business. Her parents retained full control as general partners, including the right to prevent a partition and to redeem a departing LP's shares. Accordingly, the wife's expert applied a 25% minority discount and 15% marketability discount to value her interest at roughly $234,000, which the trial court accepted.

The husband appealed, urging the Court of Appeals (Indiana) to preclude the application of discounts in valuing marital assets in divorce, based on the analogy to shareholder oppression cases. Indeed, a majority of U.S. jurisdictions currently reject minority and marketability discounts when determining fair value appraisals in statutory buyback cases to prevent a windfall to the majority owners at the minority's expense. Given the parents' rights in this case, it was clear that they would be the likely buyers should the wife need to sell her LP interest to effect the distribution of marital property. The wife might even sell to her parents the day after divorce, the court noted, at "considerably more" than the trial court's value.

Nevertheless, the wife had no immediate plans to sell her LP shares, and there was no danger of a windfall to the other partners. According to its broad discretionary powers, "a trial court should be able to determine the present value of a spouse's ownership in light of marketability and minority shareholder discounts," the court ruled, affirming their application in this case.

Court discounts a *controlling* interest. In *In re Marriage of Thornhill*, 2010 WL 2169086 (Colo.)(June 1, 2010), the Colorado family court adopted a 33% marketability discount for the husband's *controlling* (70%) interest in a $1.7 million oil and gas operation. The wife appealed, but the Colorado Court of Appeals affirmed, rejecting the wife's argument that discounts should be precluded when valuing marital assets for divorce, based on the state precedent in statutory fair value cases. See IRM Thornhill, 2008 WL 3877223 (Colo. App.).

This time the wife appealed to the state Supreme Court, which reviewed the leading statutory fair value precedent in Colorado. That case turned on the statute's explicit use of the fair value standard and (similar to the rationale expressed in Alexander, above) precluded discounts to prevent a windfall to majority owners at a minority shareholder's expense. By comparison, the state's marital dissolution statute does not contain the same "fair value" language, the court observed; it simply directs family courts to divide marital property "in such proportions as the court deems just after considering all relevant factors." A non-owning spouse cannot always be characterized as a "potential victim" of oppression in divorce cases, the court added.

More importantly, unlike the law in shareholder cases, "there is no clear national trend suggesting that a *per se* rule against marketability discounts is the majority view when it comes to valuing ownership interests

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Fair Value Standard

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in closely held corporations in divorce proceedings. If anything, the trend appears to go against such *per se* rules," the court observed. Although New Jersey has extended the rule prohibiting discounts from shareholder dispute cases to divorce, several states (e.g., Oregon, Florida, and South Dakota) "have left the decision of the appropriateness of marketability discounts in valuations within marital dissolutions proceedings to the trial court's discretion."

Finally, compared to the statutory fair value standard—which rejects a case-by-case approach to appraising minority interests as too uncertain and unfair—the Colorado marital dissolution statute specifically contemplates an ad hoc approach to preserve equitable distribution. For all these reasons, the court declined to adopt a *per se* rule, finding that trial courts may, in their discretion, apply discounts when valuing a spouse's business interest for purposes of divorce.

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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