Valuation Verdicts®

Current Valuation & Taxation Rulings Regarding Divorce

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Buyout Agreement Irrelevant to Valuation of Spouse's Business Interest

***In re Corclasure v. Corclasure*, 2012 Okla. LEXIS 106 (Nov. 20, 2012).** The wife owned a hardwood floor business for four years before selling a 49% interest to her fiancé for $5,000. After they married, the couple executed an operating agreement that contained a buyout clause. This provision stated that in the event of a divorce, the parties would hire an independent appraiser to value the company, but if they failed to agree on one, each would retain an independent appraiser. If these valuations diverged too much, they would hire a third appraiser to calculate an averaging valuation. The valuation date was "the last day of the month immediately prior to the month in which the [triggering] event occurred," according to the agreement. It also allowed each member to compete with the company while working for it.

In December 2009, the parties filed for divorce, but the husband remained working for and receiving income from the business. He also continued to charge expenses to the company and started a competing business using company resources, prompting the wife to obtain a court order restricting these activities.

Instead of following the buy-sell agreement, the parties each retained experts to calculate the value of the business for trial. The wife's expert, a CPA and lawyer, used an income and excess earnings approach and a Dec. 31, 2009, valuation date, which did not comply with the buy-sell, but was closest to the divorce filing and the end-of-year financial records were "better," he said. At the same time, he accounted for nearly $300,000 that the husband diverted from the business after the valuation date because "the event was both known and knowable." Based on figures from the wife, he concluded that the diversion caused the total value of the business to drop by $104,000. (The court's opinion does not provide the total value of the business.) Under the buy-sell agreement, he said the business's value was approximately $216,000.

During cross-examination, the wife's expert acknowledged a $144,000 calculation error. He also stated he used a different date than the buy-sell agreement would otherwise provide and that he didn't apply generally accepted accounting principles; rather, he followed NACVA's professional standards. Under continued questioning, he admitted to using a 39.96% capitalization rate in an earlier report, as opposed to, what he agreed was, a "relatively high" 47.05% in his final valuation and acknowledged using a C corporation tax rate although the company was an S corp. Finally, he stated that the business grossed over $126,000 in 2009 income from receipts worth $635,000.

The husband's expert, a CPA, CVA, and attorney, used a capitalized cash flow approach an a Nov. 30, 2009, valuation date per the buy-sell agreement. He made no adjustment due to the husband's competition or diversion of funds because he believed neither was "known or knowable" at the valuation date. He also did not include any enhanced benefits the husband might have received and overall valued the company at $480,000 and the husband's interest at $235,200.

The trial court adopted the husband's value and, after the appellate court affirmed, the wife petitioned the state Supreme Court for review.

The wife argued the value failed to reflect the husband's direct competition, which provided him income based on diverted funds while he continued to receive income from the marital business.

The husband claimed there were no grounds for reducing the award. His competition occurred after the valuation date, which, under the buy-sell agreement, was "unalterably" Nov. 30, 2009. Moreover, the agreement specifically permitted him to compete with the marital business.

The appellate court noted that the parties "cherry-picked" their agreement for the terms most favorable to each. They could have resolved the business valuation based on the buy-sell provision, but once they went to trial, the result turned on the statute's requirement for a "fair and just" disposition of assets. In this case, the husband bought into the business for $5,000 and then received 47 times that amount in the trial court's award, which, on its face, was not equitable, the court held. Further, the trial court should have accounted for the husband's disbursements and his competition with the business, particularly given his status as an insider.

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Once again, the buy-sell agreement's provisions were irrelevant in this regard; the focus should have been on whether the husband's actions "lowered the company's value."

The court also agreed with the wife that state precedent required addressing the husband's income and diversion of funds during the pending divorce, but declined to adopt her expert's valuation, which failed "to give a balanced picture" of these amounts, since it relied on the wife's calculations. Accordingly, the court remanded the case for a new determination of the business's value.

Notably, a strong dissent accused the majority of "invading the province of the trial court while rewriting the parties' contract." The wife made a bad business decision by selling a portion of her business to her soon-to-be husband. Their subsequent agreement was unambiguous, permitted direct competition, and provided a valuation formula. Further, the dissent cited inconsistencies in the valuation by the wife's expert, particularly his "inflated" capitalization rate and his choice of a higher C corp tax rate. For all these reasons, it would have affirmed the trial court's award.

Court Affirms No Portion of Value is Attributable to Personal Goodwill

***In Burnett v. Burnett*, 2012 Ind. App. Unpub. LEXIS 1477 (Nov. 29, 2012).** The husband was an anesthesiologist in a large practice with 68 partners. The total number of partners had remained fairly stable, with every partner holding an equal ownership interest. However, under an operating agreement, they received unequal distributions based on a formula (which the opinion does not provide). The 32 partners who joined since 2001 had paid $100, and those who left received $100 plus a termination benefit.

Actual earnings versus industry standard. At divorce, the wife presented expert testimony from a credentialed business valuator to quantify the husband's business interest, including its intangible value, that is, goodwill. Because Indiana considers only goodwill attributable to the enterprise community property, the expert eliminated the husband's personal goodwill from his calculation, using a variation of the excess earnings method.

He found the following factors indicated goodwill that inhered in the business:

- The practice was an organization with a formalized structure that required every partner to execute a covenant not to compete;
- The entity, not the individual partners, owned contracts with multiple facilities, and its ability to generate revenue did not depend heavily on the personal services that any one partner performed;
- The business's name did not feature individual partners, and its identity remained unchanged despite the arrival or departure of partners;
- The practice alone determined what partner would provide services at what facility; the husband was able to work at a facility regardless of his personal relationship with patients or surgeons; and
- As a partner in the business, the husband did not need to expend time on nonbillable activities, including finding and scheduling work and billing and collecting for it.

To determine personal goodwill, the expert reviewed industry data from a trade group about the number of billable units that anesthesiologists record annually and the compensation that corresponds with a specific production level. The husband's billable units for 2009 indicated he was slightly below the 90th percentile in terms of productivity. At the same time, his earnings exceeded those of anesthesiologists at the 90th percentile. The expert used the difference between his actual earnings and the industry standards to capitalize the excess earnings.

As to the calculated value of the husband's interest, the expert said it applied under different assumptions, including the sale of the practice, the sale of the husband's interest, and the husband's remaining a a partner or leaving the business. He concluded that the investment value was $337,000 and the fair market value was $253,000.

The trial found the expert's methodology properly eliminated personal from enterprise goodwill. The noncompete agreements and the practice's long-standing exclusive contracts with multiple facilities suggested it would continue to have value even if the husband withdrew. "This," the court said, "is indicative of enterprise goodwill." Ultimately, it adopted the appraiser's lower value and the business interest was worth $253,000.

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The husband challenged the valuation in the state Court of Appeals, claiming the trial court failed to separate personal from enterprise goodwill.

The law is well settled and requires that "goodwill that is based on the personal attributes of the individual is excluded from the marital estate," the appellate court said, citing *Yoon v. Yoon,* 711 N.E.2d 1265 (1999). The value that exists in the patient base and would be transferrable to a buyer who does not bring the same attributes to the business as the individual physician is enterprise value, the court continued.

The evidence supported the trial court's valuation based on the expert's calculation. Moreover, the court stated, the lower court's "extensive findings of fact and conclusions of law" made it easy to discern what portion of the expert's aggregate value was attributable to the husband's personal goodwill: "none."

Valuation of Family Business Survives Expert's Deviation from Industry Standards

***In Russell v. Russell,* 2013 Ark. pp. LEXIS 151 (February 27, 2013).** The husband challenged the trial court's valuation of a family business, claiming there was no credible evidence to show it had a "fair market value" independent of the company's founder - his stepfather.

At divorce, the husband and wife agreed on the division of all property but disagreed about the value of his one-third interest in his stepfather's business, which he acquired during the marriage.

Both sides presented expert testimony, and both experts agreed that the value of 100% of the company was $3 million, but their computations of the value of the husband's interest differed greatly.

In a pretrial deposition, the wife's expert, a CPA, issued a disclaimer: His valuation did not follow the industry standard or his own practice; he intended it only for himself and his client, not for third parties. Normally, he would discuss general economic conditions, industry-specific and company-specific risks, a standard value for the shares, and goodwill. Here, he did none of these things because he had agreed with the wife what numbers and discounts to apply.

He said he "dropped the Mergerstate average control premium of 29.6% to 10%," reasoning that the husband had some control over cash flow but admitting that a willing buyer of his shares might not think that control followed the purchase and may discount the value by 50%. He applied a 5% marketability discount even though he agreed that a buyer might aim for a much higher rate, between 30% and 40%.

Later, in his trial testimony, he said he discounted the company's value by 10%. Since the husband and his two brothers, who each also owned one-third of the shares, could take money of the company, they all had a degree of control. Although he recognized that the average marketability discount was 35%, he did not apply any. "Marketability and lack of control are not distinguishable," he stated.

To account for the risks related to the possible sale of the company's only client, he further discounted the value by 6%, a rate he though was high. He relied on the wife' statements that the company had retained the client despite several earlier changes in ownership and that, to her, meeting the client's requirements "was extremely important and outweighed any personal relationship." Similarly, the husband had stated the client seemed to like the company because it could adjust to changes more quickly than competitors.

Because the stepfather no longer owned the business, the wife's expert did not discount for the founder's personal goodwill.

The husband's expert, A CPA, prepared a fair market valuation that complied with industry standards. Because the company was a going concern and he could not find comparable businesses, he used an income approach. Assuming a total value of $3 million, the husband's interest was $1 million. He also thought that the company's only client might be downsizing due to changes in ownership. The expert applied a 30% discount for lack of control and a 35% discount for lack of marketability, reducing the value to $458,000, half of which -$229,000-belonged to the wife.

He then discounted the goodwill of the company, assuming the enterprise goodwill was 50% and the personal goodwill attributed to the stepfather was 50%. The total value of the wife's share was no more than $115,000, he concluded. The expert's goodwill determination assumed that the stepfather remained with the company.

The trial court found that the stepfather was the company's owner of record, but the husband and his brothers all owned an equitable interest in the business. It determined that, based on all evidence, the wife's interest in the business was worth $273,000. In a motion for a new trial, which the court denied, the husband objected that the order included pay for nonmarital personal goodwill.

The husband then challenged the decision at the Arkansas Court of Appeals. The wife failed to prove that the company had fair market value independent of the

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founder's goodwill, he argued. Specifically, the trial court's valuation rested on "questionable" expert opinion.

The appellate court acknowledged that the lower court knew that the expert, rather than following industry standards, used discounts pursuant to his agreement with the wife. But, the reviewing court said, both experts agreed on the value of 100% of the company. Also, other competent evidence supported the trial court's valuation. For example, it heard about the wife's commitment to meeting the business needs for the firm's only client and the husband's belief that the client liked the firm.

Further, the husband failed to present evidence that might lower the value of the company, including proof that the client had reduced the assignments it gave to the firm or that it was downsizing, as his expert claimed. The Court of Appeals upheld the trial court's award to the wife.

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