Fall 2014

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Current Valuation & Taxation Rulings Regarding Divorce

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Valuation Confirms Salability of 'Unique' Restaurant's Goodwill

***Brave v. Brave,* 2014 Ark. LEXIS 232 (Apr. 17, 2014).** What a difference a court makes! A divorce case involving a successful restaurant made news several months ago when the state Court of Appeals extended the scope of personal goodwill to businesses other than professional partnerships, requiring the trial court to exclude the value of the husband's personal goodwill from its calculation. To block a revaluation, the wife appealed to the state's highest court, which reviewed the trial court's determination as if the appeal had been filed with it in the first case.

EBITDA valuation. At divorce, the husband and wife vigorously contested the value of their successful restaurant. Both were 50% shareholders, but in the course of the marriage the husband, as the chef and creator of the menu, had come to play the greater role in its day-to-day operations. At trial, the spouses presented two "nationally certified business appraiser experts" who valued the restaurant using various methods, including the income approach, but their testimony proved inconsequential to the trial court's valuation. Instead, the court looked to a valuation the husband's business consultant, who was not an accountant or financial expert, offered. He said he did an "EBITDA valuation of the business" and determined the restaurant was worth slightly more than $819,000. When asked how much of it was goodwill, he replied, "[t]he goodwill part is the value of the business." This value excluded fixtures, furnishings, equipment, or anything in it, all which had a fair market value of over $82,000. At the same time he also included a $120,000 value in his calculation; he said it represented the value for a new owner to replace the husband.

The trial court ultimately found the testimony "not helpful…to the argument that we should recognize personal goodwill." But, it said, unlike most testimony in divorce cases that was developed solely for the purpose of litigation, this opinion tried to get at what the business would sell for. "The person that comes in to say this is my belief based on my assessment of what this would sell for in the open market. So that was good testimony." The trial court valued the real estate of the business entity at $495,000 and the restaurant at $895,000, including fixtures and equipment. Deducting debt of $550,000, it determined the business had a net value of $840,000, including real property. The wife's half interest in the restaurant was worth $420,000.

The husband challenged the valuation at the state Court of Appeals. The trial court was wrong not to recognize that the restaurant's goodwill was personal to him and thus non marital property, he contended. The appellate court noted the difference between corporate and personal goodwill and pointed out that, up to the present, state courts had not recognized personal goodwill in a business that was not a professional practice, such as a medical or dental office. But, "under the unique facts of this particular case, we are extending the concept to [the restaurant] because [the husband's] presence is essential to the success of the restaurant." It remanded the case to the trial court, ordering it to perform an allocation between personal and corporate goodwill. The opinion spurred a strong dissent from two judges who said the majority "selectively relied" on the witness's statements that supported its finding of personal goodwill while ignoring others that disproved it and who cautioned that the court's vague language ***risked allowing the exception to apply to "every small business with a key man."***

No extension of personal goodwill. Subsequently, the wife appealed the Court of Appeals decision to the state Supreme Court, which reviewed the trial court's ruling as to goodwill as if the appellate decision had never happened.

To assess whether the trial court erred in finding corporate goodwill, the Supreme Court honed in on very different aspects of the consultant's testimony than the Court of Appeals had done. The high court did not adopt the husband's position that there was personal goodwill in nonprofessional practices, such as the restaurant at issue. Also, even if there was, the Supreme Court said, there was no evidence that the trial court erred in finding corporate goodwill only in this instance. The witness said he valued the restaurant as if sold on the open market and this valuation included goodwill. Moreover, his valuation took into account the replacement for the husband.

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"Goodwill is characterized as corporate goodwill…if the evidence establishes the salability or marketability of the goodwill as a business asset," the court pointed out. Therefore, the trial court did not err in assigning the goodwill to the business. The state Supreme Court set aside the Court of Appeals' decision; there was no revaluation.

Court Affirms 'Market Valuation Assessment' of Family Businesses

Prevost v. Prevost, 2014 Minn. App. Unpub. LEXIS 288 (April 7, 2014). A recent appeals court decision tackles the issue of how to value a closely held business for marital property purposes where state law on the one hand has leaned heavily on the eight factors set forth in IRS Revenue Ruling 59-60 and on the hand has cautioned against their rigid application and a too-narrow approach. The case serves as a reminder for valuators to familiarize themselves with the applicable case law.

During the marriage, the husband started two companies. He was the sole owner of a construction company he had formed in 1984, and he owned 51% of a maintenance company, with his brother owning the remainder. The parties agreed that the husband should get the entire interest of both companies but argued over their values. At trial, they presented expert testimony.

The wife's expert undertook a "market valuation assessment" for both companies using four different approaches to determine the price at which the companies would sell to a willing buyer: a percentage of average annual sales, a percentage of gross sales of the most recent full year, a percentage of gross profits, and a multiple of the average annualized seller's discretionary earnings (SDE). The use of the SDE allowed buyers to estimate the "true" cash flow necessary to pay themselves, make payment on interest and principal on any debt financing, and retain earnings in case of contingencies, the expert explained. He reviewed the businesses' internal tax returns from 2010 and 2011 and their internal profit and loss statements for 2010 to 2012. Moreover, he considered the effect of the 2008 economic downturn on the construction industry as well as signs of an upward trend between 2010 and 2012 and looked at sales of other comparable businesses. He also used industry rules to measure the sales value of contracting services.

He pointed out that some of the assets of the business had more value than the corporate books showed; for example, the construction company's balance sheet indicated more than $223,000 in fixed assets, reduced by a little over $189,000 in depreciation. He concluded that the construction company probably would sell for $288,000 and the husband's interest in the maintenance company was worth $11,000.

The husband's expert applied various valuation methods for both entities. As to the construction company, under the cost approach, looking at the value of its assets, he found it had a negative book value of about $82,700. After adjustments, he concluded it was worth approximately $4,200. For the income approach, he used the "capitalization of earnings method" to estimate the earnings capacity of the company. He found there was no record of compensation for the husband and modified the earnings to reflect an "appropriate market officer compensation," which he set at about $120,300 per year. Subtracting that amount from the company earnings yielded a negative income. He concluded there were no earnings to capitalize. Even though the company existed since 1984, the expert said he was unable to use the market approach because the business was a startup.

For the maintenance company, the asset approach generated a negative value. Further, the expert concluded that deducting market wages for the husband under the income approach also yielded a negative value. And, since the company only existed since 2010, he said he was unable to do a market valuation.

Improving market, but negative value? The trial court credited the valuations of the wife's expert but lowered the value of the maintenance company by half—$5,500—to reflect the difficulty in selling a company with divided ownership. It said the valuations the husband's expert proposed were not persuasive. How could a business be worth only $4,200 in 2012, "when the market is improving and there are no demonstrated, significant changes to the business," the court asked. both businesses showed rising ordinary business income between 2010 and 2012. Also, since the construction business was not a startup company, there was no reason not to do a valuation under the market approach.

In a motion for a new trial, the husband contended the wife's expert "put together a marketing proposal" instead of a valuation. He did not "follow established methods." The trial court disagreed and denied the motion.

The husband then appealed to the Minnesota Court of Appeals, claiming the wife's expert did not know the applicable law—specifically, IRS Revenue Ruling 59-60, and the case that applied it. Therefore, his valuations were unreliable and the trial court erred in adopting them.

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No one approach fits all. At the outset of its analysis, the appeals court emphasized that state courts have employed a number of different approaches to value closely held corporations for marital property purposes. In an influential case, the state Supreme Court said: "Although Revenue Ruling 59-60 sets out the procedure used by the Internal Revenue Service for estate and gift tax valuation, we regard the eight fundamental factors therein identified as equally appropriate for use and analysis in determining the value of a closely held corporation as marital property for purposes of equitable distribution." *Nardini v. Nardini, 987 Minn. LEXIS 841 (1987)*.

The eight factors are: (1) the nature of the business and the history of the enterprise from its inception; (2) the economic outlook in general and the condition and outlook of the specific industry in particular, (3) the book value of the stock and the financial condition of the business; (4) the earning capacity of the company; (5) its dividend-paying capacity; (6) enterprise goodwill or other intangible value; (7) sales of the stock and the size of the block of the stock to be valued; and (8) the market price of stocks of corporations engaged in the same or a similar line of business having their stocks traded in a free and open market.

But the *Nardini* court pointed out that a proper valuation not only was a matter of applying the relevant facts, but also required the use of common sense and sound judgment in weighing the facts and "determining" their aggregate significance." And it noted that the value of a family business "cannot be less than a sum equal to the net proceeds which could be realized from the forced sale of the tangible [and intangible] assets…after payment of all liabilities."

Besides *Nardini*, the appeals court here looked to a treatise on valuing closely held corporations in the divorce context, which proposed four methods: book value, capitalization of earnings method, dividend paying, and liquidation value to compute the entity's fair market value. But the authors caution that state courts have discredited book value because it is subject to manipulation and inaccuracies.

In this case, the appeals court found that the four-prong approach the wife's expert took, his considering the economy and the conditions particular to the industry, and his comparing the husband's business to others that sold as reported in national databases represented steps in line with the IRS revenue ruling and *Nardini*, even if the expert did not refer to those authorities in his report. Further, the expert addresses certain inaccuracies related to book value. As for the district court, it gave reasons for rejecting the valuations of the husband's expert. And, by discounting the value of the maintenance business to reflect divided ownership, the trial court showed it did not blindly accept the valuation of the wife's expert. In sum, even though the methods the wife's expert used were not the only ones with which to value the entities under state law, they provided sufficient support for the trial court's value conclusions. Therefore, the appeals court affirmed the findings.

Divorce Court Discredits Experts for Manipulating Data

Hoker v. Hoker, 2012 Iowa. LEXIS 277 (April 11, 2012). During the parties' 12 year-marriage, they started a trucking company, of which the husband was the sole equity owner. At trial, both parties submitted their respective expert valuations of the company, each purporting to apply the fair market value standard and agreeing that the net asset value (NAV) approach was the most appropriate in this case. The wife's expert also used the market approach, relying on sales data of similar companies.

Different access to information. Under their NAV approaches, the experts essentially subtracted the trucking company's total liabilities from its total assets. However, only the husband's expert had access to financial statements as of the end of the year closest to the trial date (Dec. 31, 2011). These showed assets in excess of $1.6 million and liabilities of $1.4 million, resulting in a fair market value of approximately $234,000. The husband's expert applied a 10% discount for lack of marketability to the private company, for a final value of $210,000.

In contrast, the wife's expert relied on the company's December 2009 balance sheets - the only information available to her as of the trial date, she said, because the husband denied her access to any more recent records. Based on their indication of total assets of just over $1.4 million and liabilities of $650,000, the wife's expert concluded the company was worth nearly $790,000, without applying any discounts.

The trial court discredited both expert opinions. It could not rely on the husband's expert, it said, because his valuation included the husband's purchase of new equipment for the company during the pendency of divorce proceedings. Although the husband might have had legitimate business reasons for making these purchases, their timing also cast his actions in "legitimate doubt," the court said. "Simply stated, [the husband] had both the reason and opportunity to manipulate the financial structure and condition of the [business] to decrease" its overall net value by between $150,000 and $200,000. Since he'd also requested the business in any property division and intended to operate it after the divorce, the court also did not believe a marketability discount was appropriate, particularly under an NAV approach.

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At the same time, the court found the wife's valuation 'suspect' because her expert relied on dated financial data and inaccurate estimates of the value of the business's "rolling stock." The court also criticized the expert's market approach for "manipulation of the comparable sales data" to include sales of businesses that were neither temporally, geographically, nor functionally similar. As a result, the court used the undiscounted value by the husband's expert ($234,000) and added back the minimum amount of value lost to the equipment upgrades ($150,000), for a total value of $385,000, and the husband appealed.

Summary affirmation. In reviewing the record, the appellate court affirmed that "only part" of the increase in the trucking company's liabilities could be supported as a business decision; the remainder appeared to be a way to manipulate the company's overall net value during the dissolution. As a result, the adjustment to the valuation by the husband's expert was proper, particularly in light of the trial court's findings on credibility and the range of evidence presented.

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