Spring 2015

Valuation Verdicts®

Current Valuation & Taxation Rulings Regarding Divorce

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Treatment of Debt Skews Valuation of Franchise Business

In re. *Freihage v. Freihage,* 2015 Ill. App. Unpub. LEXIS 14 (Jan. 7, 2015). A recent divorce case raises interesting issues as to how to value a company owning McDonald's franchises. The dispute featured two experts who were seasoned in franchise valuation, and both performed a discounted cash flow analysis but reached results that were approximately $10 million apart. The trial court's calculation generated its own set of questions with the parties as well as the appeals court.

Divergent views on DCF factors. Over the course of the marriage, the husband bought seven McDonald's restaurants. In the process, he accumulated debt to a bank in the amount of $3.7 million and to a family trust in the amount of $5.8 million. In 2000, the husband created a single-member limited liability company (LLC) that owned the McDonald's franchises. He also was the president and sole shareholder of a management company that operated the franchises.

At divorce, the LLC was the most significant asset and as such fueled the most contention between the spouses. Both parties presented testimony from experts who had deep knowledge of the McDonald's franchise system and who used the discounted cash flow (DCF) analysis to value the company. But the experts disagreed over components, such as the applicable discount rate and sales growth rate. And, although they both allowed that the restaurants required improvements, they disagreed as to whether and how certain rebuilds and reinvestments in the restaurants would take place.

The husband's expert stated that he spent 75% to 80% of his time working with McDonald's operators and franchises and thus far had performed between 50 and 100 valuations of McDonald's restaurants. Moreover, his firm was a member of the National Franchise Consultants and Accounts (NFCA), an organization that had an extensive database on which members could share monthly financial information and compare one firm's clients with stores in the U.S. that showed a similar sales volume. The database included information on 3,400 McDonald's restaurants.

According to the expert, there were two key components to a valuation of the LLC: sales volume and rent. For his calculation, he visited all seven restaurants and reviewed year-end financial statements, an NFCA report, McDonald's "P&L Opportunity Report" for the top 50 stores in the same television market as the LLC's restaurants, and information about possible rebuilds and reinvestments in the LLC's restaurants. He explained that he used the NFCA database, rather than McDonald's opportunity report, to compare the LLC's restaurants with some 200 to 400 McDonald's franchises that had a comparable sales volume. The opportunity report, he said, provided a much smaller pool of comparable restaurants — about 300.

For his DCF analysis, he projected cash flow for 10 years based on a cash flow statement. He said the "standard" discount rate was 20%, but he opted to use a 30% discount rate for one restaurant to account for an "increased risk based on its expected lease expiration in 2016." In projecting future sales, he used a 2% growth rate.

He explained that capital expenditures were an important consideration in valuing the company. He included an average of $20,000 per year to account for routine repairs and equipment replacement in all the restaurants. Based on information he gleaned from a letter from McDonald's, he also included $769,000 in future expenses that would go toward remodeling some of the restaurants over the next five years.

As to financing a rebuild or reinvestment, he explained that McDonald's franchise owners had three choices: (1) they could pay 100% of the cost and receive lower rent costs; (2) they could divide the cost equally; and (3) they could pay one-third of the cost and let McDonald's pay the remaining two-thirds. The husband, the expert said, had a history of paying 100% of the rebuilding costs and indicated to him he would continue to do so. The plan was to rebuild one restaurant in 2014 at a cost of $2.85 million and another in 2016 at a cost of $2.8 million. There was an expectation that the rebuilds would increase sales, the expert said.

Based on all of the data, the husband's expert determined the total value of the restaurants was almost $10 million. Subtracting the cost of reinvestments and "excess liabilities, including the bank and the money owed to the family trust, which by the parties' stipulation totaled $9.5 million, the expert arrived at a net value of the LLC of almost $310,000 as of the valuation date.

The wife's expert was equally competent. An experienced CPA and certified valuation analyst, he said that 85% of his business was related to McDonald's. His accounting firm, too, belonged to the NFCA.

For his valuation, he reviewed the LLC's financial statements, franchise and lease agreements, and five-year sales history, and he also visited the restaurants. He said there was information that McDonald's treated the $5.8 million debt to

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the family trust as equity, not debt, for purposes of determining total business equity. Therefore, he opted to do the same.

For his DCF analysis, he used a 20% discount rate for some, but not all, of the restaurants. He said he had seen discount rates of 19% or 20% for McDonald's restaurants. He decided to apply a 19% discount rate to one restaurant and an 18% discount rate to another because the latter had a "less-than-average sales volume." He explained that a lower sales volume meant that a restaurant ran less of a risk that a competitor would open nearby. Further, he used a 3% sales growth rate based on historical annual sales increases, which were between 2.5% and 3%.

He used the McDonald's opportunity report to compare the LLC's restaurants' historical data to other restaurants in the specific market and region. He said it was not "fair" to compare the LLC to 3,400 restaurants that were located over the U.S., considering the different cost structures that existed in different regions.

Just like the competing expert, he assumed $20,000 in annual reinvestment costs, but he did not factor into his calculation nearly $670,000 for additional reinvestments, calling the reinvestments "speculative," He said he was aware that the husband customarily paid 100% of the rebuilding costs but applied only $1.75 million to cover the costs of the two rebuilds that were imminent.

Ultimately, he determined the LLC was worth over $16.1 million, prior to deductions - over $6 million more than the competing expert stated. The wife's expert only allowed for $4.9 million in liabilities, counting the bank debt but not the family trust debt, and concluded the LLC was worth about $11.2 million.

The wife presented additional expert testimony from a financial analyst who had worked for many years for McDonald's. This expert confirmed that, in calculating total business equity for the LLC, McDonald's chose to exclude the debt to the family trust. He explained that his decision was based on information McDonald's received about the trust and which "comforted" McDonald's and caused it to assume there was less of a risk.

Trial court's unaccountable valuation. The trial court acknowledged that both experts were "well qualified" but had "divergent views as to the factors making up the discounted cash flow valuation approach." It said it agreed with each expert on some of the factors. For example, it found the husband expert's use of the NFCA database was "more reasonable as a bench mark" than the wife expert's reliance on the opportunity report. It added that other choices that husband's expert made also were more credible.

Without further explanation, the court stated that the LLC's value was $10.6 million, less debt. It noted the parties' major disagreement over the company's debt treatment and rejected the wife's claim that the $5.8 million from the family trust was a gift to the marriage. There was "clear, convincing and overwhelming evidence that these were [business] loans," the court found. It concluded the LLC's value "net of debt" was nearly 1.1 million.

Post-trial the wife filed a motion for reconsideration, questioning, among other things, the method the court used to classify debt. The trial judge said: "I can't remember the detail because of all of my notes as far as the calculations…I thought I was coming to the right conclusion at the time."

The wife next appealed the judgment to the state's appellate court, contending the trial court's valuation of the LLC was error.

The appeals court agreed that the trial court had determined a predebt value of $10.6 million "without articulating its basis for its conclusion." This failure, the appeals court said, "has provided many challenges for the parties, as well as the this court, on appeal." It added that it had spent a significant amount of time to "discover the mathematical formula utilized by the trial court." Notwithstanding its own efforts and those of appellate counsel, it was unable "to duplicate the right combination of mathematical calculations" to arrive at the exact $10.6 million predebt value.

But the appeals court went on to say that it did not believe the trial court randomly selected the $10.6 million figure as one that was between the lower predebt value of $10 million and the higher value of $16.1 million. Rather, careful consideration of the record suggested the trial court rejected the wife expert's proposition that the $5.8 million debt to the family trust represented business equity. If one were to use the wife expert's predebt value of $16.1 million and subtract $5.8 million, the result would approximate the $10.6 million predebt value, the appeals court observed. From this amount, the trial court may have deducted bank and family trust debt to arrive at a "net of debt" value of $1.1 million, the appeals court surmised.

Since there was some evidence that the family trust debt was a loan, it was not error for the trial court to consider this amount debt, it noted. By extension, the trial court's valuation of the LLC was "not against the manifest weight of the evidence," the appeals court concluded and upheld the valuation.

Court Trusts Process to Test Expert's Calculation of Value

In re. *Hipple v. SCIX, LLC,* 2014 U.S. LEXIS 113198 (Aug. 13, 2014). Calculation reports periodically become a point of contention in litigation in trial and appeals courts.

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Courts have responded in different ways to questions about their usefulness and reliability. A recent case explores the issue of whether expert testimony based on a calculation of value is admissible under *Daubert*.

Prior to marriage, the husband founded a company that marketed and sold Steel Seal, a car repair product that sealed blown head gaskets. The company had three patents related to the product. Subsequently, the husband transferred his membership interest to his son. During the marriage, the wife made two loans to the company, totaling $350,000. The company books later showed additional creditors—the husband and companies he had set up—for loans in the amount of $210,000. After the divorce, the husband caused the son to sign an agreement designating the husband as a secured creditor, which the husband used to take possession of the company's assets. The son later died.

The wife sued the husband and his entities alleging fraudulent transfer of the company's assets and the proceeds of the assets. Specifically, she claimed that he took the business's inventory, which was worth over $490,000; the husband claimed it was $110,000. She also accused the husband of orchestrating the fraudulent transfer of licensing rights to sell and produce Steel Seal to one of his companies such that he continues to benefit from the proceeds of the fraudulently transferred assets. In contrast, by the time the company went out of business, the wife had recovered only about $53,500.

Although the court found the transactions had "badges of fraud," it denied the wife's summary judgment motion because there was an issue for trial as to what assets were transferred and what their value was. The wife's summary judgment motion included expert testimony on the value of the company's assets on the transfer date, which the defendants challenged in a pretrial *Daubert* motion.

SDE-based calculation. The proposed testimony was based on an expert report in which the wife's expert stated that he prepared a calculation of value of the company—as opposed to a more extensive opinion of value resulting in a conclusion of value. During his deposition, he explained that he had limited information about the company's financial records and, therefore, was unable to do a full appraisal. He explained that one way to value an asset or a company is to examine the sale of comparable businesses to determine a multiplier based on the annual seller's discretionary earnings (SDE) of each business. In this case, he was able to calculate the total personal withdrawals from the company and a related company that had acquired the licensing rights to Steel Seal for the relevant years. He classified the withdrawals as SDE. He also found that comparable businesses were valued at an average of 2.92 times the annual SDE generated by the companies. To value the subject company, he applied the 2.92 multiple to the average SDE he had determined for the two companies at issue. He concluded that a reasonably equivalent value for the transfer of the company's assets was approximately $1.8 million.

The defendants claimed that, since the expert merely completed a calculation report, the testimony failed two of the *Daubert* requirements: reliability and fit (or relevance). Therefore, they asked the court to preclude it.

The court disagreed. It defined a calculation of value as an engagement in which the appraiser and the client agree on the valuation approaches and methods; the work performed does not include all of the procedures an opinion of value requires, the court noted. Also, an opinion of value allows the appraiser to decide which valuation methods and approaches are appropriate under the circumstances and results in a conclusion of value, the court went on to say.

The court found that both types of engagement are approved by the American Institute of Certified Public Accountants (AICPA) and there was no reason to prevent the trier of fact from hearing the expert's testimony. According to the court, he explained why he could not perform a full valuation, and his methodology and assumptions were clear. Any questions as to the specifics of the testimony went to its weight and should be the subject of cross-examination. The testimony based on the calculation of value was admissible under *Daubert*, the court concluded.

Divorce Court Limits Professional Goodwill to Value of Non-Compete

In re. *Banchefsky v. Banchefsky*, 2010 WL 3527578 (Ohio App.) (Sept. 9, 2010). Dentist sells his practice during divorce. In the *Banchefsky* case—and for reasons the Ohio Court of Appeal's opinion does not reveal, the husband sold his solo cosmetic dentistry practice for $580,000 during the proceedings. In the purchase agreement, the parties allocated specific amounts to the tangible assets ($125k), patient records ($20k), agreement not to compete ($15k), and unspecified "goodwill" ($416k). The husband and wife agreed the sale was arm's length and the price reflected the current fair market value for the dental practice.

For purposes of divorce, however, the husband's valuation expert said that the value attributed to the non-compete in the purchase agreement was "arbitrary." To find its appropriate value, he subtracted the tangible asset value from the total sale price and allocated the remainder ($431,000) to professional and enterprise goodwill. Specifically, the husband's expert defined "professional goodwill" as a direct function of earnings from patients who patronized the husband for his individual and personal attributes. He characterized enterprise goodwill as "goodwill that would go along with the business practice itself and could be sold with or without" the husband. To distinguish the components in this case, he applied the Multiattribute Utility Model (MUM), developed by valuation and forensic analyst David Wood, CPA/ABV, CVA (Mt. Vernon, IL). Using MUM, the expert found that the appropriate value for the husband's willingness not to compete was $215,000 and constituted professional, non-divisible goodwill.

The trial court expressly acknowledged MUM's utility in determining the fair market value of a professional practice,

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but in this case, it found the model was neither necessary nor appropriate due to the arm's length sale of the business. Accordingly, it determined the husband's personal goodwill was worth no more than the value assigned to the non-compete in the purchase agreement ($15k), and it divided the remainder of the sale proceeds ($565,000) equally between the parties.

The husband appealed, arguing that the trial court should have deferred to his expert's opinion and his application of MUM. The appellate court confirmed the utility of MUM in "determining the impact an individual's departure might have on the fair market value of a business." However, like the trial court, it also found that "it was simply unnecessary to determine the value of the covenant-not-to-compete through the use of a business model pertaining to the hypothetical case of a hypothetical business" when there was evidence of an actual sale. It also found, based on prior case law, that a covenant not-to-compete is a non-marital asset. Accordingly, the $15k non-compete constituted the husband's personal goodwill and his separate, non-divisible property, the court held, and confirmed the trial court's allocation of value in all respects.

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