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Current Valuation & Taxation Rulings Regarding Divorce

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Lay Testimony About Offer to Buy Represents Admissible Valuation Evidence

In re. Berger v. Berger, 2015 Ohio App. LEXIS 5336 (Dec. 31, 2015). In an Ohio divorce case, the wife appealed the trial court's exclusion of a friend's testimony as to his offer to buy the husband's company. She also attacked the prevailing expert's valuation, both in terms of the expert's qualifications and methodology. The appeals court declined to second-guess the lower court's rulings on the parties' expert opinions. But it found the trial court missed the issue in the case, the valuation of the contested company, when it brushed aside a real-world offer to buy as irrelevant. This case includes a useful discussion on valuation methodology and gives insight into how an expert's arguments play to the court.

A 'real' offer? The husband owned a 99.85% equity interest in a privately held company that owned and operated manufacturing companies in the United States, Mexico, and China. Part of the husband's interest was separate property that the husband either had received as a gift from his parents or had acquired prior to the marriage.

A major point during the divorce proceedings concerned the valuation of the company and the valuation of the marital portion of the husband's interest, that is, the appreciation in value during the marriage. However, the court's opinion does not provide great detail (legal and factual) on the issue of separate property.

Both parties retained business valuation experts whose testimony the trial court admitted. At the same time, the wife tried to introduce testimony from a former employer and friend, who, she said, had made a written offer to pay \$12 million for 80% of the company's stock; under the offer, the husband would retain a 20% interest in the company and would stay on for another five years.

The trial court, after asking the husband whether the company was for sale and hearing the husband say that it had never been for sale, refused to admit the testimony of the wife's employer/friend, finding it was not relevant. The court said: "An offer for sale for a company that's not even for sale? People can offer any kind of monetary amount for a company that they're never going to have to pony up the money for because it's not for sale." The wife testified on direct examination that she

thought the company was worth \$15 million based on the friend's offer to buy.

Experts' different views of the company. Neither of the business valuers came close to valuing the company at \$15 million. But the experts also disagreed sharply with each other's valuation of the company and, even more, the valuation of the marital portion of the company.

The wife's expert portrayed the company as "very diversified" because its entities made different products and catered to a varied clientele. He explained that, generally speaking, diversification was a good thing: It meant less risk to a business because, if one part did not perform well, its other segments would not suffer negative consequences. The wife's expert allowed that there was some risk to the husband's business because the husband and certain "key" employees were "so integral" to the company's operations.

The wife's expert valued the company under a market approach, an asset approach, and an income approach. Under the market approach, he said he looked to the Standard Industrial Classification Codes (SIC codes) to find comparable companies and concluded the company was worth \$14 million.

Under an asset-based analysis, he found the company was worth \$7.8 million. However, neither he nor the opposing expert relied on the result from this valuation methodology in determining the final value.

Under the income approach, the wife's expert performed a discounted cash flow (DCF) analysis based solely on the company's management projections. Ultimately, he relied on the DCF result to conclude the fair market value of the husband's interest in the company, on a controlling basis, was \$10.5 million.

The husband's expert saw the company in a completely different light. It was not "diversified" but "fragmented," he said. According to him, a diversified company had a common core, which a fragmented company lacked. The subject company and its subsidiaries shared a management team, but the subsidiaries had nothing in common. They served different segments of

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the population. The expert pointed out that the company grew by acquiring businesses, not organically. This meant going into debt. He described the company as highly leveraged and at risk of not having enough cash to cover its debt. He said part of the reason for his lower valuation of the company was its increase in debt (\$5.6 million), which lowered the fair market value.

In terms of methodology, he rejected the market approach, finding there were no companies comparable to the husband's company considering its "eclectic" nature. He criticized the wife's expert for looking to publically traded companies as comparables. Those companies, he said, had sales in the billions whereas the subject company had sales of only \$40 million during the relevant years. He also objected to the use of the SIC codes whose categories, he thought, did not capture the nature of the husband's company.

The husband's expert's asset-based valuation showed the company was worth about \$6.5 million, but the expert did not rely on it.

Instead, he relied on the income approach. He explained that he used a capitalization of earnings approach to determine the company's historical cash flow. He explained that it was "key" to look at a company's past performance to obtain a complete picture of any company.

He also used a DCF analysis to determine the company's future performance. He considered management projections but cautioned that the company did not ordinarily prepare projections - only at the request of its bank. Therefore, the projections were "optimistic." In reviewing projections for 2008, 2012, 2013, and 2014, he found the company had not met its goals for 2008 and 2012. Part of the reason was the economic slow-down, he allowed, but part of it was the optimistic nature of the projections, he concluded.

The parties' experts disagreed over the need to look at a company's past performance. The wife's expert said doing so in this case would not provide reliable information as to the company's ability to generate cash flow considering the recession. In contrast, the husband's expert maintained a buyer would want to see how the company had done in the past rather than simply rely on projections.

According to the husband's expert, the company's fair market value was about \$7 million.

Disagreements over determining appreciation in value. Under Ohio law, even though part of the husband's interest in the business was separate property, the

wife had a right to part (generally 50%) of any appreciation in value that occurred during the marriage.

The wife's expert relied on gift tax returns to value the marital portion of the business. He concluded it was worth nearly \$9.4 million.

The husband's expert arrived at a value of a bit over \$4 million. He explained that, even though considering gift tax returns was "useful," there were other factors to consider that in this case suggested there was no appreciation during the marriage. He said that, early in its history, from 1993 to 1997, the company showed income of about \$2.5 million. In contrast, later, from 2007 to 2011, the income had dropped to about \$1.2 million. As the husband's expert saw it, the husband now owned more of a company that was worth less.

The wife's expert relied on gift tax returns from the early years, when there was more income and less debt, the husband's expert claimed. He said that, under the income approach as he performed it, the final value of the appreciation was about \$4 million. (The court's opinion states two slightly different figures as to the fair market value of the appreciation. It does not provide details on valuation methodology.)

The trial court credited the valuations the husband's expert proposed. It approved of the expert's two-part income approach, and it credited the expert's observations that the company's growth was by acquisition and at the cost of increasing its debt and that the company was not performing "as well as it did before." The fair market value of the marital portion of the business was about \$4 million, the trial court found.

Wife says Pratt would not approve. In appealing the judgment at the state Court of Appeals, the wife launched a series of attacks against the trial court's judgement, including its value determinations. Most of the arrows missed their targets, but the wife's claim that it was error to exclude the testimony of her employer/friend to buy most of the company for \$12 million had traction with the appeals court.

"To conclude that what [the friend] was willing to pay for the company was not relevant because the owner was not willing to sell disregards the ultimate issue - the value of [the company]," the Court of Appeals said. There was evidence that the offeror had done a review of the company's financial performance and had received "other information" from the wife's attorney. It appeared he had significant knowledge if he was willing to pay \$12 million for 80% of the company, the appeals court said. The offer was evidence of a valuation based

on the market approach, the Court of Appeals decided.

It added that any issues as to how believable the offeror was as a witness or how sound his method for arriving at this offer was went to credibility, not to the relevance and admissibility. Credibility issues were best addressed during cross-examination.

The appeals court found the erroneous exclusion of relevant valuation testimony was sufficient to remand, and it ordered the trial court "to revisit" the valuation of the company. It instructed that, in doing so, the trial court had to consider not only the expert testimony, but also allow the offeror to testify about his offer and the basis for it.

The wife's attacks on the prevailing expert testimony were less successful. Some of them lacked support in case law or revealed a misreading of the record or misstatement of the testimony, the appeals court found. For example, the appeals court dismissed the wife's claim that the trial court erred when it accepted the conclusions of the husband's expert over the wife's expert because her expert was more qualified. Unlike the husband's expert, the wife's expert previously had been appointed as a special master to perform complex business valuations. The appeals court said it was not clear why such an appointment made one expert's testimony more credible than the other's and that the wife failed to state a reason or provide case law to support her claim.

The wife contended the husband's expert conceded he did not complete a market-based valuation. Not doing so made his opinion "worthless," she argued. The appeals court disagreed. First, the expert was only required to consider three of the valuation approaches. He did not have to complete them. Here, the husband's expert explained that no companies were similar to the subject company. Consequently, his abandoning the market approach was not a surprise, the appeals court said.

The wife maintained that the husband's expert applied a discount for lack of marketability that was too high - 21.3% - considering the husband was the majority owner of the company. Also, the expert testimony relied on studies involving minority owners.

The husband countered that his expert explained that the "fragmented nature" of the company would make it more difficult to sell the company: Because it would take longer to sell the company, the rate of the marketability discount was higher. Also, the husband said, his expert was able to justify the use of the contested studies because the stocks at issue were restricted in nature. This is what affected the expert's analysis of the marketability discount, not the minority position of the stocks, the husband claimed.

The appeals court dismissed the issue by noting the trial court had discretion to believe the explanation the husband's expert gave for using "minority owner studies."

Finally, the wife argued Shannon Pratt, "the undisputed and acknowledged expert with respect to business evaluation procedure," would not approve of the methodology the husband's expert used to value the company. Accordingly, the trial court should have rejected the valuation.

The trial court was under no obligation to accept Pratt's methodology just because of his reputation, the Court of Appeals said.

Based on the trial court's improper exclusion of relevant valuation testimony, the Court of Appeals ordered the lower court to redetermine the value of the company as well as the value of the marital portion of the company.

Spouse's Unilateral Stock Agreement Sets Value in Divorce Action

In re. *Baumbouree v. Baumbouree*, 2016, La. App. LEXIS 1388 (July 13, 2016). In a Louisiana divorce case, the trial court applied the value stated in a stock agreement the physician owner-spouse had entered into with his firm in the context of partition. In her appeal, the wife objected that by doing so the trial court had assigned an "arbitrary price...not based on any indicia of financial value" to the husband's enjoyment and use of the ownership interest. A majority of the appeals court affirmed, but two dissenting judges agreed with the wife.

During the marriage, the husband, a pediatrician, bought one share in a medical group for \$1,000. A stock subscription agreement specified four circumstances in which the corporation would buy back each share for \$1,000. The wife refused to sign the contract.

After a final divorce judgment had been issued, the husband filed a motion asking the trial court to rule as a matter of law that the value of his share for purposes of marital distribution was \$1,000.

The wife opposed the motion, arguing the stock was community property and the agreement was not applicable to her because she had not signed it. Moreover, the agreement only applied in limited circumstances, which did not include divorce and/or partition. In an affidavit, her CPA expert explained that in order to determine the fair market value of the company's stock he would need to consider intangible assets such as goodwill and going-concern value.

The trial court granted the husband's motion. The wife appealed the ruling to the state Court of Appeal, making essentially the same arguments she had made in the trial court proceeding.

A majority of the appeals court called the wife's arguments "fundamentally flawed." Even though the stock

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was community property, the right to manage the stock exclusively belonged to the husband. The contract was valid, and the wife's refusal to sign the agreement did not affect the applicability of the contract's stock valuation, the appeals court said.

Moreover, under applicable case law, it was inappropriate to consider the goodwill of the husband or the goodwill of the other stockholders in valuing the husband's share, the appeals court said.

The dissent noted that, although in this case the stock agreement set the value in case of the disposition of the stock in four specific situations, it did not set the value for the husband's use and enjoyment of the stock. To determine that value, the trial court should remand the case for further valuation, the dissent said.

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