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Current Valuation & Taxation Rulings Regarding Divorce

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Court Rejects Bright-Line Rule for Valuing Appreciation of Nonmarital Assets

***In re Witt-Bahls v Bahls,* 2016 Fla. App. LEXIS 1451 (Feb. 3, 2016).** Active and passive appreciation of separate property is one of the most contentious issues in divorce cases, particularly in this age of entrepreneurship. Valuators know that much of the fight is over methodology—how to show conclusively that the increase in the value of the nonmarital asset is due to the efforts of the owner spouse or is due to market-related circumstances or the efforts of others in charge of the company. A recent case in Florida tackles the issue from the perspective of scope—how far should the nonowner spouse's right to share in the increased value of nonmarital assets extend?

Husband owns stock but not the company. This appreciation case differs from the familiar scenario featuring a spouse who built his or her business prior to the marriage. Here, the husband began working for a big, privately held, international company prior to the marriage and at that time bought a large amount of company stock with a bank loan. During his tenure at the company, he had some supervisory responsibility. But, even at the peak of his career, several layers of management were above him. Also, during his marriage, while working for the company, he was twice demoted. He was ultimately terminated, and his stock was liquidated. The shares sold for substantially more than the outstanding balance on the loan the husband had used to buy them.Testimony from the husband's CPA showed there were no payments on the loan other than interest payments.

The trial court determined the stock was separate property and its increase in value was passive and, therefore, not subject to marital distribution.

The wife appealed the ruling. The appeals court opinion states the wife asked for a rule "that all appreciation of the stock of a company for which a spouse works is a marital asset." The court's language suggests the wife either asked for a rule that would shift the burden of showing the appreciation was passive in nature and, therefore, not part of the marital estate to the stock-owning spouse or that the appreciation in value during the marriage was marital property as a matter of law.

Existing analysis stays in place. Either way, the Florida Court of Appeal rejected the wife's proposition and used the opportunity "to address the passivity of appreciation of stock in a marriage."

The court said with emphasis that, under the existing analytical framework, the increased value of stock from a company for which the owner spouse works can qualify as a marital asset and, thus, be subject to distribution. But it can also be a nonmarital asset. The crux of the matter is "whether the husband exerted the sort of 'effort' required to move the appreciation value from the nonmarital category to the marital one," the court stated.

The Court of Appeal went on to say that cases that have found the appreciation was a marital asset typically involve a family-owned or family-run business in which the stock-owning spouse holds a significant position. In the instant case, neither of these "key features" was present, the appeals court found. The company for which the husband worked was not owned or operated by his family. Moreover, he played no significant role in the management of the company. At most, he was a "middle manager," the court said. He did not contribute to the appreciation in the value of the company's stock, and the increase never converted into marital property. The wife had no claim on it.

The court cautioned that the wife's proposed rule might force trial courts into examining "how much of the increase in value of a multi-national corporation each and every hourly employee was responsible for." Such an expansion of the concept of marital assets was the province of the legislature, the Court of Appeal noted, upholding the trial court's ruling.

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Different Theories Justify Classifying Loan to Business as Marital Asset

In re McNee v. McNee, **2017 Ohio. App. 4033 (Sept. 14, 2017).** In an Ohio divorce case, one issue valuation experts disagreed on was how to account for a personal loan the owner-spouse had made to his businesses during the marriage. The owner had built two of his three businesses before the marriage. The trial court suggested there were different ways to look at the loan, but they all supported the conclusion that the money was a marital asset. The appeals court agreed. It noted this was very much a case of competing expert testimony and declined to second-guess the trial court's credibility determinations.

Four BV methods. The husband and wife married in fall 2009. Before the marriage, the husband had formed two related recycling businesses. During the marriage, he set up a third, freight-hauling business. The husband was married before and, in connection with his first divorce in 2006, had obtained an appraisal that valued the recycling businesses at $776,000.

A major issue during the second divorce proceedings was the combined value of the husband's businesses.

The appraiser who had performed the 2006 valuation also served as the husband's expert in the instant case. This expert found that, in March 2014, the end date of the second marriage, the businesses were worth only $104,200. According to the expert, there were four common ways to value companies: (1) the capitalization of earnings method; (2) the discounted cash flow analysis; (3) use of net book value; and (4) forecasting. He said he used the capitalization of earnings approach. He concluded that the value of the businesses had dropped considerably between 2006 and 2014 and that there was no marital value due to the continuing losses.

The wife's expert dismissed the importance of the 2006 valuation, noting this valuation was more than a year old and therefore "stale." She explained that she had valued the businesses as of September 2009, the date of marriage, and as of March 2014, the end of the marriage. She determined that, in March 2014, the businesses were worth $266,000. She calculated an increase in value of $72,000. She also added the amount of a shareholder note in the amount of $284,000 to the $72,000. The note represented money the husband had lent to the businesses. The wife's expert said this money could be considered either a loan or equity in the company. According to the wife's expert, during the years of marriage, the value of the businesses had increased by $356,000.

The husband's expert objected to the opposing valuation. He found the methodology the wife's expert used (not explained in the court's opinion) was acceptable but said the expert incorrectly included $150,000 in the valuation when this was money the husband used to pay down the debt.

A second expert for the husband agreed with the husband's first expert that the rival expert had improperly increased the businesses' value by $150,000 and had not properly accounted for the shareholder note. When asked on cross-examination about the $284,000 note, this expert agreed the money was available to the husband, who could take it out for his own use. This expert also agreed with the wife's expert that it was improper to consider the 2006 valuation for purposes of determining the premarital value of the businesses, where the current marriage did not take place until September 2009.

Increase in value. The magistrate who initially heard the matter adopted the proposition of the wife's expert that the $284,000 represented an increase in the value of the businesses during the marriage. He also noted that the businesses would keep on generating over $300,000 in income for the husband. At the same time, the magistrate rejected the claim by the wife's expert that the businesses had increased by $72,000 during the marriage

The trial court adopted the magistrate's findings over the objections of the husband. It said the $284,000 note either represented a contribution the capital of the businesses, in which case there was an increase in value, or it was a marital debt the businesses owed to the parties. The trial court noted that the husband's second expert had agreed that, no matter how one classified this amount, it was money available to the husband. This amount was a marital asset, the court decided.

The husband appealed the trial court's valuation with the state Court of Appeals. He argued it was improper to value the businesses based on the loan he had made to the company. He also objected that the trial court failed to consider the uncontroverted evidence that the business was worth $776,000 before the marriage and that its value had fallen during the marriage. And even though he agreed the businesses generated income for him, the husband maintained that income stream was different from the actual value of the business.

At the start of its discussion, the Court of Appeals noted the trial court had broad discretion in terms of determining which side's valuation expert the court believed. The appeals court said it could only overturn the trial court's decision if the latter had committed an abuse of discretion, that is, had acted "unreasonably, arbitrarily, or unconscionably."

The appeals court found no abuse of discretion. "This is a case of competing experts," it said. The husband's first expert and the wife's expert disagreed, and the husband's second expert agreed with the husband's first expert on some points and the wife's expert on other points. For example, the husband's second expert took issue with how the wife's expert arrived at her numbers but agreed with the wife's expert that the $284,000 the husband had put into the business was available to the husband. This expert also agreed with the wife's expert that the 2006 valuation was not the proper indicator of the premarital value of the businesses.

In terms of the valuation data, the Court of Appeals added that there was no testimony as to how the three-year gap between the end of the first marriage (2006) and the beginning of the second marriage (2009) affected the 2006 valuation. Consequently, the earlier, $776,000, valuation was of no consequence. There was no evidence as to the premarital value of the businesses, the Court of Appeals found. It upheld the trial court's valuation.

Court Treats Outpatient Surgery Center as Extension of Physician's Practice

In re Bulloch v. Bulloch 2**017 Louisiana. App. (Jan. 18, 2017)** A Louisiana divorce decision centering on the husband's interests in two medical entities is the perfect primer on the goodwill jurisdiction in that state. The case also raises questions on valuation methodology and the classification of post-petition distributions to the owner-spouse.

Louisiana is a community property state. The husband, an orthopedic surgeon, had an ownership interest in an outpatient surgery center and also was a shareholder in a medical practice.

The husband typically performed procedures his patients needed at the surgery center. As a member, he received regular distributions that were contingent on his ownership interest, not on the number of surgeries he performed. On the other hand, to maintain member status, he had to perform a certain number of surgeries at the surgery center.

The valuation of the husband's interest in the surgical center was one flashpoint during the divorce proceedings. The parties' experts used a similar, income-based approach but arrived at vastly different numbers based in part on a disagreement over the applicable capitalization rate and the decision by the husband's expert to assign a zero growth rate. Further, the husband's expert decided that, of the total value of the interest, $1.2 million, over $730,000 was goodwill and 70% of that value was personal goodwill that needed to be deducted from the overall value.

The trial court adopted the value determination of the husband's expert. The wife unsuccessfully appealed, arguing the valuation was flawed both in terms of the use of a zero growth rate and the goodwill deduction.

The appeals court declined to second-guess the trial court's decision to accept the methodology the husband's expert had used. The expert's decision not to apply a growth rate because the wife would not be able to share in the company's future growth was plausible, the reviewing court decided.

The more difficult question, the appeals court said, was the goodwill deduction. Under the applicable state law, only enterprise goodwill was community property. Here, the wife argued that, since the husband was not an employee or director or board member of the surgical center, no goodwill in the entity was attributable to the husband. The husband argued the surgery center was an extension of his medical practice.

The appeals court found the husband's argument more persuasive. It pointed out that the operations of the surgery center depended on the goodwill the physician members brought to it by way of sending their patients there. Consequently, the trial court did not err when it accepted a valuation that deducted for the husband's personal goodwill.

A related issue arising out of the husband's interest in the surgery center was how to classify the substantial distributions the husband had received during the 22-

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month post-petition period until the partition judgment.

The trial court awarded the payments to the husband, reasoning they were compensation for the work the husband had done after petitioning for divorce.

The appeals court disagreed, finding the wife was entitled to half of the distribution amount because the payments represented the "civil fruits" of the former community property. The distributions were conditioned on the member's ownership interest rather than the surgeries a physician member performed. The goodwill analysis that went into the valuation of the community's interest in the surgery center already took into account the procedures the husband performed and which reflected his skills and efforts, the appeals court said.

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