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Valuation Verdicts®

Current Valuation & Taxation Rulings Regarding Divorce

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Owner's Problematic Business Practices Support Finding of Enterprise Goodwill

In re Goodman v Goodman, 2018 Ind. App. LEXIS 86 (Mar. 6, 2018). A recent Indiana divorce case reviews the state's position on how goodwill should be assigned where the business represents a marital asset. This fiercely litigated case shows how not to argue in favor of personal goodwill. Also, the trial court's exceeding difficulty in determining the business's income and the value of its assets will resonate with family law experts and attorneys.

Hiding assets. During the marriage, the parties established a business that took care of trees (tree trimming, tree removal, stump grinding). Both spouses worked in the business, but the husband was in "complete and total financial control" over the business as well as the parties' personal possessions.

On paper, the husband had a business partner. She turned out to be his daughter from a previous marriage, who testified at trial that she had never received any income from the business. There was evidence that the husband periodically put title in business assets in his children's names. Moreover, there was evidence that the husband tried to hide his assets, including substantial winnings from gambling. Witnesses said the husband carried large sums of cash with him and counted wads of money on the kitchen table. He encouraged customers to pay in cash or write checks to him personally. He cashed the checks at the customers' banks to ensure the amounts paid did not appear in his business records and were not deposited to the business accounts. Several years of tax returns showed net income of less than $20,000, but the trial court found that contrary evidence suggested that, in 2013, the husband had cashed checks and received cash payments amounting to nearly $160,500, which he did not report as income. Neither party offered valuation expert testimony.

In a provisional order, in 2012, the trial court assigned the operation of the business and the expenses of running the company to the husband. During the next five years, the parties waged war in court over a number of issues. Throughout this period, the wife continued her involvement in the business. Further, the wife's son from a previous marriage testified at trial that, for about 10 years, he had worked in the business in a supervisory position that came with financial responsibilities.

In December 2015, the marriage was dissolved, but the conflict between the parties kept escalating. In 2016 and 2017, the trial court held a series of hearings. The court found that, even after the parties had filed for divorce, the husband continued to buy business equipment in his name and sometimes placed title to various assets in his children's names.

The trial court ultimately awarded the husband the business, but it decided to deviate from the presumed equal division of marital property by awarding the wife 60% to account for the husband's dissipation of marital assets. The court found that, for 20 years, the wife worked for the business, but she never received any income. Because of the wife's significant role in the business, the court said it was appropriate to attribute some goodwill to the business, particularly since there was no business valuation and the parties fiercely disputed what the business was worth. The court said it had no accurate way to value the business and therefore decided "that the best [this court] can do is take what it believes to be the annual net income and divide that in half to assign a goodwill value to the business. [Wife] would then be entitled to 60% of that figure." By the court's account, the enterprise goodwill was over $76,700.

'Transferable' business. On appeal the husband raised a number of challenges, including the argument that the trial court erred when it assigned goodwill to the company. He claimed the survival of the business depended on his continued presence. He noted that the business's assets were in his personal name, that he paid employees in cash, and that he accepted checks written to him personally as opposed to the business. Therefore, all goodwill was personal to the husband, he contended.

Legal principles. The Indiana Court of Appeals noted that, based on state Supreme Court precedent, enterprise goodwill is considered marital property and is divisible,

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whereas personal goodwill is not. See *Yoon v. Yoon*, 711 N.E 2d 1265 (Ind.1999). In the controlling *Yoon* case, the high court said that enterprise goodwill was "based on the intangible, but generally marketable, existence in a business of established relations with employees, customers, and suppliers." Enterprise goodwill relates to the business's location, its name recognition, business reputation, and other factors depending on the business. "It is not necessarily marketable in the sense that there is a ready and easily priced market for it, but it is in general transferable to others and has a value to others."

Personal goodwill, on the other hand, represents the future earning capacity of the individual. The court in *Yoon* explained that the state's legislature had decided that "relative earning power" was not a divisible asset. Consequently, goodwill based on a particular individual's personal attributes was not includible in the marital estate, the high court said in *Yoon*.

Applied to instant case. In the instant case, the trial court's determination that there was enterprise goodwill was well founded, the state Court of Appeals said. It noted that the wife and her son had been involved in the business. Further, the husband periodically had placed business assets in his daughter's name and on paper made her a co-owner. "Accordingly, the business was 'transferable' to other family members," and not dependent on the husband's personal efforts, the Court of Appeals concluded.

It also found that the husband's business practice of dealing in cash with employees and customers and buying equipment in his own name did not show the business was dependent on his efforts, as the husband tried to argue, but showed his "propensity to intermingle personal and business assets," suggesting an inference of hiding assets.

The Court of Appeals upheld the enterprise goodwill value of $76,700 as well as the trial court's other findings. It commended the trial court for wading through tons of loose exhibits to piece together the parties' marital estate. The trial court had accomplished a "herculean task," the reviewing court said.

Difficulty in Valuing a Small Business

In re. Hultz v. Kuhn, 2019 Md. App. LEXIS 151. A Maryland divorce case illustrates the difficulties an appraiser charged with valuing a small company in the divorce context may face and how he or she may prevail in court.

The wife was the sole shareholder in a tree service business. The issue at divorce was the size of the monetary award to the husband. Initially, neither spouse offered much valuation evidence. The trial court performed a value determination based on a recent tax return that an en banc panel overturned. At the remand hearing, both parties presented expert testimony from CPAs who had valuation credentials.

The wife's expert found the company had a value of zero. The husband's expert explained in detail the numerous obstacles he encountered to performing a valuation. The company did not provide all of the requested financial information and the company's tax preparer and management did not answer most of the questions the expert had asked. The company only made available four years of tax returns and a QuickBooks file, which did not "match up" from an accounting point of view. The expert also said that, from other "tax work," he was able to see there were accounting problems. He noted "some troubling trends regarding…revenues to operating costs…as time passed." Sales were declining, but expenses were increasing, he noted.

The expert considered all three valuation approaches but concluded here the market approach generated the only reliable indicator of value. He made it clear that he normally would prefer to do an income analysis, but he didn't have the necessary information and the information he received was problematic. For the market approach, he used Pratt's Stats (now DealStats) and attained a value of about $408,000, which he decided was too high for this kind of company. In light of the company's poor performance, he applied a "very heavy discount for lack of marketability," i.e., 50%. He recognized the significant payroll tax liability, which would make it less likely that someone would buy the business. The DLOM reduced the fair market value to $204,000. The trial court found it difficult to reconcile the zero value with the company's employing 11 people, paying the employee who took over the husband's job a $65,000 annual salary, allowing the wife to pay herself $40,000 and $50,000 in 2014 and 2015, respectively, and other factors. The court credited the opinion of the husband's expert, noting his credentials and the detailed explanation he gave of the various valuation methods and the obstacles he faced in doing the valuation.

The state Court of Special Appeals upheld the trial court's findings.

Takeaway. Courts may be sympathetic to an expert whose work is stymied by the other side's lack of cooperation. Therefore, talk about it!

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Contentious ruling from Minnesota high court on dealing with earnout payments in divorce

In re. Gill v. Gill, 2018 Minn. LEXIS 613. In an important ruling, a divided Minnesota Supreme Court recently ruled on whether earnout payments related to the state of the husband's interest in a lucrative company were a marital asset. Family law financial experts will appreciate the extended discussion of the concepts of valuation and classification.

The dispute involved Talenti, a gelato and sorbet producer (offering 43 flavors as of this date). The husband indirectly held an interest in Talenti through a different entity, Wyndmere. Eventually, David Goliath Group LLC (DGG) became the parent company of Talenti, and Wyndmere became one of several members of DGG. Under state law, Wyndmere (created during the marriage) was presumptively marital property.

The parties married in 1993 and separated in 2013, while DGG's members negotiated a sale to Unilever. The sale closed in December 2014. Per a July 2014 letter of intent, Unilever agreed to pay "an aggregate maximum purchase price" of $350 million --$180 million would be paid at the closing of the transaction. Moreover, members of DGG were entitled proportional shares in two future earnout payments whose value was based on 2015 and 2016 net sales and would not exceed $170 million. The same provisions appear in the parties' purchase agreement. The husband negotiated a separate employment agreement and received extra compensation for the continuing employment.

The district court determined a valuation date of September 2014 and valued the company based on the upfront payment ($180 million). The court found the earnout payments were highly uncertain (they could be as little as "$0," the court said) and represented compensation for the husband's future efforts to grow the company. Therefore, they were not marital property.

A majority of the state Supreme Court disagreed, finding the earnout payments were part of the purchase price. "Wyndmere received the contractual right to the upfront payment and the potential earnout payments only by selling the parties' marital asset, which was acquired during the marriage and before the divorce was finalized.

Court Rebuffs Litigant's Attack on Own Expert's Income-Based Valuation

In re. Stocker v. Stocker, 2017 Ohio. App. LEXIS 4834. An Ohio divorce case illustrated that experts need to be prepared for attacks from all sides, including their own clients, The husband retained an expert to value the family business, an adult novelty retail store. The trial court adopted the valuation of the husband's expert, but, on appeal, the husband claimed his expert had undervalued the asset by using the wrong methodology. The appeals court called the husband's argument "counterintuitive" and rejected the claim.

Income approach. The spouses set up a business that owned an Adam & Eve franchise. The wife managed the company's daily operations. The parties agreed the wife would become sole owner of the business.

At the final divorce hearing, the husband offered a business valuation from a certified valuation analyst. The expert chose the income approach, noting that, to a prospective buyer, the value of the business was in the cash flow it generated rather than in its assets, which consisted of inventory, cash, and some furniture and fixtures. The expert added that using the market approach was also inappropriate. A search of the widely used BIZCOMPS database did not yield any similar market transactions. The husband's expert concluded the business's fair market value was nearly $338,000.

The wife presented testimony from an expert who critiqued the opposing expert's valuation and determined the business was worth about $205,000. This expert also used an income approach but used different inputs, which reduced the valuation. (The appeals court decision does not provide further details.).

The trial court adopted the magistrate judge's decision to credit the valuation of the husband's expert.

The husband appealed the business valuation and other findings by the trial court. He claimed the trial court's value conclusion was "against the manifest weight of the evidence and an abuse of discretion." Specifically, the husband's valuation expert failed to take into account the assets the company owned-a savings and a checking account. The husband should be awarded half of the amounts in the accounts.

Best value for the business. The Court of Appeals suggested the husband's objections to his own expert's valuation did not make sense. The parties had agreed that the trial court should award the business to the wife, and the husband's expert testified the income approach generated the best value for the business. The income approach, "by design does not take into consideration the assets of the business," the appeals court said. It noted the wife had introduced expert testimony to reduce the value of the business. By adopting the valuation of the husband's expert, the trial court, in fact, required the wife to make a greater equalization payment to the husband than she would have had to make had the court adopted the other valuation. Further, the husband did not offer an alternative valuation

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based on a different approach, and it was not clear why he did not include the values of other assets and the wife's goodwill in his argument.

No "flat" rule exists that only one method of valuation is appropriate when dividing marital property, the Court of Appeals said. When there is conflicting testimony as to the value of an asset, the trial court has discretion to believe all, part, of none of the witnesses' testimony. Here, the trial court had credible evidence to support a $338.000 business valuation. "We cannot say that the trial court clearly lost its way" in crediting the valuation by the husband's own expert, the Court of Appeals concluded.

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