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Valuing Goodwill in Divorce: Communication and Consistency are Critical

Two recent divorce decisions demonstrate how important communication among the client, counsel, and financial expert(s) can be in any given case, especially when the primary asset is a professional practice. Calculating a credible goodwill value requires the expert to have adequate disclosures, accurate data, and a complete understanding of appropriate methodologies.

Husband's expert gets a surprise at trial. In re Marriage of Theurer, (Cal. Ct. App.)(Nov. 17, 2009)(unpublished) considered a well-established orthodontist with 14 people on staff, all the latest technology, and up to 150 patients per day. The practice grossed $2.6 million, earning the husband $1.3 million before tax. Notably, he averaged 921 new patients per year—more than three times the average.

At trial, the wife's expert used the excess earnings approach, estimating the husband's reasonable compensation at $500,000, a goodwill value of $2.5 million and an overall practice value of $3.0 million. Similarly, the husband's first expert used the earnings approach, but applied a lower cap rate and higher compensation ($776,000) to reach a goodwill value of approximately $990,000, plus tangible assets. He then deducted patient prepays as a liability (over $1.1 million), for a final practice value of only $126,905.

The husband's second expert was a broker; he said the excess earning approach was not normally used to value professional practice goodwill. Instead, he used two industry rules of thumb, a multiplier of net income and a multiplier of gross revenues, to reach a value between $1.3 and $1.5 million. He did not deduct patient prepays, and though new patient starts were important, he said, he had not received this information from the husband. (The court opinion does not explain why.) On learning that the husband received 866 new starts that year, the expert was "visibly shaken," saying that would make a buyer "clap his hands."

The trial court found that the husband's two experts effectively impeached each other, on the use of an appropriate methodology and patient prepays. The second expert also lost credibility when he showed such evident surprise on the stand. The court accepted the wife's expert value, reducing the cap rate to reflect the practice's "substantial" dependence on the husband's skills. This led to a goodwill value of $1.9 million, or roughly midway between the three experts' numbers—and the husband appealed.

"There is no absolute rule specifying how goodwill of a particular practice should be valued and any reliable method is acceptable if warranted by the facts," the appellate court held, stating the broad rule, applicable in most jurisdictions. Indeed, the excess earnings approach, discredited by the husband's second expert but utilized by his first (and the wife's expert), "is a method that is commonly used to determine the value of goodwill in a professional practice." In this case, the evidence amply supported the trial court's determination, especially given the lack of consistency, information, and agreement among the husband's two experts.

Good use of rebuttal expert. Compare Helfer v. Helfer, Inc., (Supr. Ct. W. Va.)(Sept. 9, 2009), in which the husband also retained two experts to value his solo chiropractic firm, using the first as a primary witness and the second only in rebuttal. The first used a straight excess earnings and cost approach, to value the practice at $41,000, excluding any goodwill.

In contrast, the wife's expert used the same approach to value the practice at $388,000, finding "some" practice goodwill, including the value of its location, facilities, telephone numbers, patient lists, and other data. However, he also acknowledged that clients and revenues had recently fallen and failed to assign a specific dollar amount to the practice goodwill.

Interestingly, the husband's rebuttal witness criticized the excess earnings method, because in this case, the firm's liquid assets (cash and accounts receivable)

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were already subject to marital distribution. Further, the wife's expert failed to obtain a tangible asset appraisal, relying instead on the wife's opinion that they were worth over $53,000. By comparison, the husband's expert followed IRS guidelines to calculate their depreciated value at less than $7,000.

The wife's expert also failed to consult comparative salary data or the parties' income tax returns to estimate reasonable compensation, using small business studies instead. He also noted the firm's "great location" in his goodwill calculation, but pegged its rental cost at only $10 per square foot (compared to $18 by the husband's expert), which effectively changed earnings. In fact, the practice goodwill had no value, the rebuttal expert said, and the trial court agreed, valuing the practice at $41,000.

On appeal, the wife claimed the husband's primary expert failed to calculate any value for goodwill; likewise his rebuttal expert failed to provide an independent value. Thus the trial court erred by relying on the combination of testimony to assign a zero value to goodwill.

The rebuttal expert reviewed both expert reports, however, and was "clearly knowledgeable" with their calculations, the appellate court held. Moreover, he clearly detailed the "serious" flaws in the wife's expert calculations and the more credibility findings by the husband's primary expert, including the lack of excess earnings. Based on this consistency among experts, the trial court was well within its discretion to conclude a zero value for goodwill.

Two Taxpayer Victories Demonstrate Winning Facts for FLPs

As textbook examples of how to form, fund, and operate a family limited partnership (FLP)—sufficient to value various assets (including publicly traded securities, real estate, and restricted holdings) at substantial discounts for federal estate tax purposes—the Murphy and Black cases make excellent reading for attorneys and financial advisors alike.

Legitimate business purpose proves critical. The Murphy Oil Corp. grew from a small family-owned business into a $2 billion international conglomerate. During the 1990s, Mr. Murphy established an FLP with $89 million in company stock plus bank and real estate holdings. Importantly, this represented only half his net worth and he never mingled his personal assets with the FLP's. Overall, the father retained a 95% limited partnership interest in the FLP, with his two sons in charge of daily operations.

For five years, the FLP traded assets, managed employees, held regular meetings, and prepared regular statements. It made only two distributions, with appropriate adjustments to the partners' capital accounts. After the father died unexpectedly in 2002, the IRS cited over $34 million in tax deficiencies and the estate sued for a refund. In Estate of Murphy v. U.S., (W.D. Ark.)(Oct. 2, 2009), the federal court found the FLP was created to:

- Pool and invest the family assets according to the father's philosophy;
- Pass management responsibility onto the next generation;
- Enable the father to gift interests in the FLP while the underlying assets stayed under central management;
- Educate the father's heirs about wealth acquisition, management, and preservation; and
- Protect the family assets from creditors, divorce, and dissipation by future generations.

Moreover, the FLP was an active, ongoing entity that respected partnership formalities. Based on these strong facts, the court concluded the FLP was established for legitimate and significant non-tax purposes, sufficient to exclude the value of its underlying assets from the father's gross estate per IRC Sec. 2036(a)(1)(bona fide sale exception for adequate consideration).

To value Mr. Murphy's 95% LP interest, the court considered the parties' credentialed experts, who took the net asset values of the underlying interests before applying Rule 144 and blockage discounts as well as minority and marketability discounts. Their results diverged widely, but in each instance the court found the taxpayer's expert to be more credible, largely because he considered specific qualitative factors, including the FLP's substantial cash balance and the relative holding period, risk, distribution policy, and transfer restrictions of its assets. After adopting all the estate's discounts, the court found the fair market value of the 95% Murphy LP interest to be $74.5 million—and ordered a complete tax refund.

Another winning story. Samuel Black worked his way up from peddling newspapers on the street to senior vice president and second largest shareholder of the Erie Indemnity Co., a national insurance company. To pool, protect, and prolong his family's wealth, Mr. Black formed an FLP in 1993, retaining a 1% general partnership interest with LP interests dispersed among his son and his grandsons' trusts, with substantial restrictions. He funded the FLP with

Erie stock worth $80 million, which increased to $318 million over the next seven year. The partnership distributed 92% of Erie dividends, with appropriate adjustments to the partners' accounts, and the Blacks never dipped into the assets for their own expenses.

Mr. Black died in 2001 and Mrs. Black followed soon after. The IRS assessed deficiencies totaling over $83 million on their estate tax returns. The parties resolved all the valuation issues prior to trial, leaving only the Sec. 2036(a) issue; i.e., whether the stock transfers were bona fide, for a legitimate non-tax purpose. The taxpayer claimed the following in support:

- The FLP's net asset value increased dramatically through active investment according to Mr. Black's "buy and hold" philosophy;
- The transfer restrictions successfully prevented Mr. Black's son from dissipating his assets in divorce and his grandsons from reaching their stock, even when their trusts terminated; and
- The Black family's consolidated position allowed it to maintain a seat on the Erie board.

The taxpayer also cited Estate of Schutt v. Comm'r (T.C. Memo 2005), in which the Tax Court validated an FLP for its "unique circumstances"—primarily its pooling of assets according to the founder's investment philosophy, to preserve them against claims from creditors, divorcing spouses, and irresponsible heirs. The IRS tried to distinguish Schutt by claiming that Black's concerns for his Erie holdings was either "ill-founded" or insignificant. The court was persuaded by the precedent, however, and the similar "unique" facts of this case. Moreover, the FLP respected partnership formalities, including appropriate adjustments for contributions and distributions. Accordingly, the court held that the fair market value of Mr. Black's FLP interest, rather than the fair market value of the underlying Erie stock, was includable in his gross estate (Estate of Samuel Black v. Comm'r U.S. Tax Ct. 133 T.C. No. 15 filed Dec. 14, 2009.)

Checklist: Make Sure Your Expert Survives a Daubert Challenge

Why do experts get excluded from court? Lack of reliability is the leading cause under the Daubert standard, followed by lack of relevance and lack of qualifications, according to the most recent studies. Methodological flaws caused by the misuse of accepted financial and/or economic methods are also a frequent basis for denying financial expert testimony. And, of course, any new or untested approach will receive heightened scrutiny, under Daubert's by now familiar four-part test:

- Has the theory or technique been scientifically tested?
- Has the methodology been peer-reviewed and published in professional journals?
- Does it have a known error rate, with established standards to control its use?
- Is the methodology generally accepted by the relevant professional community?

Thirteen questions for your expert. Nearly 18 years after the U.S. Supreme Court's decision in Daubert (1993), only about half of states apply the federal standard. The remaining apply the "general acceptance" test of Frye v. U.S. (D.C. Cir. 1923), or some hybrid or independent standard. Thus it is important for attorneys to know their local court rules, to understand how high they have set the admissibility hurdles for expert testimony. For those jurisdictions that apply Daubert or a similar standard, the following 13-point checklist will help you evaluate your financial experts prior to litigation. If the experts can't answer any one question to a satisfactory degree, perhaps they shouldn't be retained in the case.

1. Do you have the requisite background, training, and experience required to gain acceptance by a court if a Daubert hearing is held?
2. Is it realistic to expect that your testimony will be admissible?
3. Has anyone performed a review of your work to see if it appears reasonable? "I'm lucky—I have the luxury of asking folks in my office to help me," Michael Costello (Decosimo Advisory Services, Speaker at the American Society of Appraisers (AICPA) National Business Valuation Conference, San Francisco) said. When he was a solo/small firm practitioner, he would pay his peers to review his report.
4. Have you followed all relevant professional standards? These can include the standards promulgated by the AICPA, The Appraisal Foundation (Uniform Standards of Professional Appraisal Practice), etc.
5. Have you used proven, commonly accepted valuation methodologies? Is the method generally endorsed by experts in the field? Can you cite relevant publications to support them?
6. If you apply an unusual or novel method, has

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it been peer-reviewed? If so, is there a basis on which the method would gain general acceptance in the BV professional community?

7. Does your work fit the case? Are your assumptions reasonable, given the underlying facts? (Attorneys: Make sure to clarify which facts will be admissible at trial.)
8. Is the underlying data reliable? Did you take reasonable steps to ensure the accuracy of the information before deriving your conclusions?
9. Have you considered alternative scenarios? This is especially critical in lost profits and economic damages cases, in which causation plays such a critical role.
10. Are your assumptions consistent with the facts?
11. How have you dealt with facts that are inconsistent with the ones you used?
12. Are you familiar with the relevant statutes and case law to assist in developing a damages or other economic theory?
13. Have you considered the track record of the relevant industry and the performance of comparable companies within that industry? Note: In the current economy, make sure your expert understands how the subject company and its comparables are faring.

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