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VALUATION Trends

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Court Affirms No Portion of Value Is Attributable to Personal Goodwill

***Burnett v. Burnett,* 2012 Ind. App. Unpub. LEXIS 1477 (Nov. 29, 2012)**

The husband was an anesthesiologist in a large practice with 68 partners. The total number of partners had remained fairly stable, with every partner holding an equal ownership interest. However, under an operating agreement, they received unequal distributions based on a formula (which the opinion does not provide). The 32 partners who joined since 2001 had paid $100, and those who left received $100 plus a termination benefit.

Actual earnings versus industry standard. At divorce, the wife presented expert testimony from a credentialed business valuator to quantify the husband's business interest, including its intangible value, that is, goodwill. Because Indiana considers only goodwill attributable to the enterprise community property, the expert eliminated the husband's personal goodwill from his calculation, using a variation of the excess earnings method.

He found the following factors indicated goodwill that inhered in the business:

- The practice was an organization with a formalized structure that required every partner to execute a covenant not to compete;
- The entity, not the individual partners, owned contracts with multiple facilities, and its ability to generate revenue did not depend heavily on the personal services that any one partner performed;
- The business name did not feature individual partners, and its identity remained unchanged despite the arrival or departure of partners;
- The practice alone determined what partner would provide services at what facility; the husband was able to work at a facility regardless of his personal relationship with patients or surgeons; and
- As a partner in the business, the husband did not need to expend time on nonbillable activities, including finding and scheduling work and billing and collecting for it.

To determine personal goodwill, the expert reviewed industry data from a trade group about the number of billable units that anesthesiologists record annually and the compensation that corresponds with a specific production level. The husband's billable units for 2009 indicated he was slightly below the 90th percentile in terms of productivity. At the same time, his earnings exceeded those of anesthesiologists at the 90th percentile. The expert used the difference between his actual earnings and the industry standards to capitalize the excess earnings.

As to the calculated value of the husband's interest, the expert said it applied under different assumptions, including the sale of the practice, the sale of the husband's interest, and the husband's remaining a partner or leaving the business. He concluded that the investment value was $337,000 and the fair market value was $253,000.

The trial court found the expert's methodology properly eliminated personal from enterprise goodwill. The noncompete agreements and the practice's long-standing exclusive contracts with multiple facilities suggested it would continue to have value even if the husband withdrew. "This," the court said, "is indicative of enterprise goodwill." Ultimately, it adopted the appraiser's lower value and found the business interest was worth $253,000.

The husband challenged the valuation in the state Court of Appeals, claiming the trial court failed to separate personal from enterprise goodwill.

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No personal goodwill. The law is well settled and requires that "goodwill that is based on the personal attributes of the individual is excluded from the marital estate," the appellate court said, citing *Yoon v. Yoon,* 711 N.E.2d 1265 (1999). The value that exists in the patient base and would be transferrable to a buyer who does not bring the same attributes to the business as the individual physician is enterprise value, the court continued.

The evidence supported the trial court's valuation based on the expert's calculation. Moreover, the court stated, the lower court's "extensive findings of fact and conclusions of law" made it easy to discern what portion of the expert's aggregate value was attributable to the husband's personal goodwill: "none."

Bogdanski Compares Recent 'Baffling' FLP Rulings

Professor John Bogdanski (Lewis & Clark Law School) was interviewed about recent developments in federal tax valuation.

Q: What are your thoughts on the *Wandry* decision?

A: *Wandry* moves estate planners another step toward being able to eliminate valuation uncertainty, or at least better control it. The case involved a couple who made an intrafamily gift of interests in a family business that were difficult to value; each of the parents phrased the gift of shares to children and grandchildren in terms of a dollar amount. The dollar value was determined to keep the gifts at or below the lifetime and annual gift tax exemptions, and the gift documents specified that if there was a valuation redetermination and the interests had a greater value than the targeted dollar amount, they would be "adjusted" downward. The IRS did establish a higher value than the estimate, but this simply meant a lower percentage of gifted shares. There was no gift tax due, the family said.

The Tax Court rejected the IRS's claim that the gifts should be treated as the larger percentages, as stated on the schedules on the gift tax returns. Holding for the taxpayers, it said the revaluation just meant that there was less of a gift to begin with.

Under *Wandry*, the IRS's audit on the valuation issue won't result in any additional gift tax being owed. An IRS agent trying to decide whom to audit and what issues to raise has a major disincentive to pick a fight over valuation.

Unhappy with *Wandry*, the IRS issued one of its "nonacquiescences"—warning that it will continue to assert that defined value clauses are void because they are against public policy.

Q: Why do you think the 2011 *Petter* case is actually more aggressive than *Wandry*?

A: *Wandry* was a big win for the taxpayer, but in one important way, it was only a temporary victory.

The *Petter* case was more of a coup for the taxpayers than *Wandry*. Here, the donor specified that if her valuation of the shares was finally determined to be too low for gift tax purposes, the value that exceeded the fixed dollar amount would go to a charity. This happened when an audit found the taxpayer's estimate was too low. The Tax Court and the 9th Circuit ruled that the excess that went to charity qualified for a charitable contribution deduction—which meant that the IRS never received any extra gift tax.

Q: Share your thoughts on *Estate of Stone* and *Estate of Kelly*.

A: *Estate of Stone* and *Estate of Kelly* were two big winners, in that Tax Court judges found that the setup of each FLP was a "bona fide sale" and therefore not subject to Section 2036(a). That meant that the discounts for lack of control and lack of marketability could stand. If Section 2036(a) applies, the discounts tend to go out the window.

The FLP in *Stone* didn't have many favorable facts. Yet it successfully argued that the parents in the family had a nontax motive for setting up the entity, which was to manage family assets. Its only asset was forestland that required no management—it sat idle for years between the establishment of the partnership and the decedent's death. There was some talk of developing it into something, someday, but the details were pretty vague. The FLP was a sleeper, and the family closed its checking account after a while because nothing was going into it or coming out of it. The parents paid the property taxes on the land out of their own pockets, which is usually problematic. But the estate won anyway.

Kelly was an interesting case. At the formation of the FLP, the decedent was incompetent; her four children were making all the decisions as her co-guardians. In effect, they thwarted the mother's estate plan, which called for unequal distributions among the children. By using the FLP and distributing shares, they managed to equalize the bequests among the four of them. The court held that this was a valid nontax motive for the FLP. It's perplexing because, for tax purposes, the relevant intent was the mother's. The children's actions defeated her intent.

Q: How does Estate of Turner II compare with the others?

A: When comparing *Estate of Turner* to *Stone*, one sees inconsistencies. In *Turner*, the FLP flunked Section 2036(a), in large part because the court found that there was nothing in the FLP that required management—the children were not involved in setting up the entity, and the decedent's relationship with the assets didn't change. The same could be said of *Stone*, where the decision went exactly the other way.

I'm generally a bigger fan of the Tax Court than many practitioners are, but I find the inconsistent outcomes troubling. The result regarding FLP discounts shouldn't depend on which judge rules on the case.

Q*: What should be made of* *Keller*?

A: *Keller* involved a deathbed FLP because the decedent signed some partnership formation documents in her hospital bed. Several loose ends were not tied up before she died—leaving blanks on schedules, failing to retitle assets in the partnership, that sort of thing. The arrangement was so sketchy that the lawyers gave up on the whole partnership idea and put the file away.

About a year later, one of the attorneys heard about the *Church* case, also out of Texas, In *Church,* a district court allowed discounts for an FLP even though important formalities only received attention after the decedent's death. Inspired, the *Keller* lawyers took care of all the details of the partnership after the decedent's death.

The family in *Keller* paid the estate tax without any discounts for the partnerships because, at the time the return was filed, they had abandoned the FLP plan. But after they revived it, they went to federal district court for a refund. Sure enough, just as in *Church*, the court ruled that intent plus a few signatures on some bare-bones documents sufficed to create a partnership under Texas law. With the partnership came the valuation discounts that the taxpayers wanted. The government appealed to the 5th Circuit, but it affirmed.

Lessons on Using the Guideline Public Company Method From the Delaware Court of Chancery

Valuation-related decisions from the Delaware Court of Chancery provide important guidance to business appraisers across the country, according to this speaker.

"In the Tax Court, you're more likely to disagree about discounts than the valuation of the business. It's the opposite in the Delaware Court of Chancery; there, discounts are largely irrelevant because the valuations often follow the 'fair value' standard—which tends to represent aggregate equity value before discounts." The speaker believes this standard allows appraisers to focus on valuing the operating business as opposed to calculating discounts, "which can be subjective and less quantitatively based."

"To me," the speaker adds, "discounts are not really appraisal; they're what I call 'finishing the appraisal.'"

Despite the Court of Chancery's stated preference for the discounted cash flow method (DCF), it does accept the guideline public company method. As is likely the situation in any venue, the party presenting the comparables carries the burden of proving that the selected companies are truly comparable. According to the speaker, the court seems to scrutinize the proffered comps more than other courts. As a result, the comp sets it accepts can be very small.

In Travelocity.com Inc., the experts were unable to formulate reliable projections because the online travel industry was still in its infancy. The court found the only reliable valuation metric was a sole comparable company (Expedia.com). The respondent's expert argued for a 40% discount to the comparable multiples, but the petitioner's expert wanted a 10% discount. Noting the subject company's higher cost of capital, lower growth rate, lesser cash flow, and less attractive business model, the court applied a 35% discount to the comparables EBITDA multiple (two-thirds weighting) and EPS multiple (one-third weighting).

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The speaker points out that “unlike many other appraisers, the Court of Chancery believes that a comparable company analysis includes a built-in minority discount because individual shares of publicly traded stocks represent minority positions.” Thus, the speaker says, “the court routinely permits the addition of a premium to compensate.” For example, in Travelocity.com, it “corrected” for the minority discount by adding a 30% premium.

As the speaker sees it, the court’s frequent addition of a premium arguably is inconsistent with its general refusal to allow the addition of a control premium to the DCF method, even when the terminal value was determined via an exit multiple approach. “In Delaware cases, appraisers frequently calculate public company multiples and apply them to the subject company’s EBITDA. However, if that EBITDA already includes control-type adjustments, or if it simply represents control-level cash flows, then the resulting value is a control value,” the speaker says. “There’s probably no need for an additional premium; not to mention the fact that the evidence we use for control premiums has numerous flaws. Adding premiums is something the court currently permits, but it may be open to a compelling argument as to why it’s not unilaterally appropriate. I suspect that trend may not last much longer.”

“The court’s main opposition to transactions is that the multiples might include prohibited synergies,” the speaker says. It also may object to transactions that are not contemporaneous. “If the transaction did not occur in the same economic environment that existed on the valuation date, the pricing may have been affected.” For example, in *Kleinwort Benson Ltd. v. Sigan Corp*., the court stated: “The merger and acquisition data undoubtedly contains post-merger value, such as synergies … that must be excluded from appraisal value.”

“The court’s attitude raises some interesting questions,” the speaker notes. “The appraiser in a dissenting shareholder suit or fair value case must determine value immediately prior to the transaction without giving effect to the benefits resulting from the transaction. But calculating multiples from M&A transactions may mean those multiples include synergies resulting from the transaction. If a public company buys a similarly situated private company in the same industry, is that really fair market value? The buyer was the highest bidder; it won the auction and probably paid some kind of strategic price,” the speaker adds. If appraisers apply the multiple of that deal to the subject company, they may inappropriately include synergies in their valuation.

In *Sunbelt,* the court rejected one expert’s proposed comparable transactions because they included companies that differed from the subject in size, product lines, geography, real estate payments, and post-closing price adjustments. The expert’s use of a median multiple did not compensate for using inappropriate comparables, the court found. In *Highfields Capital,* a case in which the petitioner’s expert used older transactions from a prior bull market period and, worse, failed to include the only highly probative transaction, the court disregarded the analysis in its entirety.

This said, in the absence of reliable projections upon which to base a DCF or as an additional valuation technique, the court will consider comparable transactions if they are, indeed, sufficiently comparable.

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