VALUATION Trends

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# Debate Over Tax-Affecting Plays Out in Divorce Case

**Bernier v. Bernier, 2007 Mass. LEXIS 598 (May 7, 2007)**

The debate over the valuation of Subchapter S corporations has "bedeviled" the legal and appraisal communities for some time, according to the Massachusetts Supreme Court in this recent divorce case. Here, the debate played out in the "diametrically opposed" approaches to tax-affecting taken by the couple's experts.

**Discounts at stake, too**

The couple owned two S corporations, which operated supermarkets in the upscale Martha's Vineyard community. The husband's expert treated the S corporations as though they were C corporations, applying a 35% "average" tax rate to earnings. This was appropriate, he said, because a potential purchaser would factor these tax consequences into the expected rate of return. He also applied a 10% "key man" discount—because the husband was critical to the supermarkets' continued operation—and a 10% "marketability" discount to account for the costs of any sale. He used no growth rate in his valuation because of declining revenues and uncertain future growth. Overall, the husband's expert valued the S corporations at $7.85 million.

The wife's expert declined to apply C corporation tax rates, because no sale of the business was contemplated and the S Corporations did not pay taxes at an entity level. No discounts applied, because the husband intended to stay in full control after the divorce. Because revenues were just emerging from the downward growth trend, he believed a 2.5% growth rate (to account for inflation) was appropriate. Overall, the wife's expert valued the S Corps at a $16.4 million.

The trial judge adopted the husband's value and faulted the wife's expert for omitting discounts and for "improperly" combining pre-tax and post-tax data in his valuation.

**Tax Court vs. Delaware Chancery precedent**

On review, the Massachusetts Supreme Court first noted that shareholders in a Subchapter S corporation enjoy the "considerable benefit of avoiding the 'double taxation' of corporate dividends that is hallmark of the C corporation." But this distinction begs the questions "whether, and how," to account for the tax consequences. Courts have come down on different sides of the debate. A line of Tax Court cases, beginning with Gross v. Commissioner (affirmed by the 6th Circuit in 2001) through Dallas v. Commissioner (2006), have declined to adjust the values of pass-through entities to account for the avoidance of double taxation. In Del. Open MRI Radiology and Assoc. v. Kessler (2006), however, the Delaware Chancery Court recognized the comparative benefits of S corporation ownership by calculating its value to the shareholder as well as to any potential purchaser.

In Bernier, the Court ultimately found the Delaware Chancery's "trenchant" analysis more persuasive. By applying the presumed C corporation tax rates, the trial court understated the value of the couple's S corporations. It failed to compensate the wife fully for her loss of ownership and its related tax benefits, especially given the "uncontroverted" evidence that the husband would continue to operate the profitable supermarkets after the divorce, including the historic practice of making cash distributions. Even though Del. Radiology was decided after trial, these facts should have prompted the judge to "look past the all-or-nothing approach" of the parties' experts.

Under these circumstances, the metric employed

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by the Delaware Chancery "provides a fairer mechanism for accounting for the tax consequences" of transferring ownership of the S corporations from one spouse to the other, the Court held. In the context of divorce, in which one party will retain and the other be entirely divested of ownership in any marital asset, "the judge must take particular care to treat the parties not as arm's-length hypothetical buyers and sellers in a theoretical open market but as fiduciaries entitled to equitable distribution" (emphasis added).

In its review of the "key man" and marketability discounts, the Court also held that both discounts were inappropriate, since the husband would remain in complete control, contemplated no sale, and intended to continue the businesses as "going concerns." A 2.5% growth rate was also appropriate, because there was no evidence that future growth would fall short of inflation. The Court remanded the case for a determination of the "complex" valuation issues, and emphasized that the final judgment should reflect the statutory requirements of equitable distribution.

## *Characterization of Professional Goodwill Under Continued Scrutiny*

Hess v. Hess, 2007 Me. LEXIS 83 (July 5, 2007)

Currently, Maine is one of a handful of states that has yet to decide whether the goodwill of a professional practice constitutes marital property; and if so, whether there should be a further distinction between enterprise goodwill (marital) and personal or professional goodwill (nonmarital). The majority of U.S. jurisdictions (twenty-eight states) now make that distinction, while fifteen hold that both enterprise and personal goodwill are marital property. Four states preclude characterizing goodwill as property—and two, Alabama and Georgia, also have yet to decide.

**Did Maine go with the rest of the nation?**

During the Hess divorce, the trial court reviewed valuations of the husband's investment business submitted by both parties' experts. After considering the different opinions, the court expressly found the approach, methodology, and factors used by the wife's expert more reliable in establishing the fair market value of the investment firm at $328,000.

On appeal, the husband contended that the court erred by classifying the goodwill derived from the business as divisible marital property, because nearly all of that intangible value was personal--inextricably linked to his individual efforts, talents, etc. The husband urged the appellate court to adopt the distinction between enterprise and personal goodwill pursuant to May v. May (a 2003 decision by the West Virginia Supreme Court, oft-cited for its summary of national holdings and the majority rule).

The Supreme Judicial Court of Maine declined to rule on that discrete issue. Although the parties' experts disagreed on the ultimate value of the business, they both considered that a large portion of its value stemmed from goodwill, which could be quantified and transferred. (Presumably, neither expert attempted to distinguish enterprise from personal or professional goodwill.) The Court confirmed the trial court's ruling that the goodwill value of the business was an asset--transferrable and divisible.

## *Court Erred by Excluding Value of Noncompete From Enterprise Goodwill*

In re Marriage of Baker, 2007 Minn. App. LEXIS 94 (July 3, 2007)

Minnesota follows the majority rule, distinguishing between enterprise or "institutional" goodwill (transferable) and personal goodwill (nontransferable) in divorce proceedings. This case questioned the allocation of a noncompetition agreement to institutional goodwill.

At trial, a neutral expert valued the husband's practice at $112,000, plus practice goodwill at $365,000, which included $73,000 in "institutional" goodwill. The trial court adopted $112,000 as the practice value but excluded the goodwill. Its reasoning: The expert had tied this value "directly to the execution of a noncompetition agreement." Specifically, the expert testified that the only way a buyer would pay the $365,000 for practice goodwill was if the husband signed a noncompete.

**Noncompete doesn't restrict employment**

On appeal, the Court noted the general rule

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that any value that attaches to the restrictions on a spouse's future employment is generally considered that spouse's nonmarital property, nontransferable in the divorce. But a noncompetition agreement "does not, by itself, establish that a spouse will be restricted in his or her future employment." A noncompete may be a protective device to assure the value of the business's goodwill if, for example, it precludes the spouse's solicitation of customers and employees or prohibits divulging of trade secrets.

Clearly, the expert distinguished the value of the practice's goodwill that was personal to the husband from the value of the "institutional goodwill" attributable to the practice. The latter depended on such factors as having a workforce in place, having a relationship with a hospital for referrals, and having a lease. None of these restricted the husband's future employment, the Court said:

Thus, even if a buyer required a noncompetition agreement to be attached to the value of the practice's institutional goodwill in addition to the value of the husband's personal goodwill, that portion of the noncompetition agreement pertaining to the institutional goodwill would not be intended to restrict husband's future employment.

The value of the institutional goodwill is marital property, subject to equitable division, and the trial court erred by excluding it from its valuation of the practice.

## *Case of First Impression: Does Statutory Fair Value Include a Control Premium?*

Northwest Invest. Corp. v. Wallace, 2007 Iowa Sup. LEXIS 87 (July 13, 2007)

Currently, seven states have adopted the 1999 amendments to the Model Business Corporation Act (MCBA)—specifically, its provisions disallowing consideration of minority and marketability discounts in fair value assessments. (These states are Connecticut, Idaho, Iowa, Maine, Mississippi, Virginia, and West Virginia; Florida has adopted a variation). But none of these state courts had considered whether the amended fair value definition mandates appraising the corporate shares on a marketable, control basis—until this Iowa case.

**A case of 'dueling appraisals'**

In 2003, a bank holding company effectively "squeezed out" three minority shareholders in a reverse stock split. Based on an expert fair value appraisal, the bank's directors paid the minority owners $33.23 per share for their respective interests and provided notice of their statutory appraisal rights. The minority shareholders rejected the payment and, based on their expert appraisal, demanded $64 per share. The bank refused and filed an appraisal action in Iowa district court. This time, it submitted a second appraisal, which posited a fair value of $48 per share. The bank paid the difference to the minority owners, plus interest. The minority shareholders rejected the payment and went to trial.

In its second appraisal, the bank's expert relied primarily on an income approach, capitalization of earnings method, giving it a 90% weight. He also used the guideline-company method, deriving an estimated price-to-book multiple from public comparables, applying it to the bank's adjusted book value and adding a 15% control premium (necessary because the public stock prices reflected minority interests). Weighting this approach 10%, he then "rolled up" the combined values through the holding company and its various interests and assets, concluding a fair value of the bank's shares at $48.

The expert for the minority shareholders used a combination of discounted cash flow (DCF) and market analyses. For the latter, he considered guideline sales of publicly traded stock and sales of controlling interests in financial companies, creating for each a price-to-tangible book value ratio and a price-to-earnings multiple, for a total of four values. He added a 40% control premium to the DCF value and the two valuations based on publicly traded stock transactions. (Sales of controlling interests in financial institutions already accounted for the premium.) Averaging the five values, which ranged from approximately $61 to $73 per share, he determined the fair value of the bank's stock at $64 per share.

**Prior inconsistent valuations**

One serious evidentiary problem with the bank's appraisal: It was "significantly lower" than recent appraisals done for the bank's employee stock option plan and its own reverse stock split. The district court found these multiple inconsistent appraisals of substantially the same assets "difficult if not impossible to reconcile." Second, the Court also could find no rational basis for the different weights accorded the valuation methods, and it simply disagreed with the bank's position that a "well-run, high-performing

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business….should either have no or very little control premium added to determine fair value."

The district court adopted the "more credible" fair value appraisal by the minority shareholders' expert, including his addition of a control premium. In reviewing this aspect on appeal, the Iowa Supreme Court looked to the official drafters' comments to the 1999 MBCA amendments--in particular, their explanation for precluding minority and marketability discounts from a fair value appraisal. Their intent was:

*…to adopt a more modern view that appraisal should generally award a shareholder his or her proportional interest in the corporation after valuing the corporation as a whole, rather than the value of the shareholder's shares when valued alone (Court's emphasis).*

"If an appraiser is valuing the corporation as a whole," the Court added, "then a control premium is certainly proper." Further, by disallowing discounts for lack of marketability and control, the legislature "implicitly required shares to be valued on a marketable, control interest basis." A control premium, if supported by the evidence, is therefore appropriate, and the Court affirmed the $64 per-share value offered by the minority shareholders' expert

**A note on synergy**

Lastly, the bank argued that the control premium was "inflated with synergistic value because the market data upon which [it] is based included corporate mergers." The bank's fair value should be determined on a standalone basis rather than in a possible merger.

The minority shareholders did not present evidence that a merger was in the bank's future or that its value should be based on anything but a going concern, standalone basis. "Nevertheless, there is nothing wrong with [the dissenters' expert] basing his opinion, in part, on the aggregations of actual sales data involving mergers and acquisitions," as this evidence reflected the marketplace. While the expert conceded that synergistic value was likely embedded in the data, comparable sales transactions are still "the best empirical evidence generally available to quantify a control premium," the Court said.

Based on the available data, the minority shareholders' expert determined control premiums ranging from 36% to 52% for companies comparable to the bank. His "conservative approach" also attempted to remove any marketplace distortions. "Although we cannot be certain what effect, if any, synergistic value had on [the expert's] calculations," the Court concluded, "it is more appropriate to accept [his] control premium in order to eliminate the [prohibited] minority discount … than to make no adjustment at all."

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