TRUGMAN Valuation

VALUATION Trends

Winter 2019

Court Adopts Appreciation Analysis That Places 'Specific Dollar Value' on Goodwill

***Mann v. Mann,* Case No. 14-DR-1064 N, Circuit Court of the Twentieth Circuit in and for Lee County, Fla. (July 7, 2016)**

In recent years, appreciation in the value of separate property has become one of the most contested issues in divorce cases. Valuation expert testimony has been critical for the parties both to show (or refute) an increase in value and to quantify the marital portion of that increase, assuming it exists. The valuation discussion in a recent Florida divorce case is noteworthy because it shows how a goodwill analysis may fit into an appreciation determination and how a noncompete analysis may fit into the personal goodwill determination.

The parties married in September 2003. At that time, the husband was a family lawyer and the wife was a 50 percent shareholder in a family thrift store business (Cosas Buenas Baratas Inc. (CBB)), which had stores in various states, including Florida. The business, which the wife's father started in 1987, was organized as an S corporation. The wife worked there while she was in college and later full time, starting at the bottom and eventually ending up as CBB's president and CEO. Along the way, the wife cultivated a critical relationship with the business' main supplier of inventory, the Vietnam Veterans Association (VVA). Typically, VVA solicited donations and in a bid process, used an operator, including CBB, to pick up the donated goods. CBB paid VVA for the inventory and then sold the donated goods in its stores. After the wife's father, who initiated the relationship with VVA, pulled back from the business, the wife assumed full responsibility for maintaining the connection.

The VVA connection was vital for CBB's success, even more so when VVA moved away from a strict open bid process and used more VVA operators with whom it had proven personal relationships. This new arrangement, which developed during the divorce proceedings, meant CBB no longer had to participate in a bidding war to ensure renewal of its one-year contract with VVA.

During the wife's 17-year involvement with the family business, she acquired 65 shares (of 100 shares) in three transactions. A flashpoint throughout the litigation was how the shares should be legally classified. Were any them separate property or were all 65 shares (a controlling interest in the company) marital property?

The first transaction took place in 1998, when the wife and her father agreed that he would transfer 38 nonvoting shares of CBB to the wife at $27 per share. In exchange, the wife signed a nonrecourse promissory note for over $1 million. In 2001, the wife and her father agreed that he would transfer an additional 12 shares of nonvoting stock for the same per-share price. The wife signed another nonrecourse promissory note for $324,000, and the second transfer was memorialized in a stock certificate. The transaction resulted in the wife owning 50 percent percent of the total number of CBB shares. The agreement between the wife and her father was that she would pay her father for the shares out of distributions received from the company. Because of the company's S corporation status, the wife was liable for income tax on the distributions. At the date of marriage (September 2003), the wife's payments on the shares totaled nearly $198,000.

A third stock transfer took place in July 2004, after the wife and husband were married. The husband, convinced that the wife's father did not act in the wife's best interest and that the prior transfers were not real, enlisted the help of an attorney he knew to pursue a modification of the prior notes. The amended agreement also provided that the wife's father would transfer an additional 15 shares to the wife. The new agreement stated the other agreements were still in effect to the extent the 2004 agreement had not modified them. The 2004 transfer increased the wife's shares in the company to 65, which resulted in her owning a controlling interest in CBB. Also, the 2004 amendment gave the wife voting rights to all shares.

The wife had been running the company since 2001. At the time of the divorce proceedings, the company had 200 employees in four stores across the country. Throughout the marriage, the wife kept working at the company and financially provided for the family. Meanwhile, after the marriage, the husband closed down his law practice, declared that he would become a mediator and later, with backing from the wife, became a county judge. However, during the divorce proceedings and before his term as judge was up, he resigned his judgeship and stopped working or searching for work. He never contributed to the business.

The parties separated in June 2013 and the husband filed for divorce in March 2014. The parties did not have any joint bank accounts or real estate. The divorce proceedings centered on CBB: how to classify the 65 shares the wife held in the company and how to determine the value of the marital interest in the

Continued on next page...

In this issue

- Court Adopts Appreciation Analysis That Places 'Specific Dollar Value' on Goodwill
- Court Rejects Appreciation in Value Calculation, Citing SSVS Violations
- Expert's Inability to Defend Income Analysis 'Is Decidedly Troubling', Court Says

company.

The husband's main argument, to which he returned again and again, was that all of the 65 shares were marital property because the wife only "actually" acquired them by way of the 2004 stock modification agreement that the husband had negotiated with the wife's father. The husband maintained that the 1998 and 2001 stock purchase agreements were illusory or void for lack of consideration.

The trial court rejected this argument, finding the wife had had legal ownership of the initial 50 shares before the marriage. As such, those shares were not a marital asset and not subject to equitable distribution at divorce.

At the same time, the court found that the additional 15 shares the wife acquired after the marriage, in the 2004 transfer, represented a marital asset.

Although the wife's 50 shares in the company were not a marital asset, under the applicable state statute, the appreciation (enhancement) in value of a nonmarital asset is a marital asset if the appreciation results either from the efforts of either party during the marriage or from the contribution to or expenditure of marital funds. Passive appreciation in value (an increase generated by market forces) does not render the appreciation a marital asset.

The court found here there was not enough evidence that the husband contributed marital labor to enhance the value of the wife's 50 shares. However, the wife's efforts—leading and managing the company—resulted in an increase in the value of those shares, making the enhancement in value a marital asset for purposes of an equitable distribution analysis, the court said.

The parties offered testimony from three valuation experts to determine the value of the marital portion in the wife's 65 shares in CBB. Two experts testified on behalf of the husband, one expert testified on behalf of the wife. They used different valuation dates.

The court clarified that the total marital value of the wife's shares required the three experts to subtract the value of the wife's 50 shares as of the date of marriage from the total marital value of the wife's 65 shares as of the date of valuation.

Value of 50 shares (nonmarital property). The husband's first expert calculated the value of the 50 shares as of the date of marriage was $376,000 in total. The husband's second expert determined the value was $500,000 in total. The wife's expert found the value was $400,000 in total.

Value of 65 shares. The husband's first expert determined that the value of the wife's 65 shares was $3.1 million. The husband's second expert found the value was $2.6 million or $2.8 million, depending on the valuation date. In contrast, the wife's expert found the value of all shares was $1.56 million.

Marital value of 50 shares (nonmarital) and 15 shares (marital). The husband's first expert, using as valuation date December 31, 2013, the last year-end closest to the date of divorce filing, calculated a marital value of $2.7 million. The husband's second expert, using as valuation date December 31, 2012, the last year-end closest to the date of separation, found the marital value was $2.1 million; alternatively, using as a valuation date December 31, 2013, the last year-end closest to date of divorce filing, this expert achieved a marital value of $2.3 million. In contrast, the wife's expert, using the date of separation, June 2013 as a valuation date, determined the marital value was just short of $1.2 million.

Significantly, the calculations the wife's expert provided included a goodwill analysis that separated the goodwill attributable to the wife (personal goodwill) from the value of the wife's ownership interest in the company. He was the only expert to quantify any goodwill.

The analysis pivoted around the wife's strong ties and relationship with the company's key inventory supplier, VVA. This relationship, the expert explained, was the "secret sauce" to keeping the company a going concern. Without the wife's relationship with VVA, the company would not have access to inventory and would stop existing, since 90 percent of the company's inventory came from VVA. Moreover, the wife's strong connection to VVA assumed particular importance when VVA changed the open bid process to a process that relied on personal relationships with known VVA operators, including CBB.

At trial, the experts agreed that the measure of the wife's personal goodwill was the amount a willing buyer for the company would pay for a noncompete agreement from the wife. If a willing buyer does not think it necessary to require the wife to execute a noncompete, the logical conclusion is that there is no significant goodwill attributable to the wife, the court noted. But if, in an arm's-length transaction, a willing buyer would be expected to make the wife's noncompete a condition of the purchase, then personal goodwill exists and its value would be the amount the buyer was willing to pay for the noncompete agreement, the court noted. The wife's expert maintained that, here, a willing buyer would definitely require the wife to sign a noncompete as a condition of purchasing her interest in CBB.

On the other hand, the husband's first expert claimed there was no goodwill attributable to the wife. In the alternative, even if there was personal goodwill, it was not worth much, this expert contended. The husband's second expert admitted in court that he was not familiar with the process of valuing a noncompete agreement.

The court agreed with the wife's expert that the proper valuation date was the date of separation. This was the date when the parties "ceased acting as marital partners, and there was no evidence of reconciliation" between the separation and filing for divorce, the court noted.

The court said the valuation date issue was but one reason why the court adopted the value determinations that the wife's expert proffered. This expert had "far superior credentials with regard to the nature and type of valuations required here," the court said. It also pointed out that he was the only expert "who placed a specific dollar value on the Wife's personal goodwill." The court agreed with the expert that an "'arm's length' buyer of Wife's interest in CBB Inc. would almost certainly require a noncompete agreement from the Wife as a precondition to any purchase and sale transaction." The court noted how difficult it would be for any outsider to break into the thrift store business as a VVA operator without help from an existing operator who had strong ties with VVA. It adopted the statement by the wife's expert that the value of the wife's noncompete to a potential buyer would be $900,000.

The court also noted that a relationship with a key supplier, such as existed here, was a "strong element of personal goodwill apart from relationships with CBB, Inc.'s retail customers."

The court pointed out that the husband's first expert had

developed his valuation on the mistaken assumption that VVA still used an open bid process. The court dismissed this expert's claim that his analysis of 58 transactions involving similar companies showed the market did not consider noncompetes important. The court noted that, on cross-examination, this expert admitted he had not given an accurate report of the examined data, but had intentionally ignored certain transactions to support his claim that most transactions did not require a noncompete. The court further observed that the expert had never testified in a trial. Yet, said the court, he held firmly to his opinion on the noncompete issue, even as he admitted he had never been involved in a transaction where the buyer did not insist on a noncompete from the seller. This expert's testimony lacked credibility, the court concluded. It also dismissed the opinion of the husband's second on the goodwill/noncompete issue, noting his lack of experience.

In adopting the value conclusions the wife's expert proposed, the court found the value of the marital portion of the wife's interest in the company was $1.16 million for purposes of the court's equitable distribution analysis. The breakdown was as follows: $800,000 in appreciation in 50 shares brought to the marriage plus $360,000 for 15 shares acquired during marriage, resulting in a total marital value of $1.16 million.

Finally, the court noted that, throughout the marriage, the husband had greatly benefitted from the wife's nonmarital assets and the increased value of CBB, while doing relatively little work himself. "Consequently, he will leave this marriage with significantly more than he had prior to the marriage," the court said.

On Sept. 1, 2017, the Florida 2nd District Court of Appeal affirmed the trial court's findings per curiam. The appeals court did not issue a written opinion.

Court Rejects Appreciation in Value Calculation, Citing SSVS Violations

***Hebert v.* Cote, Case No. 312017DR000305, Circuit Court of the Nineteenth Judicial Circuit in and for Indian River County Florida (Order May 29, 2018 and Order August 29, 2018)**

This appreciation in value case that collapsed when the court decided in two orders to exclude valuation testimony the nonowner spouse offered to make a claim to a portion of the increase in value of the owner spouse's separate business. The expert's calculation did not meet the statutory requirements for valuing the asset and failed the expert admissibility requirements, the court found. Moreover, testimony from an SSVS expert showed the appreciation analysis breached the professional standards in several regards. The nonowner spouse's subsequent attempt to introduce a revised calculation failed for essentially the same reasons, leaving her unable to meet her legal burden.

Background. In April 2003, the husband set up a Canadian company (Canix Colo Inc.) that provided "business technical collocation services." This meant offering server space in a multivendor-enabled environment, direct connection to optic networks, domain name hosting, etc. The company was very successful and in February 2011, the husband sold it for about $37 million. Net sales proceeds were about $22 million.

The husband and wife married in October 2009, years after the creation of the company. The company, by all accounts, was the husband's separate property.

The issue during the divorce proceedings was whether the marital unit had a right to a portion of the appreciation in value the company experienced during the marriage. The analysis has two parts. For one, the court has to make a determination that there was an appreciation (or "enhancement") in value. Assuming the court finds there was an increase in value, it must determine the reasons for the appreciation in order to determine whether all or a portion of the enhanced value is marital property. Under the applicable law, if a nonmarital asset increases in value during the marriage, only the part of the appreciation that is the result of either party's efforts qualifies as marital property. Basically, once the owner spouse shows the asset was separate property, the nonowner spouse must show there was an enhancement in value and it is marital property. If he or she succeeds, the other party has to show that some or all of the enhanced value is not part of the marital property.

Here, the applicable valuation dates were the value of the company on the date of marriage (October 2009) and on the date of the sale of the company (February 2011).

To quantify the increase in value, the wife retained a valuation expert who calculated what he called a "minimum marital component" from the proceeds of the sale of the company. The marital portion was $8.9 million from the gross sale and nearly $6.5 million from the net sale, the expert determined.

Broadly speaking, the approach he used considered revenue and earnings between July 2009 and July 2010 (not the valuation dates) to determine a percentage change. He applied this percentage change to the valuation dates (October 2009 and February 2011) to calculate a value for retained earnings as of the date of marriage. He calculated a goodwill value by subtracting the retained earnings as of the sales date from the gross sales price. He then applied the percentage change to the goodwill value to determine the goodwill value as of the date of marriage. Finally, he added the extrapolated value of the increase in goodwill between the valuation dates to the extrapolated value of the increase in retained earnings between those dates to arrive at the $8.9 million figure related to the gross sale.

The husband argued that the expert testimony was inadmissible under Florida's version of *Daubert*. In its May 2018 ruling, the trial court agreed with the husband and excluded the wife's expert. The court's order noted that the expert admitted he had not calculated the fair market value of the husband's company and had not determined an increase in value based on the relevant dates. Under the applicable law, he was required to do so, the court noted.

Further, he did not use any of the valuation methodologies (asset, market, income approaches) that were required under the professional standards that apply to business valuators. "Professional standards" refers to the Statement of Standards for Valuation Services (SSVS) of the American Institute of Certified Public Accountants.

The court noted that, instead, the wife's expert developed "a completely different technique" to calculate the amount allegedly owed to the marital unit. In a footnote, the court made a fact-finding that the expert's "minimum marital component" calculation "does

not meet the only recognized standard for 'fair market value.'" Further, the court's order noted the expert had not requested or received documents from the opposing party that might have been helpful in developing his valuation. The expert maintained his valuation met the SSVS because he was retained under a calculation engagement, as opposed to a valuation engagement.

The court also rejected this argument, finding a calculation engagement "has no precedent in any statutory or case law in the state of Florida to render an opinion of fair market value." The court further pointed out the expert used "subsequent acts," specifically the sale of the company, "as one of the anchor points in reaching his conclusion of valuation." Under the law, "only known facts may be used in making the evaluation," the court said. For all of these reasons, the expert opinion was inadmissible, the court concluded.

The wife filed a motion for rehearing, re-argument, and clarification in which she asked the court to reconsider its earlier order not to allow the expert to testify. However, the husband offered testimony from an expert on the SSVS who confirmed that the valuation the wife's expert had proposed failed to comply with the professional standards.

The SSVS expert had done over a thousand business valuations and was one of the three "primary writers" of the SSVS. In deposition testimony, this expert explained that all 50 states have adopted the SSVS and any CPA providing valuation services had to follow the standards. He further explained that he was only retained to provide an opinion on whether the work of the wife's expert was in compliance with the SSVS. He did not give an opinion on the methodology the wife's expert used or on the figures the wife's expert proposed.

The SSVS expert determined the new valuation by the wife's expert reflected four SSVS violations. One, the wife's expert did not seem to have a work paper file. Two, the wife's expert had not done enough work to offer a valuation opinion. Three, the opinion the wife's expert offered relied, at least to some extent, on subsequent events, i.e., documents related to the sale of the company as opposed to the date of marriage. And four, the wife's expert did not provide an engagement letter or any memorandum identifying the client and the type of valuation the expert was asked to perform.

The court rejected the wife's request to allow her expert to offer a "new" opinion. Instead, it found the work of the wife's expert "does not conform to the SSVS standards in many respects." The court also said there was no evidence the expert was "now prepared to testify to the fair market value" of the company, as the wife claimed in her motion. The court's refusal to allow the wife to recall the valuation expert meant the wife had no evidence to support her claim that there was an appreciation in value during the marriage and that the enhanced value was marital property.

Expert's Inability to Defend Income Analysis 'Is Decidedly Troubling,' Court Says

Judges are alert to incongruities in valuations, as is clear from a recent condemnation case in which landowners hired three experts to calculate the compensation owed to them. The court excluded all experts under Daubert, and it had particularly harsh words for the valuation expert who was unable to support critical elements of the valuation. The income analysis lacked "any indicia of reliability" and the capitalization rate determination was "entirely suspect," the court said.

A pipeline reached agreements with most landowners whose property was affected by the construction. However, the company litigated the compensation issue with a couple of property owners who operated a Christmas tree farm on some of the condemned land. They argued that the construction altered the soil composition and growing conditions, making it impossible to grow the "highly coveted Fraser fir tree" going forward. Also, the construction forced the owners to prematurely harvest their Christmas trees, which resulted in a substantial loss.

The correct measure of damages was the difference between the property's fair market value immediately before and after the taking, plus any incidental damages to the remaining property. Further, the court declined to exclude, as a matter of law, evidence of lost profits.

However, the court found the loss analysis the landowners' BV expert offered was fatally flawed. Assuming no trees would ever grow on the property again, she valued the business under the asset, market and income approaches. The first two analyses resulted in a loss to the landowners of $167,000 and $157,000, respectively. The income approach, which the expert said best captured the loss, increased the amount to $888,000.

Using the build-up method to determine the capitalization rate, the expert relied on Duff & Phelps' (D&P) figures for her risk-free rate of return and equity risk premium. But she rejected D&P's 5.9 percent small stock risk premium, using a 1 percent rate instead. The court noted the effect on the loss calculation was dramatic, where using a 5.9 percent rate would have reduced the expert's proposed $888,000 loss to about $339,000, leaving all the other inputs the same. The expert failed to explain "why she used the 'generally accepted' D&P's numbers when they raised her valuation but ignored the guide's suggested number when it lowered her valuation," the court said. It also questioned other inputs. Even though experts in disciplines requiring the use of professional judgment are generally less likely to be excluded, they are not immune, the court cautioned. Professional judgment alone, without a demonstrated basis in facts or data, is insufficient to support opinion testimony," the court said. It deemed the expert's opinion inadmissible.

©2019. No part of this newsletter may be reproduced or redistributed without the express written permission of the copyright holder. Although the information in this newsletter is believed to be reliable, we do not guarantee its accuracy, and such information may be condensed or incomplete. This newsletter is intended for information purposes only, and it is not intended as financial, investment, legal or consulting advice.

Florida
8751 W. Broward Blvd., Suite 203
Plantation, FL 33324
954-424-4343

www.trugmanvaluation.com

New Jersey
2001 Route 46, Suite 310
Parsippany, NJ 07054
973-983-9790