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Buy-Sell Agreements Receive Varying Consideration in Divorce

Three recent cases illustrate the various ways in which courts can consider a buy-sell agreement when valuing a spouse's interest in a professional practice, from using the formula to fix a limit on value to rejecting its purported limitations altogether. And two others consider division of goodwill and whether to divide other assets . . .

Interest in medical clinic worth no more than $1,000. In *In re Marriage of Baker*, **2011 Iowa App. LEXIS 1460 (Dec. 21, 2011)**, the husband owned a single unit in a general surgery clinic. In some years, the clinic had advanced him up to $12,000, but the husband insisted these amounts represented income, not assets. Further, under the buyout provisions of the owners' agreement, his single unit was worth only $1,000.

Based on this testimony, the trial court valued the husband's interest in the medical clinic at $1,000; the wife appealed, arguing that it should have been valued at $83,780 (presumably based on evidence that she presented at trial). The appellate court summarily dismissed her appeal, however, finding the trial court's valuation fell within the "permissible range of evidence."

Effect of law firm dissolution agreement on shareholder's interest. In *In re Marriage of Restaino*, **2012 Cal. App. Unpub. LEXIS 273 (Jan. 13, 2012)**, the husband owned a 9.7% equity interest in a law firm that specialized in large contingency fee cases. Prior to trial, the law firm began winding down, paying out substantial distributions pursuant to a confidential dissolution agreement. These funds did not represent a "buyout" of shares, the husband insisted, because "it was impossible to value a pure contingency firm." Instead, the distributions reflected the net fees remaining from any ongoing litigation, to be paid according to the firm's traditional practice of paying bonuses and income after resolution of cases.

The trial court accepted this characterization of the payouts as income, and the wife appealed, arguing that the law firm's "settlement agreement" did not control the characterization of the husband's equity interest as community property. The appellate court agreed, citing cases that permit courts to consider certain factors in deciding whether to rely on buy-sell formulas in valuing a spousal interest in a professional practice. "Merely because [the] husband agreed to alter the manner in which he would receive payment of his equity interest should not affect [the] wife's right to her portion of it," the court held. Other than sums expressly designated as salary, the court construed any distributions to the husband as "quantification of his interest in the firm" and remanded the case for further findings on its value.

Effect of shareholders' agreement on goodwill value of law firm. In ***In re Marriage of Kingery***, **2011 Okla. Civ. App. LEXIS 110 (Dec. 29, 2011)**, the husband owned a 25% interest in a law firm. During the marriage, he (and his two partners) purchased the law firm from his father-in-law at a "practice acquisition cost" of $200,000, as determined by the buy-sell formula in a shareholders' agreement. On his divorce, the husband's CPA expert valued his fractional interest in the firm at nearly $97,000, excluding the "practice acquisition" or goodwill cost; if he included this value, the husband's interest was worth just over $133,000.

To rebut this evidence, the wife's expert agreed with the higher value, disagreed with the lower, but considered the $200,000 "asset" that the husband and his two partners purchased was "goodwill." The trial court adopted the $133,000 value, and the husband appealed, arguing that it improperly included goodwill. In a rather cryptic

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opinion, the Court of Appeals found that the trial court's valuation included goodwill, "which, under this set of circumstances, should not be considered for the purposes of marital property division due to the effect of the shareholders' agreement" (emphasis by the court). As a result, it reversed the case for findings consistent with "valuation evidence not including goodwill as a factor."

In ***Swaney v. Swaney*, 2011 N.C. App. LEXIS 2648 (Dec. 20, 2011)**, the husband owned and operated an information technology firm during the marriage. At trial on divorce, he presented a business appraisal expert who testified that given its current assets and liabilities, the IT firm was worth a negative $2,230. At the same time, on cross-examination, he conceded that the firm's goodwill, based on a "reasonable" multiple of earnings over a 10-month period, was worth "in the neighborhood of $30,000," but this value hinged on the presence of a noncompetition agreement between the husband and any prospective new owner of the firm. The wife did not present a business appraiser; instead, she called on a former employee of the husband's firm who testified that "there would not be a whole lot of value" in the husband's firm—and she would not purchase it—without a noncompetition agreement or some other obligation for him to remain and run the business. At the close of the evidence, the trial court valued the firm at $64,000. This included $30,000 in goodwill and $36,000 in fixed assets, minus the $2,000 from the balance sheet approach. The husband appealed.

Held: The appellate court emphasized that in North Carolina, "the net value of a business includes goodwill, which must be valued and considered" in evaluating the business for purposes of marital dissolution. One commonly accepted method to value goodwill is the "willing buyer-willing seller" method, the court observed. In this case, the husband's expert used this approach and valued goodwill based on a reasonable multiple of earnings. In addition, the wife's witness testified that she would be willing to buy the husband's business given the execution of a noncompetition agreement. Under these facts, the court was not persuaded that the lack of an actual noncompete rendered the trial court's valuation improper. "On the contrary, the inclusion of such assumptions was necessary to fully reflect the value of the goodwill that [the husband] had accumulated as a result of his operation of the business, particularly given the absence of any indication that [he] intended to close or abandon [the firm] at less than its actual value." As a result of these findings, the appellate court concluded that the $30,000 goodwill value was based on "competent evidence and a sound valuation method" and affirmed the same. Similarly, it affirmed the trial court's valuation of the fixed assets at $36,000, based on the books and records at the time the husband bought the business. For that reason, the trial court did not have any more specific or current value for the fixed assets. Although the validity of its $36,000 was questionable and could have led to a different conclusion, the appellate court deferred to the broad discretion of the trial court to make factual findings based on the evidence presented, finding a sufficient basis in this case to support the fixed asset valuation.

In *In re Marriage of Hanscam*, **2011 Ore. App. LEXIS 1664 (Dec. 14, 2011)**, when the parties married in 1989, the husband, a CPA, already held a 25% interest in his father's accounting firm. Five years later, he purchased the remaining 75% interest, paying for it over the course of the marriage. During the same time, the husband's parents gave him (and his siblings) interests in a family limited partnership (FLP), so that, by the time the parties divorced in 2009, he owned just over 26%. Both parties retained experts to value the husband's solo CPA firm in a small town using standard methodologies. The wife's expert provided values under the income ($409,000), market ($439,000), and adjusted net asset ($154,000) approaches, but ultimately relied on the market approach and his "personal 'real-world' experience" to conclude that the CPA firm was worth $439,000.

Unlike the wife's expert, the husband's expert conducted a site visit and concluded the CPA practice was "very standard." He also rejected the market approach in this case, citing the lack of comparable CPA firms in the databases and the absence of specific identifying information. Accordingly, the husband's expert put more weight on his income ($313,000) and net asset ($202,000) values. Any value "over and above the hard assets" of the business was attributable to goodwill, he said, and in this case, all of that goodwill was personal, particularly because the husband couldn't sell his practice or transition his clients without signing a noncompetition agreement. Based on this determination, the expert concluded that the firm was worth $202,000 under the net asset approach.

The trial court relied on the husband's expert's income approach to value the firm at $313,000, less the husband's 25% premarital share but including its appreciation during the marriage (for a total of $55,000 as the husband's separate property). It also awarded the husband all of his FLP interest as his separate property, and the wife appealed.

Held: Although assets acquired before a marriage are not "marital assets," the appellate court explained, under state law (Oregon), they are considered "marital property," subject to a "just and proper division." As to the CPA firm, the court concluded that under a "just and proper" analysis, the wife was entitled to share equally with the husband's 25% premarital portion. And when a business has no value beyond its assets, absent the owner promising to continue his or her services after a sale, "there is no goodwill," the court said. Finally, the trial court correctly rejected the net asset value by the husband's expert for its failure to include enterprise goodwill, and the appellate court affirmed its $313,000 value under the income approach. It also agreed with the trial court that the husband maintained his separate property interest in the FLP during the marriage, to which the wife made no contribution and from which any appreciation was purely passive.

DCF Reliable for Calculating Lost Business Value

***JGR Inc. v. Thomasville Furniture Inds*., 2011 U.S. Dist. LEXIS 144545 (Dec. 15, 2011)**

The parties' dispute began in 1992, when the defendant allegedly violated an exclusivity provision in its contract, causing the plaintiff's furniture store to go out of business. After finding the defendant liable for the breach, a jury awarded the plaintiff $0 in lost profits but $1.5 million in lost business value.

On review from the federal district court (Ohio), the U.S. Court of Appeals for the Sixth Circuit found that the trial court had improperly permitted the plaintiff's CPA-expert to testify as a lay witness concerning damages. Accordingly, the court confirmed the jury's findings on liability but reversed and remanded the case solely on the issue of damages.

Right expert, wrong calculations. Prior to the second trial, the defendant argued that the plaintiff couldn't recover lost profits damages because in *Thomasville I*, it had failed to appeal the $0 awarded by the jury. The district court rejected this argument, permitting the plaintiff's financial expert to offer lost profits damages. After hearing evidence, the jury awarded $3.3 million in lost profits and $3.53 million in lost opportunity costs, or more than 4.5 times the prior award for lost business value.

On a second appeal, the defendant reasserted its arguments regarding the nature of damages, and the Sixth Circuit agreed. The plaintiff's failure to appeal the lost profits award after the first trial effectively precluded it from asking for lost profits at the second trial, and the court vacated the $6.83 million award. The court permitted the plaintiff to retry the issue of lost business value damages.

In its third attempt, a new financial expert focused primarily on a discounted cash flow (DCF) analysis. He compared the plaintiff's pre-breach financial information to industry data as well as the plaintiff's business plans, concluding that its flagship store should have met 1991 sales projections of $2.25 million. He kept growth flat in 1992 and from there, projected five years of sales based on industry growth rates. He then applied a 3.8% profit margin based on comparable data from the defendant's nearby stores. He also isolated industry functions, demographics, buying trends and patterns, and the regional economy to conclude that the business was worth $970,000 at the time of the breach and that the failure to reach this value was due either to "gross mismanagement" or the defendant's bad acts.

After hearing the expert's testimony and reviewing all of his analysis and assumptions, the magistrate concluded that his DCF approach was reliable, including its accounting for the company's

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finances. In effect, "assets and liabilities are sort of baked into the discounted cash flow analysis," the magistrate said. The expert's opinions were not unreliable simply because he had rejected the market and asset approaches as well as all income approaches other than the DCF.

In a second objection, the defendant argued that because all of the expert's "business value" calculations relied on discounted future earnings, they were nothing more than a claim for lost profits "thinly disguised" as a DCF analysis. The magistrate rejected this contention, too. However, the magistrate precluded the expert from calculating "lost opportunity costs" by assuming that the plaintiff would have reinvested earnings from its first destroyed store into future outlets.

Avoid obfuscation. The defendant appealed the magistrate's findings to the federal district court, reasserting its arguments that the expert's DCF approach was unreliable. "It belies common sense," the defendant claimed, "that a 'willing buyer' considering a value for [the company] would totally ignore the actual liabilities of the business or at least ensure that [its] assets and liabilities…were not different from those of 'ordinary' furniture stores."

Based on all the expert's evidence and testimony at the Daubert hearing, the court affirmed that the expert "gave adequate" reasons for explaining why and how he conducted his DCF analysis. "While he had a tendency to obfuscate and not directly answer a question posed to him on cross-examination," it said, the expert's testimony was credible and would be subject to further "vigorous" examination at trial.

Finally, the court cited Sixth Circuit precedent for the proposition that when an income-producing asset is lost, "the fair market value may be based in whole or in part on a buyer's projections of what income the buyer might derive from the asset in the future." Consequently, the court affirmed the expert's ability to present his DCF analysis to calculate lost business value for the plaintiff's flagship store but agreed that any evidence regarding lost opportunity costs exceeded the scope of the damages trial.