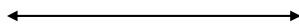


Current Valuation & Taxation Rulings Regarding Divorce

Excess Earnings Cannot be Calculated Based on One Year's Net Income



In *In re the Marriage of Rosen*, No. G025653 (Cal. App. 4th Dist. December 24, 2002), the California Court of Appeals, Fourth District considered the valuation of goodwill in a law practice. During the marriage, the husband worked as an attorney, whose cases were "limited almost exclusively to criminal appeals funded by the State of California." Only the wife presented expert testimony regarding the value of the husband's practice to the trial court. Her expert valued the goodwill of the practice using the excess earnings method. He relied solely on the husband's income from 1995, but had income information for years 1992 through the first eight months of 1988. He further relied on two national surveys, the Altman Weil and Robert Morris surveys, to establish the compensation of a comparable attorney. The trial court adopted this expert's opinion. It determined that the husband had an average cash flow of \$162,000 per year between the years 1998 and August 1996. It deducted the amount a comparable attorney would earn which it found was \$100,000 per year and the amount of owner's equity. It concluded that the business goodwill had a value of \$42,000. The husband appealed the valuation.

On appeal, the Fourth District found several problems with the wife's expert's application of the excess earnings method. It first considered the ex-

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For Valuation Expertise...

Restricted Stock Agreement Considered



In *In the Matter of Letendre and Letendre*, No. 2001-536 (N.H. December 31, 2002), the New Hampshire Supreme Court considered whether the lower court properly valued the husband's one-third interest in a closely held corporation. The stock was subject to a restrictive shareholders' agreement. The agreement fixed the price the corporation would pay to repurchase a shareholder's stock in the event of death or the desire to sell. However, the agreement did not prohibit a shareholder from selling the stock to a third party. The shareholders determined the per-share price annually. It was not based on a professional appraisal nor did the per-share price represent fair market value. The shareholders fixed the per-share price at \$6,784.40 per share six months before trial.

The trial court excluded the husband's valuation expert as a sanction for violating the discovery rules. As a result, the trial court did not have expert valuation testimony before it. The court did receive testimony from both parties as well as the corporate accountant. It also received the corporate tax return, financial statement and other corporate documents. Based on that evidence, the lower court valued the stock in accordance with the per-share price set forth in the restricted shareholders' agreement. The husband appealed.

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EBITDA Multiple Method Used to Value Piggly Wiggly Franchise

In *In re the Marriage of Franzen*, No. 02-1007 (Wis. App. January 29, 2003), unpublished, the Wisconsin Court of Appeals considered the valuation of a grocery store franchise. The husband held a 50 percent interest in the Piggly Wiggly franchise. The interest was acquired during the marriage. On the valuation date, the company was operating at a profit, but had substantial non-operational debt. The debt included an amount to the franchiser, bank debt, and an unfunded pension liability. Both parties presented expert testimony to the trial court regarding the value of the interest.

The wife's expert, a CPA, valued the business using the average of four approaches. They were the market, income, EBITDA and cost approaches. He applied a 20 percent lack of marketability discount. The expert then determined the husband's 50 percent interest to have a fair market value of \$548,707.

The husband presented two experts. The first expert, a VP of the franchiser, prepared a standard operational projection used to evaluate the value of the franchises. He concluded that the husband's franchise had a negative value because "the non-operational cash flow was insufficient to support the debt necessary to acquire the equipment, fixtures and inventory of the corporation...."

The husband's second expert, a CPA, had experience in the acquisition of Piggly Wiggly franchises. He testified that the valuation method used by husband's first expert was the

same method used to establish the sale price in all the seven Piggly Wiggly transactions in which he had been involved. Moreover, he testified that he was unfamiliar with three of the methods utilized by the wife's expert. He stated that he was familiar with the EBITDA approach and that the EBITDA approach "was the primary method he used in valuing a business." However, he had never used that approach in connection with a Piggly Wiggly franchise transaction. Moreover, he took issue with the wife's expert's application of that approach. He specifically disagreed with the expert's use of a three-year average rather than a three-year weighted average, the selection of the multiple in light of the franchise's financial performance, and the failure to consider the non-operational debt.

The trial court valued the business using only the EBITDA method. It utilized only the most recent year's earnings. It applied Standard and Poors' 5.5 multiple. The trial court then applied a 20 percent lack of marketability discount and a 20 percent minority interest discount. It concluded that the husband's interest had a value of \$324,860.20. In making this decision, the court declined to make adjustments for the business' non-operational debt. It reasoned that a reduction was inappropriate because the debt was rapidly being paid down and would shortly be paid off, resulting in a substantial increase in the husband's equity. It additionally

found insufficient evidence regarding the unfunded pension liability to warrant a reduction. In making its valuation decision the court noted that it had to make a choice between the experts, and, thus, found the wife's expert more convincing. The husband appealed.

On appeal, the husband challenged the trial court's valuation. He argued that trial court erred in accepting the testimony of the wife's expert. The appellate court stated, "reliability and credibility of expert testimony is an issue for the trier of fact. [Citation omitted]. Reliability of expert testimony is something that is subject to challenge on cross-examination in Wisconsin." It then affirmed the trial court's decision regarding the expert testimony, noting that the trial court as the trier of fact found the wife's expert more convincing.

The husband also appealed the trial court's use of the EBITDA approach. He claimed that the EBITDA approach was unreliable for valuing the business at issue. The appellate court disagreed. It noted that experts for both parties acknowledged, "the EBITDA approach was the most commonly used formula in business valuation." It further noted that the husband's second expert testified that he primarily utilized that method in performing valuations. Lastly, the appellate court noted that the husband failed to provide any binding or persuasive legal authority to support his position. Thus, it affirmed the trial court's valuation.

"Valuation Verdicts" is a publication of Larson Appraisal Services (LAS). LAS provides a wide range of business and financial services including the valuation of businesses, business ownership interests, intangible assets, and financial litigation support. This work has been performed for a variety of businesses and for various purposes including divorce. The principal, Jim Larson, has been involved in preparation and defense of those valuations since 1993. For further information on Larson Appraisal Services please call 480-657-6219 or access the electronic brochure on the web at:

<http://LarsonAppraisal.com>.

Discount for Lack of Marketability Affirmed

In *In re the Marriage of Gottsacker*, No. C1-02-615 (Minn. App. November 26, 2002), unpublished, the Minnesota Court of Appeals considered the valuation of the wife's interest in a limited liability partnership (LLP). The wife obtained the minority interest in the LLP during the marriage. It was acquired using distributions from her non-marital stock in her family's closely held steel siding company. The trial court determined the LLP interest to be marital property. In determining its value, the court applied a 28.93 percent discount for lack of marketability. Both parties appealed.

On appeal, the wife claimed that the lower court mischaracterized the LLP interest as marital property. The appellate court disagreed. It found that the district court properly characterized the wife's LLP interest as marital property since it was acquired during the marriage with marital income.

It next addressed the husband's appeal. He challenged the application of the discount for lack of marketability. The husband relied on *Redding v. Redding*, 372 N.W.2d 31 (Minn. App. 1985), for the position "that a lack-of-marketability discount is unnecessary when a fam-

ily collectively owns a majority interest in a business because, as a result of their ability to work together, the minority owners enjoy the benefits of a majority ownership in the business, which includes marketability." The appellate court disagreed. It found that *Redding* did not address a discount for lack of marketability, but considered instances of minority ownership and lack of control. Therefore, it affirmed the trial court's application of the discount. It further noted that the size of the discount was within the range of discounts presented in the evidence at trial.

Excess Earnings ... *Continued from page 1)*

pert's determination of the husband's income. It noted that the excess earnings method "first determines a practitioner's average annual net earnings ... by reference to any period that seems reasonably illustrate of the current rate of earnings." It found that the husband's net earnings fluctuated from a low of \$71,362 in 1994 to a high of \$134,610 in 1995. It determined that the expert's calculation of earnings based on one year inappropriate because it was not an average. It stated,

"Picking one year's net income, where income rises or falls from year to year, is not a reasonable basis for determining value." It further stated, "... net income for 1995 alone is neither average nor 'reasonably illustrative' of his earnings. A reasonable trier of fact could not help but conclude the expert chose to use ... net income from 1995—one of ... [the] highest earning years—solely to inflate the value of goodwill." It rejected the lower court's and the

wife's argument that his average income since 1988 was \$162,000. It found that this figure represented gross income rather than net income. It found and the wife's expert admitted that if the husband's net income had been averaged "over any period of years ..., goodwill value would be nominal or nothing." Thus, the court reversed the lower court and rendered a goodwill value of zero.

Restricted Stock ... *Continued from page 1)*

On appeal, the husband challenged the lower court's valuation. He argued that the lower court improperly relied upon the restricted stock agreement to determine the value for divorce purposes. He cited, *Drake v. Drake*, 809 S.W.2d 710 (Ky. Ct. App. 1991), for the position that the price set forth in a restricted shareholders' agreement does not establish the value for divorce

purposes, but is to be weighed as one factor among many in establishing the value. The appellate court rejected the husband's argument. It found that the lower court did not exclusively rely upon the restricted stock agreement, but considered it in connection with the parties' testimony and other corporate documents when it determined the value of the stock for di-

voice purposes. Thus, it affirmed the lower court's valuation. In doing so, it stated, "We note, furthermore, that the trial court could have found the stock redemption agreement option price in this case particularly reliable because the shareholders revalued the option price each year and last recalculated it six months prior to trial."

The brief summaries in this publication discuss only some valuation aspects of the subject cases and pronouncements. The reader is referred to the actual documents for additional details. This publication does not constitute legal, tax, accounting, or valuation advice, and it is offered as an informational service only. Those seeking specific advice should contact a professional advisor. No liability whatsoever is assumed in connection with use of this newsletter.