

Current Valuation & Taxation Rulings Regarding Divorce

Failure to Secure Independent Valuation Expert Results in Malpractice Claim

In *William P. Hatfield v. Susan F. Van Epps*, No. 3755 (S.C. App. March 8, 2004), the South Carolina Court of Appeals considered whether evidence of a sale of medical practice entered into prior to the date of divorce should have been entered into evidence in this attorney malpractice matter. Hatfield represented the law firm, which represented Van Epps in her divorce. The law firm brought suit to recover its unpaid legal fees and Van Epps counter-sued for negligent representation.

Her former husband held an interest in a surgical practice. His interest was subject to a shareholders' redemption agreement that specified a formula for the valuation of his interest. The husband was also subject to a salary continuation agreement, which applied in the event of his death, disability or retirement. "[T]he method of valuation was not limited [under this agreement] to an exclusive formula unless no bona fide offer from a third party existed."

The wife's attorney contemporaneously represented a senior partner in the husband's practice who was also getting divorced. The attorney engaged the same CPA to value the practice in both cases. This CPA was the practice's accountant. He also provided personal accounting work to the husband and wife in the underlying divorce. The CPA was instructed by the attorney to value the practice using the same methods in both cases.

The CPA considered the redemption
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For Valuation Expertise...

Accounts Receivable and Work-in-Progress Included in the Valuation of a Partnership

In *Debra Rubino v. Daniel Rubino*, 2004 N.Y. Slip Op. 01162 (N.Y.A.D. 2 Dept. February 23, 2004), the New York Supreme Court, Appellate Division, Second Department considered whether the value of accounts receivables and work-in-progress should be included when valuing an interest in professional partnership. The husband acquired a partnership interest in his law firm, specializing in corporate law. The partnership agreement provided only for the return of capital upon the withdrawal of a partner. The parties jointly hired a valuation expert to determine the fair market value of the partnership interest. The expert concluded that the partnership agreement did not provide a reasonable basis for valuing the interest, and he valued the interest using the excess earnings approach. He included \$550,000 for accounts receivable and work-in-progress in his estimation of the partnership's net tangible assets. He concluded that the interest had a value of \$1.5 million of which \$798,000 was goodwill.

The husband petitioned the trial court to exclude the value of accounts receivable and work-in-progress from the valuation of his interest because under the partnership agreement he was entitled only to a return of his capital account. The trial court agreed and granted the husband's motion. The wife appealed.

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Goodwill Valued at Zero Absent Conflicting Evidence

In *Steven B. Soileau v. Cynthia Bailey Soileau*, No. 03-1282 (La. App. 3 Cir. April 7, 2004), the Louisiana Court of Appeals, Third Circuit considered whether the trial court erred when it valued the husband's unincorporated carpentry business at zero. The trial court appointed a CPA to value the business. The CPA determined that the business had no value. The wife did not present any expert testimony of her own to provide a different valuation of the business. The trial court accepted the valuation provided by its expert and the

wife appealed.

On appeal, the wife argued that the lower court erred in failing to assign a value to the goodwill of the business. The Third Circuit initially noted that goodwill may be included as a divisible asset when valuing a commercial business but may not be included when valuing a professional corporation, and that there was insufficient evidence from which to decide whether the business was a commercial business or a professional corporation. It then considered the issue

whether the business was a commercial business. It noted that the court's expert assigned no value to the business' goodwill and there was no other evidence regarding a goodwill value. Moreover, it noted that the burden was on the wife to provide the evidence. Therefore, it ruled, "Given the unrefuted evidence of 'no value,' we find no manifest error in the trial court's determination and reliance on ... [the court-appointed expert]'s valuation." Thus, it affirmed.

(Malpractice... Continued from page 1)

agreement and the salary continuation agreement. He concluded that the husband's interest had a value of \$52,000 under the salary continuation agreement and \$665 under the redemption agreement. The husband also testified that he believed his interest in the practice to have a value of zero dollars. The trial court accepted the CPA's valuation under the salary continuation agreement.

Prior to the date of divorce, the husband's medical practice agreed to be sold to a hospital for \$3.1 million. The sale closed on the day after the date of divorce. The husband received \$775,000 for his interest.

The wife brought suit against her attorney for malpractice. She claimed that the attorney committed malpractice when he engaged the corporate CPA to value the business, rather than obtain an independent valuation expert. She asserted that this resulted in an undervaluation of the husband's interest. At trial, the wife attempted to have the sale introduced into evidence. The trial court excluded this information. It ruled that the evidence was not relevant to the valuation issue under *McElveen v. McElveen*, 332 SC 583 (Ct. App. 1998)

because value was established by the salary continuation agreement. It further noted that even if the evidence was relevant, it was inadmissible because it was "highly prejudicial." The wife appealed.

On appeal, the wife argued that the lower court erred when it did not enter the sale of the practice into evidence. The appellate court agreed. It first noted that divorcing parties are entitled to share in the appreciation or depreciation of a marital asset occurring between the date of separation and the date of divorce. Under that rule, the trial court should have entered the sale price into evidence.

The court further noted that the trial court misinterpreted *McElveen*. It noted that *McElveen* discussed the probative value of a buy-sell agreement when that agreement requires a mandatory sale and purchase of the stock at a specified formula price. It noted that under the facts of this case, the salary continuation agreement simply provided the company with a right of first refusal and did not specify a

valuation formula. It stated, "We certainly did not hold [in *McElveen*], however, that such an agreement was the only way to value a medical practice or that other evidence of value was inadmissible." (Emphasis in original). It concluded, "It is readily apparent that the agreement to sell the practice ..., which was entered into prior to the parties' merits hearing and thereafter finalized, tends to make it more probable that Van Epps' claim of malpractice was meritorious." Thus, it ruled that the trial court erred in excluding evidence of the sale price. It further noted, "In assessing Van Epps' claim of malpractice ..., the jury was clearly entitled to know that ... [the husband's] interest, which was valued at zero by ... [him] and approximately \$665 and \$52,000 by [the CPA] ..., was ultimately purchased for \$775,000, and that the agreement to purchase it was signed ... prior to the merits hearing in the parties' domestic action." Thus, it remanded the matter back for a new trial on the malpractice claim as it related to the business valuation.

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Business Appraisal Would Have Helped Show “Material Benefit” in Wife’s Effort to Set Aside Property Settlement Agreement

In *In re the Marriage of Martin and White*, No. G032239 (Cal. App. 4 Dist. April 20, 2004), unpublished, the California Court of Appeals for the Fourth District considered whether a property settlement should be set aside on the grounds of duress. Throughout the marriage, the husband owned a business. The parties separated in 2001 following an incident of domestic violence. A property settlement, which included the business, was negotiated by December 2002. In the husband’s financial disclosure, he listed the business with a value of “unknown.” The settlement agreement provided for an equalization payment to the wife, \$50,000 of which was for her interest in the business. Between

the date of separation and the property settlement, the husband retained control over the parties’ assets. This situation left the wife, who had recently reentered the workforce, strapped for cash. Three weeks after negotiations, the wife signed the agreement. In March 2003, the wife moved to set aside the agreement on the grounds of duress. The trial court granted her motion, and the husband appealed.

The appellate court initially noted, “A condition of relief is that ‘the court shall find that ... the moving party would materially benefit from the granting of the relief.’” The court then noted that the parties contested whether the business was established prior to or during the marriage. It fur-

ther noted that the wife did not present any evidence showing that the business was financed with community funds or appreciated during the marriage through community contributions. The court stated, “But there is no evidence of the community contributions, essential to show ... [the wife] got less than her community share and stood to do better if the judgment is set aside. Without the required showing of material benefit from vacating the judgment, there is simply no basis for granting relief.” Thus, the court reversed the lower court and upheld the parties’ property settlement agreement.

Private Company Must Be Valued

In *Norberto Menendez v. Nancy M. Rodriguez-Menendez*, No. 3D02-1572 (Fla. App. 3 Dist. March 31, 2004), the Florida Court of Appeal, Third District considered the lower court’s distribution of a closely held business between divorcing parties. During the marriage, the parties acquired a software development and web design company, which employed the husband. The wife maintained other employment. The trial court did

not place a value on the parties’ business. Rather, it equally distributed the stock in the business between the parties. They appealed the distribution.

On appeal, both parties agreed that the trial court erred when it equally divided the business between them. They argued that the business should have been valued and its value distributed between them. The court agreed. It found that leaving divorced parties as shareholders of a closely held com-

pany leaves them financially entangled and that such a result is “intolerable.” The appellate court ruled, “The parties must, therefore, on remand present proper valuation evidence for ... [the company] so that the trial court may, as the parties agree, award this asset to one of the spouses and ‘devise a plan of distribution which causes the least interference with the ongoing business of the corporation, yet which is practical and beneficial to both spouses.’”

(Accounts Receivable... Continued from page 1

On appeal, the wife argued that the trial court erred in excluding the value of the accounts receivable and work-in-progress. The Second Department agreed. It stated, “the withdrawal provisions of the ... partnership agreement do not provide a reasonable basis for valuation because to ‘limit defen-

dant’s interest to the capital account ... ignore[s] defendant’s status as a continuing and productive partner in an ongoing enterprise.’” It further concluded, “Applying the excess earnings method to this case, accounts receivable and work-in-progress must be included in establishing the value of

the husband’s partnership interest in his law firm. Only by doing so, can the husband’s interest in an ongoing concern be taken into consideration.” Thus, it reversed the lower court’s decision.

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.