



## INTRODUCTION

**Matt Stelzman**

Welcome to the introductory issue of the Henderson Hutcherson & McCullough Litigation & Valuation Insider, the newsletter designed to provide you with the resources needed to stay up-to-date in the field of forensics, litigation and business valuation.

At Henderson Hutcherson & McCullough, we let the numbers do the talking. With five professionals certified in the field of business valuation and forensic accounting by the National Association of Certified Valuation Analysts (NACVA), the only credentialing board to be accredited by the National Commission for Certifying Agencies (NCCA), and the American Institute of Certified Public Accountants, we are positioned to provide you with the highest quality services available in the Chattanooga area.

We not only have the certifications, we also have the experience. With over 115 years of accumulated experience in forensics, litigation and business valuation, as well as traditional accounting, we provide our clients with the peace of mind of knowing they are working with professionals who strive to provide objective and unbiased opinions. Having worked on cases - from small locally owned businesses to large international companies - we bring the knowledge and experience clients expect and demand.

On behalf of the entire Henderson Hutcherson & McCullough Forensic, Litigation & Valuation Group, we appreciate you taking the time to read through our newsletter. Please call us if you have any questions or would like to discuss opportunities to work with our group.

## DON'T PUT ESTATE PLANNING ON THE BACK BURNER

**Jack London**

As a result of the estate tax repeal scheduled for 2010, many people mistakenly believe that estate planning is no longer necessary. Others think that estate planning is just for the very wealthy. But the estate tax is scheduled to return in 2011, and, thanks to years of rapid real estate appreciation and entrepreneurial growth, many estates already exceed the \$1 million estate tax exemption scheduled to be in effect for 2011 and after. So having an up-to-date estate plan in place is important and a valuator can play a key role in the process.

### THE TEAM APPROACH

With so much at stake, a team approach to estate planning is important. Attorneys specialize in legal matters. Valuators help crunch the numbers, strategize and support estate tax filings.

Some estate planning teams might also include other types of professionals - such as tax and insurance specialists and personal property appraisers - to ensure all the bases are covered.

### THINK BEYOND BUSINESS VALUATION

The estate planning process starts by identifying assets and estimating how much they're worth. Valuators are an integral part of this early phase, and they do more than appraise businesses. They also help identify and value intangible assets, such as customer lists, patents, copyrights, lease agreements, noncompete agreements and proprietary software.

Some intangibles are transferable to a third party. Others represent personal goodwill, which means their values are inextricably linked to the business owner as an individual. If the owner dies, personal goodwill usually fades away. A valuator can help decide into which category a business's intangibles fall.

Moreover, a valuator can identify key person risks. If a business anticipates economic hardship following the unexpected loss of a key person, management needs a contingency plan. A valuator can help. For example, he or she can assign a dollar value to the time required to get the business back up and running after a key person's departure.

This figure can then be used to purchase key person life insurance coverage. It can also be a wake-up call to management underscoring the importance of grooming successor managers capable of continuing operations.

### RESPONDING TO IRS CHALLENGES

Credible and independent valuation expertise is especially important if the IRS challenges values assigned to assets on a gift or estate tax return. In the negotiations stage, valuers can field technical IRS inquiries, provide additional documentation for valuation conclusions and prepare rebuttal memos.

If a settlement can't be reached, a formal valuation report may demonstrate that the estate provided credible valuation evidence, thereby shifting the burden of proof to the IRS. Customarily, the expert's written report also serves in lieu of verbal direct testimony, unless the Tax Court permits otherwise.

### START PLANNING TODAY

There's no time like the present to start (or revisit) estate plans — with the help of a competent team of professionals. Once valuers identify assets and assign value, they can help brainstorm which tools — such as annual gifts, trusts or family limited partnerships — will help minimize taxes and meet other estate planning objectives.

Many believe that Congress is unlikely to allow estate tax repeal to occur but that legislators will take action to ensure some continued estate tax relief during and after 2010. This uncertainty makes estate planning complicated but critical.

## IS IT THE DRIVER OR THE CAR?

### Personal vs. practice goodwill Randall Hebert

In auto racing, the winning vehicle is usually pretty easy to spot — it's the one that crosses the finish line first. But one wonders how often arguments break out afterward about whether the victor was truly deserving. That is, did the driver really win the race, or did he or she simply have the best car?

In the business valuation world, a similar debate continues to rage over personal goodwill vs. practice goodwill. And though several court cases have dealt with the two concepts, there has been no consensus

on methods for distinguishing between them. Thus, this can be a particularly thorny valuation area — especially in the divorce arena, where it quite often arises.

### DEFINING THE TERMS

Personal goodwill is intangible value based solely on the efforts or reputation of a business owner. In some instances, it may also include profits that would be lost if that individual weren't present. For example, a surgeon who is well known for her ability and experience would have personal goodwill because patients will likely come to her specifically for those skills.

Meanwhile, practice goodwill is a company's intangible value that's not attributable to its owner. Over time, as a business grows in size and structural complexity, its goodwill typically begins to change from personal to practice.

When a company is small, the majority of its goodwill comes from the owner's personal relationships, know-how, reputation and personality. But as it develops, a greater portion of the goodwill relates to factors such as contractual relationships, location, facilities and work force.

### DEBATING THE RELEVANCY

The objective of a typical valuation is to estimate a company's equity, including its tangible and intangible value. And traditional appraisal methods don't differentiate between personal and practice goodwill, which sometimes isn't a problem.

Other times, however, it is — particularly in divorce proceedings, where the personal vs. practice goodwill debate continues to rage. In some states, courts don't consider personal goodwill a marital asset subject to distribution between the two parties. As a result, a valuator must quantify the portion of value attributable to personal goodwill and exclude it from the value of the business.

Yet some courts have concluded that personal goodwill should be marital property. In *Dugan v. Dugan*, for instance, the Supreme Court held that both personal and practice goodwill are marital property because ignoring the nonowner spouse's contributions to the company's development would be inequitable. Clearly, it's important to understand the state case law in the jurisdiction applicable to the subject business.

Another instance that requires distinguishing between personal and practice goodwill is the allocation of purchase price for tax or financial reporting purposes. In cases involving the purchase or sale of a business, determining whether either — or both — types of goodwill exist in significant amounts can influence how the deal is structured.

For example, a buyer negotiating to have the seller sign a separate, personal noncompete agreement may indicate substantial personal goodwill because the agreement presumably restricts the seller from using his or her skills to generate similar value for a competitor.

This may affect the appraisal methods applied as well.

### APPORTIONING THE VALUE

When valuing a business using an income approach, there's an implicit assumption that all of the intangible value reflected in the company's earnings stream is transferable. Yet personal goodwill may not be transferable and would need to be quantified and deducted from the value of the business.

One of the methods a valuator may use to estimate personal goodwill is first examining the factors that relate to practice vs. personal goodwill and calculating the percentage of each. Then he or she can apportion the total goodwill of the business to personal and practice goodwill according to those percentages.

### ADDRESSING PROFESSIONAL VS. COMMERCIAL

In some jurisdictions, disagreement remains regarding the measurement of personal goodwill for a commercial business owner vs. that for a professional practice owner. Many observers believe personal goodwill typically arises solely in the context of a professional practice. And, they say, even if a commercial business has only one owner, it's difficult to attribute much of the value to personal goodwill.

*For example*, in *Frazier v. Frazier*, an Indiana appellate court dealt with the valuation of a single-location retail furniture store. The owner spouse's attorneys claimed that most of the goodwill was personal.

After the facts were reviewed, however, very little of the value could be attributed to the owner spouse. Many of the customers were from the general public and the owner spouse didn't have a special relationship with any of them — or with the company's suppliers.

At the end of the day, an appraiser needs to examine both the nature of a commercial business and its standard industry practices to determine whether personal goodwill exists.

### STUDYING THE CASE LAW

A number of other landmark cases have dealt with professional goodwill. In *Lopez v. Lopez*, a California appellate court's decision identified several factors that valuers should consider before expressing an opinion. These include the professional's:

- *Age and health,*
- *Demonstrated past earning power,*
- *Reputation in the community for judgment, skill and knowledge, and*
- *Comparative professional success.*

Also important are the nature and duration of his or her role in the practice, either as a sole proprietor or as a contributing member of a partnership or professional corporation.

A Tax Court case, *Norwalk v. Commissioner*, also sheds light on the issue. Here the court indicated that, generally, to transfer the goodwill of a professional

practice, the parties must sign off on an enforceable noncompete covenant or other such agreement.

### RECOGNIZING THE CHALLENGE

As mentioned, differentiating between personal and practice goodwill is often required in divorce and tax proceedings. But this creates a challenge in that there are no "standard" methods to distinguish between the two types of goodwill. In addition, different jurisdictions approach the matter differently.

Ultimately, whether goodwill of any kind exists and how to divide it equitably depends on the facts and circumstances of each case. And any methods a valuator decides to rely on should be well supported and well documented to withstand scrutiny.

## TAKE NOTHING FOR GRANTED IN DIVORCE CASES

### Matt Stelzman

Nothing is a sure win in divorce court. Each state has its own laws governing equitable distributions, which permit family court judges significant leeway in allocating assets and support.

When the parties leave business valuation issues to the discretion of family courts, they risk unexpected outcomes and inequitable allocations. This draws out the divorce process and incurs additional professional fees on appeal.

Out-of-court settlements preclude courtroom surprises. But if court is unavoidable, it's imperative that the parties review relevant state statutes and case law — in and out of their jurisdiction — to prevent potential hang-ups.

### GOODWILL

One of the most common areas of discrepancies in divorce valuations is the proper treatment of goodwill. Most states require valuers to appraise goodwill and split it into two components: personal goodwill and business goodwill. In these jurisdictions, the former is a personal asset, excluded from the marital estate. The latter, along with the company's tangible value, may be subject to division in a marital dissolution.

But not all states agree with the majority view. Idaho recently joined a smaller group of states that make no distinction between personal and business goodwill. Instead, these states include all goodwill in the divisible marital estate.

In *Stewart v. Stewart*, the Idaho Supreme Court ruled that the personal goodwill of the husband's dermatology clinic (valued at approximately \$211,000) was marital property. The court found "no principled reason to treat the goodwill of a business differently

when it is a professional service.”

Accordingly, it refused to “enter the morass of trying to draw a distinction between the value attributable to a professional practice by virtue of the individual attributes of the professional and the value of goodwill not attributable to those personal assets, valuing each separately, and then dividing the latter but not the former.”

A small number of states also refuse to enter this “morass” by specifically excluding all goodwill from the marital estate. When addressing the goodwill conundrum, it’s common to look outside a divorcing couple’s state’s jurisdiction for guidance — especially if little or no relevant case law exists.

### BUY-SELL AGREEMENTS

Many businesses have legal contracts that protect against unexpected events, such as the death or disability of an owner. In addition, these agreements may establish the terms of a voluntary buyout. When valuing a business for divorce purposes, the question arises: Does the buy-sell agreement provide evidence of the company’s value?

The answer varies from one jurisdiction to the next. For example, in *Barton v. Barton*, the Georgia Supreme Court recognized that “the buy-sell price in a closely held corporation can be manipulated and does not necessarily reflect true market value.” (For a closer look at another case, see “Buy-sell agreements: Evidence of value in divorce?” at right.)

Parties who rely solely on buy-sell agreements to determine business valuation may get burned. But buy-sell agreements — along with other documentary evidence — are integral to valuator’s analyses.

### REASONABLE COMPENSATION

Equitable asset allocations and support payments require estimates of reasonable compensation for the monied spouse. Compensation studies — such as those published by the U.S. Department of Labor or the Wall Street Journal — are popular resources for estimating reasonable compensation. Although divorce courts have accepted these studies in countless cases, some situations require valuator’s to dig deeper.

For instance, in *re Marriage of Ackerman*, the wife’s accountant used the MedicalGroup Management Association’s Physician Compensation and Production Survey to estimate a range of reasonable compensation of \$291,000 to \$355,000 for her husband, a plastic surgeon in Newport Beach, Calif. Conversely, the husband’s expert used the American Medical Association’s Physician Socioeconomic Statistics surveys to arrive at a reasonable compensation estimate of \$515,000.

But the court was not persuaded by either expert’s testimony, opining that neither compensation study was “sufficiently fine-tuned and honed in our area to be particularly valuable.” Applying its own quality control, including an informal survey of local plastic surgeons

performed by the husband’s expert, the court determined that reasonable annual compensation was approximately \$544,000.

### VALUATION EXPERTISE

One aspect of divorce valuations seems universal: Family court judges prefer independent appraisal expertise and thorough analysis. When divorcing business owners (or their spouses) fail to present adequate valuation evidence, they put themselves at the mercy of the court. A professional appraisal can save time, money and frustration over the long run.

### BUY-SELL AGREEMENTS: EVIDENCE OF VALUE IN DIVORCE?

In one landmark California case, in *re Marriage of Nichols*, a law firm’s value was based on the buy-sell formula, to which the firm had strictly adhered in past transactions. This divorce case lists three criteria to consider when deciding whether to use a formula set forth in a buy-sell agreement as evidence of value in a divorce case:

1. Proximity of the date of the buy-sell agreement to the date of separation (to ensure the agreement was not entered into in contemplation of marital dissolution),
2. Existence of an independent motivation for entering into the buy-sell agreement, such as a desire to protect all partners against the effect of a partnership dissolution, and
3. Whether the value resulting from the agreement’s purchase price formula is similar to the value produced by other approaches.

Adhering to these criteria can help prevent potential problems in using a buy-sell agreement formula in marital dissolution proceedings.

### CALL THE LITIGATION & VALUATION SPECIALISTS AT HENDERSON HUTCHERSON & MCCULLOUGH, PLLC

**JACK LONDON**  
CPA, CVA, CFE, CGFM, ABV, CFF  
423.702.7277  
jlondon@hhmcpas.com

**MATT STELZMAN**  
MBA, AVA, CFFA  
423.702.8147  
mstelzman@hhmcpas.com

**LAURA REID**  
CPA, CVA  
423.702.7693  
lreid@hhmcpas.com

**CARL HENDERSON**  
CPA  
423.702.7266  
chenderson@hhmcpas.com

**BLAKE CALLAHAN**  
AVA  
423.756.7771  
bcallahan@hhmcpas.com

**KRISTINA DAVIS**  
423.702.7699  
kdavis@hhmcpas.com

**RANDALL HEBERT, MBA**  
MBA, CPA, CVA  
423.702.8145  
rhebert@hhmcpas.com