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Neutral Expert Determines Insurance Agency Value in Difficult Divorce Case

Hancock v. Hancock, 2008 WL 2930586 (Tex. App.) (July 31, 2008)

In a divorce that took almost two years to litigate, in part because of the husband's alleged financial abuses, the court appointed an independent expert to value the Hancock Insurance Agency. The expert based his valuation on \$3.4 million of projected policy renewals through the end of the year—approximately six months from the trial date. Historically, the agency had earned revenues 8% to 12% of referrals, so he applied a 10% revenue rate or \$340,000 in expected revenues. These future commissions were probable, he said, based on the agency's "very lengthy history" of earning the commissions "year after year." The expert added a receivable from the IRS and a small assessment for furniture and fixtures to reach a total asset value of \$442,000, and then subtracted liabilities for an unadjusted book value of \$272,000. He applied a 25% marketability discount to reach a net value of just over \$200,000.

Before trial, the expert updated his numbers in a two-page exhibit, which noted \$170,520 as an "Adjusted Value." He also told the court that the business had vacated its building, and could be subject to a possible judgment of approximately \$80,000 for unpaid rent; at trial, he offered a hypothetical calculation that assumed payment of the liability. But the expert also served as receiver for the business, and had yet to be served any legal demand for payment; nor had he been able to locate any potential buyers. Finally, he testified that the 25% marketability discount was higher than normal for a

controlling interest, but this accounted for the possibility that customers might not renew at historical rates.

The wife told the court that during the divorce proceedings, her husband had set up two other insurance companies, diverting \$300,000 to \$400,000 from the marital business. She also said that during the marriage, a potential buyer had discussed a price of 1.5 times book value for the business, which would have made it worth about \$600,000 at the time.



The husband offered his own expert, who testified that the agency had lost all but one of twelve large accounts; the loss indicated his importance to the business, he said. Plus, he criticized the court-appointed expert for assuming a 100% renewal rate.

Evidence lends to easy conclusion. Overall, the evidence

"easily" led the trial court to value the insurance agency at \$170,520, not including the alleged judgment for unpaid rents. The court-appointed expert assumed a 100% renewal rate only after considering the longevity of the accounts and the short term that would elapse before revenues would "roll in," it said. The possibility that customers would not renew appeared in his higher-than-normal 25% marketability discount. (The trial court also found that the husband had dissipated over \$300,000 in marital assets.)

The husband appealed the decision—but on review, the higher court found the valuation fell within the trial court's broad discretion and the range of evidence, which supported the \$170,520 appraisal for the insurance agency.

Should ‘Highest and Best Use’ Govern Fair Value Standard in Dissenting Shareholder Case?

Holiday Medical Center, Inc. v. Weisman, 2008 WL 2677504 (N.J.) (July 10, 2008) (unpublished)

The board of directors of a New Jersey nursing home wanted to sell the facility, its land, and other assets to a private, non-profit school for \$8 million. The nursing home would net about \$2 million from the sale, after paying off an existing mortgage of \$3,075,464 and other miscellaneous items—including a \$3 million donation to the non-profit buyer.

Liquidation value versus going concern. After the sale went through, a 5% minority shareholder dissented and sought a judicial appraisal of her shares. The judge appointed an independent appraiser, who found that the nursing home was “marginally financially feasible.” Its value as a going concern was only \$5,540,000 compared to a liquidation value of \$7 million, which lay primarily in the real property assets. Neither the shareholder nor the board of directors disputed the appraisal, its alternate valuations, or its methodologies.

The shareholder tried to enjoin distribution of the sale proceeds, but by then the board had already distributed 80% to the remaining shareholders. The court ordered the board to pay the dissenting shareholder 80% of her share as well, or \$80,000. But the shareholder still claimed she was owed over \$116,000 based on her share of the appraised liquidation value (\$7 million) minus the outstanding mortgage but not including any charitable donation to the buyer, for which she never received any benefit (in terms of a charitable deduction). In other words, she claimed that statutory fair value should be based on a ‘highest and best use’ analysis.

The board objected, claiming that the going concern appraisal (\$5,540,000) represented the fair value of the nursing facility; and that its \$80,000 reimbursement constituted fair value of the shareholder’s interest.

Asset approach violates fair value standard? The trial court agreed with the board, rejecting the “highest and best use” standard as controlling in a fair value accounting. When the board completed the sale, it stripped the dissenting shareholder of her ongoing

interest in the nursing home, the court explained. The independently appraised values established a range of value for the facility, anywhere from the best case (\$7 million liquidation value) to worst case (\$5,540,000 going concern). Accordingly, given both parties’ acceptance of the appraisal, the shareholder’s interest ranged from \$40,000 to \$80,000.

The trial court was also satisfied that the arms-length sale of the nursing home established fair value for all shareholders, dissenting or not. But the shareholder appealed the decision, arguing that “as a matter of law” the fair value statute requires the “highest and best value” standard.

The New Jersey Superior Court, in an unpublished decision, rejected this contention. Under local as well as Delaware law, a corporation’s going concern value is acceptable to determine the fair value of a dissenting shareholder’s interest. In this case, the trial court did not adopt the going concern value but merely used it to corroborate the sales price, which—after deductions, including the charitable donation—resulted in a corporate value of \$2 million.

However, the appellate court remanded the case for the lower court to provide its basis for accepting the sale transaction price, which included the charitable donation, over the going concern value—which did not. It should also clarify whether the shareholder could benefit from the charitable donation and how this would factor into the court’s overall findings of fair value.

Colorado Court Considers Fair Value Standard in Divorce

In re Marriage of Thornhill, 2008 WL 3877223 (Colo. App.) (Aug. 21, 2008)

In this case, the Colorado Court of Appeals becomes the latest to rule on whether to extend the statutory fair value standard in dissenting shareholder cases. In particular, the court examined its preclusion of marketability discounts to valuing a business in divorce.

An oil and gas interest worth \$1.625 million. After a 27-year marriage, the Thornhills executed a separation agreement, including the disposition of the husband's 70.5% interest in an oil and gas business. The husband's expert valued the husband's share at \$1.625 million, after the application of a 33% marketability discount. The wife, who did not have the benefit of counsel when she signed the agreement, later disavowed it at the hearing on final orders. But the trial court ratified the agreement, despite her protest. The wife appealed.

The appellate court voided the agreement, finding that its provisions were unconscionable. The wife was not legally or financially sophisticated, the court contended, and had no access to counsel. More importantly, the agreement provided for the husband to pay the wife half of the marital assets (some \$750,000) in equal monthly payments over ten years, without any provision of interest or security for the debt. The court remanded the matter to the trial division for a new determination and disposition of the assets.

Maintaining, "it may arise on remand," the court considered the wife's contention that no marketability discounts should apply to the value of the husband's business. She offered case law that precluded marketability discounts when determining the fair value of a dissenting corporate shareholder's interest pursuant to the applicable statutes, based on analysis of the relevant statutes in several jurisdictions and provisions of the Model Business Corporation Act.

Statutory fair value discourages squeeze-outs. Dissenting shareholder statutes are intended to protect minority owners from the vagaries and involuntary nature of cash-out mergers, the court observed. A rule that prevented minority shareholders from receiving less than their proportionate share of the firm's entire value would transfer wealth from the minority to the controlling shareholders and would encourage corporate squeeze-outs.

But those same considerations do not apply in a divorce case. First, the applicable marital dissolution statutes do not contain the "fair value" language of the business corporation statutes. Second, the "fair value" standard (in statutory fair value cases) does not equate to "fair market value" standard in divorce cases; as a result,



"the common practice of including a marketability discount in calculating fair market value is not permitted in dissenting shareholder valuations," the court held.

Finally, it declined to adopt *Brown v. Brown* (N.J. 2002), in which the New Jersey Superior Court of Appeals extended the reasoning of dissenting shareholder cases to hold that marketability discounts are not appropriate in marital dissolution proceedings. Instead, the court was persuaded by the decisions "of numerous other jurisdictions" that have applied marketability discounts when valuing interests in closely held companies for purposes of divorce.

The court expressed no opinion regarding an appropriate discount in this case, although it cited a range, from 10% to 35%, in other cases. Instead, it simply directed the trial court to make a clear record of its reasons for applying any discount, "to facilitate review on appeal."

Expert Evidence Helps Decide Partnership 'Divorce'

Schuetzle v. Lineberger, 2008 WL 2406825 (Wash.) (June 16, 2008) (unpublished)

Like divorce cases, partnership dissolutions are often costly and conflicted. And in both settings, one party's

qualified valuation professional can help decide the outcome—especially when the opposing party opts not to retain an expert.

Expert concludes club worth over \$1 million.

Two married couples formed a partnership to run an athletic club. After six years in operation, the majority owners (60% partnership interest) terminated the 40% owners. The minority partners sued for a dissolution and accounting of the partnership, and the court held a valuation hearing. The minority partners presented a valuation expert, who used the combined income, market, and asset approaches to conclude that the club was worth nearly \$1.08 million. He also calculated \$93,510 in unpaid distributions to the minority partners.

By contrast, the majority partners did not retain an expert appraiser or offer an alternate valuation. Rather, the couple's husband simply testified that the expert's value conclusions were "much too high" for "various reasons," including increased competition from other health clubs.

Not surprisingly, the trial court credited the expert's testimony, with a couple of exceptions. It rejected an

adjustment to the club's income based on "minimally adequate staffing," as well as his optimistic view that the club would rebound from the increased competition and a stagnant growth rate. To reflect these concerns, the trial court discounted the expert's value by 25%, arriving at a final value of \$807,000. The minority partners' 40% share amounted to \$322,800, plus unpaid distributions. The majority partners appealed.

Hard to argue without alternative valuation evidence.

In an unpublished decision, the Washington Court of Appeals reviewed the trial court's conclusions. Although the court didn't discuss the valuation evidence in much detail, it found the trial judge acted reasonably in accepting the expert evidence as a starting point—especially given the lack of a credible, alternative valuation from the opposing side. It was also within the judge's discretion to make appropriate adjustments, including the blanket 25% discount. "The trial court took the weaknesses of [the expert's] valuation into account and discounted his final calculation," the higher court held, in confirming the valuation conclusion as well as the unpaid distributions.

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