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For What It's Worth

Spring 2007

Greetings Everyone

It's been a busy few months for the CBIZ LVS group. We have been working on a few large cases with some interesting issues. In this issue of **For What It's Worth**, we will focus on valuation issues in the context of divorce.

In the first article, "**How to Avoid Post-Divorce Dissatisfaction**", we describe a 2006 New York Appeals case in which two highly educated divorce clients decided to reach settlement without proper discovery and with limited advice from attorneys and accountants. The wife was, not surprisingly, dissatisfied when her husband sold his business shortly after the divorce was final for millions of dollars more than they had agreed it was worth. The second article, "**Law on Enterprise Goodwill in Divorce Limits Valuation in Latter Legal Malpractice Action**", describes a malpractice suit in Illinois that addresses the change in the treatment of goodwill in that state for purposes of divorce. Finally, we have included an article from a divorce in Kentucky. "**Another Court Considers the Distinction between**

Personal vs Enterprise Goodwill" shows that Kentucky has a similar practice to Colorado in the treatment of goodwill.

We would appreciate your feedback on this newsletter. Please drop us an email at lvnews@cbiz.com and let us know if you are finding it helpful (and how we can improve it.) Please email us if you would like additional copies, would like to receive it by email, or would like to opt out of receiving it. And, as always, give us a call if you would like to get to know us: we'll buy lunch.

Kind regards,

Eric Six, CPA/ABV

P.S. A Drastically Literal Way to Divide Property

Reuters reported in March 2007 that a 43-year old German decided to settle his imminent divorce by carefully measuring, then chain sawing a family home in two and making off with his half in a forklift truck. For more details and a video of the news story, see www.msnbc.msn.com/id/17545638/?GT1=9145.

How to Avoid Post-Divorce Dissatisfaction: Hire Good Help

Kojovic v. Goldman, 2006 N.Y. App. Div. LEXIS 12518 (October 19, 2006)

This is yet another case where the parties thought they could do it more cheaply and quickly themselves: The husband was CEO and minority shareholder (7-8%) of a closely held information technology company; the wife was a former financial analyst with an MBA. When the couple decided to divorce, they moved rapidly, exchanging simplified financial information and waiving further discovery. After retaining some legal and accounting assistance, they reached a comprehensive settlement within four months of filing.

Per the agreement, the wife received \$1.15 million cash, plus annual maintenance of \$87,500 for four

years. She also signed off on conducting any further inquiry into the husband's assets, in particular his shares of the IT company.

Just over a month after the agreement was executed, however, the company sold for approximately \$225 million, of which the husband received \$18 million. The wife sued for fraud and rescission of the settlement, claiming the husband had affirmatively misrepresented the liquidity of his shares. She also asserted that it was the husband's obligation to disclose the value and potential value of his shares and that he concealed knowledge of the "imminent" sale of the company.

The husband moved to dismiss the wife's claims, relying on the settlement agreement waivers and New York precedent. But the lower court denied his motion, finding that the wife's assertion of affirmative

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misrepresentations distinguished the case from those upholding similar settlement agreements; and the wife appealed.

Disdain for such claims

“This Court does not stand alone in its disdain for post-divorce claims of concealment,” the appeals court began. The Court found nothing irregular or unconscionable about the settlement agreement. The case did not involve the concealment of an asset, but rather its valuation and potential sale. Given the wife’s professional background and her retention of an attorney and an accountant, “she should have been aware of the distinct possibility that [the company] would be sold.”

That the wife opted for an immediate and certain payout over the risk of an eventual sale did not warrant setting aside the settlement, the court held. That the husband harbored a more optimistic assessment of the potential value of his minority interest than he disclosed—or even had additional information that he kept to himself—was “irrelevant.” That the parties could have “freely availed themselves of any number of valuation and discovery procedures...but declined to do so,” is the lesson from hindsight, which this case helps bring home to divorcing parties.

Law on Enterprise Goodwill in Divorce Limits Valuation in Later Legal Malpractice Action

Weisman v. Schiller DuCanto and Fleck, 2006 Ill. App. LEXIS 849 (September 21, 2006)

Over the past two decades, states’ laws on valuing goodwill in a professional practice in marital dissolution cases have shifted, until the majority now recognizes enterprise goodwill (as distinguished from professional or personal goodwill) as a component of marital property. This Illinois case happened to fall in the cracks of the shift. In early 1994, when the parties filed for dissolution, the controlling state law held that it was inappropriate to value the goodwill of a professional practice and did not recognize the concept of enterprise goodwill. (This may explain why neither side immediately retained expert appraisers to value the husband’s law firm.)

The parties’ divorce became contentious, with allegations that the wife used drugs and the attorney-husband failed to comply with routine financial discovery regarding his partnership interest. Three years before,

his law firm had litigated a partnership dissolution case with a former partner, which ended with the trial court holding the partner to the \$1.2 million price provided by the buy-sell agreement.

Likewise, the agreement also held the husband in this case to a \$1.2 million buyout price, but he had submitted a handwritten financial statement attributing a zero value to his partnership interest. The wife’s attorneys finally had to ask for an interim award of fees so that she could hire an expert to value the husband’s interest; but by the time of their request in November of 1994, the trial date was fewer than three months away.

Wife settles using buy-sell valuation

In January of 1995, the wife fired her attorneys and hired a new law firm, which was unable to convince the court to continue the February trial date so the parties might complete discovery, including compelling the husband to comply with his alleged lapses. Not surprisingly, the parties settled the case two days before trial. On the advice of her new law firm—including a letter between the partners indicating their belief that the buy-sell agreement represented the value of the husband’s interest—the wife settled, receiving approximately \$3 million. She then sued her former lawyers for failing to obtain an expert appraisal of the husband’s partnership interest—right around the time, in June of 1995, that the Illinois Supreme Court first recognized the concept of valuing enterprise goodwill in a professional practice.

Wife offers evidence of enterprise goodwill

In her action for legal malpractice, the wife presented testimony by an expert who valued the husband’s law firm as of the date of divorce at \$7.9 million, making his 48% share equal to approximately \$3.8 million. Before trial, however, the trial court disallowed the expert’s opinion, because it incorporated enterprise goodwill (which state law did not recognize at time of dissolution); it also barred him from offering any new valuation evidence so close to trial. The ruling effectively limited the expert to analyzing the valuation report used in the 1991 partnership dissolution—which he did, carrying the law firm’s value forward over the years to approximately \$4.15 million, making the husband’s share worth \$2 million. This evidence wasn’t sufficient to persuade the jury, however, and they returned a verdict exonerating the wife’s former attorneys of malpractice.

On appeal, the wife claimed her expert should have been permitted to present the \$7.9 million valuation, citing the post-dissolution cases that recognized enterprise goodwill. The Appeals Court disagreed: “As

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the concept of enterprise goodwill was not recognized until...June 1995, [the law firm] was not negligent in failing to value [the husband's] enterprise goodwill...in 1994."

The wife countered by arguing that her expert's \$7.9 million didn't include goodwill; she quoted his report:

...We have estimated the Fair Market Value of 100% of the [husband's law firm] as of December 31, 1994 to be \$7,902,000 before adjusting for different components of Goodwill.

But the very next line of the report read, "As shown in the Capitalization of Earnings section, approximately 94% of the value of the Firm lies in Goodwill," and of this 94%, approximately 90% was enterprise goodwill. Under these facts, the wife's former attorneys were not liable for basing their work on the state of the law at the time of dissolution.

Another Court Considers The Distinction Between Personal vs. Enterprise Goodwill

***Gaskill v. Robbins*, 2006 Ky. App. LEXIS 364 (December 8, 2006)**

In this Kentucky divorce case, the wife was a successful oral surgeon, having opened two practices during the marriage, to which the husband had contributed his tax and accounting skills.

At trial, in valuing one of her practices, the wife's expert attributed a zero value to goodwill. In his opinion, the goodwill was all "personal"—that is, derived entirely from the wife's individual skills, reputation, and knowledge. He concluded that the fair market value of her practice was \$114,000.

The husband's expert took the opposite view. Without distinguishing any separate components, he included goodwill in his overall calculations, concluding that the wife's practice had a fair market value of nearly \$670,000.

Trial court felt compelled to value goodwill

The trial court rejected the wife's valuation, saying, "[T]here is no reported legal authority for the distinction in goodwill" made by her expert. In fact, in adopting the valuation by the husband's expert, the lower court held, "[I]t is generally accepted in Kentucky that the goodwill of a closely held medical corporation should be assigned value in a dissolution proceeding."

On appeal, the wife contended that the family court "operated under the misconception that it was compelled to assign a goodwill value" to her practice, and the Court of Appeals agreed. While Kentucky law requires considering goodwill in the valuation of a medical practice, it does not compel its inclusion. Thus, the case merited remand.

A chance to join the majority

At the wife's urging, the appeals court also considered whether Kentucky law should join the majority of U.S. jurisdictions in distinguishing enterprise and personal goodwill in divorce actions.

The wife cited a survey from a 2003 West Virginia case, *May v. May*, in which the state Supreme Court found that twenty-five U.S. jurisdictions made the distinction, with only enterprise goodwill constituting divisible marital property. Kentucky fell into the minority of twelve that do not exclude the personal component from the overall goodwill of a business and/or professional practice. (The remaining states have not directly addressed the issue.)

After a brief discussion of the majority/minority views as well as related Kentucky law, the Court of Appeals in this case decided it was "not inclined to deviate from long-standing precedent by creating a wholesale change of law holding that 'personal' and 'enterprise' goodwill should be distinguished for purposes of property valuation in a divorce proceeding"—not even in the case of a sole proprietorship.

Precedent aside, principles of equity persuaded the Court to continue to hold that the "form of the business enterprise [cannot] defeat the [marital] community's interest in the professional goodwill." Any other ruling, it said, would ignore the contribution made by the non-professional spouse to the success of the professional—as in this case, where the husband had contributed his financial time and skills, among other things, to the wife's practice.

Leaves question for the state Supreme Court

As in the *May* case, which went through an appeals process to the highest state level, the Kentucky Court of Appeals may simply have deferred the ultimate question to the state Supreme Court.

In a dissent, a senior appellate judge opined that "'personal' goodwill should not be considered marital property to be divided between the parties." However, he added, "[T]his is a matter to be addressed to our Supreme Court," as both the trial and appellate courts had not erred in their rulings under current Kentucky law.

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